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Governance Complexities in Firms with Dual Class Shares

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ABSTRACT

In a typical public company, shareholders can elect the board, appoint auditors, and approve fundamental changes. Firms with dual class share (DCS) structures alter this balance by inviting the subordinate shareholders to carry the financial risk of investing in the corporation without providing them with the corresponding power to elect the board or exercise other fundamental voting rights. This article fills a conspicuous gap in the scholarly literature by providing empirical data regarding the governance of DCS firms beyond the presence of sunrise and sunset provisions. The summary data suggest that the governance of DCS firms is variable. A large proportion of DCS firms have no majority of the minority voting provisions and no independent chair. By contrast, almost half of the DCS firms have a sunset clause and a majority of independent directors. Finally, just under one-third of DCS firms have change of control provisions over and above existing law. On the basis of this evidence,

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this article argues against complete private ordering in favor of limited reforms to protect shareholders in DCS firms including: mandatory sunset provisions, disclosure relating to shareholder votes, and buy out protections that would address weaknesses inherent in DCS firms.

1

Introduction

In a typical public company, shareholders can elect the board, appoint the auditors, and approve fundamental changes. In other words, they can participate in the governance of the firm. Firms with dual class share (DCS) structures alter this balance by inviting the subordinate shareholders to carry the financial risk of investing in the firm without providing them with the corresponding power to elect the board or exercise other fundamental voting rights. As Hu and Black explain, DCS "decouple" voting rights and economic ownership.[1]

The rationale underlying DCS is that they preserve family or founder control while allowing the firm to gain access to capital in public equity markets.[2] By localizing control on the founders, DCS structures prevent the firm from being easily acquired without the founders' cooperation.[3] Indeed, DCS protect the founders from the demands of ordinary share-

[1]Hu, H. and B. Black (2008) 'Equity and Debt Decoupling and Empty Voting II: Importance and Extensions' 156 University of Pennsylvania Law Review 625.

[2]*Ibid.*

[3]Wen, T. (2014) 'You Can't Sell Your Firm and Own it Too: Disallowing Dual-Class Stock Companies from Listing on Securities Exchanges' 162 *University of Pennsylvania Law Review* 1495, online: http://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=9447&context=penn_law_review.

holders, in turn allowing them more freedom to grow the corporation.[4] In the process, DCS dissuade potential suitors who would be willing to pay a premium for shares (a boon to all shareholders, except the controlling shareholder, of course). In short, DCS allow the founders to focus on long-term value creation and motivate them to make firm-specific investments in their own human capital.[5]

Heated controversy has arisen because DCS effectively insulate management and the board, leaving the subordinate shareholders exposed to decisions that potentially undermine their economic interests.[6] DCS allow the firm to extract capital from subordinate shareholders without providing them with the voting power that allows them to participate in the governance of the firm.[7] In short, DCS allow managers and the

[4]Hill, A. (18 July 2011) "Enrolment Open for an MBA in Murdoch", *Financial Times*, online: http://www.ft.com/cms/s/0/2fda9e8e-b176-11e0-9444-00144feab49a.html#axzz2IYIKmzDt as cited by Wen, *ibid.*

[5]Cronqvist, H. and M. Nilsson (2003) 'Agency Costs of Controlling Minority Shareholders' 38 *Journal of Financial and Quantitative Analysis* 695; DeAngelo, H. and L. DeAngelo (1985) 'Managerial Ownership of Voting Rights: A Study of Public Corporations with Dual Classes of Common Stock' 14 *Journal of Financial Economics* 33; Bergstrom, C. and K. Rydqvist (1990) 'Ownership of Equity in Dual-Class Firms' 14 *Journal of Banking and Finance* 255.

[6]Anand, A. (22 February 2016) "The success stories of dual-class shares miss an incontrovertible truth", *The Globe and Mail*, online: https://beta.theglobeandmail.com/report-on-business/rob-commentary/the-success-stories-of-dual-class-stocks-miss-an-incontrovertible-truth/article28830388/?ref=http://www.theglobeandmail.com&; Shareholder Association for Research and Education (April 2004) "Second Class Investors: The use and abuse of subordinate shares in Canada", *Shareholder Association for Research and Education*, online: http://www.share.ca/files/Second_Class_Investors.pdf; Masulis, R. W., C. Wang and F. Xie (2009) 'Agency Problems at Dual-class Companies' 64 *Journal of Finance* 1697; Harris, M. and A. Raviv (1988) 'Corporate Governance: Voting Rights and Majority Rules' 20 *Journal of Financial Economics* 203; Wen, *supra* note 3.

[7]Willis, A. (5 August 2005) "Dual Class share structure should end, Caldwell Told" *The Globe and Mail*, online: https://www.theglobeandmail.com/report-on-business/dual-class-share-structure-should-end-caldwell-told/article18243209; Critchley, B. (14 May 2015) "Time for regulators to take major look at DCS" *Financial Post,* online: https://business.financialpost.com/news/fp-street/time-for-regulators-to-take-major-look-at-dual-class-shares/wcm/7b02fd1c-d28a-422c-ba39-aac77a1b6bb7; Surowiecki, J. (18 May 2012) "Unequal Shares" *The New Yorker*, online: www.newyorker.com/magazine/2012/05/28/unequal-shares; Deal Professor. (3 February 2017) "Snap's Plan is Most Unfriendly to Outsiders" *The New York Times*, online: https://www.nytimes.com/2017/02/03/business/dealbook/snap-ipo-plan-evan-spiegel.htm; Economist, The. (22 September 2014) "Out of Control" *The Economist*,

board to set the short-term and long-term strategy for the firm without the accountability checks provided by participation in the corporation by subordinate shareholders.[8]

Some commentators argue that DCS should be permitted because otherwise, DCS firms would be left to the whims of incompetent or uninformed shareholders.[9] Others argue that the weaker governance associated with DCS is built into the firm's stock price and ultimately *caveat emptor* should rule the day. That is, all investors have the choice as to whether to invest and "if you don't like them, don't buy them."[10]

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online: https://www.economist.com/news/finance-and-economics/21618889-more-worlds-big-stockmarkets-are-allowing-firms-alibaba-sideline.

[8]Anand, A. (2012) 'Was Magna in the Public Interest?' 49 *Osgoode Hall Law Journal* 311.

[9]Sharfman, B. S. (2018) 'A Private Ordering Defence of a Company's Right to use Dual Class Share Structures in IPOs' 63 *Villanova Law Review* 1 (Forthcoming), online: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2986164.

[10]Hasselback, D. and B. Shecter. (5 May 2015) "From Cara Operations ltd to Shopify Inc: Why DCS are suddenly cool again" *Financial Post*, online: business.financialpost.com/news/fp-street/from-cara-to-google-why-dual-class-shares-are-suddenly-cool-again; [*Hasselback and Shecter*] who quotes Carol Hansell, arguing that "if investors don't like dual-class shares, don't buy them."; See also Khalil, S. and M. Magnan (2007) 'Dual-Class Shares: Governance, Risk and Rewards' *Ivey Business Journal Online,* online: http://iveybusinessjournal.com/publication/dual-class-shares-governance-risks-and-rewards/; Bainbridge, S. (15 November 2015) "What To Do About Dual Class Stock (If Anything)?" *Stephen Bainbridge's Journal of Law, Politics, and Culture,* online: http://www.professorbainbridge.com/professorbainbridgecom/2015/11/what-to-do-about-dual-class-stock-if-anything.htm. Bainbridge states, "Public investors who don't want lesser voting rights stock simply won't buy it. Those who are willing to purchase it presumably will be compensated by a lower per share price than full voting rights stock would command and/or by a higher dividend rate. In any event, assuming full disclosure, they become shareholders knowing that they will have lower voting rights than the insiders and having accepted as adequate whatever trade-off is offered by the firm in recompense."'; See also Lee, I. B. (8 November 2005) "There is a Logic in Dual-Class Shares" *National Post,* online: https://www.law.utoronto.ca/documents/lee/DualClassOpEd.pdf; Allaire, Y. (27 May 2015) "In Praise of Dual-Class Shares"*Financial Post*, online: business.financialpost.com/fp-comment/in-praise-of-dual-class-of-shares.

The opposition to DCS continues to grow with leading shareholder groups and owners of stock market indices voicing opposition to them.[11]

As the controversy has grown, so has the divergence of subtopics covered in empirical studies relating to DCS firms. For example, Adams and Ferreira review the empirical evidence relating to disproportional ownership and conclude that DCS firms are popular in the United Kingdom, though the number of such firms is decreasing in Europe.[12] In analyzing the private benefits of control across several countries, Dyck and Zingales identify transactions that involve DCS firms and measure the control premium for the holders of the superior shares (*i.e.* with voting power) relative to the subordinate shares (*i.e.* without voting power).[13] They find that higher benefits of control are associated with more concentrated ownership.[14] These are but two examples from the extensive literature relating to DCS which, as discussed below and in Appendix 1, suggest that DCS structures, and the academic literature relating to them, are convoluted and complex.

As a starting point, and in order to provide some factual context for the discussion, note that since 2008, almost 10 percent of all US firms completing IPOs have done so with a DCS structure in place.[15] In 2015, 24 percent of firms that listed their shares on US stock exchanges had DCS, compared to 15 percent of public firms in 2014 and only 1

[11]Bebchuk, L. A. and K. Kastiel (2017) 'The Untenable Case for Perpetual Dual-Class Stock', 103 *Virginia Law Review* 585, online: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2954630. [*Bebchuk and Kastiel*] citing ISS and GMI Ratings. Also see, Ontario Securities Commission, *MI 61-101 Protection of Minority Security Holders in Special Transactions and Companion Policy 61-101CP Protection of Minority Security Holders in Special Transactions* (1 February 2008), online: www.osc.gov.on.ca/documents/en/Securities-Category6/rule_20080201_61-101_protect-minority.pdf.

[12]Ferreira, D. and R. Adams (2008) 'One Share-One Vote: The Empirical Evidence' 14 *Review of Finance* 51, online: http://personal.lse.ac.uk/FERREIRD/51.pdf.

[13]These countries include Canada, Denmark, Finland, Germany, Italy, Mexico, Norway, Sweden, and the United States. See Dyck, A. and L. Zingales (2004) 'Private Benefits of Control' 59 *Journal of Finance* 593.

[14]*Ibid.*

[15]Der Marderosian, L. (25 May 2017) "2017 IPO Report"*Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), online: https://corpgov.law.harvard.edu/2017/05/25/2017-ipo-report/.

percent in 2005.[16] A number of well-known US firms, including Alphabet and Facebook, have long had DCS. In Canada, the list of DCS firms includes icons of the Canadian corporate establishment: Bombardier, Power Corp., Rogers Communications, Onex and Canadian Tire. In recent years, both countries have seen a remarkable increase in IPOs with DCS including Fitbit, Box, and a division of Alibaba in the U.S. and Cara, Aritzia, Freshii and Stingray in Canada.[17] Recently, stock market indices including the S&P 500 have taken actions to exclude new listings with DCS such as Snap Inc.'s 2017 IPO.[18] Obviously, change is in the air regarding DCS.

For some jurisdictions, this debate has potentially severe consequences because DCS firms play an important role in the economy due to their substantial size relative to the average listed company. In Canada in 2015, for example, 85 out of 1487 firms listed on the Toronto Stock Exchange (TSX) – roughly 5.72 percent – had DCS.[19] These DCS firms had an average market capitalization of $3.39 billion,[20] while the average market capitalization of the TSX as a whole was $1.5 billion and the median market capitalization of the TSX was a mere $111.9 million.[21] In short, DCS firms constitute a large percentage of the overall TSX Market Cap (approximately 12 percent). DCS firms

[16]Feldman, S. G. (7 April 2016) "BNA Insights: IPOs in 2016 increasingly include Dual-Class Shareholder Voting Rights", *Bloomberg BNA,* online: www.olshanlaw.com/media/publication/362_Feldmanpercent20BNApercent20Dual-Classpercent20Article.pdf.

[17]See Hasselback and Shecter, *supra* note 10. Also Solomon, D. (4 November 2015) "Shareholders Vote with Their Dollars to Have Less of a Say"*New York Times*, online: https://www.nytimes.com/2015/11/05/business/dealbook/shareholders-vote-with-their-dollars-to-have-less-of-a-say.html.

[18]See Fortune. (1 August 2017) "Incentives vs. Control: An Analysis of U.S. Dual-Class Companies" *Fortune*, online: fortune.com/2017/08/01/snap-snapchat-stock-shares-sp-500/.

[19]Data taken as at Dec 31, 2015. Toronto Stock Exchange. (31 December 2015) "Listing With Us"*Toronto Stock Exchange*, online: https://www.tsx.com/listings/listing-with-us. See also Merkley, M. (9 February 2015) "Multiple Voting Shares: Don't Call It a Comeback"*Blake, Cassels & Graydon LLP*, online: http://www.blakes.com/English/Resources/TrendsInsights/Pages/details.aspx?AnnouncementID=78.

[20]Data obtained from Standard & Poor's Capital IQ and supplemented by FactSet's financial database.

[21]Toronto Stock Exchange*, supra* note 19.

constitute a big enough group to matter. Therefore, this article begins with the proposition that we should carefully consider them.

A central question that arises, and which this article addresses, is the extent to which private ordering should be respected, understanding that corporate law generally upholds the choices that parties make. To what extent should the law allow the founders to pursue their "idiosyncratic vision" for the DCS corporation?[22] This article undertakes a comprehensive analysis of the empirical and theoretical literature relating to DCS (which includes a complete reference chart in Appendix 1) before turning to focus on governance characteristics of DCS firms. What governance mechanisms do DCS corporations typically have? Do these governance mechanisms suggest that regulatory reform would be useful? This article argues against complete private ordering in favor of three modest reforms to improve governance in DCS firms including: mandatory fixed-term sunset provisions with a majority of the minority vote at the end of the term; disclosure relating to shareholder votes; and, buyout protections that would address weaknesses inherent in DCS firms.

At least one other academic article analyzes DCS structures from an empirical standpoint. Winden examines sunrise and sunset provisions found in the charters of DCS firms, with a dataset of 123 U.S. public firms. He points out, rightly, that such provisions can satisfy both the desire of entrepreneurs to pursue their idiosyncratic visions for value creation without fear of interference or dismissal and the need of investors for a voice to ensure management accountability.[23]

Unlike Winden's study, this article examines not one but five governance characteristics of DCS firms and does so in the Canadian context where DCS have historically been more prevalent. Using a hand-collected dataset comprised of all 85 DCS firms on the Toronto Stock Exchange, it

[22]Goshen, Z. and A. Hamdani (2016) 'Corporate Control and Idiosyncratic Vision', 125 *Yale Law Journal* 560, online: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2228194. Sharfman, *supra* note 9.

[23]Winden, A. W. (2017) *Sunrise, Sunset: An Empirical and Theoretical Assessment of Dual-Class Stock Structures,* Rock Center for Corporate Governance at Stanford University Working Paper No. 228, online: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3001574.

examines governance characteristics with respect to these firms that are salient in debates about DCS and governance generally.[24] This article also takes a broader look at the policy implications of continuing to respect private ordering as a means for regulating public corporations.

This full-fledged examination of DCS firms comes at an opportune moment. With controversy and potential regulatory reform on the agenda, the question persists as to how and whether regulators will respond to the issues this article discusses. But before reform occurs, we should know more about DCS, including DCS governance. Section 2 provides background in terms of the DCS structures and the diametrically opposed views that exist regarding DCS. Section 3 examines theoretical approaches that can be used when analyzing DCS firms including agency theory and principal cost analysis. Section 4 reviews divergences of findings in the empirical literature while Section 5 takes up two case studies of transactions in which DCS firms transformed their respective governance structures. Section 6 examines five governance characteristics against which DCS firms can be examined. Section 7 outlines the methodology and context while Section 8 sets forth data regarding DCS firm governance. The empirical analysis reveals that generally speaking, the governance of DCS firms is highly variable as one might expect but certain similarities persist, most significantly the common presence of independent directors on the board. Section 9 focuses on policy alternatives for regulatory reform prior to the conclusion in Section 10.

[24]The list draws on Anand, A., F. Milne and L. Purda (2012) 'Domestic and International Influences on Firm-level governance: Evidence from Canada' 14 *American Law and Economics Review* 68.