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Governance Complexities in Firms with Dual Class Shares

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Annals of Corporate Governance

Published, sold and distributed by:
now Publishers Inc.
PO Box 1024
Hanover, MA 02339
United States
Tel. +1-781-985-4510
www.nowpublishers.com
sales@nowpublishers.com

Outside North America:
now Publishers Inc.
PO Box 179
2600 AD Delft
The Netherlands
Tel. +31-6-51115274

The preferred citation for this publication is


ISBN: 978-1-68083-429-1
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Full text available at: http://dx.doi.org/10.1561/109.00000015
Annals of Corporate Governance
Volume 3, Issue 3, 2018
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Annals of Corporate Governance, 2018, Volume 3, 4 issues. ISSN paper version 2381-6724. ISSN online version 2381-6732. Also available as a combined paper and online subscription.

Full text available at: http://dx.doi.org/10.1561/109.00000015
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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,
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.
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-

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2Ibid.
holders, in turn allowing them more freedom to grow the corporation.\footnote{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#a13221F1K737 as cited by Wen, ibid.}


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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The opposition to DCS continues to grow with leading shareholder groups and owners of stock market indices voicing opposition to them.\textsuperscript{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.\textsuperscript{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 (\textit{i.e.} with voting power) relative to the subordinate shares (\textit{i.e.} without voting power).\textsuperscript{13} They find that higher benefits of control are associated with more concentrated ownership.\textsuperscript{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.\textsuperscript{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


\textsuperscript{14}Ibid.

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. 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. 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. These DCS firms had an average market capitalization of $3.39 billion, 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. In short, DCS firms constitute a large percentage of the overall TSX Market Cap (approximately 12 percent). DCS firms

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20 Data obtained from Standard & Poor’s Capital IQ and supplemented by Fact-Set’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?\(^\text{22}\) 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.\(^\text{23}\)

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


Introduction

examines governance characteristics with respect to these firms that are salient in debates about DCS and governance generally. 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.