There is a logic in dual-class shares

By Ian B. Lee
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There's nothing unfair about dual-class share structures.

Many journalists, academics and institutional investors have argued for years against dual-class share structures, where companies have two classes of shares with different voting rights. They argue that such structures are "undemocratic," unfair and even dangerous for investors. David Beatty, the managing director of the Coalition for Good Governance (a group of institutional investors), recently said that his members' opposition to dual-class structures was akin to "religious ideology." Ideology it may indeed be, because the arguments against dual-class shares rest on flawed logic.

Consider first the claim that democracy and fairness require the principle of one-share, one-vote. The problem with this argument is that "democracy" (assuming it is even relevant to corporations) does not necessarily translate into a one-vote-per-share rule. Wouldn't one vote per person be more democratic? And shouldn't the employees in a corporate "democracy" have the right to vote?

Actually, the whole discussion of democracy in relation to dual-class structures is beside the point. Finance is all about creating classes of investors. It is no more unfair to have first- and second-class shareholders than to have a mortgage on your house, even though a mortgage grants to one creditor a priority that your other creditors do not have.

The opponents of dual-class structures also claim that those structures are dangerous for investors in that they increase "governance risk." In fact, investing in a company that has a controlling shareholder (even by buying its non-voting shares) is one way for a small investor to reduce governance risk.

Small shareholders cannot and do not monitor corporate managers effectively on their own. If a company has only small shareholders, there is a risk that no one will monitor the managers. (In principle, the board of directors is supposed to monitor the managers, but this just raises the question of who will monitor the board.) In a company with only small shareholders, what keeps managers in line, for the main part, is the risk of a hostile takeover.

A small shareholder can try to overcome the monitoring problem by investing in an actively managed mutual fund that will monitor companies on behalf of its unitholders. But another approach is to buy shares in a company that has a controlling shareholder. The controlling shareholder benefits when the company is profitable and therefore has a natural incentive to monitor the managers, keep costs down and generate profits. This is exactly what the small shareholder wants.

By investing in discounted-voting shares in a dual-class company, the small shareholder gives up the "stick" of a hostile takeover. Dual-class companies cannot easily be taken over without the
controlling shareholder's co-operation. There is also the chance that the controlling shareholder will try to divert assets from the corporation, although there are laws to deal with that risk, as Lord Black's former associate, David Radler, has learned the hard way. What the small shareholder gains from the arrangement is the monitoring services of a large shareholder who is in it for the long haul, and in some cases the trade-off may be worth it.

A lot will depend on the integrity and competence of the controlling shareholder, and therefore on who the controlling shareholder is. That's one reason why non-voting shares usually provide that the controlling shareholder cannot sell his or her shares without the other shareholders being able to get out on the same terms.

People do not buy second-class shares because they are dupes. Second-class shares exist because companies offer them on terms that are acceptable to their buyers. From the company's perspective, a controlling shareholder (often a founding family) wants to raise capital without losing control and without increasing the company's debt. So the company offers non-voting shares. From the investor's perspective, the investor wants to buy into the company's equity -- wants a share of the company's upside potential -- rather than settling for the fixed (albeit safer) returns that come from buying the company's bonds. If the price is right, the investor will buy the non-voting shares. There's no unfairness in that.

I can understand why institutional investors might shy away from buying non-voting shares. The main beneficiaries of dual-class structures are small shareholders and founding families, not institutional investors. Institutions can do their own monitoring. But some opponents of dual-class structures call for regulatory reforms that would prevent companies from offering or listing non-voting shares. These reforms would reduce, not broaden, investors' choices.

Professor Ian B. Lee teaches corporate law at the University of Toronto, Faculty of Law.