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UNIVERSITY OF CALIFORNIA

Berkeley Center for Law,
Business and the Economy

University of California, Berkeley
School of Law
2850 Telegraph Ave, Suite 500
Berkeley, CA 94705-7220

Ph: 510.642.0532 – Fax: 510.643.7095
E-mail: BCLBE@law.berkeley.edu
http://www.law.berkeley.edu/bclbe.htm

Dual-Class Structure: An Option for Innovators and Market Stability

By Alvaro Pereira, L.L.M. Candidate 2016 | December 3, 2015

A dual-class structure is a feature of corporate governance that allows for the creation of two categories of shareholders—each class with different voting rights. The increasing number of corporations adopting this type of structure before going public has recently made headlines in regulatory, professional, and scholarly circles. In spite of the critiques, there are reasons to believe that it is an important tool to promote innovation and prevent market volatility.

Much of the controversy surrounding differentiated shares boils down to discomfort with the fact that this structure inherently limits the rights of certain shareholders and broadens the rights of others. In this sense, it is no surprise that use of differentiated shares has been continuously debated since the Securities and Exchange Commission ("SEC") unsuccessfully tried to ban them in the 1980s.

Former SEC Chairman, Charles C. Cox, summarized the traditional critique of differentiated shares in 1986 when he spoke to the New York Exchange Advisory Committee and proclaimed that, "shareholder voting is fundamental and must be required, not permitted." Many still find this view is appealing. After all, shareholders are all owners and all of them should always have the right to approve or reject crucial decisions.

On the other hand, supporters of dual-class structures contend that it allows founders the ability to retain control of the company and guarantee that it will continue on the same path that initially attracted investors without suppressing shareholders' rights to profits. Supporters further contend that it also restricts the influence of investors who could influence the company in a direction which would be detrimental to long-term profits because of the shiny allure of short-term gains.

In recent months, this debate has been reignited for two primary reasons. First, more and more publicly listed companies have started to adopt a dual-class structure. In 2015, almost 15% of publicly listed companies in the United States implemented a dual-class ownership structure. Whereas only 1% were registered as such in 2005. Second, the preponderance of a new class of shareholder represents a new challenge for investment fund managers. Their investments, as a unified voice, give them the power to pressure corporate boards and officers in ways that unarticulated, disorganized, and single-share owners could never have the power to do. Some insist that this preference for dual-class ownership has arisen from the concern of founders to protect themselves from the powerful voices of such organized shareholders which could fundamentally change the direction of companies against the founders' wishes.

Many companies have found success with a dual-class structure. Google is the chief example. The company is permanently increasing its profits each quarter and has not suffered from the volatility generated by short-term investment-seeking. After 10 years in the public market, only 10 stocks have beaten its performance.

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While some companies have demonstrated a success with dual-class structures, others have determined upon which public exchange to be traded based on rules allowing or disallowing dual-class structures. Alibaba decided to go public on the New York Stock Exchange, rather than in Hong Kong were the "one-vote, one vote" rule disallows dual-class structures, in part to preserve the ability of its founders to fight short-term investment-seeking at the detriment to long-term profits.

There are multiple reasons to believe that these companies' decisions to implement dual-class structures were the "right" move for them because their value is heavily attached to their innovative capacity. Likewise, there is evidence that the dual-class structure model stops serving its protective purpose once companies underperform—as was the case of the *New York Times* or the *Washington Post* whose founders had no other option but to sell their structure-protected privileges after multiple quarters of underwhelming performance and missed profit targets.

The real issue for this newly-favored dual-class structure model is whether these structures can protect founders and allow consistent growth and success in today's volatile markets. Alternatives like sunset provisions (which prevent opportunistic shareholders from accessing all the privileges of the voting shares) have yet to be widely tested and studied under real market conditions. For the moment, dual-class structures have proven useful to founders of companies that remain on a profitable track and regularly meet expected performance projections. Time will tell if market shifts and future innovations in corporate governance lead companies to disfavor this model and turn to a different model for structuring shareholder ownership. However, for the moment, dual-class structures look like they're here to stay.