

**DUAL-CLASS SHARE STRUCTURES AND  
BEST PRACTICES IN CORPORATE GOVERNANCE**

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## **DUAL-CLASS SHARE STRUCTURES AND BEST PRACTICES IN CORPORATE GOVERNANCE**

### **INTRODUCTION**

Until recently, corporate governance practices were not considered to have a major impact on a company's financial performance; as a consequence, they drew little attention from investors. However, recent corporate scandals such as those at Hollinger Inc. in Canada, Enron in the United States, and Parmalat in Italy, have prompted investors to put a greater premium on transparency, accountability, and other sound governance practices. These scandals illustrate how the absence of effective corporate control can put a company and its investors at great risk – a matter of particular importance in Canada, where 46% of the population owns shares, whether directly or indirectly via mutual funds or superannuation funds.<sup>(1)</sup> Today, higher standards of corporate governance are becoming obligatory for public companies wanting to maintain investor confidence and improve long-term performance.

Broadly, corporate governance systems comprise the framework of rules, relationships, systems and processes an organization has in place for overseeing its direction and management. An important aspect of best practices in corporate governance deals with shareholder rights. This paper discusses shareholder rights, focusing on the issues raised by dual-class share structures. It examines their prevalence in Canada and the reason for their emergence, as well as their concentration in certain sectors. It also considers their advantages and disadvantages, as well as recent changes to the regulatory environment that may serve to diminish their use.

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(1) According to the Toronto Stock Exchange, 2002.

## **CORPORATE GOVERNANCE AND SHAREHOLDER RIGHTS**

By their nature, public companies are characterized by a separation of ownership from control. In return for their equity, the owners (shareholders) profit from a company's performance through price appreciation and dividend distribution. Shareholders delegate decision-making rights to a board of directors; directors, in turn, delegate day-to-day responsibilities to the corporate managers.

As a result of this separation of ownership from control, a system of corporate governance is necessary to align the incentives of all groups. Sound governance practices can protect shareholders and the value of their investment in the company by holding managers accountable, and ensuring that directors and management act in the shareholders' best interests.

Typical best practices in corporate governance include a requirement that the board of directors be composed of a majority of independent (i.e., outside), non-executive directors, as well as a separation of the roles of Chief Executive Officer and Chairperson of the Board. Systems should be in place to ensure full and proper disclosure of financial information and executive compensation. Other processes should be put into place to limit management power and ownership concentration.

One of the most effective means of controlling management's behaviour is to grant shareholders the right to vote on major issues. Normally, these rights are proportionate to the shareholder's equity stake in the company. Common voting rights include the right to elect directors and the Chairperson, and the right to vote on proposals for fundamental changes affecting the company, such as mergers or liquidation. Other rights may include the right to vote on equity-based compensation plans and approve senior executive appointments. It is these rights that are often severely limited under governance systems that allow dual-class share structures.

### **WHAT ARE DUAL-CLASS SHARE STRUCTURES?**

Many company founders wish to avoid the dilution of control that normally accompanies the public issuance of shares. One mechanism at their disposal is to issue different classes of shares that confer different voting rights on the holder. These are known as dual-class

share structures, or, alternatively, as restricted- or subordinate-voting share structures. Note that this is substantially different from the situation where one group of shareholders or a single shareholder holds a significantly large share position to control the company. In this latter case, control is proportionate to the financial risk conferred by share ownership. In contrast, dual-class share structures alter the normal 1:1 relationship between cash flow rights and voting rights.

A wide range of dual-class structures exist. In some cases, the superior class allows multiple votes per share; in others, the superior class carries only a single vote per share while the inferior shares are non-voting. Restricted-voting structures that confer special voting rights on the superior-class shareholder, such as the right to elect a certain number of board members or approve executive compensation plans, are also possible. So are various other types of dual-class structures. Essentially, the term covers any structure that confers a disproportionate amount of control on one group of shareholders in relation to their equity participation in the company.

As an incentive to investors, subordinated shares often pay higher dividends and are generally more liquid – that is, they can be bought and sold more readily on public stock exchanges – than shares that have superior voting rights. Conversely, superior shares normally trade at a premium over subordinated shares (should they trade at all), reflecting the greater degree of control over the company conferred by the distinct voting rights.

**Table 1**

**Share Identification on the Toronto Stock Exchange**

<b>Symbol</b>	<b>Type</b>	<b>Description</b>
NV	Non-voting shares	Shares which have no right to vote, or a right to vote only in certain limited circumstances.
MV	Multiple-voting shares	Shares which have more votes than the issuer's standard voting shares.
SV	Subordinate-voting shares	Shares which carry a right to vote, where there is another class or classes of shares outstanding that carry a greater voting right on a per-share basis.
LV	Limited-voting shares	Shares which have the right to vote only in certain limited circumstances.
RV	Restricted-voting shares	Shares which carry a right to vote, subject to some restriction on the number or percentage of shares that may be voted by the owner.

Source: Toronto Stock Exchange.

## EMERGENCE AND PREVALENCE

Over the past 30 years, Canadian companies have made growing use of dual-class share structures in financing their operations. The incidence of superior voting shares in Toronto Stock Exchange (TSX) companies rose from 5% in 1975 to over 15% in 1987.<sup>(2)</sup> While there are indications that the use of dual-class share structures in Canada has peaked, currently an estimated 20% to 25% of companies listed on the TSX make use of some form of dual-class share structure or special voting rights.<sup>(3)</sup> In comparison, in the United States, where rules on dual-class shares are much more restrictive and investor opposition is more vocal, just over 2% of companies issue restricted shares.<sup>(4)</sup>

Examples of this practice include some of Canada's most renowned and largest companies: Bombardier Inc., Magna International Inc., Rogers Communications Inc., Shaw Communications Inc., Alliance Atlantis Communications Inc., Power Corporation, Telus Corporation, Quebecor, and Onex Corp., to name only a few. Magna International Inc., for instance, issues both Class A subordinate-voting shares and Class B shares. Class B shares carry 500 votes for every one Class A share vote. This structure has allowed Magna's founder and Chairman to maintain control over the company with just 3.4% of the company's equity.

Dual-class share structures emerged in these companies for a variety of reasons. Historically, Canadian companies issued shares with multiple voting rights to preserve family control while gaining access to capital in public equity markets. To retain voting control over the firm, the family kept the high-voting stock for themselves and sold the restricted-voting shares to the public. Even today, these structures are common among family businesses that wish to go public, and often represent a transitional phase between private and full public ownership. As the company grows, controlling shareholders may opt to move to more equitable voting structures in a bid to build a larger investor base.

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(2) Randall Morck, "The Market and the Closely Held Corporation in Canada: The Implications of Concentrated Share Ownership for Corporate Performance," *Canadian Investment Review*, Vol. 9, Issue 1, Spring 1996.

(3) Elizabeth Church, "Special Class Shares Hard to Give Up," *The Globe and Mail* [Toronto], 25 September 2003.

(4) The New York Stock Exchange allows U.S. companies to list dual-class voting shares. Once shares are listed, however, companies cannot reduce or restrict the voting rights of the existing shares or issue a new class of superior voting shares.

Past restrictions on foreign investment also served to encourage the use of dual-class share structures. For example, the 1967 revision to the *Bank Act* bestowed a 10% voting cap on all chartered banks and capped aggregate foreign ownership at 25%. While some of these restrictions have been lifted, the federal government continues to limit the level of foreign ownership of companies in various regulated sectors, including telecommunications, broadcasting, media and entertainment, and airlines. Even now, companies that use dual-class shares tend to be largely concentrated in these sectors. These companies often justify the continued use of such structures by the need to avoid violating foreign-ownership restrictions, while attracting adequate equity investment from foreigners.<sup>(5)</sup>

An additional explanation as to why companies that favour dual-class share structures are concentrated in the broadcasting and cable industries relates to the takeover protection conferred by subordinated voting. The existence of a large control block of shares makes it difficult for an investor to mount a hostile takeover of a firm. Since government regulators provide a limited number of broadcast licences, often the only method of obtaining a licence is to take over an existing company. Thus, it is argued that licensed firms have a greater incentive to protect themselves by issuing dual-class shares. Additionally, it is often the case that dominant individuals and families have played a significant role in the foundation and growth of the major cable and media firms in Canada.<sup>(6)</sup>

## **BENEFITS**

Dual-class share structures have persisted despite growing opposition from shareholder groups. Controlling shareholders argue their benefits, reasoning that these structures can insulate the company from the need to meet short-term financial expectations which can be detrimental to building long-term value. Company founders reluctant to use debt financing see these structures as a way to grow the company without giving up control. With no takeovers to worry about, founders also are more likely to remain in charge and benefit shareholders with their skills and expertise. Entrepreneurship is encouraged by ensuring that founders reap future benefits from their efforts, instead of having subsequent shareholders capture the company's

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(5) Morck (1996).

(6) Andrew Osterland, "Class Struggle," *CFO Magazine*, October 2001.



gains. Damaging behaviour on the part of superior-class shareholders may be curtailed by the fact that controlling shareholders have an interest in maintaining a good reputation among investors in case they need to raise additional equity. Founding families who hold the majority of the voting power also have an incentive to bequeath a valuable asset to their offspring and relatives.<sup>(7)</sup>

Undeniably, some of the best-performing companies in their sectors in Canada have multiple-voting share structures. In this respect, not all shareholders, and in particular individual small investors, are concerned with the voting rights attached to a share. They may be more interested in the potential of sharing the company's wealth or trading on future prospects by buying cheaper, subordinated shares.

## **DISADVANTAGES**

Despite the potential benefits, opposition to share structures with inequitable voting rights is growing, led by large institutional investors. Proxy voting guidelines of the largest pension funds in the country, including the Canada Pension Plan Investment Board, the Ontario Teachers' Pension Plan, the Ontario Municipal Employees' Retirement System, and the British Columbia Investment Management Corporation, all support single-class share structures. The Canadian Coalition on Good Governance, formed by 23 of Canada's leading institutional investors with a combined \$400 billion in assets, is also opposed to dual-class share structures. These investors believe that dual-class shares disadvantage public shareholders by contributing to poor overall corporate governance. The Canadian Coalition on Good Governance believes that "any corporate governance regime is suspect if all the structures, protections and processes can be negated by a voting interest well beyond the economic interest."<sup>(8)</sup>

First, these structures are alleged to be unfair because they confer economic power on a select few superior-class shareholders while permitting them to pass off the majority of the financial risk. Second, detractors believe that in many cases, favoured insiders and superior-class shareholders are able to expropriate funds from those holding lesser voting shares through self-dealing, extravagant executive pay, and overly generous bonuses and stock option plans. Superior-class shareholders may also direct the company's cash flow to personal projects

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(7) George Bragues, "Dual shares do work: Shareholder democracy has no place in equity markets," *National Post*, 20 May 2004.

(8) Canadian Coalition on Good Governance, <http://www.ccg.ca>.

unrelated to the core business. The third concern centres on accountability. Subordinated voting arrangements can entrench poorly performing management and insulate managers from accountability for their actions, since the dual-class structures preclude shareholders from mounting successful challenges. This is especially problematic in situations where the founder is both the Chief Executive Officer and Chair of the Board.

Finally, some studies have shown that, as an investment, dual-class share structures tend to underperform single-class structures over time. These studies found that firms with stronger shareholder rights have higher firm value, higher profits, higher sales growth and lower capital expenditures, and made fewer corporate acquisitions. A 1996 study by Toronto-based Burgundy Asset Management Ltd. found that the profitability of Canadian dual-class firms was significantly below that of their U.S. rivals in the same industries, and also below that of Canadian companies with conventional voting rights. The study estimated that the shortfall was in the order of 0.5% to 0.7% annually.<sup>(9)</sup> While minimal on an annual basis, over time this difference is significant. A U.S. study found investors that sold U.S. companies with the weakest shareholder rights and bought those with the strongest shareholder rights earned an additional return as high as 8.5%.<sup>(10)</sup>

Hollinger International Inc. presents an extreme example of the detrimental effects of dual-class share structures. Former Chief Executive Officer Conrad Black controlled all of the company's Class B shares, which gave him 30% of the equity and 73% of the voting power. Holders of publicly traded shares of Hollinger had limited rights to make decisions in terms of executive compensation, board appointments, and mergers and acquisitions. According to a report made public by the Securities and Exchange Commission, Mr. Black appointed the majority of board members, who, in turn, were unlikely or unwilling to oppose his authority. The same report found that Mr. Black exacted excessive management fees, consulting payments, and personal dividends from the company. In all, the aggregate funds taken by Mr. Black and Hollinger's other chief executives were estimated at 95.2% of Hollinger's entire adjusted net income during 1997-2003, sums in excess of \$400 million.<sup>(11)</sup>

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(9) Burgundy Asset Management Ltd., *Second Class Owners?* <http://www.burgundy-asset.com/sept-96.asp>.

(10) Paul A. Gompers, Andrew Metrick, and Joy L. Ishii, "Corporate Governance and Equity Prices," *Quarterly Journal of Economics*, Vol. 118, Issue 1, February 2003, pp. 107-155.

(11) On 31 August 2004, the U.S. Securities and Exchange Commission made public a report by a special committee of Hollinger International. The report is available at: <http://www.sec.gov/Archives/edgar/data/868512/000095012304010413/y01437exv99w2.htm>.

## REGULATORY ENVIRONMENT

In Canada, securities regulation is the responsibility of the provinces, although the federal government regulates ownership of companies in various sectors. At the provincial level, there are no legal prohibitions on dual-class share structures for companies issuing stock, nor does the Toronto Stock Exchange impose any outright restrictions. This may be a result of the historically weak corporate governance laws in Canada – a situation that is in part due to the fragmentation of the regulatory system. Provincial securities commissions were not established until the 1930s; for much of the last century, corporate disclosure was piecemeal and trading on insider information was legal. It was only in the mid-1960s that the Ontario Securities Commission (OSC) mandated standardized disclosure and moved to curtail insider trading. It is important to note, however, that the financial regulatory system is improving. Through the efforts of the Canadian Securities Association, an informal body made up of representatives of the 13 provincial and territorial securities regulators, Canada is moving towards strengthening and consolidating its regulatory regime.<sup>(12)</sup>

Since the 1960s, shareholder rights have slowly been gaining recognition across Canada, leading the TSX and the OSC to introduce provisions designed to protect the rights of holders of subordinated shares. In 1987, the TSX required listed companies with dual-class share structures to provide takeover protection (known as a “coat-tail protection”) to holders of non-voting or restricted-voting shares. Coat-tail provisions generally permit holders of non-voting or restricted-voting shares to participate equally with the holders of the superior-voting shares in a formal bid for superior-voting shares.

Later, the OSC established the rights of restricted-voting shareholders to receive the same information received by those holding superior-class shares, and the right to attend shareholders’ meetings. Moreover, reorganizations or reclassifications of common shares into restricted-voting shares must have the approval of the majority of the minority shareholders.

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(12) For more detail, please refer to Tara Gray and Andrew Kitching, *Reforming Canadian Securities Regulation*, PRB 05-28E, Parliamentary Information and Research Service, Library of Parliament, Ottawa, August 2005.

More recently, the TSX moved to provide more transparency in the marketplace by creating new stock symbol designations for company shares with different voting rights. Stock symbols on the TSX now indicate whether the shares have multiple votes, single votes or no votes, or if other share classes offer more influential voting rights. The OSC also requires issuers of subordinated stock to clearly identify the shares as having restricted voting rights.

## **RECENT DEVELOPMENTS**

Changes in the regulatory environment proposed by the 2005 Budget may lead to a further decline in restricted share use. Until recently, at least 70% of the assets of Canadian tax-exempt funds, such as superannuation plans and individual registered retirement pension plans, were required to be invested in Canada. This limitation had narrowed the investment options for pension funds, leading them to choose dual-class share structure companies in order to maintain adequate diversity in their portfolios.<sup>(13)</sup> With these restrictions lifted, there is reason to believe that investors will choose to invest in companies outside Canada with greater shareholder rights and, by implication, stronger governance practices. Canadian corporations may face particular pressure to abandon dual-class structures in order to maintain their institutional investor base.

The passage of the Sarbanes-Oxley Act (SOX) in the United States in 2002 may also lead to a decline in restricted share use in Canada, at any rate for larger Canadian companies, as most are inter-listed on U.S. exchanges. SOX introduced an extensive collection of corporate governance and disclosure reforms in the United States, including mandated increased disclosure, new board oversight provisions, and improved internal controls. Most of these new requirements will also apply to Canadian companies that have securities listed on a U.S. stock exchange. While SOX does not explicitly address share structures, the greater emphasis on best practices in corporate governance and greater scrutiny has led some U.S. companies to abandon dual-class shares. To maintain investor confidence, Canadian issuers are finding it in their best interest to align themselves with best practices in U.S. capital markets. Regulators are introducing new measures designed to strengthen the Canadian corporate governance and disclosure regime.

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(13) Shareholder Association for Research and Education, *Second Class Investors: The Use and Abuse of Subordinated Shares in Canada*, April 2004.

## CONCLUSION

While dual-class share structures have some demonstrated benefits, investor opposition is growing. Ultimately, the market will decide whether these structures persist. Changes to the regulatory environment now mean that investors are no longer limited to a narrow universe of Canadian companies and have the opportunity to “vote with their feet.” Should the market value sound governance practices, including greater shareholder rights, more Canadian companies will undoubtedly follow suit. For now, most of the investor opposition resides with the large institutional investors. Individual investors seem willing to be disenfranchised – as long as the stock performs well. And, with stock markets in Canada strongly outperforming those in the United States, individuals and institutions seem content to invest in Canada, regardless of their opposition to dual-class structures.