

THE ANATOMY OF DUAL CLASS SHARE STRUCTURES: A COMPARATIVE PERSPECTIVE

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To delineate the merits and demerits of dual class share structures, we should compare them to dispersed ownership structures with control contestability, concentrated ownership structures, and other control-enhancing mechanisms. Dual class structures facilitate long-term business strategies, firm-specific investments, equity financing and risk-taking, and they are simple, transparent and stable; but they insulate corporate controllers from shareholder monitoring, proxy contests and hostile takeovers, exacerbate tunnelling and shirking problems, and enable corporate controllers to achieve an extreme voting-cash flow rights divergence and to infringe existing shareholders' voting rights. Law can deal with most disadvantages of dual class structures, except shirking problems. Policy-makers should ensure that law provides shareholders with sufficient protection and then make a choice between dual class structures' benefits and constraints on shirking derived from concentrated corporate ownership.

I. Introduction

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In most companies, equity entails votes proportionately. Shareholders use their voting rights to monitor and, in certain circumstances, replace controllers of corporate affairs. This mechanism is employed to curb the agency problems between corporate controllers and public shareholders that the former may act in their private interests while at the expense of the latter's investment benefits.¹

However, in some companies, voting rights and cash flow rights attached to shares are separated. As a result, some shareholders possess control over the company with holding a disproportionately low percentage of equity, while other shareholders, who own more residual claims to the company's assets, have little influence over corporate decisions. Such governance structures where some shares, per unit of their cash flow rights, effectively give their holders more voting rights than other shares do are termed, in this article, as "dual class (share) structures".

Whether dual class structures are efficient organizational forms has been subject to great controversy since their emergence until now, because they simultaneously bring the benefits of a flexible capital structure and exacerbate the agency problems inherent in a corporate form of business.² This article establishes a new three-layer

¹ Depending on context, a corporate controller may be a director or a controlling shareholder. Both of them are disciplined by shareholders' voting rights. When shares are dispersedly held, corporate control is held by directors, but they can be removed by shareholders' votes. In a company with controlling shareholders who do not hold a majority of equity, the insurgent may seize control by acquiring more shares than the current controlling shareholders do. Although it is much more difficult, or even impossible, to capture corporate control when there exist controlling shareholders, controlling shareholders are less likely to harm the company because they sustain most of the value effects of their own actions as a result of their large shareholding.

² For the modern literature arguing for dual class structures, see Scott Bauguess, "Recontracting Ownership and Control: The Effects of Differential Voting Rights after Dual Class Recapitalization" (DPhil Thesis, Arizona State University 2004); Arman Khachaturyan, "Trapped in Delusions: Democracy, Fairness and the One-Share-One-Vote Rule in the European Union" (2007) 8 *European Business Organization Law Review* 335; Scott W. Bauguess, Myron B. Slovin and Marie E. Sushka, "Large Shareholder Diversification, Corporate Risk Taking, and the Benefits of Changing to Differential Voting Rights" (2012) 36 *Journal of Banking & Finance* 1244. For the modern literature arguing against dual class structures, see Lucian A. Bebchuk, Reinier Kraakman and George Triantis, "Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights" in Randall K. Morck (ed), *Concentrated Corporate Ownership* (University of Chicago Press 2000); Ronald W. Masulis, Cong Wang and Fei Xie, "Agency Problems at Dual-Class Companies" (2009) 4 *The Journal of Finance* 1697; Paul A. Gompers, Joy Ishii and Andrew Metrick, "Extreme Governance: An Analysis of Dual Class Firms in the United States" (2010) 23 *The Review of*

analytical framework (hereinafter “Framework”) according to the governance effects achieved by dual class structures, and delineates their merits and demerits under the Framework. Further, this article demonstrates the role that law can play in the control of the downside of dual class structures and the trade-off inside a dual class structure when law provides public shareholders with sufficient protection. In particular, this article tries to offer to HK securities regulators some insights into the reasonableness of Hong Kong’s current policy that prohibits dual class listed companies. Nonetheless, most findings in this article apply to dual class structures generally, and may be found useful by other jurisdictions.

In Hong Kong, unlisted companies are free to choose their security-voting structures. The Companies Ordinance (Cap 622) (CO) confers on a company great discretion over voting issues.³ At common law, a dual class structure adopted by a private company was permitted and enforced by the House of Lords.⁴ However, the Stock Exchange of Hong Kong (SEHK) will refuse listing applications from (present and would-be) dual class companies, and companies already listed on the SEHK are not allowed to recapitalize themselves into dual class.⁵ In 2013, the SEHK’s refusal to list Alibaba Group Holding Ltd whose initial public offering (IPO) raised US\$25 billion through the New York Stock Exchange (NYSE) initiated a heated debate over Hong Kong’s current policy.⁶ The Hong Kong Exchanges and Clearing Ltd (HKEx), the

Financial Studies 1051. Two articles review the theoretical models and the empirical evidence of dual class structures. Mike Burkart and Samuel Lee, “One Share-One Vote: The Theory” (2008) 12 *Review of Finance* 1; Renée Adams and Daniel Ferreira, “One Share-One Vote: The Empirical Evidence” (2008) 12 *Review of Finance* 51.

³ CO, s 588(4).

⁴ *Bushell v Faith* [1970] 1 All ER 53.

⁵ SEHK Main Board Listing Rules, r 8.11; SEHK Growth Enterprise Market (GEM) Listing Rules, r 11.25. The two rules allow the listing of dual class companies in exceptional circumstances agreed with the SEHK. However, to date, the SEHK has never listed a company using this exception. HKEx, “Concept Paper on Weighted Voting Rights” (August 2014) para 80.

⁶ Leslie Picker and Lulu Yilun Chen, “Alibaba’s Banks Boost IPO Size to Record of \$25 Billion” *Bloomberg* (22 September 2014), available at <http://www.bloomberg.com/news/articles/2014-09-22/alibaba-s-banks-said-to-increase-ipo-size-to-record-25-billion> (visited 9 February 2015).

parent company of the SEHK, commenced a market consultation in August 2014,⁷ but postponed its second stage indefinitely due to the Securities and Futures Commission's (SFC) opposition to dual class listings.⁸

II. Dual Class Share Structures: Forms and Prevalence

Dual class share structures may be employed in several forms. The typical form is plural / multiple classes of shares with unequal votes. In most typical dual class companies, two classes of ordinary shares are issued, i.e. the inferior voting class "A" and the superior voting class "B". "A" shares carry one vote per share, and are mainly issued to outside shareholders, while "B" shares carry multiple votes per share, and are generally held by corporate insiders, such as founders, directors, senior officers and people having close connections with them. In this security-voting structure, "B" shares are also called multiple voting shares. Alternatively, class "A" may consist of non-voting ordinary shares or non-voting preference shares with increased dividend rights, while "B" shares carry one vote each.⁹

Another form of dual class structures is priority shares. These shares confer on their holders special decision or veto rights, irrespective of the proportion of their equity stakes.¹⁰ A common structure is that a fixed number or percentage (usually a majority) of directors are elected by the holders of priority shares and others by the remaining shareholders.¹¹ Alternatively, some companies issuing formally one class of shares

⁷ HKEx (n 5 above).

⁸ "SFC statement on the SEHK's draft proposal on weighted voting rights" (25 June 2015), available at <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=15PR69> (visited 17 October 2015). See also HKEx, "Consultation Conclusions to Concept Paper on Weighted Voting Rights" (June 2015).

⁹ HKEx (n 5 above) para 140; Deminor Rating, "Application of the One Share-One Vote Principle in Europe" (March 2005) p 3. Preference shares with guaranteed dividend rights are excluded because they have some key characteristics of debt.

¹⁰ Institutional Shareholder Services (ISS), Shearman & Sterling LLP and European Corporate Governance Institute (ECGI), "Report on the Proportionality Principle in the European Union" (2007) p 8.

¹¹ HKEx (n 5 above) paras 137–139.

grant special control rights to particular persons through provisions in their constitutions. Besides enhanced director election rights, corporate constitutions may provide that certain shareholders have veto rights over control transactions, or that their presence be necessary for the quorum for a board meeting.¹² In comparison with typical dual class structures where “B” shares have general superior voting rights, these governance structures attach “B” shares’ privilege to specific matters.

There are few doubts that dual class structures are prevalent in developed economies. US corporate insiders can make use of all forms of dual class structures mentioned above to leverage their voting rights.¹³ Gompers, Ishii, and Metrick (2010) find that about six per cent of all companies listed in the United States issue shares with unequal votes, and they comprise about eight per cent of the overall US stock market capitalization.¹⁴ In the 16 EU member states studied by ISS et al. (2007), multiple voting shares, non-voting ordinary shares, and priority shares are available in eight, five, and nine jurisdictions respectively.¹⁵ Of all sample listed companies, 24 per cent issue multiple voting shares, and non-voting ordinary shares and priority shares are found respectively in one and two per cent of these companies.¹⁶

III. The Three-Layer Analytical Framework

In accordance with the logical sequence of the governance effects that dual class share structures achieve, their advantages and disadvantages can be sorted into three layers.

¹² *Ibid.* paras 143–146.

¹³ Shearman & Sterling LLP, “Proportionality between Ownership and Control in EU Listed Companies: Comparative Legal Study” (2007), Exhibit B, p 3.

¹⁴ Gompers et al. (n 2 above) p 1053.

¹⁵ ISS et al. (n 10 above) p 15. It should be noted that the prevalence of dual class structures in the 16 EU member states is underestimated in this article. ISS et al. (2007) also research “non-voting preference shares” which may grant higher or guaranteed dividend rights. Since preference shares with guaranteed dividend rights are not considered as a form of dual class structures in this article due to the reason explained in note 9, ISS et al.’s (2007) findings on “non-voting preference shares” are not reported. *Ibid.* p 7.

¹⁶ *Ibid.* p 25.

First, corporate insiders adopt dual class structures with the purpose of becoming or continuing as controlling shareholders. Hence we need to explore the pros and cons of a controlling shareholder structure (CS) compared to a governance structure with dispersed ownership and no controlling shareholder (NCS). Second, CS structures can be achieved by two ways: corporate insiders may either have concentrated ownership of a single class company or hold a dominant portion of voting rights without proportionate cash flow rights. Hence we need to explore the pros and cons of voting-cash flow rights separation compared to a concentrated ownership structure. Third, voting-cash flow rights separation can be achieved by many control-enhancing mechanisms (CEMs) in addition to dual class structures, such as pyramids, cross-shareholdings, and security derivatives in the market for corporate votes. Hence we need to explore the pros and cons of dual class structures compared to other CEMs.

IV. CS Structures and NCS Structures

A company's public shareholders generally do not engage in the management though they may commit a great amount of capital to the company. Consequently, corporate controllers may devote insufficient efforts to corporate affairs or pursue goals other than shareholder value, i.e. "shirking";¹⁷ worse still, they may loot shareholder wealth by transferring corporate resources to their own pockets, i.e. "tunnelling".¹⁸

In a widely-held company without a controlling block of votes, if managers run the business inefficiently or tunnel corporate resources, shareholders can intervene in fundamental business decisions or even replace incumbent management without its

¹⁷ Mark J. Roe, "Corporate Law's Limits" (2002) 31 *J Legal Stud* 233, 235.

¹⁸ The term "tunnelling" derives from a well-known paper with the same title. See Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, "Tunnelling" (2000) NBER Working Paper No 7523, available at <http://www.nber.org/papers/w7523> (visited 11 February 2015). For a discussion about various kinds of tunnelling behaviour, see Vladimir Atanasov, Bernard Black and Conrad S. Ciccotello, "Law and Tunneling" (2011) 37 *The Journal of Corporation Law* 1.

consent by mounting a proxy battle for directorial positions or by selling the control to a hostile bidder. In addition, shareholders may simply sell their shares in the market to avoid further losses, which will drive the price down and ultimately attract a control bidder. On the contrary, in a company where insiders hold a dominant portion of votes, management suffers little exposure to outside shareholder monitoring, proxy contests and hostile takeovers, which inevitably increases corporate controllers' ability to exploit outside shareholders. The positive effects of a takeover threat on corporate performance are proved by both theoretical models and some empirical evidence.¹⁹

However, shareholder monitoring and control contestability may distort optimal management decisions, and thus diminish firm value. Firstly, thanks to their positions, managers usually have better information about the company than outside shareholders.²⁰ When shares are dispersedly held, shareholders may sell control to a hostile bidder because of their mistaken belief or lack of information about the company's current performance or prospects.²¹ Consequently, management has to employ costly signalling devices to convince shareholders that the current utilization of corporate resources is optimal.²² In many cases, such communication of information is impossible or difficult because value-maximizing projects may require substantial secrecy for competitive reasons or generate no substantial profits until sometime in future.²³ When the costs of communicating private information are too large, management may choose more visible projects whose value can be more easily seen by shareholders, instead of value-maximizing ones.²⁴ A theoretical model shows that

¹⁹ Burkart and Lee (n 2 above) p 25; Adams and Ferreira (n 2 above) pp 69–72.

²⁰ Jeffrey N. Gordon, "Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice" (1988) 76 *Cal L Rev* 1, 11.

²¹ *Ibid.*

²² Daniel R. Fischel, "Organized Exchanges and the Regulation of Dual Class Common Stock" (1987) 54 *U Chi L Rev* 119, 138.

²³ Gordon (n 20 above) p 11.

²⁴ Fischel (n 22 above) p 138.

managers have less initiative in certain activities, such as searching for new investment opportunities, when outside shareholders are likely to interfere and remove them.²⁵ This may even sometimes lead to managerial myopia: managers may pursue projects that favour short-term earnings over long-term interests of the company to avoid being undervalued and replaced.²⁶

Secondly, managers have fewer incentives to invest in firm-specific human capital when they perceive high risks of being replaced against their will.²⁷ For managers, the internal labour market within a particular company is different from the external one across all companies.²⁸ Since every company has its own important characteristics, a manager is expected to invest her time and resources to gain specific knowledge and skills concerning the particular company that she serves. Firm-specific knowledge and skills can increase managers' value to a particular company, but do not affect their value in the external labour market.²⁹ Therefore, a manager is willing to acquire such knowledge and skills only when she can obtain some rewards for doing so from the company she currently belongs to. However, the value of managerial firm-specific investments is not observable in a short time period since future contingencies out of managers' control have large impacts on corporate performance.³⁰ As a result, it is unlikely for managers and shareholders to conclude an ex-ante explicit contract specifying the remuneration for firm-specific investments. When the observation period enlarges, it becomes easier to discern the impact of firm-specific investments on corporate performance because positive and negative random events tend to cancel one

²⁵ Mike Burkart, Denis Gromb and Fausto Panunzi, "Large Shareholders, Monitoring, and the Value of the Firm" (1997) 112 *Quarterly Journal of Economics* 693.

²⁶ Burkart and Lee (n 2 above) p 27.

²⁷ Fischel (n 22 above) p 137.

²⁸ Gordon (n 20 above) p 18.

²⁹ *Ibid.*

³⁰ *Ibid.* pp 15, 18.

another out over time.³¹ Hence the remuneration for managerial firm-specific investments normally takes the form of long-period employment. In a company with an NCS structure, managers always run the risk that their employment will be terminated by ill-informed shareholders or a hostile bidder who gains control from them, which decreases managers' incentives to invest in firm-specific human capital.

When shareholder monitoring and control contestability are weakened by the existence of a controlling shareholder, the various costs resulting from information communication are lower, managers have more incentives to make firm-specific investments, and companies are more likely to adopt business strategies that generate long-term profits. There is empirical evidence indicating the benefits of managerial entrenchment.³²

V. Voting-Cash Flow Rights Separation and Concentrated Ownership Structures

When a CS structure tailors more to a company's specific governance and business needs, the company has a choice in a free market: deviating from the one share-one vote principle or having concentrated corporate ownership.

5.1. Voting-Cash Flow Rights Divergence and Diminution in Firm Value

A CS structure under one share-one vote, which implies concentrated ownership of a single class company, establishes a strong link between controlling shareholders' control power and their personal wealth within the company. Thanks to their large shareholding, the exercise of discretionary power by controlling shareholders is, to a large extent, confined in a way that also benefits non-controlling shareholders and the company as a whole, since the benefits of efficient operations and the costs of tunnelling

³¹ *Ibid.* pp 16, 18.

³² Burkart and Lee (n 2 above) pp 26–27.

and shirking behaviours are both proportionately and thus largely enjoyed and borne by controlling shareholders. When controlling shareholders reduce their ownership of the company, they can externalize the costs of inefficient operations to non-controlling shareholders, but become more susceptible to outside shareholder monitoring, proxy contests and hostile takeovers.

When voting rights are decoupled from cash flow rights, corporate control is disconnected from controlling shareholders' interests associated with the company as a whole. This reduces controlling shareholders' incentives to maximize shareholder wealth while increases their incentives to exploit non-controlling shareholders. Theoretical models demonstrate that, as the fraction of equity necessary for retaining control decreases, controlling shareholders can extract more private benefits,³³ and are more prone to make inefficient decisions on project choice, firm size, and control transfers.³⁴ Empirical evidence shows that voting-cash flow rights divergence is positively and significantly associated with excess CEO compensation, while negatively and significantly associated with the marginal value of corporate reserves, stock returns on acquisitions and the contribution of capital expenditures to firm value.³⁵ Overall, Gompers et al. (2010) find a negative and significant relationship between voting-cash flow rights divergence and firm value.³⁶

However, concentrated ownership structures come with costs besides benefits. Simply put, there is always a tension between corporate control and equity financing under one share-one vote.

5.2. Corporate Control and Equity Financing

³³ *Ibid.* pp 22–24.

³⁴ Bebchuk et al. (n 2 above) pp 301–306.

³⁵ Masulis et al. (n 2 above) pp 1703–1716.

³⁶ Gompers et al. (n 2 above) p 1073.

Capital plays a key role in the business success of a company. Generally, companies can employ two instruments to raise capital: debt and equity. Since debt imposes on companies a heavy burden of interest payment, in many cases, companies prefer raising equity. Logically, there are two determinants of equity financing, i.e. corporate controllers' willingness to sell equity and public investors' willingness to purchase non-controlling stakes. The latter, as recurrently argued by the well-known law and finance scholarship, is largely determined by the level of investor protection provided by law,³⁷ whereas the former has not been seriously treated by academia until recently.³⁸ This article argues that corporate controllers are willing to sell equity when it does not result in their loss of corporate control.

5.2.1. Control Value and “Good” Private Benefits of Control

The dilemma confronting corporate controllers who want to seek additional capital from a stock market is that issuing equity to the public normally implies diluting their control power. Although companies are in great demand for capital, corporate control is so valuable that almost all corporate controllers are unwilling to put it in the public for grabs. The value of control may result from the “bad” private benefits that corporate controllers can extract by tunnelling company resources.³⁹ However, even when law provides sufficient shareholder protection to make little shareholder expropriation feasible, control power is still extremely valuable to corporate controllers because, in

³⁷ See generally, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, “Law and Finance” (1998) 106 *Journal of Political Economy* 1113; Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, “Investor Protection and Corporate Governance” (2000) 58 *Journal of Financial Economics* 3; Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, “The Law and Economics of Self-Dealing” (2008) 88 *Journal of Financial Economics* 430.

³⁸ In particular, Prof. Paces makes a great contribution to this topic. See Alessio M. Paces, *Rethinking Corporate Governance: The Law and Economics of Control Powers* (Routledge 2012). See also Lucian Arye Bebchuk, “A Rent-protection Theory of Corporate Ownership and Control” (1999) NBER Working Paper No 7203, available at <http://www.nber.org/papers/w7203> (visited 13 February 2015).

³⁹ Bebchuk (n 38 above) p 8.

many occasions, control power is a necessity for them to gain the “good” private benefits produced by their firm-specific investments.

Part IV describes the situation where corporate controllers are pure managers, i.e. agents of shareholders. The existence of controlling shareholders reduces the risks of involuntary management replacement, and thus helps secure the remuneration for managerial firm-specific investments. In fact, corporate controllers act not only as agents of shareholders but also as entrepreneurs whose firm-specific investments, i.e. entrepreneurship, are crucial to corporate success. Entrepreneurs are precious creators who can foresee profitable business opportunities that other market participants do not appreciate and the market is hence unable to price.⁴⁰ Therefore, whether the value of entrepreneurship is verifiable depends on the success of a company and the extent thereof.⁴¹ Combining with the fact that corporate performance is a noisy signal of the value of firm-specific investments, the characteristic of entrepreneurship makes it impossible for entrepreneurs to contract ex-ante and explicitly with outside shareholders for the remuneration for their firm-specific investments.⁴²

Obviously, entrepreneurs have no incentive to provide entrepreneurship unless they can possess its value. Owing to the unavailability of ex-ante explicit contracts, in the eyes of economists, an *implicit* agreement where both parties agree to a *deferred* remuneration for entrepreneurship emerges here.⁴³ Such deferred remuneration cannot be considered as a source of shareholder expropriation, because it accounts for the

⁴⁰ Paces (n 38 above) p 16.

⁴¹ *Ibid.* p 123.

⁴² *Ibid.* pp 124–125. The markets’ inability to function in the initial stages of the development of a company before high financial returns are anticipated is regarded by Prof. Mayer as a market failure that should be resolved by private benefits that encourage investments in these stages. See Colin Mayer, “Firm Control” in Joachim Schwalbach (ed), *Corporate Governance: Essays in Honor of Horst Albach* (Springer 2001) p 85.

⁴³ For an insightful exposition of implicit agreements and their implications in the relationships between shareholders and other stakeholders, see Andrei Shleifer and Lawrence H. Summers, “Breach of Trust in Hostile Takeovers” in Alan J. Auerbach (ed), *Corporate Takeovers: Causes and Consequences* (University of Chicago Press 1988) pp 33–68.

surplus that would not be produced without it. In other words, the deferred remuneration supports entrepreneurship, and it neither accounts for existing market value nor leads to redistribution of the assets that a company have already acquired.⁴⁴ This is the reason why it is regarded as “good” private benefits of control.⁴⁵ Though it still invites further research on the real forms of such deferred remuneration in business life, some non-pecuniary benefits are undoubtedly included, such as the psychic satisfaction of bringing a company to success,⁴⁶ the promotion and protection of family names,⁴⁷ and the social status of controlling a successful company.⁴⁸

Although “good” private benefits of control enhance corporate performance *ex-ante* by encouraging firm-specific investments, they may become inefficient *ex-post* by hindering value-increasing control transfers.⁴⁹ The ongoing benefits brought by entrepreneurship may be exhausted sometime in future, and there may appear a more skilful control bidder under whose management more profits can be generated on the same business. Certainly, entrepreneurs will object to transferring control to other people unless their firm-specific investments are rewarded. This means, if an entrepreneur’s consent is necessary for a takeover, a part of the efficiency gains of the takeover, in whatever form the law permits and the entrepreneur is willing to accept, needs to be paid exclusively to the entrepreneur, rather than shared among all of the shareholders, and failure to do so will frustrate the takeover.

Nevertheless, the above situation simply amounts to the enforcement of an implicit agreement where a deferred remuneration for entrepreneurship is agreed upon

⁴⁴ Alessio M. Paccès, “Control Matters: Law and Economics of Private Benefits of Control” (2009) ECGI Law Working Paper No 131/2009, p 3, available at <http://ssrn.com/abstract=1448164> (visited 6 March 2015).

⁴⁵ Paccès (n 38 above) p 16.

⁴⁶ Paccès (n 44 above) p 9.

⁴⁷ Mayer (n 55 above) p 81.

⁴⁸ Ronald J. Gilson, “Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy” (2006) 199 *Harv L Rev* 1641, 1664.

⁴⁹ Paccès (n 44 above) p 3.

ex-ante by entrepreneurs and outside shareholders. The special benefits granted to an entrepreneur in a control transaction is merely one form of such deferred remuneration.

Pacces (2012) provides a good overview of the whole story:

“[W]hen private benefits involve neither distortion nor diversion of the firm’s surplus, they fill in the gaps of market (contractual) incompleteness. In other words, they account for some value that would have *not* been produced otherwise. Such a value depends on firm-specific investments by the entrepreneur. In the jargon of contract theory, the same value is ‘nonverifiable’, and therefore it cannot be contracted upon at the outset. Ex-post, one might regret that private benefits provide no guarantee that firm (shareholder) value is always being maximized. But one should not forget that ex-ante, in the absence of those benefits, there would have been no firm (or, at least, not *that one*) and no value to maximize.”⁵⁰

By their very nature, the implicit agreements described earlier are unenforceable before courts; meanwhile, outside shareholders have strong incentives to breach such agreements in order to maximize their wealth ex-post. To keep the ability to enforce the implicit agreements by themselves, entrepreneurs must grasp corporate control in their own hands to rule out any redistribution of “good” private benefits through proxy contests and hostile takeovers. Therefore, parting with corporate control is never an option to entrepreneurs who still await remuneration for their firm-specific investments. Since the importance of entrepreneurship is common to most companies, we expect that corporate control is generally entrenched. This expectation is supported by the

⁵⁰ Pacces (n 38 above) p 93.

empirical evidence indicating the predominance of concentrated ownership structures and CEMs in stock markets around the world, including in the developed economies with relatively good shareholder protection laws and hence restricted tunnelling opportunities.⁵¹

5.2.2. One Share-One Vote and Inferior Corporate Investment Strategies

Controlling shareholders' resistance to relinquish corporate control may make companies adopt inferior investment strategies under the one share-one vote principle.

Firstly, to avoid the dilution of its controllers' control power, a company has to forego a profitable investment opportunity if pursuing the opportunity requires equity financing and its controllers have no sufficient personal wealth to maintain their controlling portion of equity. Moreover, the situation may not change even when the controlling shareholders have enough personal wealth, because purchasing more shares increases the unsystematic risk associated with their investment in the company.⁵² In consideration of their large shareholding and their human capital sunk in the company, the controlling shareholders have already borne a great amount of unsystematic risk, and a further increase in the risk is really not a favourable move.⁵³ Consequently, the company's future growth is restricted owing to its inability to invest in new profitable projects.

A governance structure allowing voting-cash flow rights separation can solve the aforementioned underinvestment problems. A company with such a structure can

⁵¹ Rafael La Porta, Florencio Lopez-De-Silanes and Andrei Shleifer, "Corporate Ownership Around the World" (1999) 54 *The Journal of Finance* 471; Stijn Claessens, Simeon Djankov and Larry H.P. Lang, "The Separation of Ownership and Control in East Asian Corporations" (2000) 58 *Journal of Financial Economics* 81; Adams and Ferreira (n 2 above) pp 54–56.

⁵² Ronald J. Gilson, "Evaluating Dual Class Common Stock: The Relevance of Substitutes" (1987) 73 *Va L Rev* 807, 828. Unsystematic risk is the risk associated with investment in a particular asset that could be eliminated by holding a diversified portfolio.

⁵³ Fischel (n 22 above) p 139.

sell extra cash flow rights to the public to get the capital necessary for financing a new project while retain voting rights in the hands of controlling shareholders. As a result, the pursuit of new profitable investment opportunities will not be obstructed by controlling shareholders' desire to retain control power. Bauguess (2004) finds that dual class companies perform better in the seasoned equity offering market than they do when single class and also better than benchmark single class companies do.⁵⁴ In addition, dual class companies' overall performance are slightly improved after they are recapitalized into dual class.⁵⁵

Secondly, a large equity stake held by controlling shareholders exacerbates their risk aversion. In order to avoid tying excessive risks to their investment, controlling shareholders may keep the company from pursuing projects with higher risk but higher expected returns, and they may as well engage in empire-building activities, e.g. acquiring a wide variety of assets unnecessary for the company's core business, to diversify corporate operations. However, unduly few corporate risks are always accompanied by low productivity.

In a company with voting-cash flow rights separation, controlling shareholders can reduce risks to their investment by selling their cash flow rights to the public, rather than giving up risky investment projects or conducting empire-building activities. As a result, investment opportunities with highest net present value will be chosen, even though they are risky or generate no substantial profits until sometime in future.⁵⁶ The corporate focus will also be strengthened. Bauguess et al. (2012) find that dual class companies whose controllers cash out a significant part of their economic ownership

⁵⁴ Bauguess (n 2 above) pp 99–110. A single class company is selected as the benchmark for each sample dual class company on the basis of the latter's industry classification and market capitalization. *Ibid.* p 66.

⁵⁵ *Ibid.* pp 88–89.

⁵⁶ Fischel (n 22 above) pp 139–140.

expand corporate core operations and divest non-core ones after becoming dual class, while benchmark single class companies keep large investment in both core and non-core business activities.⁵⁷ In addition, these dual class companies have greater profitability and higher capital expenditures after becoming dual class, and they also outperform benchmark single class companies.⁵⁸

5.3. An Explanation for Different Findings of Event Studies and Valuation Regression Studies in the United States

US scholars have conducted deep and extensive empirical research on US dual class listed companies. They mainly use two methodologies: event studies and valuation regressions. The former aim at uncovering share price reactions to announcements of changes in security-voting structures, i.e. dual class recapitalizations;⁵⁹ the latter regress book-to-market ratio⁶⁰ or Tobin's q ratio⁶¹ as proxies for firm value on measures of voting-cash flow rights divergence and control variables.⁶² Since event studies require data on the performance and market price of a company before the event date, they can only study companies implementing relevant changes after going public. Hence the sample size in event studies is much smaller than in valuation regression studies.⁶³

There is a manifest distinction among research findings. Event studies generally document that firm value increases or remains the same when companies are

⁵⁷ Bauguess et al. (n 2 above) pp 1251–1252.

⁵⁸ *Ibid.* p 1251.

⁵⁹ A listed company can alter its constitution to adopt a dual class structure either at the time of its IPO or sometime after its shares are publicly traded. The latter is termed by academia as a “dual class recapitalization”.

⁶⁰ For its definition, see <http://www.investopedia.com/terms/b/booktomarketratio.asp> (visited 12 June 2015).

⁶¹ For its definition, see <http://www.investopedia.com/terms/q/qratio.asp> (visited 12 June 2015).

⁶² Adams and Ferreira (n 2 above) pp 62–63.

⁶³ Cf Bauguess (n 2 above) p 64; Gompers et al. (n 2 above) p 1057.

recapitalized into dual class,⁶⁴ while almost all valuation regression studies suggest that voting-cash flow rights divergence reduces firm value.⁶⁵ The analysis of the relationship between corporate control and corporate investment strategies in Section 5.2 may provide some insights into the differences in these empirical results.⁶⁶

Valuation regression studies examine the pure effect of voting-cash flow rights divergence on firm value, and what they actually find is that, other things being equal, an increase in a wedge between voting rights and cash flow rights results in a decrease in firm value. The problem, from the perspective of policy-making, is that other things are never equal. Without an instrument to decouple voting rights from cash flow rights, controlling shareholders may forego valuable investment opportunities or diversify corporate operations, which they would not do otherwise. In other words, valuation regression studies can justify the prohibition of dual class structures if, when there is no voting-cash flow rights separation, controlling shareholders are willing to make the same decisions as they do under dual class structures, which requires that they pursue investment opportunities irrespective of the dilution of their control power or increased risks to their investment. Put in the analytical framework of corporate control established by Paccos (2009, 2012),⁶⁷ the findings of valuation regression studies represent the *ex-post* inefficiency of dual class structures which, nevertheless, cannot be used to deny their *ex-ante* efficiency.

On the contrary, event studies examine share price reactions to announcements of dual class recapitalizations, and thus the effects of all things around dual class structures on firm value, including, for example, the impact of a profitable investment

⁶⁴ For example, Bauguess (n 2 above); Bauguess et al. (n 2 above).

⁶⁵ For example, Gompers et al. (n 2 above); Masulis et al. (n 2 above).

⁶⁶ It should be noted that I lack a statistical background. What follows is my deductive analysis of the relevant empirical studies.

⁶⁷ Paccos (n 38 above); Paccos (n 44 above).

project that controlling shareholders might forgo under a single class structure. This situation reveals the endogenous nature of dual class recapitalizations: a company may change its security-voting structure when it anticipates positive performance effects derived from a new profitable investment project.⁶⁸ Consequently, we do not know whether the dual class structure or the investment project or both contribute to the increased firm value. As endogeneity mingles effects of different variables together, it is certainly a big concern to scholars who try to find the truth. However, it seems strange that policy-makers also worry about endogeneity so much.⁶⁹ If a dual class structure is necessary for a company to pursue new investment opportunities, then policy-makers do not need to consider which one enhances firm value when making rules of dual class structures. What really reduces event studies' utility to policy-makers is their limited sample size.

In a word, one source of the differences in the findings of event studies and valuation regression studies is their different research scope of dual class share structures. A strong support for this explanation is the fact that Gompers et al. (2010) find no significant relationships between dual class status and stock returns,⁷⁰ nor between dual class status and firm value;⁷¹ that is, different verdicts are given to dual class structures by the representative valuation regression study when the authors shift their focus from the effect of voting-cash flow rights divergence to the one of dual class status.⁷²

⁶⁸ Adams and Ferreira (n 2 above) pp 64–65, 84–85.

⁶⁹ HKEx (n 5 above), Appendix IV, para 34.

⁷⁰ Gompers et al. (n 2 above) pp 1060–1061.

⁷¹ *Ibid.* p 1073.

⁷² However, it should be noted that the authors argue that the non-significant relationship between dual class status and stock returns indicates the fact that investors knew what they were buying due to their substantial knowledge of dual class companies from the relevant academic debate and regulatory scrutiny in the United States during the 1980s and 1990s. *See ibid.* pp 1060–1061.

The paramount reason why this article focuses on the literature about US dual class listed companies is that the United States is well known for its high-quality shareholder protection laws and fierce market competition, and hence “neither distortion nor diversion of the firm’s surplus” can be committed without reasonable limits by an US corporate controller, which is a precondition for “good” private benefits—the foundation stone of the analysis in Section 5.2—to function properly.⁷³ In comparison, in developing economies with a low level of shareholder protection, firm value is significantly and negatively related to not only voting-cash flow rights divergence but also the existence of CEMs.⁷⁴ Therefore, this explanation simply points out that dual class structures are efficient when adopted for proper business purposes.

Interestingly, the United States appears to be a perfect counter-example of the analysis in Section 5.2. Indeed, the United States is famous for entrepreneurial spirits, whereas it is characterized by the rare existence of controlling shareholders in its listed companies.⁷⁵ It seems difficult to explain why US entrepreneurs put control in the public, in consideration of the great value of entrepreneurship. The answer is, however, simple: they do not.

The strong directorial autonomy popular among corporate America leads to the unique US-style control-cash flow rights separation, which generally enables an US entrepreneur to secure corporate control even when all equity is issued to public investors.⁷⁶ Simply put, US corporate laws assign the dominant part of corporate power to the board of directors and allows the board to implement anti-takeover devices. The

⁷³ Paces (n 38 above) pp 113–115.

⁷⁴ Karl V. Lins, “Equity Ownership and Firm Value in Emerging Markets” (2003) 38 *The Journal of Financial and Quantitative Analysis* 159.

⁷⁵ Marco Becht, “Beneficial Ownership in the United States” in Fabrizio Barca and Marco Becht (eds), *The Control of Corporate Europe* (Oxford University Press 2002) 291.

⁷⁶ This point is not discussed in detail since it goes beyond the scope of this article. For detailed and insightful expositions of this point, see Sofie Cools, “The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers” (2005) 30 *Del J Corp L* 697, 738–750, 755–757; Paces (n 38 above) pp 178–187.

former grants the board a powerful and irresistible position against dispersed shareholders and the latter precludes the emergence of a hostile controlling shareholder. As a result, US entrepreneurs normally do not need to worry about losing control as long as they appoint themselves and / or their allies as directors before equity financing. They can thereby guarantee the rewards for their firm-specific investments, without the need to fetter their companies' pursuit of valuable investment projects, as exactly in the case of a dual class company.

VI. Dual Class Share Structures and Other Control-Enhancing Mechanisms

If a company prefers voting-cash flow rights separation due to its specific governance and business needs, it must decide what CEM to employ.

6.1. Pyramids, Cross-Shareholdings and the Market for Corporate Votes

Three commonly used CEMs besides dual class share structures are pyramids, cross-shareholdings and security derivatives in the market for corporate votes.

Two simple examples briefly illustrate how pyramidal and cross-ownership structures separate voting rights from cash flow rights.⁷⁷ Assume that Mr Smith is the controller of companies A and B which both formally comply with one share-one vote. In a pyramidal structure, Mr Smith holds 50 per cent of A's equity, and A in turn holds 50 per cent of B's equity. Consequently, Mr Smith effectively controls company B with only 25 per cent of its cash flow rights. In a cross-ownership structure, Mr Smith holds 25 per cent of A's and B's shares respectively, and the two companies hold another 25 per cent of the equity of each other. Mr Smith's control over the two companies is hence entrenched, while he has only one-third cash flow rights of the whole group.⁷⁸ Both

⁷⁷ For the mathematical models of voting-cash flow rights separation in pyramidal and cross-ownership structures, see Bebchuk et al. (n 2 above) pp 298–300.

⁷⁸ *Ibid.* p 300.

pyramids and cross-shareholdings can further enlarge a wedge between voting rights and cash flow rights by linking more companies.

Stock lending is a prominent example of derivative techniques in the market for corporate votes that can decompose one share-one vote. In a stock lending transaction, a borrower purchases a lender's shares under an agreement that the borrower is obliged to sell equivalent shares back to the lender in future. Since the ownership of the shares is transferred temporarily to the borrower, the borrower can exercise related votes in a certain period of time, but she is liable under the agreement to pay to the lender the dividends or other distributions on the shares during the "loan" period. The lender may also charge some fees. Though stock lending is typically employed to facilitate short selling, a corporate insider can utilize it to gain enough voting rights to push through a desired proposal during a general meeting of shareholders.⁷⁹

In addition, a corporate insider who seeks to circumvent one share-one vote may also use a "zero-cost" collar, which involves buying a put option of her shares and simultaneously selling a call option.⁸⁰ A put option gives its owner the contractual right, but not the obligation, to sell a specified amount of an underlying security at a specified price within a specified time / on a specified date, and a call option gives its owner the right to buy securities. The collar can thus limit downside loss with "zero cost" in the sense that the payment for the put option is offset by the proceeds from the sale of the call option.⁸¹ As a result, the insider's voting rights are retained while her cash flow exposure is reduced.⁸² A similar effect can be achieved through a short-position

⁷⁹ Henry T.C. Hu and Bernard Black, "Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership" (2007) 13 *Journal of Corporate Finance* 343, 350.

⁸⁰ *Ibid.*

⁸¹ *Ibid.* p 367.

⁸² Khachaturyan (n 2 above) p 354.

shareholding.⁸³ The insider can sell short a number of shares amounting to part of her shareholding,⁸⁴ and thereby become economically interested merely in the remaining part of her shareholding, with retaining the votes attached to all her shares, until her obligation to return the “borrowed” shares is due.

6.2. Disadvantages of Other Control-Enhancing Mechanisms

Like valuation regression studies of dual class share structures, most empirical studies of pyramids and cross-shareholdings find that voting-cash flow rights divergence caused by these CEMs is significantly and negatively related to firm value.⁸⁵ However, pyramids and cross-shareholdings have their own disadvantages, compared to dual class structures.

Firstly, pyramidal and cross-ownership structures are quite complex and opaque in the real world.⁸⁶ These structures lengthen agency chains in a corporate group, and make it difficult for public investors to know who the ultimate controllers of their investments are.⁸⁷ The controllers of a complicated corporate group have more opportunities to exploit non-controlling shareholders by engaging in tunnelling transactions which are difficult to detect and analyse in such a group.⁸⁸ The rare existence of complex organizational structures is believed to be an important factor in the relatively low level of tunnelling in the United States.⁸⁹ Secondly, pyramids and

⁸³ *Ibid.*

⁸⁴ Short selling is the sale of a security that the seller has “borrowed”. The “borrowing” process is the same as a stock lending transaction. Available at <http://www.investopedia.com/terms/s/shortselling.asp> (visited 12 May 2015).

⁸⁵ For a good overview of the relevant literature, see Adams and Ferreira (n 2 above) pp 66–69.

⁸⁶ For real examples of pyramidal and cross-ownership structures, see La Porta et al. (n 51 above) pp 481–491; ISS et al. (n 10 above) pp 36–80; Bebchuk et al. (n 2 above) pp 299–301.

⁸⁷ Bryane Michael and Say Goo, “Last of the Tai-Pans: Improving the Sustainability of Long-Term Financial Flows by Improving Hong Kong’s Corporate Governance” (2013) AIIFL Working Paper No 16, p 18, available at <http://www.aiifl.com/> (visited 13 May 2015).

⁸⁸ Atanasov et al. (n 18 above) p 39.

⁸⁹ *Ibid.*

cross-shareholdings have negative effects on liquidity of securities markets.⁹⁰ For example, in the pyramidal control chain established by Mr Smith, the direct stake of company A in company B ties up 50 per cent of the latter's shares which are thus unavailable for public trading.⁹¹

In contrast, dual class structures are simple and transparent. It is a child's play to calibrate the wedge between voting rights and cash flow rights in a dual class structure.⁹² When no other CEMs are employed, public investors can easily discern the controllers of a dual class company. Tunnelling transactions are less likely to escape market and legal scrutiny. Moreover, dual class structures can even facilitate liquidity because more equity can be sold to the public without affecting corporate control. In addition, a corollary of the simplicity of dual class structures is that, other things being equal, the administrative costs of a dual class company are lower than those of a pyramidal or cross-ownership corporate group.

The central problem of security derivatives in the market for corporate votes is that they can be utilized to establish or reinforce an insider's control over a company *after* its equity is issued to the public. Consequently, investors are unable to discount share price for the increased risks of shareholder expropriation. On the contrary, with regard to dual class IPOs, outside shareholders know what they are purchasing and insiders have to bear a market penalty for voting-cash flow rights separation.⁹³ Even regarding complicated pyramidal and cross-ownership structures, outside shareholders at least have an opportunity to understand the organization of a corporate group if they put in enough efforts.

⁹⁰ Marco Becht, "European Corporate Governance: Trading off Liquidity against Control" (1999) 43 *European Economic Review* 1071, 1073.

⁹¹ *Ibid.*

⁹² Bebchuk et al. (n 2 above) p 297.

⁹³ Henry T. C. Hu and Bernard Black, "The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership" (2006) 79 *S Cal L Rev* 811, 858.

The same problem is found in dual class recapitalizations as well.⁹⁴ However, in many aspects, security derivatives perform worse. First, dual class recapitalizations at least require shareholder approval for they entail alterations to corporate constitutions, but engaging in derivative transactions does not because it is a purely private decision.⁹⁵ Second, a dual class recapitalization is a one-time adjustment after which corporate control is known, and subsequent investors can pay a discounted price for inferior voting shares.⁹⁶ But a new corporate controller may emerge through derivative transactions anytime. Most important, as explained in Section 7.3, the aforementioned problem associated with dual class recapitalizations can be solved by proper regulations, thanks to the simplicity of dual class structures.

Another big problem is that a shareholder, by using security derivatives, may have negative economic interests in the company with retaining her voting rights.⁹⁷ For instance, she may sell short more shares than those she owns. Therefore, she will vote for value-destruction resolutions to make a profit from the decline of share price.⁹⁸ In addition, due to the private nature of derivative transactions, their utilization is less transparent.⁹⁹ This is believed to be an important reason why decoupling voting rights from cash flow rights via the market for corporate votes has not yet been extensively studied by academia.¹⁰⁰

Despite their disadvantages, pyramids, cross-shareholdings and security derivatives have important functions that make a policy prohibiting them unreasonable.

⁹⁴ See Section 6.3 below.

⁹⁵ Hu and Black (n 93 above) p 860.

⁹⁶ Hu and Black (n 79 above) p 358.

⁹⁷ Khachaturyan (n 2 above) p 354.

⁹⁸ For real examples supporting the argument, see Hu and Black (n 93 above) pp 825, 828–829, 834–835. Regulators may mitigate this problem, to some extent, by prohibiting “naked” short selling, i.e. selling a share short without first borrowing it or ensuring that it can be borrowed. Securities and Futures Ordinance (Cap 571), s 170.

⁹⁹ Regulators may mitigate this problem, to some extent, by requiring market participants to disclose short positions. Securities and Futures (Short Position Reporting) Rules (Cap 571AJ).

¹⁰⁰ Adams and Ferreira (n 2 above) p 73.

A corporate group can create internal markets for capital, labour and talent within the group, in order to make up for the defects of external market institutions.¹⁰¹ It may also create a group reputation for risk-sharing that the group-affiliated companies will support each other.¹⁰² In developing economies with weak rule of law, intra-group transactions may be an attractive alternative to inefficient formal contract enforcement mechanisms, e.g. a corrupt and incompetent judicial system.¹⁰³ Stock lending, put and call options and short selling are all important financial activities, contributing to greater liquidity of securities markets. They also help market participants to hedge their risks and thus improve the levels of risk-sharing in modern commercial industries.

Nevertheless, the advantages of these CEMs, except for risk-sharing, are outside the context of voting-cash flow rights separation. Due to the key characteristics of a company, its controllers may need merely to separate their voting rights from their cash flow rights for the benefits delineated in Section 5.2, but they may desire neither to create internal markets nor to participate in derivative markets. In this situation, a ban on dual class structures compels corporate controllers to use pyramids, cross-shareholdings or derivative transactions, which generates high efficiency costs by virtue of these CEMs' drawbacks that could otherwise be avoided if dual class structures were permitted.

6.3. Disadvantages of Dual Class Share Structures

Compared to other CEMs, dual class share structures have two disadvantages. The first one is straightforward: a controller of a dual class company can decouple voting rights from cash flow rights infinitely. In theory, the corporate controller can hold all of the

¹⁰¹ Tarun Khanna and Yishay Yafeh, "Business Groups in Emerging Markets: Paragons or Parasites?" (2007) 45 *Journal of Economic Literature* 331, 335–341.

¹⁰² *Ibid.* p 348.

¹⁰³ *Ibid.* pp 341–342. However, note that the empirical evidence therein supports the argument to a limited extent.

voting rights with no economic interests in the company through various dual class structures. She may issue voting shares with no cash flow rights to herself and non-voting shares to the public; moreover, she may hold priority shares to which all decision rights are attached and issue ordinary shares to public investors, or the company's constitution may stipulate that she possesses all decision rights.

There exist some natural constraints on voting-cash flow rights divergence arising from other CEMs. In pyramidal and cross-ownership structures, corporate controllers need to link more companies to enlarge wedges between voting rights and cash flow rights in certain companies. This requires public investment in other group members. Decoupling voting rights from cash flow rights through stock lending and short selling requires a sufficient supply of shares for "borrowing" in securities markets. Shareholders who want to influence corporate decisions are unlikely to "lend" their shares to others. The voting power of a corporate insider who utilizes short selling and collars is unable to exceed the number of the shares that she holds.

Some commentators may argue that policy-makers do not need to worry about the issue of infinite voting-cash flow rights divergence, because it is subject to market scrutiny: investors will simply not buy the shares of a dual class company whose controllers have only negligible cash flow rights. However, anecdotal evidence suggests that investors' rationality should not be overestimated. Two best-known examples were Dodge Brothers, Inc. and Industrial Rayon Corporation. The former solicited public investment of US\$130 million, while its controlling bank purchased a majority of the superior voting shares for mere US\$2.25 million; the latter's insiders took the full control with mere 0.33 per cent of the whole equity.¹⁰⁴ No proper business

¹⁰⁴ Joel Seligman, 'Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy' (1986) 54 *Geo Wash L Rev* 687, 694; William Ripley, *Main Street and Wall Street* (Boston: Little, Brown, and Company 1927) pp 86–87.

purposes or strategies could justify such unreasonable wedges between voting rights and cash flow rights, but amazingly, investors were still willing to invest in the two companies. In fact, the two examples were used by an influential scholar, Prof. William Ripley, to enhance his opposition to dual class structures, who was invited to the White House to discuss the subject by Calvin Coolidge, the then President of the United States.¹⁰⁵ In consideration of, inter alia, the high-level participation of retail investors in the HK securities markets,¹⁰⁶ HK securities regulators should take seriously the possibility of extreme voting-cash flow rights divergence caused by a dual class structure.

The second disadvantage of dual class share structures is about dual class recapitalizations: a listed company may alter its constitution to become dual class *after* its equity is issued to the public. Typical dual class recapitalization mechanisms are “exchange offers”, “pro rata dividends”, and “time-phased voting plans”.

The former two mechanisms require a constitution amendment that authorizes the issuance of a new class of superior voting shares. Then in exchange offers, shareholders are given a finite period of time to choose either to keep their existing shares or to exchange for superior voting shares. In most cases, increased dividend rights are granted to existing inferior voting shares, and a transfer of superior voting shares to anyone other than corporate insiders leads to an automatic loss of superior voting rights.¹⁰⁷ In a pro rata dividend, the company pays a dividend in the form of superior voting shares to all shareholders. The number of superior voting shares a shareholder receives is proportionate to her shareholding at the time of the dividend payment. The restriction on transferring superior voting shares may or may not exist in

¹⁰⁵ Seligman (n 104 above) p 695.

¹⁰⁶ HKEx, ‘Retail Investor Survey 2011’ (April 2012) p 1.

¹⁰⁷ Gordon (n 20 above) pp 40–41; Bauguess (n 2 above) pp 17–19.

this mechanism.¹⁰⁸ Recapitalizations through time-phased voting plans require a constitution amendment that gives multiple votes to shares acquired before the recapitalization date and held continuously thereafter, and to shares subsequently acquired and held continuously for a particular period. By the nature of this mechanism, a transfer of superior voting shares deprives them of their multiple votes. An exception is generally made for transfers to corporate insiders.¹⁰⁹

Although dual class recapitalizations require shareholder approval, a thorough analysis of shareholder voting process reveals that shareholders' approval of a recapitalization proposal does not necessarily support a belief that this decision increases shareholder wealth.¹¹⁰

As explained in Parts IV and V, most positive and negative parts of dual class structures come from the same core characteristic, namely insider control combined with voting-cash flow rights separation, and thus attach to each other seamlessly. Consequently, it is a difficult task for public shareholders to evaluate a recapitalization proposal. Corporate insiders can make use of strategic behaviour to further complicate such evaluation and to distort shareholder choices towards what insiders favour.

Firstly, corporate insiders can bundle a recapitalization proposal with an unrelated proposal independently desired by outside shareholders.¹¹¹ For example, a company may announce that it will increase dividends paid to shareholders if the recapitalization proposal is passed but not otherwise. In exchange offer recapitalizations, increased dividend rights associated with inferior voting shares also act as a "sweetener". Secondly, corporate insiders can threaten not to pursue new investment projects through issuing ordinary shares, declaring that they highly value

¹⁰⁸ Gordon (n 20 above) pp 41–42; Bauguess (n 2 above) pp 19–21.

¹⁰⁹ Gordon (n 20 above) p 42; Bauguess (n 2 above) p 130.

¹¹⁰ Gordon (n 20 above) pp 40–60.

¹¹¹ *Ibid.* p 48.

corporate control.¹¹² Such a threat usually seems credible due to the reasons explained in Section 5.2.

When the assessment of the effect of a recapitalization proposal is complex, collective action problems of shareholder voting function to guarantee the approval of the proposal. Owing to the small shareholding of an individual public shareholder, the costs of obtaining sufficient knowledge and information in order to make a sensible choice usually exceed the expected return. Hence a shareholder normally votes for a recapitalization proposal without careful consideration.¹¹³ Even when some public shareholders determine that the proposal will diminish shareholder wealth, they do not have incentives to organize opposition. Their gains from the defeat of the proposal are proportionate to their shareholding, whereas their expenditure on organization is unlikely to be reimbursed by other shareholders.¹¹⁴ In this situation, waiting for others to do the work is a better choice.

In a word, shareholder approval of a dual class recapitalization may result not from its quality, but from collective action and strategic choice problems of shareholder voting. Then comes the next problem: some dual class recapitalization mechanisms, once approved, can deprive existing shareholders of their voting rights, regardless of their true wills and without due compensations.

Time-phased voting plans entail a restriction on transfers of superior voting shares. Consequently, voting rights held by existing shareholders cannot be priced by securities markets, and voting power of corporate insiders becomes stronger as outside shareholders adjust their investment portfolios.

¹¹² *Ibid.* pp 49–50.

¹¹³ *Ibid.* pp 43–44.

¹¹⁴ *Ibid.* p 44.

Exchange offers coerce existing shareholders to give up their voting rights even when no restriction is imposed on transfers of superior voting shares. Collective action problems always make it the optimal strategy for a public shareholder to maintain her inferior voting shares.¹¹⁵ If so many public shareholders exchange for superior voting shares that corporate insiders are unable to entrench their control, an individual shareholder gains more by refusing the exchange. She can thereby obtain the increased dividend rights and free-ride other shareholders' efforts against managerial opportunism. If insufficient public shareholders exchange for superior voting shares, she is still better off to refuse the exchange. Despite the increased agency risks, she at least gets a dividend preference. As a result, almost all shareholders will follow this strategy and voting rights will be concentrated in the hands of corporate insiders, though the optimal strategy for outside shareholders as a group may be to keep insiders from enhancing their control power. It should also be noted that the value of increased dividend rights attached to inferior voting shares is unlikely to correspond with the value of superior voting rights,¹¹⁶ owing to the absence of market pricing in exchange offer recapitalizations.

In contrast, pro rata dividends without restrictions on transfers of superior voting shares do not infringe existing shareholders' voting rights. Such a recapitalization does not vary the original distribution of voting power in a company, and shifts in the control distribution can only occur as a result of market transactions made by individual shareholders after the completion of the recapitalization. These analyses may explain the findings by Bauguess (2004) that share price reactions to dual class recapitalization announcements by exchange offer firms are negative and

¹¹⁵ Gilson (n 52 above) pp 833–834; Gordon (n 20 above) pp 57–58.

¹¹⁶ Superior voting shares generally have 10 votes each, and inferior voting shares normally have extra 10 per cent of dividend rights. Gordon (n 20 above) p 40.

significant, while recapitalizations by pro rata dividends, most of which impose no restriction on transferring superior voting shares,¹¹⁷ have non-negative effects on share prices.¹¹⁸

VII. Law and Demerits of Dual Class Share Structures

After analysing the merits and demerits of dual class share structures, policy-makers, who shape the legal and regulatory frameworks within which dual class companies are managed, need to explore the role that law can play in the control of the downside of dual class structures.

As explained in Parts IV, V and VI, dual class structures have disadvantages respectively in each layer of the Framework. First, corporate controllers are not exposed to outside shareholder monitoring, and cannot be replaced through proxy contests or hostile takeovers. Second, corporate controllers have less incentive to maximize shareholder wealth (shirking), but more to divert company resources to their own pockets (tunnelling). Third, corporate controllers can separate voting rights from cash flow rights infinitely and employ certain dual class recapitalization mechanisms to deprive non-controlling shareholders of their voting rights.

7.1. Illusory Advantages of NCS Structures

In general, policy-makers do not necessarily need to deal with the drawbacks of dual class share structures compared to NCS structures, because the functions of proxy contests and hostile takeovers to discipline managerial inefficiency are, to a large extent, illusory in the real world.

¹¹⁷ Of the 106 pro rata dividend companies in the sample, 79 companies trade both classes of shares on a stock exchange. Bauguess (n 2 above) p 136.

¹¹⁸ *Ibid.* p 80.

Hostile takeovers are quite rare, not only from a worldwide perspective,¹¹⁹ but also in the United States and the United Kingdom where widely-held listed companies predominate.¹²⁰ “In fact ... unsolicited tender offers are so rare and sporadic that a director or manager who shirks his responsibilities by playing golf when he should be working is undoubtedly more likely to be struck by lightning while on the course than to be fired after a hostile takeover.”¹²¹ Moreover, hostile takeovers are usually not motivated by the need to replace inefficient management. UK evidence shows that the performance of targets of hostile takeovers is not significantly different from that of targets of friendly takeovers or non-acquired companies;¹²² on the US part, poor corporate performance has little explanatory power about the probability of a company receiving a hostile bid.¹²³ In fact, hostile takeovers are more likely to be caused by an acquiring company’s need to restructure its assets.¹²⁴

Shareholders have even less incentive to discipline managerial inefficiency through proxy contests than hostile takeovers.¹²⁵ Both organizations of proxy contests and hostile takeovers are quite expensive. However, in hostile takeovers, a successful bidder can take possession of the largest part, if not all, of takeover gains; while in proxy contests, most efficiency gains derived from management replacement will be free-ridden by other shareholders who do not contribute to proxy solicitation. In practice, even if a proxy contest does take place, it usually constitutes a part of an entire

¹¹⁹ <http://imaa-institute.org/resources/statistics-mergers-acquisitions/> (visited 24 February 2016).

¹²⁰ Pepper D. Culpepper, *Quiet Politics and Business Power: Corporate Control in Europe and Japan* (Cambridge University Press 2011) 34.

¹²¹ Stephen M. Bainbridge, *Corporation Law and Economics* (Foundation Press 2002) p 717.

¹²² Julian Franks and Colin Mayer, “Hostile takeovers and the correction of managerial failure” (1996) 40 *Journal of Financial Economics* 163, 171–177.

¹²³ G. William Schwert, “Hostility in Takeovers: In the Eyes of the Beholder?” (2000) 6 *The Journal of Finance* 2599, 2620–2624.

¹²⁴ Franks and Mayer (n 122 above) pp 168–169; Sanjai Bhagat, Andrei Shleifer, and Robert W. Vishny, “Hostile Takeovers in the 1980s: The Return to Corporate Specialization” (1990) *Brookings Papers on Economic Activity: Microeconomics* 1.

¹²⁵ Paces (n 38 above) pp 184–185.

hostile takeover strategy.¹²⁶ The same economic rationale applies to shareholders' other monitoring behaviour.

The disciplinary functions of NCS structures have even much less relevance to Hong Kong because of the undoubted concentrated corporate ownership in its stock market.¹²⁷ Hence this article concentrates on laws and regulations that deal with dual class structures' demerits in the second and third layers of the Framework.

7.2. Law and Extreme Voting-Cash Flow Rights Divergence

As explained in Section 6.3, a controller of a dual class company may decouple voting rights from cash flow rights infinitely, and anecdotal evidence suggests that market mechanisms alone are unable to solve this problem. It is thus necessary for policy-makers to intervene. When controlling voting-cash flow rights divergence caused by multiple voting shares, policy-makers generally place limits on the maximum number of votes carried by a superior voting share. Among the EU member states studied by Shearman & Sterling LLP (2007), Denmark,¹²⁸ France, Hungary, and Sweden adopt this approach.¹²⁹

It is worth noting that the basis for calculating a superior voting share's votes does matter. For example, section 67(1) of the Danish Public Companies Act 2006 (DPCA 2006) provided that the increase of the voting rights of a certain class of shares should not exceed 10 times the votes per unit of par value as compared to the votes held by the class of shares with the least voting rights per unit of par value; chapter 4, section 5 of the Swedish Companies Act 2005 (SCA 2005) provides that no share may carry

¹²⁶ *Ibid.* p 184.

¹²⁷ Claessens et al. (n 51 above) p 103; Michael and Goo (n 87 above) pp 29–30.

¹²⁸ It should be noted that the restriction on the maximum votes of superior voting shares in Denmark is abolished by a new Act in 2009 because it retires the concept of par value on which the restriction was based. Danish Act on Public and Private Limited Companies 2009, ss 45, 46, 47.

¹²⁹ Shearman & Sterling LLP (n 13 above), Exhibit B, pp 8–13.

voting rights which are more than 10 times greater than the voting rights of any other share. Although the two sections have the same effect in normal circumstances, a practice that once appeared in the HK securities market presents a serious challenge to the Swedish approach.

In the 1970s when dual class listed companies were not prohibited in Hong Kong, seven companies conducted issuance of “B” shares to raise capital.¹³⁰ These “B” shares carried one vote each, and thus had equal voting rights to the companies’ existing “A” shares. However, “B” shares entitled their holders to only a fraction of the dividend rights carried by “A” shares, and the par value of “B” shares were proportionately discounted.¹³¹ In comparison with purchasing “A” shares, a corporate insider could acquire multiple voting rights with the same amount of investment in the company by purchasing “B” shares. Assume that a Swedish company adopts the same capital structure, and that the par value of its “B” shares is less than one-tenth of the par value of its “A” shares. The company thereby decouples voting rights from cash flow rights to an extent exceeding what is actually allowed by the SCA 2005, while technically complying with the Act, because “B” shares and “A” shares both have one vote each. To prevent this situation, Swedish courts and regulators need to interpret chapter 4, section 5 of the SCA 2005 broadly. On the contrary, this situation will not arise under section 67(1) of the DPCA 2006.

We can observe that the control of superior voting shares’ maximum votes is most effective when a calculation basis is connected with their economic elements instead of inferior voting shares’ votes. However, the approach of the DPCA 2006 cannot be directly transplanted into jurisdictions which nowadays retire the concept of

¹³⁰ HKEx (n 5 above) para 83.

¹³¹ *Ibid.* para 84.

par value, such as Sweden and Hong Kong. One solution to this problem is to use shares' economic rights, e.g. dividend rights, as the basis for calculating a superior voting share's votes. An example rule is that the voting rights of any share should not exceed 10 times the votes per unit of its dividend rights as compared to the votes held by the class of shares with the least voting rights per unit of their dividend rights.

Of course, to frustrate infinite voting-cash flow rights divergence, policy-makers should consider as well other forms of dual class structures, besides multiple voting shares. The wording of chapter 4, section 5 of the SCA 2005 indicates that non-voting shares are forbidden in Sweden.¹³² Moreover, pursuant to the SCA 2005, priority shares are available,¹³³ but in a public company, more than 50 per cent of the directors should be appointed through general shareholders' elections.¹³⁴ The situation under the DPCA 2006 is the same.¹³⁵

It can be safely concluded that a system of rules regulating multiple voting shares, non-voting shares, and priority shares render impossible extreme voting-cash flow rights divergence in dual class companies. If Hong Kong permitted dual class listings in future and worried about possible infinite voting-cash flow rights divergence, it could adopt a rule similar to section 67(1) of the DPCA 2006 with a different calculation basis, and limit decision rights that can be assigned to priority shares and particular persons.

7.3. Law and Coercive Dual Class Recapitalizations

As explained in Section 6.3, some dual class recapitalization mechanisms enable corporate insiders to coerce existing shareholders to give up their voting rights; but

¹³² Shearman & Sterling LLP (n 13 above), Exhibit C, Part 2, pp 235–236.

¹³³ SCA 2005, cap 8, s 8.

¹³⁴ SCA 2005, cap 8, s 47.

¹³⁵ Shearman & Sterling LLP (n 13 above), Exhibit C, Part 1, pp 65–66, 71.

unfortunately, collective action and strategic choice problems of shareholder voting render public shareholders unable to prevent the infringement of their voting rights by voting down a dual class recapitalization proposal at a general meeting. This situation invites regulators to intervene. According to the Voting Rights Policy of the NYSE, dual class listings are generally permitted with one qualification: existing shareholders' voting rights cannot be disparately reduced or restricted through any corporate action or issuance.¹³⁶ In particular, the NYSE regards dual class recapitalizations by means of time-phased voting plans and exchange offers as inconsistent with the Policy.¹³⁷

The essence of the US regulatory approach is allowing companies that have already been controlled by insiders to raise equity from the public without affecting insider control, while forbidding companies that have already raised equity from the public to change their control distribution and to import insider control which does not exist at the beginning. In the former situation, the law protects the contracts concluded between controlling shareholders and public investors well informed of the situations they would be in after purchasing inferior voting shares; in the latter situation, the law eliminates controlling shareholders' ability to alter unilaterally the terms on control distribution in a corporate contract. The US approach strikes a good balance between contractual freedom and fairness.

The SEHK accepts the merits of the US regulatory approach, but it would place additional limitation on dual class listings if the current prohibition was removed: dual class structures should be restricted to new listing applicants only.¹³⁸ It is believed that, following the midstream implementation of a dual class structure by an existing listed company, "the relative value and voting power of shares held by ordinary shareholders

¹³⁶ NYSE Listed Company Manual, s 313(A).

¹³⁷ *Ibid.*

¹³⁸ HKEX (n 8 above) para 111.

would be lower than it had been prior to the re-structuring”.¹³⁹ In contrast, investors engaging in a dual class IPO will not be unfairly treated since they purchase inferior voting shares “in full knowledge of the existence and terms of the [dual class] structure and any risks associated with it”.¹⁴⁰

However, this policy interferes somewhat too far in market freedom. Firstly, a ban on dual class recapitalizations that infringe existing shareholders’ voting rights suffices to protect the original positions of public shareholders in a listed company; whereas prohibition of all kinds of dual class recapitalizations may over-kill value-increasing ones proposed by existing listed companies that need to adjust their security-voting structures to changes of market conditions.

Secondly, when restrictions on transfers of superior voting shares do not exist in a recapitalization mechanism, market pricing functions in the sale of superior voting shares by public shareholders just as it does in the purchase of inferior voting shares in a dual class IPO. Both the premium for superior voting rights and the discount for inferior voting rights act as compensations for increased agency risks, and both compensations are priced by securities markets. There is no reason for permitting dual class IPOs while prohibiting dual class recapitalizations without infringement of existing shareholders’ voting rights.

The only justification for prohibiting all dual class recapitalizations seems to be the coercion inherent in the voting process of a recapitalization proposal. However, the coercion derives from collective action and strategic choice problems of shareholder voting generally, but does not from the characteristics of a recapitalization proposal. Corporate insiders can also take advantage of these shareholder voting problems to push

¹³⁹ *Ibid.* para 106.

¹⁴⁰ *Ibid.* para 107.

through other fundamental corporate changes, e.g. switches of a company's core business and place of incorporation. Law generally allows these fundamental changes, subject to stringent procedural requirements, and dual class recapitalizations are not so special that should be treated differently. Therefore, this article suggests that Hong Kong should adopt a rule similar to the Voting Rights Policy of the NYSE if it permitted dual class listed companies someday.

7.4. Law, Tunnelling and Shirking

Tunnelling results in the non-pro rata distribution of corporate resources between corporate controllers and non-controlling shareholders which is not allowed by law. Law directly controls tunnelling behaviour, especially through the enforcement of corporate constitutions and corporate controllers' fiduciary duties.¹⁴¹ On the other hand, shirking impairs the quality of business decisions which is generally not subject to legal scrutiny. Judicial evaluation of business decisions with no conflict of interests is normally disfavoured by an economy because, in a corporate context, judges are scarcely able to distinguish between "bad decisions and proper decisions that turn out badly".¹⁴²

Firstly, business decisions are inevitably made on the basis of incomplete information and uncertainty of future contingencies,¹⁴³ but people always judge them with hindsight. When a business decision ultimately causes loss, it is often regarded as negligent irrespective of its real quality, while the same decision would be considered

¹⁴¹ Directors owe fiduciary duties to the company. Under Anglo-HK law, a controlling shareholder held to be a shadow director may also be subject to these duties. *Vivendi SA v Richards* [2013] EWHC 3006 [142]–[143]. US corporate laws impose fiduciary duties directly upon controlling shareholders. *Jones v HF Ahmanson & Co* 460 P2d 464, 471–472 (Cal 1969); *Kahn v Lynch Communications Sys Inc* 638 A2d 1110, 1115 (Del 1994); *Sinclair Oil Corp v Levien* 280 A2d 717, 720 (Del 1971).

¹⁴² Melvin Aron Eisenberg, "The Divergence of Standards of Conduct and Standards of Review in Corporate Law" (1994) 62 *Fordham L Rev* 437, 444.

¹⁴³ *Ibid.*

very clever if it turned out profitable because of changes in some factors outside corporate controllers' control. For the sake of fairness, judges must form their opinions on the appropriateness of a business decision by reviewing the circumstances at the time when the decision was made, rather than its consequences. However, judges are not experts in business, and as outsiders to the company, they have even less information than its controllers do.

Secondly, unlike other professional practices, entrepreneurship entails a great degree of uniqueness. Judges are not experts in medicine either, but they can evaluate the quality of a doctor's decision by reference to a generally accepted standard of medical practices.¹⁴⁴ However, there is not such a standard for entrepreneurs. The fact that other entrepreneurs would make different decisions in similar circumstances tells judges very little about a particular entrepreneur's negligence.¹⁴⁵

Consequently, as for assessing the quality of a business decision, judges will do systematically worse than the company's internal governance mechanism. Moreover, the above reasons also render accurate determination of damages almost impossible.¹⁴⁶ When there is large potential for judicial error, corporate controllers will make decisions with as few risks as possible in order to avoid legal disputes. Therefore, second-guessing business decisions regularly by courts will stifle innovation and entrepreneurship, and judges are supposed to leave the disputes over business decisions to the company's internal governance mechanism.

Put another way, corporate controllers need enough freedom to take action to maximize shareholder wealth. Meanwhile, the flip side of such freedom is to enable

¹⁴⁴ Eisenberg (n 142 above) p 444.

¹⁴⁵ Paces (n 38 above) p 250.

¹⁴⁶ Edward B. Rock and Michael L. Wachter, "Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation" (2001) 149 *University of Pennsylvania Law Review* 1619, 1651. For a real example, see *Re Styland Holdings Ltd (No 2)* [2012] 2 HKLRD 325 [145].

corporate controllers to shirk their duties. The legal scrutiny strong enough to sweep all shirking behaviour away inevitably penalizes as well honest entrepreneurs' attempts to maximize shareholder value that unluckily turn out a failure. It is thus preferable to preserve such freedom and having most shirking behaviour outside legal scrutiny is a necessary price to pay for fairness and efficiency.

Intelligent judges are fully aware of the above story, and they generally show a great reluctance to get involved in business decisions without conflicts of interests. In the United States, this judicial attitude brings about the well-known “business judgment rule”:

“[I]t is not [courts’] function to resolve for corporations questions of policy and business management. The directors are chosen to pass upon such questions and their judgment unless shown to be tainted with fraud is accepted as final. The judgment of the directors of corporations enjoys the benefit of a presumption that it was formed in good faith and was designed to promote the best interests of the corporation they serve.”¹⁴⁷

As a result, when the substance or quality of a business decision is called into question, US judges normally refuse to hold relevant directors liable for the decision’s bad outcomes.¹⁴⁸

Nevertheless, US corporate laws place some limits on the business judgment rule to prevent the *severest* shirking behaviour. Firstly, the rule is not applicable if there is no informed business decision. To acquire the rule’s protection, directors must have a good knowledge of corporate affairs, pursue the information that raises a cause for

¹⁴⁷ *Davis v Louisville Gas & Electric Co* 142 A 654, 659 (Del Ch 1928). See also *Shlensky v Wrigley* 237 NE2d 776, 779–780 (Ill App Ct 1968); *Kamin v Am Express Co* 383 NYS2d 807, 810 (NY Sup Ct 1976).

¹⁴⁸ Eisenberg (n 142 above) pp 440–443; Rock and Wachter (n 146 above) pp 1663–1668.

concern, and follow due procedures to make decisions.¹⁴⁹ In effect, a duty of “process due care” is imposed on directors: the courts will focus on the reasonableness of the decision-making process a director follows, as opposed to the reasonableness of the decision he ultimately arrives at.¹⁵⁰ Secondly, the minimum quality of a business decision is required. Directors who have no conflicted interests and exercise process due care will still not be protected by the business judgment rule if they make an *irrational* decision that serves no corporate purpose.¹⁵¹ In Delaware, this principle takes the form of a prohibition on wasting corporate assets, and a transaction constitutes a waste if it involves “an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which *any* reasonable person might be willing to trade”.¹⁵²

Although Anglo-HK law does not have the concept of “business judgment rule”, the orthodoxy has long been settled that the courts should not substitute their own views about corporate affairs for directors’ good-faith judgments. Two centuries ago, Lord Eldon LC held that “This Court is to be required on every Occasion to take the Management of every Playhouse and Brewhouse in the Kingdom ...”¹⁵³ More recently, Lord Greene MR emphasized the principle again: “[Directors] must exercise their discretion *bona fide* in what they consider—not what a court may consider—to be in the interests of the company ...”¹⁵⁴

Nonetheless, some objective elements of directors’ duties in Anglo-HK law seem to pave the way for the courts to vet business decisions. First, directors should act *bona fide* in the interests of the company (the duty of loyalty). The courts will assess

¹⁴⁹ Eisenberg (n 142 above) pp 440–441.

¹⁵⁰ *Brehm v Eisner* 746 A2d 244, 264 (Del 2000).

¹⁵¹ Eisenberg (n 142 above) pp 442–443.

¹⁵² *Lewis v Vogelstein* 699 A2d 327, 336 (Del Ch 1997) (emphasis added).

¹⁵³ *Carlen v Drury* (1812) 1 Vesey & Beames 154, 158.

¹⁵⁴ *Re Smith & Fawcett Ltd* [1942] 1 All ER 542, 543.

the compliance of the duty by checking, besides a director's subjective state of mind, a decision's reasonableness by reference to what "an intelligent and honest man in the position of a director of the company concerned ... reasonably [believes]".¹⁵⁵ Second, directors must exercise reasonable care, skill and diligence.¹⁵⁶ The standard refers to a reasonably diligent person with both the general knowledge, skill and experience that the relevant director has and those that may reasonably be expected of a person carrying out the director's functions.¹⁵⁷ Hence, in theory, a director may be punished for making a low-quality decision, whether she acts honestly or not.

However, to avoid interfering in genuine business decisions, Anglo-HK judges exercise their discretion very cautiously. With respect to the objective facet of the duty of loyalty, the courts will evaluate the quality of a business decision objectively when "a director fails to address his mind to the question whether a transaction is in the interests of the company."¹⁵⁸ If a director honestly believes that her action / inaction is beneficial to her company, a breach of the duty will occur only when "it is established that the relevant exercise of the power is one which could *not* be considered by *any* reasonable director to be in the interests of the company."¹⁵⁹ As we can see, this standard is quite similar to the waste standard under Delaware law.

Regarding the duty to exercise reasonable care, skill and diligence, the courts mainly attack a director's non-involvement in the management of the company,¹⁶⁰ failure to supervise corporate operations,¹⁶¹ and not considering important factors in

¹⁵⁵ *Charterbridge Corporation Ltd v Lloyds Bank Ltd* [1970] Ch 62, 74.

¹⁵⁶ CO, s 465(1); Companies Act 2006 (UK), s 174(1).

¹⁵⁷ CO, s 465(2); Companies Act 2006 (UK), s 174(2).

¹⁵⁸ *Madoff Securities International Ltd (in liquidation) v Raven* [2013] EWHC 3147 [194].

¹⁵⁹ *Re Southern Counties Fresh Foods Ltd* [2008] All ER (D) 195 [53] (emphasis added).

¹⁶⁰ *Re Brian D Pierson (Contractors) Ltd* [2001] 1 BCLC 275.

¹⁶¹ *Re Barings plc (No 5)* [1999] 1 BCLC 433; *Lexi Holdings plc (in administration) v Luqman* [2009] 2 BCLC 1. See also John Lowry, "The Irreducible Core of the Duty of Care, Skill and Diligence of Company Directors" (2012) 75(2) *MLR* 249.

decision-making.¹⁶² However, if directors do take into consideration the factual circumstances surrounding a business decision, the courts will defer to directors' judgments, and directors will not be held liable simply for mistakes in their decisions.¹⁶³

Barma J gave a good summary of the general judicial approach in a court decision:

“While I accept that the court should not set itself up as a tribunal to which disgruntled litigants can appeal against the commercial decisions of the board of directors, I do not think that this excludes the possibility that the court can and should, in an appropriate case, inquire into the *manner* in which the decision was reached. ... If it is shown that the directors have taken account of the relevant factors, and have not acted for improper purposes, the weight that they choose to assign to the various factors which they properly take into account is a matter for them, and not something with which the court should concern itself.”¹⁶⁴

In effect, Anglo-HK corporate laws also impose a duty of ‘process due care’ on directors as their US counterparts do.

It can be safely concluded that US and Anglo-HK courts will only intervene in *egregious* cases with *extreme* shirking behaviour. However, most shirking behaviour is not severe enough to fall into this category, and most corporate controllers who shirk their duties may escape legal liability in practice. Nevertheless, law can still facilitate other institutions able to curb shirking effectively.¹⁶⁵ For example, high-quality

¹⁶² *Chitung Futures Ltd (in liq) v Arthur Lai* [1994] 1 HKLR 95; *Cheuk-Kwan Equitable Life Assurance Society v Bowley* [2004] 1 BCLC 180; *Re Rontex International Holdings Ltd* [2010] HKEC 413.

¹⁶³ Stefan Lo and Charles Qu, “Duties of Directors and Officers under the Hong Kong Companies Ordinance” in Susan Kwan et al. (eds), *Company Law in Hong Kong: Practice and Procedure* (Hong Kong: Sweet & Maxwell / Thomson Reuters 2015) para 6.047.

¹⁶⁴ *Passport Special Opportunities Master Fund, LP v eSun Holdings Ltd* [2011] 4 HKC 62 (CFI) [150], [152] (emphasis added).

¹⁶⁵ Roe (n 17 above) p 244.

antitrust law contributes to competitive product markets which can punish inefficient management. However, it has to be admitted that law *cannot directly* control shirking behaviour,¹⁶⁶ except the severest one.

VIII. Conclusion: What Should Policy-Makers Consider?

The governance effects of dual class share structures are three-fold. Compared to NCS structures, dual class structures prevent shareholders with inferior information from influencing corporate decisions and encourage corporate controllers to make firm-specific investments; but they insulate corporate controllers from shareholder monitoring, proxy contests and hostile takeovers. Compared to concentrated ownership structures, dual class structures provide companies with broader access to equity financing and reduce corporate controllers' excessive risk-aversion; but they decouple corporate controllers' power from their personal wealth within the company, and thus exacerbate both tunnelling and shirking problems. Compared to other CEMs, dual class structures are simple, transparent and stable; but they may separate voting rights from cash flow rights infinitely, and certain dual class recapitalization mechanisms can deprive existing shareholders of their voting rights.

By virtue of the great value of entrepreneurship, CS structures are usually the first choice for entrepreneurs. Policy-makers in most jurisdictions, including Hong Kong, do not necessarily need to deal with the drawbacks of dual class structures in the first layer of the Framework. With respect to the other two layers, law should curb tunnelling and eliminate corporate controllers' abilities to achieve an extreme voting-cash flow rights divergence and to infringe existing shareholders' voting rights. However, law cannot control shirking directly. Therefore, when law provides sufficient

¹⁶⁶ *Ibid.* p 245.

shareholder protection, the real trade-off inside a dual class structure is between its benefits encapsulated above and the problems of shirking.

Accordingly, policy-makers should first take every step to ensure that law carries out its tasks well. Dual class structures' disadvantages compared to other CEMs can be dealt with by relatively simple rules, whereas the solution to tunnelling problems entails complicated corporate controllers' fiduciary duties and their enforcement. If a policy-maker is confident about the law of its jurisdiction, then it may make a choice between dual class structures' benefits and constraints on shirking derived from concentrated corporate ownership, taking into account the market conditions in its jurisdiction, including the efficacy of institutions that can curb shirking. If the policy maker prefers the latter, it needs to further think about the regulation of other CEMs since they can separate voting rights from cash flow rights as well.