Dual-class share structures in Canada: Review and recommendations

The Institute for Governance of Public and Private Organizations

Policy paper # 1

October 2006
Acknowledgement

This policy paper is the first issued by the Institute. It was written by Professor Yvan Allaire, chairman of the board of the Institute. The board has formally approved this policy statement*. Members of the board participated at length to the discussion of this paper and made several significant contributions. In particular, board member Mr. Stephen Jarislowsky made insightful recommendations and suggestions that greatly enhanced the final product.

Useful comments and suggestions were also received from other experienced board members as well as from academic researchers.

*Mr. Pierre Bernier, executive vice-president of the Autorité des marchés financiers du Québec abstained because of the regulatory role of the Autorité.
Introduction

In Canada and, indeed, wherever there are functional stock markets, differences between classes of shareholders in publicly listed corporations raise important and controversial issues. Thus, the European Commission has undertaken a vast consultation on a proposed directive to enshrine the “one share, one vote” principle. Everywhere, the topic has proved divisive, particularly when the positions of the parties are couched in the simple vernacular of public pronouncements. Unfortunately, the arguments for or against dual classes of shares are still heavily weighted by ideology and misconceptions.

The aim of this paper is a) to outline the scope of the issue in Canada, b) review the terms of the debate, c) introduce relevant research findings and d) propose a framework of safeguards that could enhance the benefits of dual share structures and minimize their potential downside.

Scope of the issue in Canada

Dual-class share structures are a common feature among Canadian publicly traded corporations. As of April 2005, 96 companies (or 6.57 %) of the 1,459 listed on the TSX had a dual-class share structure (NUPGE report, 2005). Of these 96 companies, one third were domiciled in Quebec, two-thirds in the rest of Canada, mainly in Ontario. (See Appendix B).

Appendix C shows that the voting power dilution resulting from dual-class shares varies enormously across this set of companies. Overall, the median voting power dilution is 4.38 (meaning that the median controlling shareholder has 4.38 times more votes than the equity owned). For Quebec companies, the median voting power dilution is 2.68; for companies outside Quebec, the median voting power dilution is 5.06.

The frequency of dual-class structures has declined steadily since 1988 when there were 177 companies with dual-class structure; there were 164 in 1993 and 148 in 1998. (Amoako-Adu and Smith, 2001)
Dual-class share structures do not always translate into absolute control (>50% of votes). There is some ambiguity about the notion of control in reported statistics. Sometimes, the term “control” refers to any shareholder holding more than, say, 10% of the votes (Canada), 20% (Continental Europe), or 5% (United States).

Indeed, by adopting a broad definition of “control” and a large base of companies, the prevalence of “control” and “family firms” increases dramatically. For instance, with a criterion of 10% shareholding as defining control and a sample of 500 (non financial sector) companies with market capitalization greater than 10 millions $, Bozec and Laurin find that 51% were “family controlled” and 24% were “controlled” by non family entities (Parizeau, 2005), in many cases without recourse to a superior-voting class of shares.

It would be more appropriate to label these shareholders “significant” or “block-holders”, whether they achieved that status through multiple-vote shares or otherwise. Some of the proposals made in this policy statement would be relevant to the general issue of block-holders.

Allaire and Firdirotu (2003) have focused on Canadian firms with market capitalization over $300 million in February 2003. There were 177 firms selected by that criterion. In 51 cases (or 29%), a family, an individual (or a few unrelated individuals) or another company were exercising absolute control (i.e. holding more than 50% of votes).

Of these 51 companies, there were 36 where absolute control was achieved through multiple-vote shares (or superior voting shares, as there are a number of cases with non-voting shares).

The following table (Table 1) shows the distribution of these 51 companies according to the type and source of absolute control:
TABLE 1
Source and Type of Absolute Control of Companies with Market Capitalization > $300M; (Feb 2003; S&P/TSX Index)

<table>
<thead>
<tr>
<th>Source:</th>
<th>Superior voting shares</th>
<th>Ordinary shares</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Family</td>
<td>18</td>
<td>4</td>
<td>22</td>
</tr>
<tr>
<td>Individuals</td>
<td>9</td>
<td>1</td>
<td>10</td>
</tr>
<tr>
<td>Corporation</td>
<td>9</td>
<td>10</td>
<td>19</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>36</strong></td>
<td><strong>15</strong></td>
<td><strong>51</strong></td>
</tr>
</tbody>
</table>

Of course, among the 126 companies with no one holding absolute control, there were numerous instances of block-holding shareholders (i.e. >10%) by families, individual or funds.

Companies with dual share structure are the focus of this paper, with a particular emphasis on those companies where absolute control has been achieved and maintained through superior-voting shares. However, any public corporation with a controlling shareholder brings forth some of the same issues addressed in this paper.

The terms of the argument

Many entrepreneurs looking for sources of capital to finance their growth will tap into the equity market only if they are granted some safeguards against losing control of their company. (See Sercu and Vinaimont (2006), among many others, for a formal demonstration of this point)

There is a broad agreement that control through multiple-vote shares is a reasonable solution. Indeed, absent such safeguards, most entrepreneurs will shun the stock market, curtail the growth of their companies or find different sub-optimal means of financing. All would suffer: innovation, investors, economic growth and employment. Even the staunchest opponents of dual-class share structures concede the point but would limit the “privilege of multiple-vote shares” to small companies, of the type listed on the TSX-Ventures.

Other critics do not mind this entrepreneurial prerogative but would have it subjected to some termination date, some sunset clause, calling for the elimination of the dual-class structures at a certain date or on the occurrence of an event, say, the passing on of the founding entrepreneur. There is a sense that if the whims of funding entrepreneurs must
be indulged to have the benefit of their talent, so be it; but the indulgence should not persist as there are little real benefits, only potential downsides, to continued family control of enterprises.

As we shall see further on, the empirical evidence does support overwhelmingly the benefits of founder-controlled corporations (with very few exceptions, notably, Morck, Stangeland and Yeung, 1998). On the benefits of control by descendants of the founder, empirical research, though overall positive, is more nuanced. In all cases though, the quality of governance makes a significant difference.

However, when no qualified family member of the controlling shareholder is actively engaged in the management or on the board of the company, the board of directors should establish with the controlling shareholder an orderly process of transition from a dual-class capital structure to a single-class one. The notion of a sunset clause taking affect at a certain point in time might be one such process in these circumstances.

Opponents of dual-class share structure claim that unfettered control of a corporation through super-voting shares may be abused to the detriment of minority shareholders. Controlling shareholders may appropriate substantial “private benefits” of control, including nepotism in executive appointment and succession.

Controlling shareholders may, it is claimed, select subservient board members and generally act as though the company was their private fiefdom. A number of flagrant cases give credence to that position, Adelphi and Hollinger International most notably.¹

Enjoying the private benefits of control and secure in their immunity to hostile takeovers, these controlling shareholders may well turn down offers to buy their company although that would be in the interest of other shareholders.

¹ Of course, this discourse echoes the lamentations about dominant, «charismatic», CEOs of companies with a widely dispersed shareholding (i.e. with no controlling or “substantial” shareholder). It has been insistently pointed out that the worst financial fiascos of the 2001-2003 vintage occurred in companies with “impeccable” shareholder structures.
In essence, this arrangement brings about a price discount on the shares because the “control is not in the market”; i.e. prospective investors will not factor into the valuation of the company’s shares the premium from a potential takeover.

Institutional investors opposed to dual-class share structures make another point. Although they dislike these structures, they cannot “vote with their feet”; they are forced to buy the shares of these companies as part of their indexed funds; i.e. as these companies are included in stock indexes, say the S&P/TSX, any investment strategy mimicking the performance of the index will require buying shares of all companies in the index, whether single-class or dual-class.

**Defenders of multiple-vote shares** reject this whole line of argument. They cite the eloquent examples of Warren Buffet of Berkshire-Hathaway (a dual-class company) and of the two young founders of Google who refused to give in to the reigning orthodoxy on that subject.

They point out that if “substantial private benefits” were available to holders of superior-voting shares, these shares would trade at a substantial premium over ordinary shares. With the “coattail provision” in Canada, they generally don’t! [As discussed further on, absent the coattail, these shares do trade at a premium].

If family controlled firms were rife with nepotism, their performance would suffer in a significant manner. It may happen in some cases but generally it does not. Family firms tend to do better!

They further argue that investors in their shares did so with full knowledge of the shareholder structure of the company. If discount there is, it was there in the price they paid and will be there in the price they sell. There is no loss to them.

Unless of course the game plan is to buy the shares at a discount, force the removal of the dual voting structure and then hope for (or provoke) a takeover to enjoy the appropriate gain from this operation.
The notion of a sunset clause is viewed as relevant only to very specific circumstances. Sunset clauses, whether based on an event (e.g. the death of the founder) or on a specific date (e.g. on December 31st, 2009), cannot be imposed as a general rule; that would be too inflexible, given the myriad of different circumstances. Sunset clauses would also trigger various pre-emptive moves as the date or the event loomed closer.

Indeed, since 1995, fourteen (14) companies listed on the TSX have taken steps to eliminate their superior-voting shares. In six cases, a premium was paid to these shareholders. In other cases, this change in capital structure came about for various reasons that precluded the payment of a premium (e.g. at a time of financial duress, of raising additional capital, etc.) (Lortie, 2006). There are however some cases where dual-class share structures were abandoned without compensation for the holders of the superior-voting shares.

That investors, whether they like it or not, must buy these dual-class shares for indexation purposes, is an argument that receives little sympathy among defenders of these arrangements. If investors really believe companies with dual-class share structures are bound to post inferior performances, they should sell short these stocks and reap the rich rewards from this strategy, a sure way of beating the indexes. (See Gompers, Ishii and Metrick, 2003). As funds do not, as a general rule, manage only indexed funds, this investment strategy would provide a superior performance overall.

Defenders of dual-class shares concede that superior-voting shares are a form of anti-takeover defense. They point out that it may be the most benign form of defense, compared to entrenchment measures typically taken by the management of U.S. companies to fend off takeovers (poison pills, staggered boards, golden parachutes, green mail, etc.). Management–driven anti-takeover moves are successful in defeating most hostile takeover attempts but often provoke rancorous, prolonged litigations inflicting great damage on companies.

Furthermore, although a free market for corporate takeovers may be a desirable outcome for investors and financial markets, from a “political market” and public policy perspective, that outcome may well become untenable and unacceptable. A relentless quest for a free trade in corporate takeovers may bring about political and bureaucratic
interference, an inferior outcome to the present situation. The harbingers of political resistance to a free market for corporate control are evident in Europe at this time. Even in the U.S. at the state level (Gompers, Ishii and Metrick, 2003) and whenever national security is invoked, there are serious impediments to corporate takeover. Several Canadian industries are already protected from foreign takeovers (broadcasting, banking, etc.)

Finally and, ultimately, there is the compelling, rallying argument with a nice ring to it: the “one share-one-vote principle”. It is claimed that, fundamentally, dual-class share structures are an affront to the democratic principle of equality of suffrage.

Of course, it does happen that, in "the greatest democracy in the world", citizens of Vermont for instance have the equivalent of 100 votes compared to citizens of California in the business of electing U.S. senators; but these are mere quibbles. The parallel between citizenship (one person-one vote) and shareholding should be fully worked out: no newcomer to a country acquires the right to vote upon arrival; he/she must wait for a three-to-five year period, then swear an oath of allegiance, and, in many cases, renounce his/her citizenship in any other country.

So the democratic argument might contribute to fairly radical questioning of present-day arrangements:

- Require a pre-determined ownership period before a new shareholder may exercise his/her right to vote, in itself an attractive proposition;

- Set a cap on the number of votes that a single shareholder may exercise, so that all shareholders carry more or less equal weight in decision-making, irrespective of the number of shares they own.

- Open the “democratic" door to representation on the board of parties, other than shareholders, with large stakes in the company’s success and performance; e.g. the employees. (Porter, 1992) [See Faley, Mehrotra and Morck (2005) for an interesting study of labor’s voice in corporate governance].
These notions are foreign to present-day practices in North America but quite common in other parts of the world.

**Research Findings**

One would hope that “science” would cut the Gordian knot, settle the issue. However, the empirical research on this topic gives a false impression of abundance. Many studies cover a period distant enough in time to lose much of their relevance for today’s context. Other studies pertain to countries with such a different, and weaker, legal framework as to be of little pertinence for our purpose. All in all, as is often the case with controversial subjects, *Academia is enlightening but not decisive!*

But Academia is enlightening!

- **On the “private benefits” of controlling shareholders.**

It is a tenet of efficient markets that the ability of holders of superior voting share to extract private benefits would translate in a premium for multiple-vote shares when both classes of shares are actively traded on a stock exchange.

An important “private benefit” would come from appropriating, at the expense of other shareholders, the control premium a would-be acquirer would pay for the controlling shares.

In an early, path-breaking move, the Toronto stock exchange decreed in 1987 that, from that point on, any company issuing a class of shares with superior voting rights would have to include a provision that no offer to acquire the class of controlling shares would be valid without the would-be acquirer making a concurrent offer at the same terms and conditions to the other class of shareholders.

In one fell swoop, this measure has eliminated a key source of potential abuse or, to use the polite terminology of academia, the private benefits of control: the possibility for a controlling shareholder (via superior-vote shares) to sell the control of the company and
pocket the large premium that usually comes with control, while all other shareholders receive no benefit from the transaction. ²

As a result, when a coattail provision is in place, takeovers of dual-class Canadian companies produce virtually no control benefits for holders of the supra-voting shares as compared to holders of other classes of common shares. (Smith and Amoako-Adu, 1995; Clark, 2005; Nenova, 2003; Morck, Wolfenzon and Yeung, 2005)

This Canadian feature limits the relevance of conclusions drawn from studies of dual-class shares in other countries as well as Canadian studies that predate the full effect of that 1987 provision. Table 2 presents a table included in Morck (2005) on the “private benefit of control” in several countries. It shows that “private benefits” for Canadian firms are among the smallest, close to those of the United States and ahead of the United Kingdom in terms of “private benefit extraction”.

² There appears however to be some loophole that needs to be addressed; more on this later.
TABLE 2
Estimated Private Benefits of Control in Different Countries
Measured as Block and Voting Premiums and Expressed as
Percentage Premium over Market Value

<table>
<thead>
<tr>
<th>Country</th>
<th>Block Premium*</th>
<th>Voting Premiumb</th>
<th>Country</th>
<th>Block Premiuma</th>
<th>Voting Premiumb</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>27</td>
<td>Neherlands</td>
<td>2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Australia</td>
<td>2</td>
<td>23</td>
<td>New Zealand</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Austria</td>
<td>38</td>
<td>Norway</td>
<td>1</td>
<td>6</td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>65</td>
<td>Peru</td>
<td>14</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canada</td>
<td>1</td>
<td>3</td>
<td>Philippines</td>
<td>13</td>
<td></td>
</tr>
<tr>
<td>Chile</td>
<td>15</td>
<td>23</td>
<td>Polamd</td>
<td>11</td>
<td></td>
</tr>
<tr>
<td>Colombia</td>
<td>27</td>
<td>Portugal</td>
<td>20</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Czech Republic</td>
<td>58</td>
<td>Singapore</td>
<td>3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Denmark</td>
<td>8</td>
<td>1</td>
<td>South Africa</td>
<td>2</td>
<td>7</td>
</tr>
<tr>
<td>Egypt</td>
<td>4</td>
<td></td>
<td>South Corea</td>
<td>16</td>
<td>29</td>
</tr>
<tr>
<td>Finland</td>
<td>2</td>
<td>-5</td>
<td>Spain</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>2</td>
<td>28</td>
<td>Sweden</td>
<td>6</td>
<td>1</td>
</tr>
<tr>
<td>Germany</td>
<td>10</td>
<td>10</td>
<td>Switzerland</td>
<td>6</td>
<td>5</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>1</td>
<td>-3</td>
<td>Taiwan (China)</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Indonesia</td>
<td>7</td>
<td></td>
<td>Thailand</td>
<td>12</td>
<td></td>
</tr>
<tr>
<td>Israel</td>
<td>27</td>
<td></td>
<td>Turkey</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td>37</td>
<td>29</td>
<td>United Kingdom</td>
<td>2</td>
<td>10</td>
</tr>
<tr>
<td>Japan</td>
<td>-4</td>
<td></td>
<td>United States</td>
<td>2</td>
<td>2</td>
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<tr>
<td>Malaysia</td>
<td>7</td>
<td></td>
<td>Venuzuela</td>
<td>27</td>
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</tr>
<tr>
<td>Mexico</td>
<td>37</td>
<td>36</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. Block premium is average across control transactions of the difference between the price per share paid for the control block and the exchange price two days after the announcement of the control transaction, dividing it by the exchange price two days after the announcement and multiplying the ratio by the proportion of cash flow rights represented in the controlling block and expressed as a percentage premium. See Dyck and Zingales (2003). Table 2, for details.

b. Voting premium is average of estimated total vote value as a percent of firm value. See Nenova (2003), Table 5, for details.


In various studies, Canadian superior voting shares do trade at a small premium over other publicly traded shares of the same companies, reflecting the Canadian legal environment as well as the coattail provision.

Smith and Amoaka-Adu (1995) estimated the median premium at 6.37% for the period 1988-1992; Doidge (2004) calculates a median premium of 11.9% for the period 1994-2001. Nenova (2000, 2003), a Harvard researcher now with the World Bank, has carried out the most extensive cross-national research on the topic based on 1997 data. Her estimate of the control premium for superior voting shares in Canada ranges between 2% and 4%. Figures 1 and 2, drawn from her paper, show international comparisons of premium for superior voting shares (defined as “total vote to firm value”) as function of “quality of law enforcement” and “investor protection”.

- 12 -
Figure 2

Figure 1

The striking conclusion from this study and other similar ones is the critical importance of the legal framework to protect minority shareholders. With weak protection come large private benefits (e.g. Mexico, Italy, the latter has since taken several measures to improve its legal framework). With effective legal protection, only small private benefits accrue to controlling shareholders.

That is the case in Canada. The small overall premium observed for the multiple-vote shares of Canadian corporations results from the following empirical facts. In 1987, when the coattail rule was put in place, the TSX also entrenched the then-current situation; therefore a number of companies could continue to operate with a dual class of shares without any coattail provision. The TSX did not impose a period of transition. Therefore, twenty years later, the following situation prevails:

- At least 13 of the 96 companies with a dual class of shares still did not have a coattail provision;
- Of these 96 companies, 71 did not list their superior voting shares;
- Among the 25 companies that listed, only 8 had both a coattail provision and substantial float; the premium on those shares ranged from none to less than 3% over a 30-day period;
- For 12 of these 25 companies, their listed superior-voting shares are characterized by a small float and very few transactions, as most of these shares are owned by the controlling shareholders; in these cases, listing these shares appears to serve the purpose of providing the controlling shareholders with the ability to set at will an appropriate price for these superior voting shares.
- There were 5 companies among the 25, which had no coattail and a reasonable level of transactions; the premium on the superior voting shares of these companies was substantial ranging from 4% to 15% over a 30-day period;

The facts about superior-voting shares, control premium and coattails are pretty compelling:
With a coattail provision, no premium is expected nor paid to the controlling shareholders;

The absence of coattail in at least 13 cases is an anomaly twenty years after the enactment of this measure by the TSX, a situation that should be corrected;

When superior voting shares are listed but very lightly traded, one should not assume that the price of these shares reflects a market assessment of the fair value of control; as a result, it is incorrect to state that shareholders who bought the non-voting shares were informed of the market premium for the voting shares;

It is a fact, however, that buyers of the non-voting shares are well informed about the absence of a coattail provision. These companies’ information circulars typically advise, in bold letters, that “Holders of Non-voting Class B shares will not be entitled to participate in any take-over bid for the Common Shares of the Corporation”. Technically, in these cases, the holders of controlling shares could sell the control of the company without any offer made to the holders of other classes of shares;

It is also a fact that companies without a coattail provision (and sufficient float) tend to show a significant market premium for their superior-voting shares.

Absent a coattail provision, it is consistent with financial market practices to be paid a “control” premium at takeover time. But is it fair? Is it appropriate for controlling shareholders to extract a premium to which they would not be entitled, had the company listed the superior-voting shares after 1987, or had the regulators put in place an orderly process for the inclusion of a coattail provision within a reasonable period of time?

All in all, recent research results are convergent and compelling. In the Canadian legal and regulatory context, where and when an effective coattail provision is in place, the market premium on superior-voting shares is small to nil and the measured extraction of “private benefits” is minimal.³

- On the benefits of family-controlled firms

³ “Of course, there may well be non-pecuniary benefits of control (prestige, social status, influence) but these private benefits are costless to other shareholders (See Gilson, 2006)”
From the vast bibliography on the issues and challenges of family-controlled corporations, emerge the terms and conditions for the effective and successful long-run management of these companies. (See among others the excellent work of Miller and Le Breton-Miller (2006)).

Two studies deserve special consideration for our purpose because of their scope, their recent publication, their careful design and the fact that they are based on data from the U.S.A., an efficient financial market with significant similarities to the Canadian legal environment.

**The Anderson and Reeb study**
The study by Anderson and Reeb (2003, 2004) is based on the S&P500 firms (excluding utilities and financial services) over the period 1992-1999. They found that families were present (i.e. held more than 5 % of shares) in one third of these companies and accounted for 18% of outstanding equity. The authors write:

“**Contrary to our conjecture, we find family firms perform better than non-family firms**…**Overall, our results are inconsistent with the hypothesis that minority shareholders are adversely affected by family ownership, suggesting that family ownership is an effective organizational structure**” (2003, p-1301)

They point out that: “**this result however, appears to be primarily driven by family firms with greater degree of board independence relative to family firms with few independent directors**” (2004, p24, emphasis added)…

“**Our results indicate that founding family ownership, balanced and tempered with independent directors, appears to be a particularly effective organizational structure**” (2004, p.27, emphasis added)

**The Villalonga and Amit (2005) study**
Their study is based on firms, which, at any time during the period 1994-2000, ranked among the Fortune 500 list of companies. A family firm is defined here as a “firm whose founder or a member of the family by either blood or marriage is an officer, a director, or the owner of at least five percent of the firm’s equity” (2005; p.35).
These family firms account for some 36% of their Fortune 500 sample. Family shareholders owned 16% of the equity on average, with control-enhancing mechanisms (in half the cases) raising the share of vote to 33% on average. Indeed, for 12% of these very large “family companies”, the family is the largest shareholder with at least 20% of the votes.

The conclusions of their study are interesting and subtle.

“The data thus suggest that family firms are better performers than are non-family firms, which is consistent with the findings of Anderson and Reeb (2004)” (2005, p11, emphasis added)

However, family ownership creates maximum value… “when it is combined with certain forms of family management and control. Family management adds value as long as the founder serves as the CEO of the family firm, or as its chairman with a non-family CEO” (2005, p.29)

The authors of the study seek to answer a nagging issue about corporate structures:

“Which of two agency problems is more costly, the conflict between owners and managers (Agency Problem I) or the conflict between large and small shareholders (Agency Problem II)?”

The authors divide their sample into four groups, as follows:

- Type I: Family firms with control-enhancing mechanisms (dual-share classes, pyramids, cross-holdings, or voting agreements) and a family CEO. These firms might have Agency Problem II, but not Agency Problem I.
- Type II: Family firms with control-enhancing mechanisms but no family CEO. These firms might have both agency problems.
- Type III: Family firms with a family CEO but no control-enhancing mechanisms. These firms should not experience either agency problem.
- Type IV: Non-family firms, which may have Agency Problem I, but not Agency Problem II.
As shown in Table 3 herewith, there is a significant positive advantage to Type III family firms, i.e. firms with a family CEO but no control-enhancing mechanisms. It should be noted that in all cases, family firms perform as well or better than non-family firms.

<table>
<thead>
<tr>
<th>Conflict of Interest Between Owners and Managers (Agency Problem I)</th>
<th>No</th>
<th>Yes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conflict of Interest Between Large and Minority Shareholders (Agency problem II)</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Type I</td>
<td>1.93</td>
<td></td>
</tr>
<tr>
<td>Type II</td>
<td>1.94</td>
<td></td>
</tr>
<tr>
<td>No</td>
<td></td>
<td>Type III</td>
</tr>
<tr>
<td>2.66</td>
<td></td>
<td>Type IV</td>
</tr>
<tr>
<td>1.97</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Villalonga and Amit (2005) Table 4, p.38

- Measured by the q ratio, essentially a measure of the market value of assets divided by their book (or accounting) value.

In a second paper (Villalonga and Amit, 2006), the authors explore further their data bank to assess the impact of various control-enhancing measures on firm value. They conclude that dual-class shares have a negative impact on value for the first-generation of owners and a non-significant effect among second and later generation firms. They also find a positive effect on firm value for pyramidal structure and cross-shareholding agreements.

- On family firms and quality of earnings

Researchers have also investigated another claim made against family firms. Because of the undiversified wealth of family shareholders and their information advantage over other shareholders, these companies might have a strong inducement to manage earnings opportunistically (the entrenchment effect). The alternative view posits that there is a close alignment between family shareholders and other shareholders; this alignment effect would result in close monitoring of management, tight control on capital investments, swift decisions on executive changes, and commitment to long-term wealth creation.

Wang (2005) has carried out an exhaustive study of these two competing views of family firms. His conclusions are compelling:
The empirical results show that, on average, founding family ownership is associated with higher earnings quality. In particular, I find consistent evidence that founding family ownership is associated with lower abnormal accruals, greater earnings informativeness and less persistence of transitory loss components in earnings. (p.1, emphasis added)

This line of research adds to the large body of empirical findings about the governance benefits of substantial shareholding on the part of board members. (Yermack, 1996; Agrawal and Knoeber, 1996; Klein, 1998; Hambrick and Jackson, 2000; Bhagat and Black, 1999, 2001; Baghat, Carey, and Elson, 1999; Joyce, Nohria, and Roberson, 2003).

Some researchers however contend that control of large corporations by a small number of families may lead to economic inefficiencies (Morck and Yeung, 2004). This is an argument about the overall structure of ownership in a society; it has little relevance to the value-enhancing role of family firms.

- On the value of the firm

The argument goes that companies with dual share structures will be given a lower market value because of problems of performance expected as a result of such arrangements (i.e. the “agency costs”). Amoako-Adu and Smith (2005) fully test that hypothesis in a recent paper. They found no relationship in the Canadian context between a firm’s market value (measured by Tobin’s q-ratio) and its share structure, whether dual class, single class with concentrated ownership, or single class with widespread ownership. Allaire and Firsirotu (2003) found similar results for the 177 largest companies (on the basis of market value) listed on the Toronto Stock Exchange.

As noted above, Villalonga and Amit (2006) do find, in the U.S., some negative effect of dual-class shares for first-generation family firms but not for second and later generations. Zhang (2006) concludes his study of the same topic: “Overall the findings suggest that dual-class stock is not inefficient in U.S. firms” (p.23).
Furthermore, Ben-Amar and André (2005), having investigated the relationship between ownership structure and acquiring firm performance in Canada, conclude that dual-class share structures do not have any negative impact on performance.

“These results suggest that, contrary to other jurisdictions offering poor minority shareholder protection or poor corporate governance, separation of ownership and control is not viewed as leading to value destroying mergers and acquisitions, i.e. market participants do not perceive families as using M&A to obtain private benefits at the expense of minority shareholders.” (Ben-Amar and André, 2005)

Context and recommendations

General

The issue of dual class share structures brings forth a host of broader legal, social and industrial issues. From the perspective of shareholder value creation, there is strong empirical backing for removing “entrenchment” measures put in place to protect management. The case is much weaker for dual-class shares, where the entrenchment benefits accrue to a class of shareholders and not to management. Whenever and wherever the legal framework ensures the protection of minority rights and the alignment of interests between minority and controlling shareholders, there are substantial benefits accruing to small shareholders from the monitoring exercised by the controlling shareholder.

The coattail provision

Clearly, the coattail provision, along with the tighter governance rules implemented over the last ten years and the Canadian legal framework for protecting the rights of minority shareholders, have removed most, if not all, of the drivers of price premium and private benefits for Canadian dual-class-share structures. However, there are still a significant number (at least 13) of companies that benefit from the entrenchment of their status and do not have a coattail provision. The controlling shareholders of these companies could legally sell the control of the company and pocket the premium paid by the acquirer without a similar offer having been made to the minority shareholders.
Furthermore, it appears that a tightening of the coattail provision might be necessary to close some loopholes, such as the possibility of selling the controlling shares in a company to, say, two parties, neither one will, individually, acquire control but the two jointly will. Transactions of this type apparently would not trigger the coattail provision requiring that the same offer be made to all shareholders.4

**Recommendation 1**

*Tighten the coattail provision such that any offer to buy control from a controlling shareholder must be broadened to include an offer on the same terms and conditions to all other shareholders.*

A broad consensus exists around the notion that founders/entrepreneurs bring ideas, innovations and talent to a company, over and above financial capital; therefore, multiple-vote shares, not only protect them from unwanted takeovers, but also recognize this essential contribution to the success of a business.

The feature whereby a founder may have absolute control of a company with far less than 50% ownership acknowledges the value of entrepreneurship and family-owned enterprises. The issue here is to provide guidelines to entrepreneurs who in the future may want to call on public funding to finance the growth of their enterprises.

The following table shows the relationship between the ratio of multiple votes and the percentage of voting equity required for the **absolute** control of a company by a shareholder who owns all superior voting shares:

<table>
<thead>
<tr>
<th>Voting ratio</th>
<th>% of equity for control</th>
</tr>
</thead>
<tbody>
<tr>
<td>20 to 1</td>
<td>4.8%</td>
</tr>
<tr>
<td>10 to 1</td>
<td>9.1%</td>
</tr>
<tr>
<td>5 to 1</td>
<td>16.7%</td>
</tr>
<tr>
<td>4 to 1</td>
<td>20.0%</td>
</tr>
</tbody>
</table>

4 See for example the battle for control of WIC International Communications Ltd. where this particular loophole played a major role.
A number of reasons may be marshaled to support a 20% threshold. For instance, this is the level at which a buyer of a company's shares is required to make an offer to all other shareholders. It is also the threshold level of ownership for tax-exempt inter-company dividends and for the consolidation of subsidiaries.

Therefore, as a guideline for the future, it is recommended that a cap of 4 votes to 1 be placed on the number of multiple votes in a dual-class share structures. [Going forward, shares without any vote should not be permitted for a listed company]. This provision means that a shareholder must own at least 20% of the total equity to maintain absolute control of a company. 5 This minimum level of ownership seems reasonable to control a publicly traded corporation. It provides entrepreneurs with considerable latitude for growth of their company before their voting power would fall below 50% (but their effective control would remain formidable even at that point).

Recommendation 2

As a guideline for future entrepreneurs, it is recommended that the class of multiple-vote shares going forward be capped at a ratio of 4:1. Non-voting shares should be eliminated.

Board of directors

No matter how one slices the empirical evidence, there emerges a compelling support for the value-creating role of founders as CEO, chairman and controlling shareholder. The benefits of board directors with very large stakes in the company are clearly established. These benefits are enhanced when the company can count on independent-minded directors who are conscious of their role as arbiters between the

5 The general formula is: minimum equity = \( \frac{k}{1+k} \) where k is expressed as the inverse of the number of votes: i.e. 4:1 becomes k= .25 or 25% and minimum equity becomes= 25/125=20.0%. Of course, this formula assumes that a shareholder (or related shareholders) own all multiple voting shares. If a controlling shareholder, for example, were to own only 80.0% of the multiple voting shares, then, this class of shares would have to represent 30.0% of total voting equity for that shareholder to have absolute control of the company.
interest of majority and minority shareholders. These board members must ensure that no private benefit is extracted from the company by the controlling shareholders.

Indeed, it is claimed that a board essentially made up of “independent” members with little of their wealth at stakes will not be, cannot be, an effective monitor of management. The **unstated gist of Sarbanes-Oxley** and similar legislations, which are essentially designed for corporations with diffuse shareholding, is to force companies to divulge enough information for the financial markets (and its guardians) to act as effective monitors of management, whether the board will do its part or not. (At the limit of this view, *if enough information is provided to the market, boards become irrelevant.* (Gordon, 2003))

But the situation is very different for companies with a controlling shareholder. The financial markets cannot impose their views on the controlling shareholders and cannot engineer a takeover of the company. Therefore, the legitimacy and independence of boards of directors is particularly critical in situations where the company is controlled by one or a few related shareholders.

**Recommendation 3**

*Controlling shareholders should exercise their power to elect directors only for the fraction of the board equivalent to their percentage of total voting rights, with a cap of two-thirds of board members elected by a controlling shareholder.* It would be incumbent upon the **governance committee and the board to propose candidates for the board** who will likely receive a strong support from minority shareholders. Of course, once elected, all board members have a fiduciary responsibility to all shareholders. The **governance committee would determine the targeted make-up of the board, in terms of experience and expertise. The overall composition of the board should also comply with the appropriate criteria of independence set by regulatory authorities or relevant stock exchanges.**

In other words, control through superior-voting shares would place a **ceiling** of two-thirds on the number of board members elected by the controlling shareholder. “Minority”
shareholders (even those with “no votes”) would elect the remaining fraction of the board, but not less than one third of board members in all cases. (Rousseau, 2005)

An alternative approach would be for *shares with inferior voting rights* to elect at least one third of directors (more if this class of shares accounts for a greater percentage of total votes). For instance, holders of class B shares with one vote would elect a third, at least, of directors; class A shareholders, with, say, four votes, would elect two-thirds, at most, of directors.

Clearly, the much-debated proposal to let shareholders vote for each individual director *is almost a pre-requisite condition to make this recommendation effective.* However, when and if the voting system is modified to adopt individual voting, the results of the vote should not be made public; the governance committee of the board would inform shareholders whether all candidates for board position received a majority of votes; any director who did not receive a majority of votes would be asked to step down. The governance committee and the board would have to review situations where a board member received only a weak majority of votes.

The concept of cumulative voting could be introduced although it may not add much if the above recommendations were adopted.

**Succession in family-controlled corporations**

The research evidence is also clear about the conditions under which there are benefits of family control extending beyond the founder. These benefits tend to be maximized in the second or third generation when family members play an active role on the board but with a professional manager as CEO. But that is a finding with many exceptions. The history of corporations is replete with examples of great companies having been built by the sons of founders. Certainly, the admirable IBM of the 1960’s and 1970’s was the product of Thomas Watson Jr. and Johnson & Johnson achieved greatness under the son of the founder. *It is worth noting that if parents may sometimes suffer from a lack of objectivity in evaluating an offspring’s talent and abilities, there are also many cases where that judgment is sober, even harsh, particularly when the family fortune is in play.*
Be that as it may, the leadership succession in family controlled companies is an issue of legitimate concern for minority shareholders. Clearly, no one would argue that descendants of the founder be arbitrarily barred from succession because they are the descendants of the founder. Neither should a founder be given an absolute right to appoint his/her successor when the company has a large number of investors and is publicly traded.

The challenge consists in putting in place a succession process that gives the proper assurance to all parties. A few facts about succession and corporate leadership may be useful here:

- The selection of the CEO and, more broadly, leadership planning and development are among the most value-creating roles that a board can play; however, board members in North America report that they do not spend enough time on this critical task, particularly in the wake of Sarbanes-Oxley and similar legislations, the requirements of which now dominate the board’s agenda. A mere 21% of surveyed board members report satisfaction with their level of involvement in developing internal candidates for senior management positions (Charan, 2005).

- The process of CEO selection is inherently chancy (Conger and Nadler, 2004). Although fully reliable statistics are rather scarce, various sources place the failure rate for internal candidates at between 14% and 24% and at between 22% and 34% for external candidates (Byban and Bernthal, 2002); Charan reports on a Booz Allen study showing that 55% of “outside” CEOs who departed in 2003 were forced to resign by their boards; for internally chosen CEOs, the figure was 34% (Charan, 2005).

- There is some solid evidence that the optimal succession process at the top consists of what has been called “relay” succession whereby an heir is clearly identified and groomed carefully for succession. (Wei and Cannella, 2003; Rajagopalan and Zhang, 2004)

- In the midst of a growing trend towards external hires for the CEO position, several studies have cast doubt on the wisdom of that decision; Collins in his book Good to Great (2001) point out that of the 44 CEO’s in his sample of great companies, 40 were insiders; in his sample of “direct
comparison companies” (i.e. mediocre equivalents), 20 of 65 CEO’s were selected outside the ranks of the company. Khurana (2002) also makes a powerful case against the external hire as “corporate savior”.

- Clearly, the descendants of the founder, having worked for the company and proven their mettle in different jobs within the company, qualify as legitimate **insiders** for succession, the carriers of the values and traditions that give soul and substance to a corporation.
- Given the stakes, the rights of all parties and the perceived risk of nepotism, the selection of a family member as CEO should result from a rigorous process along the line of our **fifth** recommendation.

When any descendant of the controlling shareholder is a candidate for the CEO position, the controlling shareholder has enormous emotional as well as financial stakes in the selection process. Ideally, the controlling shareholder should declare his/her conflict of interest; the board would then handle the succession decision *as if it were a related party transaction*.

However, would a CEO position become really attractive to a top-notch executive if the controlling shareholder is kept out of the decision process (let alone whether that is a plausible scenario)? Any savvy candidate will realize the potential for deadly conflict between a new CEO and a controlling shareholder who did not participate in, and does not accept, the decision!

**Recommendation 4**

**Whenever a descendant or kin of the controlling shareholder is a likely candidate for the CEO position, we recommend that the independent members of the board, assisted by external advisers, if they so requested, define the personal qualities, the experience and abilities required for the next CEO. The committee and the board should discuss thoroughly with the controlling shareholder the merits of different candidates.** The chairman of the committee would report at the annual meeting of shareholders following a CEO transition on the process adopted to select the new CEO.
Transition to a single-class share structure

Whenever an individual who controls a publicly listed corporation through a superior-voting class of shares, does not have, and is not likely to have in the future, any other family member qualified to play an active role in the management or on the board of the company, this controlling shareholder must discuss with the board the process of transition in capital structure.

Recommendation 5

In cases where there is no family succession to the controlling shareholder, either in management or as qualified board members, the controlling shareholder should plan a transition to a single-class share structure when he/she becomes unable or unwilling to play an active role on the board of the company. Whether that process takes the form of a sunset clause or some other form is irrelevant.

There is ample empirical evidence that, at that stage, the controlling shareholder will maximize the value of his/her holdings by a smooth transition to a professionally managed corporation without a dual class of shares.

The practice whereby a publicly listed company controls another publicly listed company through a superior-voting class of shares (see Table 1 for the frequency of such situations), should be prohibited in the future.

Conclusions

There are benefits to the continuity and assurance of control exercised by the founding entrepreneur and/or his heirs, particularly in a world of rampaging “investors” with little interest in the long-term health and performance of companies. However, there are also risks of actions and decisions on the part of controlling shareholders that may not be in the interest of other shareholders. Therefore, the proposals contained herein seek to strike a fair balance between the costs and benefits of dual-class share structures:

1. A strengthened coattail provision should be part and parcel of any capital structure where different classes of shareholders have different voting
rights; this is an important provision in Canada, which eliminates the
greatest source of potential private benefits to a controlling shareholder:
appropriating all or a larger part of the control premium paid by an
acquirer.

2. **As a guideline for future entrepreneurs, it is recommended that the class of multiple-vote shares going forward be capped at a ratio of 4:1, meaning that 20% of the equity is required for absolute control of a company.**

3. A substantial strengthening of minority rights by having a number of independent board members, proposed by the board, elected by shareholders other than the controlling shareholder. The proportion of board members so elected should be equal to the proportion of total votes held by non-controlling shareholders, but never less than one third of board members. **Once elected, all board members have a fiduciary responsibility to all shareholders. The governance committee would determine the targeted make-up of the board, in terms of experience and expertise. The overall composition of the board should also comply with the appropriate criteria of independence set by regulatory authorities or relevant stock exchanges.**

4. Whenever a kin or descendant of the controlling shareholder is a candidate for the CEO position, independent members of the board, properly advised, would discuss the merits of various candidates with the controlling shareholder and report fully at the next annual meeting of shareholders on the process by which the board arrived at a decision.

5. When no family member of the controlling shareholder is likely to play in the future a significant role in the management or on the board of the company, the controlling shareholder should discuss with the board a process for the appropriate and orderly termination of the dual-class structures.
The overall aim of these recommendations is to enhance the benefits for all shareholders of dual-class structures. Indeed, the signal of an efficient system of legal protection for minority shareholders comes from the small premium attached to superior-voting shares, as is the case in Canada. In this sort of legal context, controlling shareholders provide substantial monitoring benefits to all shareholders. (Gilson, 2006)

Controlling shareholders should of course assess carefully the cost and benefits of maintaining these share structures; but, with the appropriate legal framework for protecting minority shareholders, the benefits would be mostly of the sort that works in the interest of all shareholders: committed, actively engaged, controlling shareholders closely monitoring management; a combination of independent board members and board members with their money and their reputation at stakes; long-term perspective and strategy, maintenance and transmission of values, loyalty and stability of talented personnel.
Appendix A

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Appendix B
Dual-class companies traded on the TSX


ADF Group Inc.
AGF Management Ltd.
Agricore United
Akita Drilling Ltd.
Alimentation Couche Tard Inc.
Alliance Atlantis Communications Inc.
Andres Wines Ltd.
Arbor Memorial Services Inc.
Astral Media Inc.
Ateco Ltd.
Becker Milk Co. Ltd. (The)
BMTC Group Inc.
Bombardier Inc.
Brampton Brick Ltd.
Caldwell Partners International Inc.
Call-Net Enterprises Inc.
Canadian Tire Corp. Ltd.
Canadian Utilities Ltd.
Canam Manac Group Inc. (The)
Canwest Global Communications Corp.
CCL Industries Inc.
Celestica Inc.
Central Fund of Canada Ltd.
CGI Group Inc.
Chateau Inc. (Le)
CHC Helicopter Corp.
Chum Ltd.
Cogeco Cable Inc.
Cogeco Inc.
Coolbrands International Inc.
Corby Distilleries Ltd.
Corus Entertainment Inc.
Cossette Communication Group Inc.
Daher Leather Inc.
Diaz Resources Ltd.
Dorel Industries Inc.
Dundee Bancorp Inc.
Electrohome Limited
Empire Company Ltd.
EXRO Electro-Optical Engineering Inc.
Extendicare Inc.
Fairfax Financial Holdings Ltd.
FirstService Corporation
Four Seasons Hotels Inc.
GLP NT Corporation
Graystone Corporation
GSW Inc.
Guardian Capital Group Ltd.
Hammond Manufacturing Co. Ltd.
Hammond Power Solutions Inc.
Inscape Corporation
International Forest Products Ltd.
Jean Coutu Group (PJC) Inc.
La Senza Corporation
Laperriere & Verreault Inc. (Groupe)
Lassonde Industries Inc.
Lindsey Morden Group Inc.
Logistec Corp.
M8 Entertainment Inc.
Magna Entertainment Corp.
Magna International Inc.
MDC Partners Inc.
Metro Inc.
MI Developments Inc.
Newfoundland Capital Corp.
Onex Corporation
Oppenheimer Holdings Inc.
Optimum General Inc.
Pan-Ocean Energy Corporation
Power Corporation of Canada
Premier Tech Ltd.
Prometic Life Sciences Inc.
Quebecor Inc.
Quebecor World Inc.
Reitmans (Canada) Ltd.
Rogers Communications Inc.
Royal Group Technologies Limited
Shaw Communications Inc.
Shawcor Ltd.
Spectra Group of Great Restaurants
Spectra Premium Industries Inc.
St. Lawrence Cement Group Inc.
Stonington Capital Corporation
Teck Cominco Ltd.
Tekmion Corporation
Telus Corporation
Torstar Corporation
Transcontinental Inc.
Trizec Canada Inc.
TVA Group Inc.
Uniforest Inc.
Van Houtte inc.
Velan Inc.
Viceroy Homes Ltd.
Wescast Industries Inc.
Zenon Environmental Inc.
Appendix C
Voting Power Dilution of TSX listed dual-class companies

* Pending Management proposal on proxy to eliminate dual class structure.