BY NEILL MAY

Two classy

Tech IPOs are back in style these days, with LinkedIn, Facebook, Twitter, and Zynga either recently public or on the brink of it. There seemed to be a lull but, consistent with the (theoretical) logic of my wardrobe, if you wait long enough everything comes back in style.

One thing these tech companies have in common, other than hordes of bleary-eyed millennials hooked to their services and an appetite for citizens' private information, is dual-class-share structures. Companies with dual-class structures divide their capital into more than one class, typically featuring subordinated voting shares, which provide holders with one vote per share, and multiple voting shares, which provide a small, privileged group of holders with many votes per share. The result is a holder or holders of multiple voting shares can control the company while holding a smaller portion of the equity.

These structures raise so many topical issues the prospect of addressing them is almost paralyzing. I stress "almost" because, as my family can sadly attest, my ignorance of an insightful perspective on an issue, and an inability to express my thoughts on that issue concisely, are rarely (never) impediments for me.

Dual-class-share structures are not just creatures of the social media craze. They, and the debate about their virtues and flaws, have been around for decades, and they are used by many prominent issuers (including Google, Power Corp., Telus, and Bombardier, to arbitrarily name a few). There are many reasons why these structures endure. Canadian companies in regulated industries, such as airlines and media companies, use them as a way to comply with regulations about foreign ownership thresholds. Often they are used because a visionary founder is seen as important to the company's fortunes such that disproportionate control in that party's hands is acceptable; Berkshire Hathaway comes to mind in this regard.

Others use dual-class structures as takeover protection, or specifically as a means of tapping the public markets without ceding control, and there continues to be demand for equity in such companies (Facebook's early days on NASDAQ notwithstanding). In fact, among all the recent discussion about the pressures of short-termism and the challenges posed by shareholder activism, dual-class-share structures provide companies some protection. Founders holding multiple voting shares can focus on the long-term with some protection from the short-term pressures experienced by more conventionally capitalized issuers.

Nonetheless, dual-class structures are controversial and run against the trend of governance reforms, which have tended to promote greater shareholder engagement and board independence. The source of these reforms is rooted in the classic argument about the "agency costs" inherent in the separation of ownership and control. To put it another way, it's believed board independence and shareholder engagement tend to limit the human tendency of those in control to reap benefits at the cost of those who have made investments but do not directly control the assets. These concerns are supported by cases that have attracted criticism and complaint, including where large premiums were paid to controlling shareholders when the dual-class structure was collapsed, where insiders compensated themselves generously, or when a sale of the company was negotiated at a price seen as less-than-optimal. There are cases where markets embraced dual-class structures based on faith in a controlling shareholder, but did not maintain that faith when the shares passed to the next generation.

Given both the demand for dual-class structures and the controversy that surrounds them, the question is what to do about them. Some stock exchanges allow them, some impose limits, some don't allow them at all. Alibaba reportedly recently decided to list on an exchange in the United States instead of in Hong Kong because the latter would not allow its founders to maintain corporate control.

On top of the rules of some exchanges, shareholder advocacy groups have attempted to influence how these structures are established and maintained. The Canadian Coalition for Good Governance issued a policy recently discouraging dual-class structures, other than in exceptional circumstances, and setting out guiding principles for those companies that decide they must have them. The principles suggest limits on board representation and a significant equity interest to be maintained by holders of multiple voting shares, a drop-dead date for those shares to convert into ordinary common shares, and no premium payable on the structure's collapse. The principles also suggest companies with dual-class structures that do not comply with the principles should explain in their public disclosure why compliance is not necessary in the circumstances.

The problem with dual-class structures is they're like snowflakes: each one is different, born of its own unique circumstances. They represent different governance structures, company sizes, visions for growth, controlling shareholders, and regulatory regimes. It's possible by setting a framework against which issuers have to explain the logic of their structures, CCGG's guidelines will improve transparency and comprehension. The specifics of the guidelines may serve as a useful straw man to promote analysis and helpful disclosure. However, for the reasons mentioned there may not be a one-size-fits-all solution. Which (ironically) undermines the other fundamental tenet of my wardrobe. CL

Neill May is a partner at Goodmans LLP in Toronto focusing on securities law, with an emphasis on M&A and corporate finance. E-mail him at nmay@goodmans.ca. *The opinions expressed in this article are those of the author alone.*

© 2013 Thomson Reuters Canada Ltd. Reprinted with permission.