# Enough with the shibboleth on dual class of shares

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### ENOUGH WITH THE SHIBBOLETH ON DUAL CLASS OF SHARES

With the Bombardier saga and the Couche-Tard warning bell, the old litany of lame arguments against dual class of shares was again dusted off by ivory-tower ideologues, predictable pundits and self-serving financial types, oblivious or ignorant of the inconvenient truth that many of Canada's industrial champions are controlled corporations often through a dual class of shares.

That is the conclusion one may draw from the Ontario *Institute for Competitiveness and Prosperity* study which identified 77 Canadian industrial champions; only 23 of them were widely-held corporations; 33 were listed controlled corporations, 19 of them via a dual class of shares; another 16 were privately held! (*Flourishing in the global competitiveness game*, working paper 11, September 2008). Furthermore, **23** of the 50 largest employers in Canada were dual class companies (Canada's 50 biggest employers in 2012, *Globe and Mail*, June 28<sup>th</sup> 2012).

That is a fundamental point that all commentators must acknowledge, starting with Prime Minister Trudeau if and when his advisers/counselors/civil servants/ministers call for the Bombardier family to abandon its control of the company; that point runs as follows:

Without a controlling shareholder, without a dual class of shares, there would be no aeronautical industry in Canada, no C-Series to compete with Boeing and Airbus, a singular Canadian feat, no Magna in Ontario (a dual class company until 2010), no Rogers Communication, no Teck Resources, no Canadian Tire, no Weston, no CGI, no Shaw and so on.

## And why is that?

In a period such as the 2002-2003 when the U.S. dollar was worth close to C\$1.60 and the stock market was seriously depressed, all these Canadian companies would have been bargains for U.S. acquirers. Canada would have reverted to the branch-plant economy of the 1950s.

In any case, at one point or another, their success would have attracted foreign buyers. May we mention Tim Horton, Alcan, Falconbridge, etc. That is the reason why so many sensitive industrial sectors are legally protected in Canada from foreign takeovers (banks, telecoms, airlines, media companies). And wisely so! For the Canadian regulatory context is one of the most hospitable to unwanted takeovers, much more so than in the United States. And don't count on the toothless Investment Canada to block foreign acquisitions.

American companies have multiple measures (although waning in effectiveness) at their disposal to rebuff an unwanted takeover of their company (staggered boards, poison pills of unlimited duration, board's authority to *just say no*, etc.) So, because of these American conditions, Boeing may carry on with its long-term investments without fear of an unwanted takeover in difficult times, and they have had quite a few.

Then, financial markets have become populated by short-term so-called investors and analysts fixated on the next quarter's earnings per share and stock performance; they have become the locus of nasty financial games played with and around publicly listed companies.

Thus, the new breed of American (and Canadian) entrepreneurs not only do they want to be shielded from unwanted takeovers they also seek to insulate themselves from the quarterly pressures of analysts and short-term investors.

In 2015, according to Proskauer Research (2016), **24%** of all new share offerings (IPOs) in the U.S. were made with a dual class structure, a sharp increase from 15% in 2014 and 18% in 2013.

So, it has come to pass that, taking their cue from Warren Buffett's Berkshire Hathaway, Ford Motors, The New York Times, CBS, UPS, Tyson, Ford, Nike, News Corp, Comcast, etc.(and, ironically, financial players of the Blackstone, KKR and Pershing Square variety!), young companies such as Alphabet (i.e. Google), Facebook, Groupon, Expedia, (and, in Canada, Cara, BRP, Shopify, Spin Master, Stingray) have issued two classes of shares, one with multiple votes which assures them of an unassailable control over their companies and makes them relatively indifferent to the short-term gyrations of earnings and stock price.

Furthermore, in Canada since 1987 (but not in the USA), companies issuing a class of shares with multiple votes must adopt, as a requirement to be listed on the Toronto stock exchange, a *coat-tail* provision. That provision essentially ensures that all shareholders will receive the same price for their shares, should the controlling shareholders decide to sell out. That twist, by itself, has removed most of the potential financial benefits of control through a dual class of shares.

Add to the mix of dual class companies the much stricter contemporary rules of corporate governance and the presence of a majority of independent directors on their boards and you have a recipe for success, for long-term strategic thinking, and for bold job-creating investments. It turns out to be a demonstrably optimal arrangement for all investors: controlling shareholders *with their wealth at stakes* managing, or supervising management, and taking a long-term view of the company.

Of course, that arrangement also means that "activist funds" and other short-term share-swappers (including money managers and institutional investors who are closet short-termers) cannot hope to make a quick buck by getting the company sold off.

## Financial performance

But, if getting good steady returns is what investors are looking for, dual class companies are indeed a good bet. The evidence is now pretty compelling that these companies perform better than conventional companies; or at least, perform as well and provide the added benefit of keeping their ownership and headquarters in the home country.

The following table provides some of that evidence from recent studies (but with different time periods):

# TABLE 1 - Performance of Canadian dual class firms, compared to single class firms (or reference index) over 5, 10 and 15 years periods

	5 years		10 years		15 years	
		Single		Single		Single
	Dual-	class or	Dual-	class or	Dual-	class or
Sources	class	index	class	index	class	index
Bloomberg, "Dual-class share structure boasts some big gainers", The Globe and Mail, April 29, 2016			12.0%	7.1%		
Fournier, P. and A. Katsoras, "The Family Advantage", National Bank of Canada, October 2015.*	13.5%	6.1%	11.3%	5.6%		
Ryan Modesto (5i Research), "The case for investing in companies with dual-class shares", The Globe and Mail, April 18, 2016.	4.2%	-0.9%	3.7%	1.1%		
Spizzirri, A., and M. Fullbrook. "The Impact of Family Control on the Share Price Performance of Large Canadian Publicly-Listed Firms (1998-2012)" Clarkson Center for Board Effectiveness, June 2013. [voting imbalance firms vs widely-held non family firms]					8.82%	6.60%
Allaire Y., and F. Dauphin. "Good Governance and Stock Market Performance", IGOPP, March 7, 2016.	8.66%	3.78%				

\* The study performed by NBC used an index of 30 Canadian family-controlled public companies, and about 2/3 of those 30 firms had dual class shares structures.

### Other benefits of dual class shares

Some American studies, for instance Jordan *et al.* (2014), have established, not surprisingly, that companies with a dual class of shares are subjected to less pressure for short-term results, have fewer transient shareholders and are much less exposed to hostile takeovers.

These same researchers document the fact that sales growth and R&D intensity were markedly higher for dual class companies.

Then, another American researcher (Xu, 2014) has shown that the cost of borrowing was some 17 to 28 basis points *lower* for firms with dual class of shares. That makes perfect sense. Creditors would know that controlling shareholders with much of their wealth invested in the company (and who cannot easily sell their shares) will manage so that no default ever occurs on the debt as such an event would wipe out their entire wealth.

#### What about some sunset clause?

It is often argued that one may (grudgingly) recognize the advantages and benefits of a dual class of shares while the founding entrepreneur holds the reins but that structure should be abandoned when he/she exits the company.

A dual class of shares becomes a sort of indulgence granted to the founding entrepreneur but which should not be transferable to the next generation. That argument misses the point. Yes, the value of the founding entrepreneur far exceeds the cash contribution of later shareholders; but, as we stressed throughout this piece, given the nature of financial markets these days, a dual class of shares provides a direct, transparent, and in Canada the only, way to insulate management from transient, short-term, agitators.

The situations are too varied to come up with a one-size-fits-all sunset clause. Certainly, the type of sunset clause which must be avoided at all costs is one that sets a precise date for control to lapse, as the approaching date will trigger all sorts of maneuvers on the part of controlling shareholders and various financial players. The founding entrepreneur and the board of directors must decide on succession and on how the eventual holders of the controlling shares will be groomed to play an effective role in *the governance* of the company, a company which may well be managed by unrelated professionals. That combination has been shown empirically to produce superior results for all shareholders.

### Conclusion

Setting aside cases of extraordinarily attractive companies, such as Amazon where Bezos still owns 18% of the shares, it is difficult for companies to undertake gutsy investments and implement strategies unfolding over many years without some buffer from the short-term pressures of contemporary financial markets. That may not be to the liking of some financial players but so be it.

That pressing reality must be acknowledged by all, including policy makers, who do not have a vested interest in making lots of money quickly. Don't be fooled by specious arguments merely disguising self-interest. Investors who would have bought a basket of shares in Canadian dual-class companies would have done well over the last ten years better than by holding shares in a portfolio of single-class companies.

Do not be swayed by the spurious argument of shareholder democracy. If shareholders were the equivalent of citizens in a democracy, then *tourists* (i.e. transient holders) would not vote and all new shareholders (i.e. *immigrants*) would have to wait for a considerable period of time before acquiring the right to vote.

Dual-class companies account for a good number of Canada's industrial champions; indeed dual class shares are a pillar of our industrial structure. That ownership structure should be encouraged, promoted and blessed, provided proper safeguards are in place to protect minority shareholders.