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One Company, Two Classes: Unpacking the Rationale and Ramifications of Dual-Class Share Structure

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Abstract
This research paper presents a thorough literature review on the origins of Dual-Class Sharing Structure (DCS) and their influence on agency problems. The study delves into existing research that predominantly supports the utilization of DCS, but also reveals inconsistent attitudes towards this structure. Throughout the investigation of DCS origins, we found that the existing literature revolved around three key aspects: market environment, corporate characteristics, and decision-makers, aligning seamlessly with the historical trajectory of DCS. In exploring agency theory, we found a major focus on whether DCS exacerbates or mitigates agency issues, which sparks divergent discussions due to the intricate interplay between internal and external governance. The conflicting perspectives surrounding DCS underscore the significance of further research in understanding the complex relationship between corporate governance and agency challenges. As the debate continues, our review contributes to the academic discourse, shedding light on the evolution of DCS and its impact on the broader corporate landscape.
Keywords: Dual-class Share Structure, Voting Rights, Agency Theory, Corporate Governance

Introduction

The ownership structure of listed companies has been a prominent topic in the field of corporate governance since the introduction of "The Separation of Ownership and Control" theory by (Berle and Means, 1932). The traditional ownership structure, which relies on the principle of "determination by majority," has its fundamental principle rooted in a "one share-one right" stock model (Ashton, 1994). However, this model exposes management to the risk of losing control over the corporation when seeking outside financing (Howell, 2017). To mitigate this risk, dual-class share structure (DCS) was introduced. Many companies employed DCS for anti-takeover purposes, enabling the founders to maintain control while also gaining external financing (Baran et al., 2023).

A DCS is typically defined by academics as a company's capital structure with two or more layers of shares (Amoako-Adu et al., 2011). In this structure, company insiders, such as founder-shareholders, hold significantly greater voting rights than the remaining shareholders (Rock, 2012). In other words, DCS refers to the unbalanced correspondence between equity shares and voting rights of shareholders in a listed business, characterized by disparities in the distribution of voting rights among different owners. An important element of DCS is the diversity of voting rights structure, deviating from equal shares and rights (Weng & Hu, 2022). Essentially, it investigates the shift in the power structure of listed company governance, wherein the shareholder group with voting rights gains significant power (Yan, 2021).

In this type of corporate ownership structure, a firm divides its issued ordinary shares into two classes, High voting rights shares and low voting rights shares (some are even 0). This division creates a separation of voting rights and residual claims, allowing certain owners, typically the founders, to maintain control of the business despite owning a minority of shares. Although Europe and the US have a long history of adopting this shareholding structure, scholars have historically shown skepticism and hostility towards the unbalanced shareholding system (Jarrell & Poulsen, 1988; Smart & Zutter, 2003; Khalil et al., 2008; Masulis et al., 2009). However, in recent years, an increasing number of publications have emerged in support of the favorable characteristics of this ownership structure (Doidge, 2004; Jog et al., 2010; Jordan et al., 2014; Zheng et al., 2021). So, after discovering two completely different views, we wondered what role DCS played in corporate governance. That is the motivation we reviewed the rationale and ramification of DCS and tried to find some reasons for this issue. And we developed our research questions as

- RQ1: What is the rationale of DCS?
- RQ2: What is the ramification of DCS?

The main objective of this research is to examine the impact of DCS on corporate behavior and performance, tracking its origin and development while searching the results of DCS. By investigating how DCS influences firm-level outcomes, we aim to provide valuable insights into the functioning and effectiveness of this ownership structure. While the existing literature predominantly leans towards resisting DCS, we have discovered that attitudes towards DCS are not entirely consistent. Moreover, our research reveals that when DCS is considered as a mediating or moderating variable, its effects on firm performance and innovation differ significantly from those of traditional single-class share companies. These findings highlight the complexity of DCS and the need for further exploration to fully grasp its implications. This study adds to the existing literature by addressing the controversies surrounding DCS and presenting new evidence on the implications of this ownership structure on corporate outcomes. By examining the unique effects of DCS on firm performance and innovation, our research contributes to a more nuanced understanding of how ownership structures can impact corporate behavior.

This paper is organized as Figure1, section 2 Explored the historical development and background of the DCS. Section 3 examined different factors under the DCS, including theoretical and empirical findings. Section 4 discussed the implications of our findings and the potential policy considerations. Finally, Section 5 concluded the study and highlighted the agenda for future research.

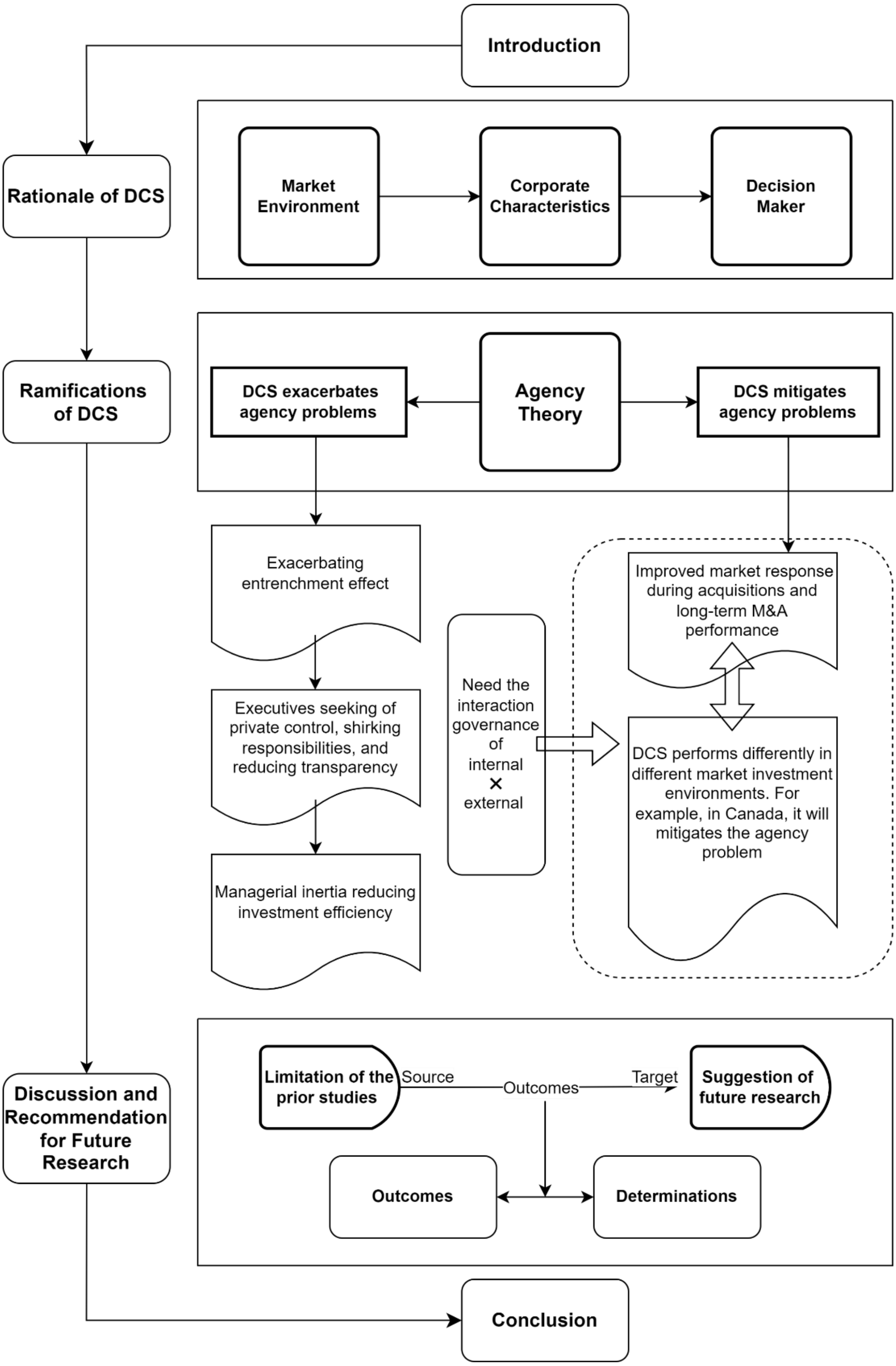

Figure 1. Research Framework

The Rationale of Dual-Class Share Structure

Background of Dual-Class Share Structure

The history of DCS dates back many years ago. The first DCS company, International Silver Company, was established in the United States in 1898. In the 1980s, in response to a wave of hostile takeovers, numerous corporations adopted DCS (Howell, 2010). Since then, academic and commercial debates on DCS have persisted. DCS has different conceptual expressions, presentation forms, and functional emphases (shown as Table1). Although there are different expressions in many countries, they are the adaptation of DCS in different environments. This also shows that DCS can be practiced in different economic and political environments.

Table1
Different Expressions of DCS in Different Counties

Region	**Expressions**	**Author(s)**	**Title**
United States	Dual share structure	Gompers et al. (2003)	Corporate Governance and Equity Prices;
	Multiple voting rights	Chaudhuri and Seo (2012)	An agency theory explanation of SEO underperformance: Evidence from dual-class firms
United Kingdom	Dual-class share	Ho (2021)	Allowing dual-class share structure companies in the Premium listing segment of the London Stock Exchange: appreciating international experiences and recognizing local conditions
Hong Kong	Weighted voting rights	Qi and Liu (2019)	Research Advancements in Foreign Weighted Voting Rights
Chinese Mainland	Dual-class equity structure	Guo (2016)	Dual-Class Equity Structure under Shareholder Heterogeneity's Perspective
	Multiple voting rights	Qi and Liu (2019)	Differentiated voting rights arrangement under dual-class share structures in China: expectation, reality, and future
	Two-tier Ownership Structure	Zheng (2018)	Issuance of Dual class Stocks and the Border of Institutional Innovations on Corporate Control Arrangements
	Different voting rights arrangement	Yan (2021)	Differentiated voting rights arrangement under dual-class share structures in China: expectation, reality and future
	Dual class Stocks	Chen and Zhao (2016)	To Be or Not to Be: An Empirical Study on Dual-Class stocks of Us Listed Chinese Companies
	Same Share with Different Rights System	Yang and Gao (2021)	Does the dual class shareholding structure promote corporate innovation? Data from Chinese companies listed in the US

The debating of DCS has been lasting for a century, primarily because of its deviation from the traditional principle "one share, one vote". Scholars have been engaged in discussing the causes and rationale of DCS since the 19th century. Although there is much controversy about DCS, we can still trace its origins through three key points: the market environment, corporate characteristics, and the decision-makers involved. Figure 2 showed the three paths of tracing origin of DCS.

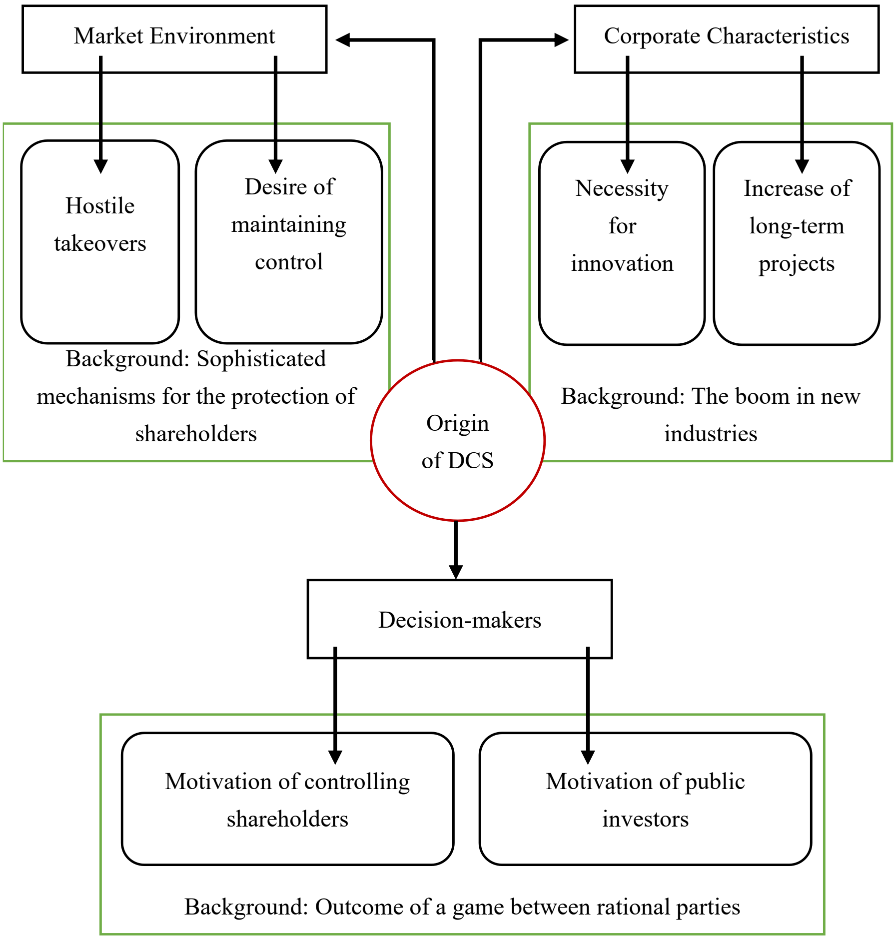

Figure 2. The Path of Tracing Origin of DCS

The Perspective of the Market Environment

DCS emerged due to market factors like increased hostile takeovers and beneficial owners' desire for corporate control. The New York Stock Exchange (NYSE) permitted DCS adoption with constraints in 1985 (Zinger, 2009). Canada and several European countries also eased DCS regulations during the 20th century, aligning with their system development. In the US and Europe, DCS usage is linked to robust investor protection systems, supporting its demand for maintaining control during equity financing for expansion (Amoako-Adu et al., 2011; Khalil et al., 2008; Niu, 2008).

DCS became popular due to the big changes of market environment, which is mainly reflected in the rise of the wave of acquisitions (Basnet et al., 2021). In order to ensure their control of company, founders were willing to sacrifice part of the value of their stocks in exchange for more voting rights, especially in the early stage of a company's establishment (Cao et al., 2020). At the same time, according to stewardship theory, even after the company was running normally, founders usually considered maximizing the company's interests by acting as a steward. So, they desired to have more say in making strategic choices in the BOD (Anderson et al., 2023).

The Perspective of Corporate Characteristics

From the perspective of corporate characteristics, most companies adopting DCS are often innovative ones. On one hand, compared to companies in traditional industries, those in emerging trends faced higher acquisition risks due to their lower fixed asset share, smaller scale, rapid technological changes, and intensified competition (Gompers et al., 2010). On the other hand, innovative activities often engaged in long-term projects requiring substantial R&D investments. Therefore, it has led to a significant increased use of DCS because of the flourishing of new industries and technological innovations. Zhang (2007), utilizing data from US-listed companies between 1990 and 1999, found that media companies and emerging firms were more likely to adopt DCS. Choi et al (2011); Ho (2019); Yan (2021) also provided similar research results in different time frames. Ho (2019) and Yan (2021) examined the similar situation China, where companies primarily from the high-tech industry adopted DCS when listing in the United States.

The Perspective of the Decision-Maker

The decision-making perspective offers valuable insights into the factors influencing the adoption of DCS.The same applies to the choice of equity system, so existing literatures analyze the causes of DCS from two key perspectives: the motivations of controlling shareholders and the considerations of public investors. Controlling shareholders emphasis on control retention stems from a strong desire to maintain decision-making authority over company operations, rather than seeking to maximize private control gains (Arugaslan et al., 2010; Bergström & Rydqvist, 1990; Dittmann & Ulbricht, 2008; Lauterbach & Yafeh, 2011). Early investigations by Bergström and Rydqvist (1990) based on information from listed Swedish corporations indicated this motivation. Subsequent studies, including Arugaslan et al. (2010) using data on US listed companies from 1980 to 2008, reinforced this finding, supporting the notion that control retention is the predominant driving force behind DCS adoption for listing purposes. Public investors' motivations in accepting DCS are not merely passive. Modern stewardship theory proposes that investors opt for non-voting shares to retain the existing management and resist potential replacements by inexperienced shareholders (Alchian & Demsetz, 1972). Furthermore, Howell (2017) pointed out that certain promising enterprises with founding shareholders rejecting equal shareholding during public listing provide an opportunity for investors to purchase stock in these companies and benefit from their potential growth.

The Ramifications of Dual-Class Share Structure

Exacerbation Effect on Agency Problems

Discussions about how DCS exacerbated agency problems began in 1988. Until now, there are still literature showing that this negative effect exists (shown as Table2). The focuses of these studies are mainly reflected in two aspects: intensifying the entrenchment effect and exacerbating the difficulty of accountability. DCS represented the interests of a small group of people (usually the founders). This special structure was somewhere between complete separation and complete centralization (DeAngelo & DeAngelo, 1985). Based on RBV theory, DCS reflected professional allocation of labor because it promised those who were better at management more power to make decisions (Howell, 2017). But at the same time, this unequal power also increased the entrenchment between management and shareholders (Wong & Hu, 2018). And as the degree of separation increased, these priority shareholders had more willingness to pursue private interests, which would hinder the development of the company (Jiang et al., 2020; Q. Zhang, 2019).

Empirical studies consistently gave the same answers, Smart and Zutter (2003) found that DCS worsens agency problems, leading to executives prioritizing private control, shirking responsibilities, and reducing transparency. Masulis et al (2009) confirmed this effect on executive compensation using Heckman's two-stage approach, analyzing data from US listed companies between 1994 and 2002. Furthermore, Gompers et al (2010) highlighted how DCS attracted investors seeking growth opportunities, as promising enterprises can retain control by not going public with equal shareholding. All these studies led to one point that DCS had an exacerbation effect on agency problems.

Table 2
DCS Exacerbates Agency Problems

Title	Author(s)	Time	Country
Dual-class recapitalizations as antitakeover mechanisms: The recent evidence	Jarrell and Poulsen	1988	U.S.
Consolidating corporate control: Dual-class recapitalizations versus leveraged buyouts	Lehn et al.	1990	U.S.
Control as a motivation for underpricing: a comparison of dual and single-class IPOs	Smart and Zutter	2003	U.S.
Dual-Class Shares and Audit Pricing: Evidence from the Canadian Markets	Khalil et al.	2008	Canada
Dual-class equity structure, nonaudit fees and the information content of earnings	Niu	2008	Canada
What's in a vote? The short- and long-run impact of dual-class equity on IPO firm values	Smart et al.	2008	U.S.
Agency Problems at Dual-Class Companies	Masulis et al.	2009	U.S.
Extreme Governance: An Analysis of Dual-Class Firms in the United States	Gompers et al.	2010	U.S.
Executive compensation in firms with concentrated control: The impact of dual class structure and family management	Amoako-Adu et al.	2011	Canada
Dual Class Ownership and Tax Avoidance	McGuire et al.	2014	U.S.
Dual-class shares, external financing needs, and firm performance	Nüesch	2016	Switzerland
Dual-class versus single-class firms: information asymmetry	Lim et al.	2016	U.S.
The survival of the U.S. dual class share structure	Howell	2017	U.S.
Information environment and earnings management of dual class firms around the world	T. Li and Zaiats	2017	19 countries
Research progress on dual-class share structure	Wang and Hu	2018	China
Research on the Dual Shareholding Structure System of the Science and Technology Innovation Board——Based on the Perspective of Investor Protection	Zhang	2019	China
Research on Enterprise Innovation Efficiency——Influence from Equity Pledge	Jiang	2020	China

Mitigation Effect on Agency Problems

The impact of DCS on the agency problem is not only negative, there are also many scholars who are committed to speaking out for DCS (shown as Table3). Carvalhal da Silva and Subrahmanyam (2007) found that abolishing the compulsory tender offer system in Brazil increased the voting premium for DCS and weakened minority shareholder protection. However, strong internal corporate governance, measured by their Corporate Governance Index (CGI), mitigated these issues. Similarly, Hossain (2015) showed that good internal governance mechanisms in firms with DCS improved market response during acquisitions and long-term M&A performance using the G-Index (Gompers et al., 2003) and E-Index (Bebchuk et al., 2009) as measures of corporate governance, addressing agency problems.

Table3
DCS Mitigates Agency Problems

Title	Author(s)	Time	Country
U.S. cross-listings and the private benefits of control: evidence from dual-class firms	Doidge	2004	U.S.
Dual-class premium, corporate governance, and the mandatory bid rule: Evidence from the Brazilian stock market	Carvalhal da Silva and Subrahmanyam	2007	Brazil
Agency Problems at Dual-Class Companies	Masulis et al.	2009	U.S.
Impact of Restricted Voting Share Structure on Firm Value and Performance	Jog et al.	2010	Canada
The impact of dual class structure on earnings management activities	Nguyen and Xu	2010	U.S.
Corporate payout policy in dual-class firms	Bradford D. Jordan and Mark H. Liu	2014	U.S.
Dual-class firms and governance: an acquisition perspective	Hossain	2015	U.S.
The impact of unique corporate governance mechanisms on corporate innovation: global evidence from a dual class share system in Internet companies	Shi and Wong	2017	China
Issuance of Dual class Stocks and the Border of Institutional Innovations on Corporate Control Arrangements	Zheng	2018	China
Dual class Structure, Sunset Provision and Firm Innovation: Evidence from US listed Chinese Firms	Zheng	2021	China
Does the dual class shareholding structure promote corporate innovation? Data from Chinese companies listed in the US	Yang and Gao	2021	China

The effectiveness of the internal governance mechanism is limited after all, which highlights the importance of establishing an external governance mechanism. Studies comparing agency problems in DCS firms across different countries reveal insights into the role of the legal environment and external governance. While DCS in US firms was found to prioritize private control gains over shareholder interests Masulis et al (2009), Canadian listed companies showed no such evidence Jog et al (2010), attributed to differences in shareholding concentration, regulatory systems, and investor protection in the respective corporate governance environments. There are also studies highlighted that enhancements in investor protection, auditing systems, accounting standards, and information disclosure can mitigate agency problems in two-tier equity firms, particularly in the US (Jordan et al., 2014; Nguyen & Xu, 2010). Chinese scholars' interests in DCS since 2017, favoring its adoption, is linked to Chinese Science and Technology Innovation Board (STAR Board) establishment (Yang & Gao, 2021; Zheng, 2018; Zheng et al., 2021).

Implication for Future Research

While our research has shed light on the origins and impacts of DCS on agency problems, there remains a considerable veil of secrecy surrounding DCS, and unraveling the century-long enigma of its existence needs extensive research endeavors. We summarized possible directions for future research. First, according to our review of the existing literature, it can be found that there were no longitudinal studies to track the performance and governance dynamics of DCS companies currently. Future research may extend the time dimension to gain a deeper understanding of the long-term impact of DCS. Secondly, from the perspective of the practice of corporate governance, existing research on DCS still only focused on agency problems. While the practice of corporate governance can be reflected in lots of aspects, such as board independence, executive compensation, BOD diversity, etc., these issues were less involved. Scholars may put more concerns on corporate governance practices within DCS companies in the future. In conclusion, our review about DCS brought possible directions of the supplements for future research.

Conclusion

Our research revealed a diverse range of perspectives on DCS, highlighting the need for further research to address the complexities surrounding DCS. By exploring the historical trajectory and the interplay between market environment, corporate characteristics, and decision-makers, we made an effort to gain insights into the rationale behind the adoption of DCS. Additionally, the examination of agency theory underscored the importance of studying how DCS exacerbates or mitigates agency issues, considering the intricate interactions between internal and external governance mechanisms. As research progresses, the identified avenues for future exploration would contribute to a more comprehensive understanding of DCS's impact on corporate governance.

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