THE DUAL-CLASS SHARE STRUCTURE

Olivia Wang[*]

In September, 2014, Alibaba Group Holding Ltd. (hereinafter Alibaba), China's dominant electronic commerce company, brought about one of the biggest initial public offerings (IPO) in the stock market.[1] Alibaba's IPO revealed that the company adopted a dual-class share structure.[2] This dual-class share structure first aroused the author's concern when the author learned that the reason why Alibaba chose to go public in the United States was that the US stock exchanges allow companies going public adopt a share structure different than the normal "one share one vote" structure. In Part I of this Essay, the author gives a brief description of how the availability of the dual-class share structure in the US stock market became an attraction. Then in Part II the Essay goes on to discuss in more detail that why Alibaba (and some internet companies and high-tech companies, see below for more detail) insists on this structure. The author found that such structure contributes to innovations and seems to enable efficient decision-making process. In Part III, however, the author will show that the dual-class share structure is a double-edged sword. The structure would impede checks on managements, which makes the shareholders in a dual-class share company less protected.

I. DUAL-CLASS SHARE STRUCTURES IS THE REASON WHY ALIBABA CHOSE TO GO PUBLIC IN THE UNITED STATES

Dual-class share structure allow insiders to hold common stock with multiple votes per share, while the public holds common stock with only one vote per share.[3] National Association of Securities Dealers Automatic

---

[*] Managing Editor elect, *Emory Corporate Governance and Accountability Review*; J.D. Candidate, Emory University School of Law (2016). I would like to thank Joseph Tabler for his guidance during the early stages of this perspective, and Drew Case for his assistance during the drafting process that helped me develop this piece to its full potential.

[1] Telis Demos, Rolfe Winkler and Matt Jarzemsky, *Alibaba Targets $155 Billion Value in IPO*, WALL ST. J. (Sept. 5, 2014), http://online.wsj.com/articles/alibaba-to-set-ipo-price-range-at-60-66-a-share-1409946492?KEYWORDS=alibaba.

[2] *See* Alibaba Group Holding Ltd., Registration Statement (Form F-1) (May 6, 2014), http://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&CIK=0001577552&owner=include&count=40.

[3] Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 687 (1986).

Quotation System (NASDAQ) and New York Stock Exchange (NYSE) both allow companies with the dual-class share structure to list on the securities exchanges.[4] Not all stock exchanges allow this kind of deviation from the basic "one share one vote" shareholder structure. For example, Hong Kong Stock Exchange (HKEx) in its listing rules clearly states:

> The share capital of a new applicant must not include shares of which the proposed voting power does not bear a reasonable relationship to the equity interest of such shares when fully paid ("B Shares"). The Exchange will not be prepared to list any new B Shares issued by a listed issuer nor to allow any new B Shares to be issued by a listed issuer (whether or not listing for such shares is to be sought on the Exchange or any other stock exchange) except: (1) in exceptional circumstances agreed with the Exchange. . .[5]

So far, HKEx has denied the use of the "exceptional circumstances" exception by any applicants,[6] including Alibaba.[7] Alibaba has repeatedly confirmed its determination to keep the current shareholder structure.[8] After receiving written confirmation from the NYSE that its dual-class share structure wouldn't be an obstacle for a U.S. listing,[9] Alibaba picked NYSE for its IPO.[10]

II. DUAL-CLASS SHARE STRUCTURES HAS ITS ADVANTAGES

Besides Alibaba, several internet companies, e.g. Google[11], Facebook[12], Groupon[13], LinkedIn[14], etc., went public with a dual-class share structure as

---

[4] *Id.*

[5] Hong Kong Stock Exchange Main Board Listing Rule 8.11.

[6] David Graham, Chief Regulatory Officer and Head of Listing of HKEx, Weighted Voting Rights Concept Paper (Aug. 29, 2014), *available at* http://www.hkex.com.hk/eng/newsconsul/hkexnews/2014/Documents/1408292news.pdf.

[7] *See* Enda Curran, *How Hong Kong Lost the Alibaba IPO*, WALL ST. J. (Mar. 15, 2014), http://online.wsj.com/articles/SB10001424052702303546204579440820673013810?mg=id-wsj ("Alibaba Group Holding Ltd.'s planned listing in New York is a blow to Hong Kong's stock exchange, which failed in an effort to change its rules so as to accommodate what could be one of the world's biggest initial public offerings.").

[8] *Id.*

[9] *Id.*

[10] Leslie Picker and Sam Mamudi, *Alibaba Picks New York Stock Exchange for IPO*, BLOOMBERG (June 26, 2014), http://www.bloomberg.com/news/2014-06-26/alibaba-picks-new-york-stock-exchange-as-venue-for-largest-ipo.html.

[11] *See* Google Inc., Registration Statement (Form S-1) (Apr. 29, 2004), http://www.sec.gov/Archives/edgar/data/1288776/000119312504073639/ds1.htm.

[12] *See* Facebook, Inc., Registration Statement (Form S-1) (Feb. 1, 2012), http://www.sec.gov/Archives/edgar/data/1326801/000119312512034517/d287954ds1.htm.

well. Dual-class share structure is popular for a reason, and this Part II describes in both general and specific ways as to how this structure benefits internet or high-tech companies.

For management in general, the benefit of dual-class share structure is obvious. With the superior voting rights in hand, although an IPO will reduce the management's proportion of stock ownership, management has no concern with their control over the company being diluted.[15] Non-controlling shareholders, in turn, are protected from conducting coercive takeover and from making mistakes with regard to the daily operation or management of the company.[16] The latter argument is supported by the so-called "short-termism" concerns.[17] Short-termism refers to companies taking actions that are profitable in the short term but do no good to the companies in the long term.[18] A typical example of short-termism is that a company, under the pressure of activist investors, seeks to increase short-term earnings by cutting research that would be beneficial in the long run.[19] Such long-term costs of short-termism are mainly produced by both shareholder interventions and management's fears of such interventions.[20] Therefore, shield boards from activist shareholders are desirable among managements, which hope to better serve the long-term interests of companies and their shareholders.[21] Dual-class share structure is one way to meet this goal of board insulation.

For internet or technology companies, dual-class share structure is highly valued because such structure contributes to innovations that would hardly generate short-term benefits, but would probably bring better future lives. In a letter to its shareholders, founders of Google stated: "outside pressures . . . often tempt companies to sacrifice long-term opportunities to meet quarterly

---

13 *See* Groupon, Inc., Registration Statement (Form S-1) (June 2, 2011), http://www.sec.gov/Archives/edgar/data/1490281/000104746911005613/a2203913zs-1.htm.

14 *See* LinkedIn Corporation, Registration Statement (Form S-1) (Nov. 3, 2011), http://www.sec.gov/Archives/edgar/data/1490281/000104746911005613/a2203913zs-1.htm.

15 Ronald J. Gilson, Evaluating Dual Class Common Stock: The Relevance of Substitutes, 73 Va. L. Rev. 807, 812 (1987).

16 *Id.* at 811.

17 Lucian A. Bebchuk, *The Myth That Insulating Boards Serves Long-Term Value*, 113 Colum. L. Rev. 1637, 1638 (2013).

18 *Id.* at 1638-39.

19 *Id.* at 1639.

20 *Id.*

21 *Id.*

market expectations."[22] With regard to Google's insist on dual-class share structure, the letter explained that Google "designed a corporate structure that is will to protect Google's ability to innovate."[23] Indeed, Google glass and Google driverless car are good examples of innovations without short-term benefits but with a view to future life. Such freedom in developing high technology attributes to some extent to Google's shareholder structure. In contrast, Apple Inc. does not have a dual-class share structure, and it is likely that shareholder actions might bring Apple to a dilemma. A recent noteworthy case is that hedge fund manager David Einhorn urged Apple to start distributing to shareholders some of the large cash holdings it had accumulated.[24]

As an electronic commerce giant with multiple services available, Alibaba is seeking both the expansion on its current services to other countries besides China, but also innovations that better serve the goal of development and cooperation in the future. For example, Alibaba opened an institution named "AliResearch" in April, 2007.[25] This institution aims at building up a business knowledge sharing platform that provides business data analysis, and successful cases of mom-and pop shops or other types of small businesses.[26] One significant business data AliResearch provides is called "internet Shopping Price Index (iSPI)", a product of AliResearch's cooperation with scholars and the National Bureau of Statistics of the People's Republic of China, which function is to indicate the general price level of goods or services trade in two of Alibaba's flagship online retail platforms, Taobao and Tmall.com.[27] In addition, AliResearch also put efforts into building up a digital library that covers data information from areas of trade, finance, map, life services, etc.[28] Right now the library has 58 billion books collection, amount to 100PB data information.[29] These data enable online merchants to obtain the the big picture of their industry, the market profile of their brands, and consumer

[22] *See* Larry Page & Sergey Brin, *Letter from the Founders*, WALL ST. J. (Apr. 29, 2004), http://online.wsj.com/articles/SB108326432110097510.

[23] *Id.*

[24] See *Einhorn's Letter: Dear Fellow Apple Shareholder*, WALL ST. J. (Feb. 7, 2013), http://blogs.wsj.com/deals/2013/02/07/einhorns-letter-dear-fellow-apple-shareholder/.

[25] AliResearch, *About Us* (阿里研究院 关于我们), http://www.aliresearch.com/about/ (last visited Nov. 8, 2014).

[26] *Id.*

[27] *Id.*

[28] Tao Yajie, *Alibaba Steps into Big Data* (陶娅洁, 十年磨一剑阿里巴巴深耕大数据), SINA FINANCE (May 22, 2014) http://finance.sina.com.cn/roll/20140522/012319184737.shtml.

[29] *Id.*

behaviors relating to their online shopping.[30] Building up a Big Data platform is both time-consuming and costly, however, once successful, it will bring major impact to the electronic commerce industry. Public investors are likely to disfavor a long-term project like AliResearch merely because its lack of short-term benefits. It is fair to conclude that Alibaba's dual-class share structure makes the Big Data dream possible to come true.

III. DANGERS IN DUAL-CLASS STRUCTURE

Although dual-class share structure has its advantages, it seems to be disfavored by investors. In recent years Council of Institutional Investors (CII) expressed to NYSE and NASDAQ several times its request of going back to the principle of one share, one vote.[31] In one of the letters CII specifically expressed that it was disappointed that NYSE allowed the listing of Alibaba after Alibaba was reportedly denied listing by HKEx.[32] In the view of long-term investors, some of the worthy goals, such as "enhancing the accountability of the listed companies", and "allowing shareholders to more easily and efficiently monitor performance of directors", are undermined by the listing of Alibaba with a dual-class share structure.[33] In addition, some scholars also challenged the view that shareholder intervention with short-term orientation leads management to initiate and take actions that are profitable in the short term but detrimental in the long term. [34] In examining investor's concerns with dual-class share structure, this Part proceeds in three stages. First, section A discusses what dangers the dual-class share structure may bring to the public investors. Second, section B examines the "short-termism" concerns and the challenges against such claim.

A. Dual-class Share Structure Eliminates Market Checks on Managerial Misconduct

Companies like Alibaba with their dual-class share structure are more likely to have concentration of power, which easily defeats checks on managerial misconduct. Pursuant to Alibaba's articles of association, Alibaba

30 *Id.*
31 *See, e.g.*, Letter from CII to NYSE on One Share, One Vote, (Mar. 27, 2014), *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2014/03_27_14_CII_letter_to_NYSE_one_share_one_vote.pdf.
32 *Id.*
33 *Id.*
34 *See* Bebchuk, *supra* note 17, at 1658.

Partnership is the management, which currently comprises of 28 members—22 members of the management and six members of the management of the related companies and affiliates.[35] Alibaba Partnership has the exclusive right to nominate a simple majority of the board of directors of the company. In its registration statement Alibaba also stated that they expected to enter into a voting agreement pursuant to which both SoftBank (now owns 34.1% shares of Alibaba) and Yahoo (now owns 22.4% shares of Alibaba) will agree to vote their shares in favor of the Alibaba Partnership director nominees at each annual general shareholders meeting.[36] This meant that, while Alibaba's founder Jack Ma and the co-founder and vice chairman Joe Tsai collectively held 13.4% of total shares outstanding, they are able to hold the majority of shareholder's total voting power.[37]

In a public traded corporation in which each share has equal voting power, the corporate governance works in a way that shareholders elect the board of directors, which in turn perform the function of monitoring possible mismanagement or self-dealing by those in control of the corporation, and selects the officers who run the corporation.[38] In contrast, in a company like Alibaba, dual-class share structure defeats the oversight function of the board, because the directors are impeded from exercising the fiduciary duties, fearing that they can be fired by a single person.[39]

There is a precedent that could further corroborate the concern raised in this section. In 2011, Yahoo, one of the majority shareholder of Alibaba at that time, claimed that it was blindsided when Alibaba transferred ownership of Alipay, which is often treated as the Chinese counterpart of Paypal, to a new company owned by Alibaba CEO and founder, Jack Ma.[40] Softbank, a Japan-based company that also owns a major share of Alibaba, declared the same thing.[41] On the other side, Mr. Ma said that the transfer was legal—due to the operation of the dual-class structure.[42] No doubt that Yahoo and Softbank

---

35 Alibaba Registration Statement at *14*.

36 *Id.*at *46*

37 *See id* at 46.

38 Tian Wen, *You Can't Sell Your Firm and Own It Too: Disallowing Dual-class Stock Companies from Listing on the Securities Exchanges*, 162 U. PA. L. REV. 1495, 1498 (2014) (citing ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 4 (1933), at 86-87).

39 *Id.*

40 Amir Efrati, *Yahoo, Alibaba Reach Alipay Agreement*, WALL ST. J., June 1, 2011, http://online.wsj.com/news/articles/SB10001424052702303745304576358002657500050.

41 *Id.*

42 *Id.*

were annoyed, but later the two majority shareholders reached an agreement with Alibaba to resolve their dispute over the ownership transfer of Alipay.[43] According to the agreement, Alipay stayed with Mr. Ma's company, while Mr. Ma promised not to use Alipay to siphon off revenue of Taobao, a Chinese counterpart of Ebay or Amazon.[44] As two of the biggest shareholders of Alibaba, Yahoo and Softbank had limited options in the face of the insider control. One could imagine the difficulties for most minority shareholders to protect themselves if this kind of blindsighting ever occurs again.

In addition to the lack of traditional oversight by the board, the NYSE rules "help" Alibaba Partnership to exercise their power even more freely by saying that companies with dual-class share structure that fall under the definition of a "controlled company" are not required to have independent directors on the board.[45] At least in theory, independent directors ensure that corporate officers do not abuse their authority or shirk their responsibilities.[46] Therefore, for those dual-class companies that are qualified as controlled companies, shareholders lack another safeguard against managements' self-dealing or misconduct.

It is worth attention that if a company with dual-class share structure results in insufficient board accountability, shareholders are not the only ones that suffer.[47] Once the traditional monitoring function of boards does not work, it will be transferred to third parties, such as the courts and the government, and the public will be forced to bear the costs.[48]

B. Dual-class Share Structure Is No Guarantee to Long-term Benefits

The argument that dual-class share structure saves a company from meeting the needs of short-sighted individuals and would benefit the company in the long run needs a second thought. As mentioned in Part II, short-termism concerns are regularly invoked to explain corporate failures and crises.[49] The

---

43 *Id.*

44 *Id.*

45 *See* NYSE Listed Company Manual, § 303A.00 (2014), available at http://nysemanual.nyse.com/LCM/, ("A listed company of which more than 50% of the voting power for the election of directors is held by an individual, a group or another company is not required to comply with the requirements of Sections 303A.01, 303A.04 or 303A.05." Sections 303A.01, 303A.04 or 303A.05 are provisions that require listed companies to have certain amount of independent directors on the board.).

46 Wen, *supra* note 38, at 1500.

47 *Id.* at1499.

48 *Id.*

49 Bebchuk, *supra* note 17, at 1646-47.

popularity of this claim makes a good defense for the arrangements of board insulation such as a dual-class share structure.[50] However, evidence supports the view that, instead of bringing out value-reducing actions in the long-term, shareholder's intervening with companies provides long-term benefits to companies, shareholders, and the economy.[51]

One source of evidence is an empirical study by Alon Brav, Wei Jiang, and Lucian Bebchuk on the long-term effects of hedge fund activism.[52] This study indicates that activist shareholders target companies whose operating performance lags behind peers, and these interventions are followed by consistent and long-term improvements in operating performance.[53] The conclusion to this study is that, taking a long-term perspective, the market does not fail to appreciate the long-term consequences of activism as insulation advocates fear it does.[54] Rather, the stock appreciation accompanying activists' initial announcement reflects the market's correct anticipation of the intervention's effect, and the initial positive stock reactions is not reversed in the long term.

Some other studies indicate that board insulation eliminates or substantially weakens insiders' incentives to better serve shareholders.[55] One study by Ronald Masulis, Cong Wang, and Fei Xie demonstrates that firms with classified boards are more likely to be associated with undesirable acquisition decisions—that is, acquisition announcements that the market determines is value-reducing.[56]

In addition, there is evidence that dual-class share structure enables managers to increase their own benefits.[57] A study by Kenneth Borokhovich, Kelly Brunarski, and Robert Parino found that managers of companies with stronger antitakeover defenses enjoy higher compensation levels.[58]

---

[50] *Id.*
[51] *Id.* at 1644.
[52] *Id.*
[53] *Id.*
[54] *Id.*
[55] *Id.* at 1679.
[56] Ronald W. Masulis, Cong Wang & Fei Xie, *Corporate Governance and Acquirer Returns*, 62 J. FIN. 1851, 1883 (2007).
[57] Bebchuk, *supra* note 17, at 1680.
[58] Kenneth A. Borokhovich, Kelly R. Brunarski & Robert Parrino, *CEO Contracting and Antitakeover Amendments*, 52 J. FIN. 1495 (1997).

In sum, the above mentioned studies clearly show that dual-class share structure has adverse effect on building a diligent and efficient board. On one hand, directors lack the incentive to better serve shareholders and the companies. On the other, the relative insulated structure prevent or delay the replacement of leaders once the leaders prove to be ill-suited for their positions.[59] Because it is important for a company to be led by individuals who are well suited for their roles, the relative insulation of the board in a dual-class company represents significant costs in the long run.[60]

One example is Reader's Digest Association, which had a dual-class share structure and was controlled by two nonprofit philanthropic foundations created by its founders.[61] The goals of the controlling persons, driven by a need to fund their own projects, were not aligned with those of the shareholders—while investors generally want the board to determine what is in the best interest of all shareholders in order to create long-term value, the board ended up issuing dividends in excess of cash flows.[62]

By examining the abovementioned studies and cases, this Part defeats the short-termism concerns as a justification of dual-class share structure. Once we see the potential risk for a dual-class company in the long run, dual-class share structure seems unnecessary.

CONCLUSION

Alibaba's IPO brought attention to its dual-class share structure. Dual-class share structure enables companies, especially those that are high-tech or internet-driven, to bring innovations to the table. However, no matter what benefits dual-class share structure may bring, this structure has the nature of board insulation, which in turn impedes checks on management. Although the right to bring a class action lawsuit against insiders is available to the shareholders in a company with dual-class share structure. Whether this mechanism provides shareholders with sufficient protection remains to be seen. What's more, the justification for the dual-class share structure—that short-term results pressures directors to focus excessively on these short-term results—is contested by several empirical studies that show that the dual-class

---

59 Bebchuk, *supra* note 17, at 1680.

60 *Id.* at 1681.

61 Wen, *supra* note 38, at 1499 (summarizing the comments of Michael S. Geltziler, Executive Vice President and CFO of NYSE).

62 *Id.*

share structure is no guarantee to long-term benefits. Given that any kinds of extra monitoring mechanism are unavailable currently under the legal system, NYSE and other stock exchange market need to seriously consider the appropriateness of keeping the soft rule of allowing dual-class share structure.