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The Influence of Dual-Class Share Structure on Enterprises

--Take UCloud as an example

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Abstract: In recent years, many outstanding technology companies in China have chosen to list overseas with dual-class share structure. The reason is that the dual class shares can prevent the founder's control from being diluted during financing. This article analyzes the first dual-class company on the Science and Technology Innovation Board in China, UCloud, to explore the impact of dual class shares on corporate governance, and proposes corresponding recommendations: prevent abuse of special voting rights and strengthen the protection of the interests of small and medium shareholders.

1. Introduction

According to China's “Company Law”, the company implements the rule of “same share and same rights, one share and one vote”. Innovative companies have repeatedly raised funds in the process of growth, resulting in the dilution of the founder’s equity and weakening of control. In order to maintain the founder’s control, the dual-class share structure has emerged. It has been 120 years since the dual-class share structure appeared. Whether it was Ford in the early days or Facebook today, these companies are representatives of industrial innovation in their era. Some domestic Internet companies have adopted a dual-class share structure to list overseas. At present, the Science and Technology Innovation Board, Growth Enterprise Market and the Beijing Stock Exchange also allow companies with dual-class share structure to be listed. On the other hand, the dispute over the control of companies such as Vanke and Jinke has caused an uproar in the market. How to accurately grasp the theoretical connotation of dual-class shares, play its positive role, and prevent its negative impact, has become a practical and theoretical problem that needs to be resolved urgently. This article takes UCloud Technology Co., Ltd. (hereinafter referred to as “UCloud “) as an example to analyze the dual-class share structure from the perspective of corporate governance and make corresponding recommendations.

The remainder of the paper is organized as follows. It discusses the related literature and theoretical basis in Section 2. Case overview and analysis are reported in Section 3 and Section 4. Section 5 reports corresponding suggestions. Section 6 concludes the paper.

2. Related Literature and Theoretical Basis

2.1 Related Literature

Regarding the impact of dual class shares on corporate governance, there is a view that dual class shares would have an adverse impact, such as Masulis et al. (2009), their research shows that agency conflicts increase in dual-class firms and managers abuses voting rights. Easterbook & Fischel (2014) believes that the founders may be more motivated to take the form of insider trading, related party transactions, or occupying company assets to empty the company under the same-share structure with different rights. Another view is that the dual-class share structure is beneficial to the development of the company. For example, Chemmanur and Jiao (2012) argues that in dual-class firms, the founders pay more attention to the long-term development of the company. The dualclass share structure allows founders to create value for the firm by investing in risky, long-term projects. Jordan et al. (2016) find that the dual-class firms have a lower probability of being taken over, and lower the short-term market pressure; the dual-class firms tend to invest more in research and development, and have higher sales growth than single-class firms.

Regarding the impact of dual-class share structure on corporate performance, scholars have three different perspectives. Nuesch (2016) shows that dual-class shares does not affect corporate performance. LI & Zaiats (2017) argue that in dual-class firms, the external supervision of the company is weakened, and founders use the higher voting rights to encroach on the interests of other shareholders, and therefore the performance of the company declines. Jordan et al. (2016) believe that dual-class share structure can incentivize managers to pay more attention to the long-term development of the company, thereby improving corporate performance. Abdullah et al. (2018) argue that the dual-class firms in the Chinese concept stocks performed better than the single-share firms in the market.

Domestic scholars mainly conduct research on dual-class share structure from the legal level and corporate governance. Zheng Zhigang (2019) suggests that although different rights in the same stock are not conducive to the protection of investors' interests, the paradigm of corporate governance has a tendency to change from a shareholder center to an founder center, and that preparations should be made to adapt to this trend. Chi Zhaomei (2020) used the Xiaomi Group as an example to analyze the impact of dual-class shares, and believes that although dual-class share structure has some negative effects, for innovative firms, it can meet the financing needs while at the same time, allowing the founder to maintain control is conducive to the stability and long-term development of the firm.

In summary, scholars have different views on the dual-class share structure. This also shows that the application of dual-class share structure is actually a double-edged sword. On the one hand, it can prevent the founder team from losing control due to financing and conform to the needs of the development of the times. On the other hand, the dual-class share structure harms the interests of ordinary shareholders, leading to increased agency costs. Generally speaking, there are different views on dual-class shares, and the Chinese firms with dual-class shares are seldom studied in the literature.This article uses UCloud as an example to discuss the positive and potential negative effects of dual-class share structure, and finally put forward corresponding recommendations.

2.2 Theoretical Basis

In a dual-class firm, the same shares have different rights. The firm issues two types of shares, one is ordinary shares, one share and one vote, and the other is the shares with special voting rights held by the founders, and the voting rights are several times that of ordinary shares.

2.2.1 Corporate Governance Theory

The principle of the same share with the same rights is a legal system based on the assumption of the homogeneity of shareholders, but the assumption of the homogeneity of shareholders ignores the difference in shareholder preferences. Outside shareholders and speculative shareholders have different focus on the company's development, and their contributions to the company are also different. Therefore, the different rights of the same shares reflect the assumption of shareholder heterogeneity.

2.2.2 Principal-Agent Theory

According to the principal-agent theory, due to the separation of enterprise ownership and management rights, operators use information advantages to do things that are detrimental to the interests of shareholders. The agency problem between shareholders and managers is the first type of agency conflicts. The second type of agency conflicts is the contradiction between controlling shareholders (agents) and small and medium shareholders (principals) caused by the separation of control rights and income rights. Controlling shareholders use their own advantages to harm the interests of small and medium shareholders. Under the dual-class share structure, the founder team is both a shareholder and an operator, and the shareholding ratio is not low. Therefore, relatively speaking, the first type of agency conflicts is not serious, and due to the separation of voting rights and cash flow rights, there is a lack of effective supervision. Under the circumstances, the agency conflicts between controlling shareholders and minority shareholders may become more serious.

2.2.3 M&a Theory

Mergers and acquisitions are an important external governance mechanism for companies, which can regulate managers' behavior through the threat of mergers and acquisitions. On the other hand, it may lead to short-sighted behaviors of managers. The dual-class share structure reduces the possibility of a company's hostile takeover, and helps to improve the short-sighted behavior of operators, so that they can devote more energy to the company's operations to enhance the company's intrinsic value. This may also cause the founder to infringe on the interests of other shareholders and increase agency costs.

3. Case Overview

3.1 Company Profile

UCloud was founded on March 16, 2012 by its founders Ji Xinhua, Mo Xianfeng and Hua Kun. It was listed on the Science and Technology Innovation Board on January 20, 2020. The company is a neutral third-party cloud computing service provider. It independently develops and provides basic resources such as computing, network, storage and basic IT architecture products, as well as big data, artificial intelligence and other products. It provides services to users through three modes: public cloud, private cloud, and hybrid cloud.

3.2 Listing Background

In 2013, the company established a red-chip structure for the implementation of the overseas listing plan. In 2016, in order to list on the domestic A-shares, it terminated the control agreement and equity pledge agreement under the red-chip structure. In November 2018, the overseas entity was cancelled. In March 2019, the company revised its articles of association and set up special voting rights. The number of shares before listing was 3,640,32,164, of which, A shares were 97688245 and class B shares were 266343919. It was approved by the China Securities Regulatory Commission on December 20, 2019. On January 8, 2020, The company was able to issue 58.59 million shares at a price of 33.23 yuan per share, and the number of publicly issued shares accounted for 13.85% of the total share capital after the issuance. Before the issuance, Ji Xinhua, Mo Xianfeng and Hua Kun directly held 26.84% of the company's shares, and held 64.71% of the company's voting rights by setting up special voting rights. After the issuance, the three founders collectively held 23.12% of the company's shares and 60.06. % voting rights.

3.3 Arrangement of Dual Class Shares

According to the company's articles of association, the company's shares held by the three founders are A-shares, and the company's shares held by other shareholders of the company are B -shares. When voting at the general meeting of shareholders on general matters, there are five votes for one share for A-shares and one vote for one share for B-shares. When the following 5 special resolutions are made at the general meeting of shareholders, A-shares will follow the one-share, one-vote principle. (1) Amend the articles of association of the company; (2) Change the number of voting rights enjoyed by A-shares; (3) Hire or dismiss independent directors of the company; (4) Hire or dismiss an accounting firm that issues audit opinions for the company's periodic reports; (5) Company merger, division, dissolution or change of company form. Unless the special voting rights arrangement is terminated by a resolution of the company's general meeting of shareholders, the company's special voting rights arrangement will continue to operate for a long time.

4. Case Analysis

4.1 The Positive Effects of Dual-Class Share Structure

4.1.1 Satisfy Financing Needs and Maintain Control

Before the change and establishment of UCloud in 2018, it has experienced 8 rounds of financing. From Table 1, it can be seen that the company's financing amount continues to increase and the founder's equity is diluted. Through the dual shareholding structure, after the issuance of shares, the three founders' shareholding in the company dropped to 23.12%, but the voting rights were still as high as 60.06%. In addition, The company implements employee shareholding plans through the employee shareholding platforms Tibet Yunxian, Tibet Yunhua, Tibet Yunneng, Duilong Yunju, Duilong Yunyou, and Jiaxing Yunfu and Jiaxing Yunxin, the limited partners of Tibet Yunxian.This laid the foundation for the company's future stable development.

Table 1 UCloud's Financing History

NO.	Registered capital/total share capital before the change (ten thousand yuan)	Issuer's registered capital/share capital changes	Registered capital/total share capital after the change (ten thousand yuan)
1	4,920.1300	The 4th capital increase in March 2016	6,890.0393
2	6,890.0393	The 5th capital increase in June 2016	14,384.6033
3	14,384.6033	The 6th capital increase in March 2017	16,212.6466
4	16,212.6466	The 7th capital increase in June 2017	17,261.5260
5	17,763.8822	The 8th capital increase in May 2018	17,763.8822
6	17,763.8822	Overall changes in September 2018	36,000.0000
7	36,000.0000	The ninth capital increase in October 2018	36,086.6667

8	36,086.6667	The tenth capital increase in November 2018	36,403.2164

Data source: UCloud's prospectus

Table 2 the Structure Of Ab Shares after the Issuance of Ucloud

Type of stock	Shareholder	% of Shares	% of Voting rights
A shares (One share and five votes)	Ji Xinhua	12.03	31.25
	Mo Xianfeng	5.54	14.40
	Hua Kun	5.54	14.40
B shares (One share, one vote)	Other investors	76.89	39.95

Data source: UCloud's prospectus

4.1.2 Motivate Founders and Reduce Short-Sighted Behaviors

Long-term investments often have higher risks. Due to short-term market pressure, company management may give up some long-term strategic investments in order to meet the expectations of market investors. The dual-class share structure can reduce the short-term market pressure on managers and pay more attention to the company's long-term development. The company's founder, Ji Xinhua, worked at Huawei, Tencent and Shanda Networks, and Mo Xianfeng worked as a senior engineer at Neusoft Group, Huawei and Tencent. The three founders made a commitment to shareholding and reducing their shareholding at the time of the company's IPO, continued to be optimistic about the company's business prospects, fully supported the company's development, and planned to hold the company's stock for a long time; within 24 months from the expiration of the lock-up period, if Attempts to reduce the shareholding price will not be lower than the issue price. The three have a certain prestige in the company and are relatively stable. The dual-class shares allow the founder to concentrate on management, thereby enhancing the value of the company.

4.1.3 Prevent Hostile Acquisitions and Promote Long-Term Development

There will be "barbarians" in the capital market who will take over maliciously. They do not consider the long-term development of the company, but only conduct capital operations to achieve short-term gains. The dual-class share structure allows these hostile bidders to dispel this idea. The high voting power conferred by the special voting rights greatly reduces the risk of the company being maliciously acquired in the future. Since high-voting shares cannot be traded in the secondary market, once they are transferred, the high-voting shares will also be converted into ordinary shares, and there will be no control disputes for subsequent refinancing. In May 2018, the three founders of UCloud signed the "Agreement on People Acting in Concert", and the three of them are the actual controllers of the company. After the listing, the voting rights of them still account for more than 60%, and the risk of malicious takeover in the future is small.

4.2 Negative Effects of Dual-Class Share Structure

4.2.1 Restricted Rights of Ordinary Shareholders

Under the dual-class share structure, shareholders with special voting rights have a decisive role in voting resolutions at the general meeting of shareholders, while limiting the influence of other shareholders in voting, especially the voting of minority shareholders cannot have a substantial impact on the voting results of the general meeting. As a result, shareholders who may have special voting rights use their voting advantages to make decisions that are detrimental to the interests of other investors.

4.2.2 Failure of Internal and External Supervision

In single-class firms, small and medium shareholders can often reserve a seat on the board of directors. In this way, at least allowing small and medium shareholders to participate in the decision-making process of the board of directors as a minority of directors. This is an important opportunity for small and medium shareholders to obtain information, understand the firm's core operating status, and express their opinions and claim their rights and interests. In dual-class firms, the board members may be candidates recognized by the founder team, and generally do not question or challenge the founder's decision-making, and ordinary shareholders cannot participate in it to influence his decision-making, leading to weakening of the internal supervision function. If managers do not do well, acquirers will appear in the market and managers will be replaced. Therefore, acquisition is a way to reduce agency costs. Under the dual-class share structure, the possibility of malicious mergers and acquisitions in the future is lower, and the threat of being replaced is less, which leads to the weakening of external supervision.

4.2.3 Increase Agency Costs

According to the principal-agent theory, the separation of enterprise ownership and management rights forms an agency conflicts between ownership shareholders and managers. In addition, agency problems will also arise between corporate controlling shareholders and small and medium shareholders, and between shareholders and creditors because of information asymmetry. In dual-class firms, because the founder is both a shareholder and often a manager, the first type of agency conflict is not aggravated compared to that of the single-class firms. However, because the founder’s voting rights as a shareholder are much higher than his shareholding ratio, there may be a problem of abuse of special voting rights, which damages the interests of small and medium shareholders and leads to increased agency costs.

5. Suggestions

In view of the negative effects of the dual class shares, this article proposes the following two suggestions:

5.1 Prevent Abuse of Special Voting Rights

In order to prevent the abuse of special voting rights, the use of special voting rights should be strictly restricted. Special voting rights are not applicable to major matters related to the basic rights of investors. In addition, the supervisory role of independent directors should be strengthened. When the general meeting of shareholders considers the appointment or dismissal of independent directors, the number of voting rights for each special voting right shall follow the one-share, one-vote principle.

The lock-up period of UCloud’s A-share holders is 36 months. Upon expiration, it may withdraw from the “Concert Persons Agreement”, and disputes between common controlling shareholders may arise. After the expiration, there is a risk of reducing shares,which affects the stability of the company's stock price and controlling rights. Therefore, there should be stricter restrictions on the reduction of special voting shares.

Under the dual-class share structure, the founders are given special voting rights. During the growth period of the company, the founders can be motivated to form a stable management team. However, with the continuous development of the company, whether the special voting rights need to be transferred or terminated, so a clear sunset clause is required . The sunset clause can have a fixed period. Once the period is met, the special voting shares are automatically converted into ordinary shares, or they can be automatically converted when certain conditions are triggered. The condition can be that special circumstances such as resignation, major illness, death, etc. occur to shareholders holding special voting rights. In this way, there are certain restrictions on the special voting rights and prevent shareholders holding special voting rights from obtaining permanent control of the company.

5.2 Strengthen the Protection of the Interests of Small and Medium Shareholders

For small and medium investors, participating in investment dividends is their basic rights and interests. The company should attach importance to the shareholders' right to dividends and fully consider the dividend demands of small and medium shareholders. In addition, the following two points should be improved.

5.2.1 Improve the Information Disclosure of Dual-Class Shares Listed Companies

For shareholders with special voting rights, listed companies are required to disclose the amount of their remuneration, the specific composition, and the long-term relationship between remuneration and performance. Strict information disclosure requirements should also be made for related-party transactions between the founder team and the company, such as the amount of specific related-party transactions and the impact caused by them. Supervision and penalties should be strengthened for founders who abuse special voting rights for personal gain and harm the interests of the company and other shareholders. During the reporting period, the implementation and changes of special voting rights arrangements, as well as the implementation of relevant measures to protect the legitimate rights and interests of investors, will be disclosed. Regulatory agencies must continue to supervise listed companies with dual-class shares.

5.2.2 Improve the Securities Representative Litigation Mechanism

In order to reduce the probability of the founders harming the interests of other shareholders under the dual-class share structure, the United States generally adopts a class action system. Drawing lessons from US securities supervision, on the one hand, there are strict punitive measures. Once it involves financial fraud or insider trading that infringes on the interests of other shareholders, severe penalties will be imposed. On the other hand, the class action mechanism helps small and medium investors seek legal protection. The second type of agency conflicts in dual-class firms is more serious, and supervision should be strengthened and penalties for violations should be increased. Further improve the securities representative litigation mechanism to truly protect the rights and interests of minority investors.

6. Conclusion

The debate on whether dual-class shares should be prohibited or not, should be subjected to mandatory sunset provisions, has been heating up over the last few years.This article uses UCloud as an example to analyze and find that the impact of dual class shares is like a double-edged sword. On the one hand, it can protect the founders' control from financing and thereby inspire the founder, allow them to invest more risky and long-term projects. At the same time, it gives the founders special voting rights, which reduces the risk of being taken over in the future and eases the founders' short-term market pressure. On the other hand, it has the following negative effects, such as the possibility of abuse of special voting rights to infringe the interests of other shareholders. The voting rights of ordinary shareholders are limited and cannot be restricted by voting, and the external market cannot be obtained through acquisition to restrict shareholders with special voting rights, resulting in the failure of external supervision. Therefore, this article proposes the following suggestions: limit the scope of the use of special voting rights, strengthen the supervisory role of independent directors, prevent the abuse of special voting rights, and use the sunset clause to avoid permanent control rights; meanwhile, strengthen the protection of the interests of small and medium investors, and further improve the information disclosure mechanism and securities representative litigation mechanism, so as to promote the healthy development of technological innovation firms.

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