ONE-SHARE, ONE-VOTE RULE
AND
FUTURE OF DUAL CLASS SHARES
STRUCTURE IN CHINA

LLM Paper
by Hao Chen
Student number : 01403421

Promoter : Professor Hans De Wulf
# TABLE OF CONTENT

INTRODUCTION ........................................................................................................................................... 1

PART I CHINESE LAWS AND RULES ........................................................................................................ 3
A. Brief History of Chinese Corporate Legislation and General One-Share, One-Vote Principle ........................................................................................................................................... 3
B. Dual Class Shares - Preferred Shares .................................................................................................. 5

PART II COMPARATIVE LAW .................................................................................................................... 10
A. US: The Rise and Fall of One-Share, One-Vote Rule ........................................................................ 10
B. EU: Renewed Interest in One-Share, One-Vote Rule ....................................................................... 13

PART III THEORETICAL UNDERPINNING OF ONE-SHARE-ONE-VOTE RULE ...... 15
A. Why Equal Voting: Learn from One-person, One-vote .................................................................. 15
B. Efficiency in Corporate Voting: Economics of Law .......................................................................... 18
C. Why Shareholders Vote and Why Only Shareholders Vote: Nexus of Contract and Residual Claims ........................................................................................................................................... 22
1. Why do shareholders vote? ............................................................................................................... 22
2. Why Shareholders Alone Have Voting Power? .............................................................................. 24

PART IV DEBATE OVER ONE-SHARE, ONE-VOTE ........................................................................... 27
A. What is So Good About One-Share, One-Vote? ............................................................................... 27
B. Should We Lean Away From One-Share, One-Vote Rule? .............................................................. 31
1. Efficiency .......................................................................................................................................... 31
2. Market for control ............................................................................................................................. 33
C. No Absolute One-Share, One-Vote .................................................................................................... 35

PART V ENLIGHTENING THE FUTURE OF CHINA'S DUAL CLASS VOTING STRUCTURE ........................................................................................................................................... 37
A. Ownership of Chinese Listed Companies .......................................................................................... 38
1. Ownership Structure of Listed companies in China ....................................................................... 38
2. High Concentration of Shareholding ............................................................................................... 39
3. Monitoring and Supervision ............................................................................................................ 40
B. Performance of Chinese Listed Companies ....................................................................................... 41
C. Status Quo of China Concept Stock in NASDAQ ........................................................................ 43
D. Dual Class Shares Structure ............................................................................................................ 45
E. Legal Protection of Minorities ........................................................................................................... 48

PART VI CONCLUSION ............................................................................................................................. 53

REFERENCES ............................................................................................................................................. 55
ONE-SHARE, ONE-VOTE RULE AND
FUTURE OF DUAL CLASS SHARES STRUCTURE IN CHINA

Hao Chen

INTRODUCTION

China went through a tough period to rebuild its corporate legal system in the 1980s. Starting from the first Chinese Company Law, China has made one-share, one-vote as a mandatory rule in corporate governance, subject to modification by the State Council. For decades, Chinese companies are not allowed to issue shares with different voting or equity rights. However, in 2013, the State Council announced a Pilot Program of Preferred Shares, and authorized the China Securities Regulatory Commission to be in charge of implementing such program.

The Preferred Shares Program has renewed the interest of Chinese academy on the rule of equal voting rights, and there is also heated debates and expectation on the possibility of dual class shares with voting power, for example multiple voting shares, in the future. Meanwhile, many local governments in China are undergoing serious debt problems, which stimulate their willingness to push the second round of privatization of state-owned enterprises\(^1\). However, some economists concerned that privatization may not be the optimal solution\(^2\) because it may be harmful to the community\(^3\), and other argue that it is better to pursue a mixed ownership while allow a separation of ownership and control\(^4\).

---


\(^3\) Wang Yahong, Privatization is Not Everything, International Herald Leader, December 27, 2013. Privatization in England cause many companies in social welfare industries, such as gas heating, to chase after profits by raising their price, which has brought a lot of harm to its consumers. [http://news.ifeng.com/shendu/gjxqdb/detail_2013_12/27/32526005_0.shtml](http://news.ifeng.com/shendu/gjxqdb/detail_2013_12/27/32526005_0.shtml)

In light of the above-mentioned background, I sense the need to take a look at the one-share, one-vote rule both from theoretical and empirical approaches. The goal of my thesis is to discover, from the perspective of one-share, one-vote rule, whether China should open the gate for a dual class shares. It is worth mentioning that although preferred shares leads to deviation from one-share, one-vote rule, it does not necessarily lead to other dual class shares with superior or low voting powers in the future because the non-voting nature and incapability of conversion of the current Chinese Preferred Shares will not affect the controlling power of existing shareholders, while issuing new shares with superior voting power would significantly dilute the control of existing shareholders and hence alternate the current voting structure. Therefore, it still requires a close look at the one-share, one-vote rule to better understand its rationale. I will mainly look at dual class shares from a voting right perspective, and the concept of “Company”, “Corporate” and “Corporation” shall have the same meaning in this thesis.

Part I of this thesis gives a look at the Chinese Regulations of one-share, one-vote principle, and the evolution of the Chinese Preferred Shares. Part II takes a comparative approach to see the development and status of one-share, one-vote rule in other countries and regions to get a better view of its advantages and disadvantages. Part III tries to figure out the theoretical underpinning of the one-share, one-vote rule, while Part IV focuses on why and why not we should apply such rule. In Part V, I look at the application of one-share, one-vote rule in Chinese companies, and the dual class shares in the world; after that, I take a look at the legal protection schemes in China to see whether it is sufficient to support a dual class shares structure. I conclude at the end of this thesis that it is unnecessary to stick to the one-share, one-vote rule, and there are circumstance that dual class shares can better serve the company and its shareholders. However, China needs to introduce more minority shareholder protection schemes while improving its current ones to better embrace the benefits of

dual class shares.

PART I CHINESE LAWS AND RULES

A. Brief History of Chinese Corporate Legislation and General One-Share, One-Vote Principle

The People’s Republic of China (PRC) has a short history of company law. For many years, the nation only existed company-regulating legislations in the form of law for companies that have foreign element involved\(^5\). For domestic companies, the rules were mostly formed in provisional regulations\(^6\) and opinions\(^7\). The very first Company Law of PRC was enacted in 1993, followed by three major amendments in 1999, 2005 and 2013, and several minor amendments. The current Company Law of PRC is the 2013 version, which entered into force from March 1\(^{st}\), 2014.

The concept of Chinese Enterprises went through several stages; the difference of each stage greatly reflected the stage of the country’s economy. From 1950-1951, right after the establishment of People’s Republic of China, the Government Administration Council of the Central People’s Government\(^8\) enacted a short-life Provisional Regulation of Privately-owned Enterprises and a supporting management measure shortly after, which defined five types of enterprises including Limited Liability Companies and Joint Stock Limited Company, and several Solely/Partially Unlimited Liability Companies. In 1954, a Provisional Regulation on Joint State-Private Enterprises was enacted, which wiped all kinds of Private-Owned Enterprises and replaced them with State-Owned or Collective Enterprises. The situation lasted for more than two decades, went all the way through the planning economy period, until the Reform and Opening-up starting from 1978. The 1979

\(^5\) While there was no uniformed company law regulating domestic enterprises until 1993, there were three laws regulating Sino-foreign joint ventures, enterprises with Sino-foreign cooperation, and wholly foreign-owned enterprises enacted in 1979, 1988 and 1986 respectively.

\(^6\) For example the 1950 Provisional Regulation for Private-owned Enterprises (《私营企业暂行条例》)

\(^7\) For example the 1992 Regulating Opinion on Limited Liability Companies and Regulating Opinion on Joint Stock Limited Company. (《有限责任公司规范意见》 and 《股份有限公司规范意见》) These two Opinions were in fact the very first statutes in China that give detailed and systematic regulations over the major two forms of company.

\(^8\) The highest and chief executive institution of national affairs in PRC during 1949-1954, later on replaced by the State Council of PRC.
Statute regulating Sino-foreign Joint Ventures and the 1980 Provisional Regulation to Promote Horizontal Joint Economy marked the revival of Chinese Corporate Legislature for both foreign and domestic enterprises. However, Limited Liability Company was not a legal existence until the 1988 Provisional Regulation on Private-owned Enterprises, which also set legal basis for Sole-proprietary Enterprises and Partnership.

The first legislations that put detailed guidance to Limited Liability Companies and Joint Stock Limited Companies were the 1992 Regulating Opinion on Joint Stock Limited Companies and 1992 Regulating Opinion on Limited Liability Companies. The 1992 Opinions mainly specified the following issues: 1) corporate structure: a dully-incorporated company shall have a two-tier board: a management board and a supervisory board, and shall note the frequency of holding a shareholder/board meeting; 2) China would take an approval approach instead of registration approach for setting up a company: all companies are required to ask for approval before they can acquire an operating license. The 1992 Opinions also listed documents and procedural rules one should know to apply for such approval. The reason why it has been so strict was seen as a counterbalance towards an ever increasing number of briefcase companies and administrative companies; 3) Procedural Rules at winding up: The 1992 Opinions represented the new start of regulating Chinese Corporations, in the sense that they re-set standards and protocols to lead companies to operate in a legal way. It also gives hope to free private economy after the long chaos for more than thirty years.

The two 1992 Opinions also mentioned voting rights, which, since then, has not changed dramatically in the following uniformed Chinese Company Laws. The rules were different according to the way a company is formed, thus I will discuss them separately.

---

The first type is Limited Liability Company, which is similar to Private Company Limited by Shares under UK law\textsuperscript{10}. The legislation has held a constant view on Limited Liability Companies that shareholder shall exercise their voting rights at the shareholder’s meeting in proportion to their respective shares of capital contribution\textsuperscript{11}. In the 1992 Opinion and 1993 Company Law, such proportional voting rights were mandatory rules, however, since the 2005 Company Law, such rule has becomes a default rule in the sense that shareholders can agree otherwise in their corporate charter.

The second type is Joint Stock Limited Company, which is similar to Public Limited Company under UK law\textsuperscript{12}. All statutes rule that each share that shareholders holds is entitled to one vote\textsuperscript{13}, but still differences occur. The 1992 Opinion allowed two types of shares in a Joint Stock Limited Company, namely Common Shares and Preferred Shares. Common Shares apply the one-share, one-vote rule, while Preferred Shares are not entitled to voting rights, unless the company failed to pay off their dividends in three consecutive years. The 1993 Company Law included only one type of share, the Common Shares, and left the State Council of PRC the power to initiate other types of shares\textsuperscript{14}. The subsequent amendments followed the 1993 trend, and it is the same case in the current Company Law\textsuperscript{15}.

B. Dual Class Shares - Preferred Shares

1. 1990s

As mentioned in the last section, preferred shares were first seen in the 1992 Regulating Opinions for Joint Stock Limited Companies. In fact, it was a quite thorough and detailed one, which not only put clear the rights of preferred

\textsuperscript{10} See Wikipedia at http://en.wikipedia.org/wiki/Types_of_business_entity#China
\textsuperscript{12} Id supra note 4
\textsuperscript{14} See Article 135 in the 1993 Company Law.
\textsuperscript{15} See Article 135, Article 132 and Article 131 in the 1999, 2005 and 2013 Company Law respectively.
shareholders in fixed return and prior rights over residual properties\textsuperscript{16}, but also specified implementing details, for example, the company may not issue new preferred shares if the aggregate profit of the company is not amount to the dividends to be paid to preferred shareholder for two consecutive years, or if it could not afford distributing dividends to common shareholders within two years after paying preferred shareholders\textsuperscript{17}. It is also worth mentioning that the scope of qualified issuing companies was even broader than the current ones that as long as the company is formed in the way of Joint Stock Limited Companies, they are entitled to issue preferred shares.

Before the 1993 Chinese Company Law, which put it clear that all shareholders shall have one vote for every share they have, several Chinese companies have taken the initiative to issue preferred shares. However, due to the limitation imposed by the Law, they all began to redeem their preferred shares. Most corporates declared redemption shortly before or after the enactment of the 1993 Company Law, while the last one did not cease to exist until the year of 2006.

1) Redemption of Preferred Shares before the 1993 Company Law

JIN BEI Auto Corporation was founded in 1988 as a joint state-owned and collective company. In July 1988, it was approved to issue one million convertible preferred shares to the public at the nominal price of RMB 100 per share. On June 10\textsuperscript{th}, 1992, JIN BEI Auto Corporation declared that all outstanding preferred shares shall be redeemed and converted into common shares\textsuperscript{18}.

2) Redemption of Preferred Shares shortly after the 1993 Company Law

Shenzhen Development Bank Co., Ltd. was founded in 1987. It was listed in the

\textsuperscript{16} See Article 32, 1992 Regulating Opinions for Joint Stock Limited Companies
\textsuperscript{17} See Id, Article 38
Shenzhen Stock Exchange from 1987, and is the very first business bank that offered stocks to the public in China. In 1988, it was approved by the State Administration of Foreign Exchange (SAFE) to offer initial preferred shares in foreign currencies. In 1989, it launched a second run for preferred shares. In 1994, the board of Shenzhen Development Bank Co., Ltd. decided to redeem all the outstanding preferred shares and converted them into common shares. In 1995, the company announced that they would redeem all the preferred shares that remain outstanding, but will no longer convert them into common shares.

In 2009, Wei Xihua, who happened to purchase one hundred preferred shares in 1988 but was not registered as shareholder by the bank found his ancient certificate, and claimed to the bank for conversion into common shares. Upon refusal, Wei Xihua sued the bank, and it was held by court that he is entitled to be preferred shareholder but will not be entitled to the conversion of shares due to the fact the bank has decided not to offer any further conversion by 1995.

3) The Last Corporate to Redeem Preferred Shares

Hangzhou Tianmushan Pharmaceutical Enterprise Co., Ltd. was founded in 1987. In order to meet the minimum registered capital requirement to be listed in the Shenzhen Stock Exchange, in 1988, it was approved to offer preferred shares. By July 1993, it has solicited 18.9 million preferred shares. In August 21st, 2006, Hangzhou Tianmushan Pharmaceutical Enterprise Co., Ltd. called a shareholder meeting to redeem all the outstanding preferred shares and agree to convert all preferred shares into equivalent amount of common shares. According to the Charter of the Company on cumulative prior dividend, by the time it declared to redeem the preferred shares, the shareholders are entitled to nearly 40% of net profit of the company in 2006.\(^{19}\)

Hangzhou Tianmushan Pharmaceutical Enterprise Co., Ltd. was the sole listed

---

corporate in China that survived from the one-share, one-vote principle and hold for as long as 13 years until it finally decided to take them away. In other words, it was not until 2006 that China is really able to take away dual-class shares in its Stock Market.

It is also noticeable that possibly due to the blank in law and the vague language in the subsequent 1992 Regulating Opinion on Joint Stock Limited Companies, all the companies that issued preferred shares went for convertible preferred shares, which was not even allowed under the current legal framework.

2. 2013 onwards

In 2013, the State Council of PRC, under the authorization of Company Law, announced a Guiding Opinion on Pilot Program of Preferred Shares, in which the State Council set up several guiding rules towards the issuance of preferred shares. According to the Opinion, preferred shares can be issued in listed companies and non-listed public companies. Preferred shareholders have prior rights over dividends and residual property at winding-up or bankruptcy, but have no voting rights\(^\text{20}\), unless the company failed to pay off dividends in three cumulative years or two consecutive years or under very specific circumstances\(^\text{21}\). The very first Guiding Document of Preferred Shares also allowed issuing companies to set in the corporate charter the possibility and conditions of convertible preferred shares. The State Council of PRC authorized the China Securities Regulatory Commission (CSRC) to enact detailed rules and take charge of implementing the Pilot Program of Preferred Shares.

Shortly after, the CSRC released a draft of Measure on Management of Pilot Program of Preferred Shares for public comment. The draft put more details in the

\(^{20}\) Except very limited issues that will significantly affect their rights and status as preferred shareholders, such as modification of corporate charter, in/decrease more than 10% of registered capital on single/cumulative basis, merger and acquisition, and issuance of other preferred shares. Preferred shareholders will vote separately when such issues occur. See Article 5 of the Guidance Opinion on Pilot Program of Preferred Shares.

\(^{21}\) See supra note 10 at Article 6
implementing procedure, including: 1) preferred shares can only be issued in companies which satisfies at least one of the following situations: among the Shanghai Stock Exchange 50 Index; issuing preferred shares as a means of financing the Merger & Acquisition of other listing companies; or issuing preferred shares as a means of financing its reduction of registered capital; 2) For listed companies who wants to issue preferred shares, the average attributable profit over the last three years shall be no less than the aggregate amount of the annual interest that the preferred shares intend to give out; 3) Listed Companies can issue preferred shares by public offering or private transaction in the Stock Exchange; non-listed public companies can issue preferred shares by private transaction in the National Equities Exchange and Quotations; 4) Listed Companies can issue convertible preferred shares, but the conversion may not take place within the first thirty-six months, starting from the date that the companies completes this issuance; and 5) Disclose information on the issuing plan.

In March 2014, CSRC unveiled the Final Version of Measure on Management of Pilot Program of Preferred Shares. The final version kept nearly all the clauses from the exposure, therefore followed what’s in the Guiding Opinion, except a main change concerning the convertible shares: “Listed companies MAY NOT issue convertible preferred shares.”

Subsequently, the Shanghai Stock Exchange, the Shenzhen Stock Exchange for listed companies, and National Equities Exchange and Quotations for non-listed public companies published their implementing and guiding documents, which mainly focused on the procedure, information disclosure and documents required for applying the issuance of preferred shares.

---

22 See Article 33, Measure on Management of Pilot Program of Preferred Shares (“第三十三条 上市公司不得发行可转换为普通股的优先股”)
PART II COMPARATIVE LAW

A. US: The Rise and Fall of One-Share, One-Vote Rule

The United States was the first Western country to establish the legal rule of one-share, one-vote. As early as in 1811, the New York’s General Law For Manufacturing Corporations stated, “each stockholder shall be entitled to as many votes as he owns shares of the stock of the said company,” which is followed by other states such as Connecticut and Michigan in 1837. In 1883, the first Delaware Corporate Law permitted corporations to decide the number of shares be entitled to the stockholders for one or more votes. By the end of nineteenth century, hardly any statutory restrictions on the one-share, one-vote rule can be found for business corporations, many state corporate statutes have made the one-share, one-vote principle as a default rule.

Dual Class Shares began to play its role in corporate capital structure since early 1900s. As corporates are free to deviate from the one-share, one-vote rule, many actually did so. During the early stage of the twentieth century, many corporate issues two classes of common stock, apart from the common shares with one vote attached to each vote, shareholders also sold shares with no voting rights at all. Dual Class Shares became a big issue in the 1920s, when a lot of companies with non-voting common shares went public, represented by a few leading companies, including Industrial Rayon Corporation and Dodge Brothers, Inc., who issued vast amount of

---

24 Act of March 22, 1811, Ch. 67, § 3, [1811] N.Y. Laws 112.
27 17 Del. Laws 147, § 18 (1883).
non-voting common stock in the New York Stock Exchange (NYSE) in 1925\(^{32}\).

The ever-increasing favor towards dual class shares brought concern to many scholars, among whom Harvard Professor William Z. Ripley was the leading proponent of one-share, one-vote rule, who called non-voting shares as the “crowning infamy” of controlling mechanism of promoters who can solicit large amount of capital while still maintain voting control\(^{33}\). In the 1925 listing, Dodge Brothers managed to sell bonds, preferred shares and non-voting common shares that worth a total of 130 million US dollars to the public while Dodge kept control of the company with only $2.25 million voting common stock, and this really led to a public outcry\(^{34}\). The NYSE had to adjust its position afterwards by promising more care to the matter of voting control when considering application for the listing of securities\(^{35}\). In 1940, the NYSE adopted a flat rule of one-share, one-vote, which blocked nearly all dual-class listing projects\(^{36}\). Still, occasional exceptions arose, among which the most well known case is the 1956 listing of Ford Motor Company despite its dual class capital structure\(^{37}\).

The takeover era of 1980s witnessed the downside of one-share, one-vote principle. Many companies that followed one-share, one-vote rule wanted to become takeover proof, therefore, they left the NYSE to join the National Association of Securities Dealers Automated Quotations (NASDAQ) or the American Exchange (AMEX), which did not block dual class capital structure\(^{38}\). In 1984, the NYSE had to suspended enforcement of its rule when General Motor threatened to leave for the NASDAQ because it wanted to issue low-vote common shares to Ross Perot in


\(^{33}\) Seligman (1986), supra note 32. quoted from W. Ripley, Main Street And Wall Street 77 (1927).

\(^{34}\) Bainbridge (1991), see supra note 30, at 569. Quoted from Loomis & Rubman, Corporate Governance in Historical Perspective, REV. 141, 152-53 (1979).


\(^{36}\) Id, at 699. “Since 1926, The New York Stock Exchange has refused to list non-voting common stock. This apparently was the first formal published enunciation that the Exchange would refuse to list non-voting common stock.”

\(^{37}\) Bainbridge (1991), see supra note 30, at 569.

\(^{38}\) Dual-class stock: Governance at the edge. Shareholder Value 2012, Third Quarter, 43. (2012)
acquiring his company\textsuperscript{39}. In 1986, after a two-year study, the NYSE requested the US Securities and Exchange Commission’s (SEC) approval of a modified rule that would allow the NYSE to list dual class stock if a majority of the issuer’s independent directors and "public" shareholders approved the recapitalization\textsuperscript{40}. The SEC declined on the NYSE’s proposal and enacted a 19c-4 rule\textsuperscript{41}, trying to get Exchanges back into line and prohibit publicly traded one-share, one-vote companies from converting into dual class structure\textsuperscript{42}. However, the rule was struck down by the D.C. Circuit and was never revived\textsuperscript{43}.

Another attempt to support the one-share, one-vote rule was the introduction of double taxation of inter-corporate dividends by President Roosevelt in 1930s\textsuperscript{44}, aiming to discourage if not dismantle pyramidal groups who are collecting “concentrated, monopolistic, tax-evading and unsocial wealth”\textsuperscript{45}. The reform was believed to be successful, as some scholar found that pyramidal groups remained unknown by 2003\textsuperscript{46}.

Nowadays, one-share, one-vote is considered as a general but yet default applicable rule. Model Business Corporation Act rules, “…unless the articles of incorporation provide otherwise, each outstanding share, regardless of class, is entitled to one vote on each matter voted on at a shareholders’ meeting”\textsuperscript{47}. State statute and federal law do

\begin{itemize}
  \item \textsuperscript{39} Ibid
  \item \textsuperscript{40} Bainbridge (1991), see supra note 30, at 577.
  \item \textsuperscript{41} 17 CFR 240.19c-4. For the purposes of paragraphs (a) and (b) of this section, the following shall be presumed to have the effect of nullifying, restricting, or disparately reducing the per share voting rights of an outstanding class or classes of common stock:…4) Any issuance of securities pursuant to a stock dividend, or any other type of distribution of stock, in which the securities issued have voting rights greater than the per share voting rights of any outstanding class of the common stock of the issuer.
  \item \textsuperscript{42} William W. Bratton, Dual-class stock: Governance at the edge, Shareholder Value 2012, Third Quarter, 43. (2012)
  \item \textsuperscript{43} Grant M. Hayden & Matthew T. Bodie, One Share, One Vote and The False Promise of Homogeneity, 30 Cardozo Law Review, 471. (2008); Bus. Roundtable v. SEC, 905 F.2d 406 (D.C. 1990)
  \item \textsuperscript{45} M. Bianchi, M. Bianco, and L. Enriques, Pyramidal Groups and the Separation Between Ownership and Control in Italy, F. Barca and M. Becht (eds.), The Control of Corporate Europe, 154. (2001)
  \item \textsuperscript{46} Morck (2003), supra note 44, at 2.
  \item \textsuperscript{47} Section 7.21 (a).
\end{itemize}
not provide for significant limitations to the issuance of shares with different voting rights and grant broad flexibility. Delaware General Corporation Law states, “Every corporation may issue one or more classes of stock or one or more series of stock within any class thereof, any or all of which classes may be of stock with par value or stock without par value and which classes or series may have such voting powers, full or limited, or no voting powers…[all rules] shall be stated and expressed in the certificate of incorporation [or amendment/resolution]…” Delaware General Corporation Law states, “Every corporation may issue one or more classes of stock or one or more series of stock within any class thereof, any or all of which classes may be of stock with par value or stock without par value and which classes or series may have such voting powers, full or limited, or no voting powers…[all rules] shall be stated and expressed in the certificate of incorporation [or amendment/resolution]…” Exchanges now allow companies with dual class structure to be listed. NYSE allows companies to issue dual-class shares and still maintain their listings, “the Exchange's voting rights policy permits the listing of the voting common stock of a company which also has outstanding a non-voting common stock as well as the listing of non-voting common stock”.

B. EU: Renewed Interest in One-Share, One-Vote Rule

Shareholder voting, as an issue in corporate governance, was an old subject in Europe. The study of shareholder voting can be traced back for four hundred years in England, at the early stage of development of Business Corporation. One example can be seen in 1568, where the charter of Mines Royal provided for one vote for each quarter of a share.


49 Chapter I, Subchapter V, Section 151 (a).

50 See NYSE, Inc., Listed Company Manual § 313(a) and supplementary material 10. (2005)


Communication of 2 October 2002\textsuperscript{54}.

The Winter Report seeks to explore a way to level the playing field for corporate takeovers in Europe. Based on the two “guiding principles”: the first being “shareholder decision-making”\textsuperscript{55}, and second being “proportionality between risk bearing and control”\textsuperscript{56}, the Winter Report introduced a “breakthrough” rule that allow a successful bidder “the ability to breakthrough any mechanisms which frustrate the exercise of proportional control”\textsuperscript{57}. Under the “breakthrough” approach, The bidder acquiring 75% or more of risk bearing capital should be able to exercise a corresponding percentage of the total votes that can be cast in a general meeting of shareholders, and to exercise the core control rights that company law grants in order to be able to control the conduct of the affairs of the company and the operation of its business\textsuperscript{58}. However, the “breakthrough” rule received wide criticizes\textsuperscript{59}. Bebchuk and Hart argued that shareholders would lose their control premium without compensation\textsuperscript{60}, and J. Coates suggested that the breakthrough rule was built purely on grounds of empirical research and that the rule would only affect a minor percentage of public firms in EU\textsuperscript{61}. The breakthrough rule is now a default rule: Member States are allowed to opt-out its application.

In 2003, the European Commission launched an Action Plan for Modernizing Company Law and enhancing Corporate Governance in the European Union. The study was undertaken by a consortium led by ISS Europe and the final report was

\textsuperscript{55} “In a takeover bid, the ultimate decision must always be with the shareholders.” See Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids, Brussels, 10 January 2002, at 20. (2002)
\textsuperscript{56} “Share capital which has an unlimited right to participate in the profits or residue on liquidation, and only such share capital, should normally carry control rights”. Id, at 21.
\textsuperscript{57} Id, at 29.
\textsuperscript{58} Id, at 32-33.
\textsuperscript{60} L. Bebchuk and O. Hart, A Threat to Dual-Class Shares, Financial Times, 2. (May 31, 2002)
\textsuperscript{61} John C. Coates IV, Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be? Discussion Paper No. 450, of the John M. Olin Center's Program on Corporate Governance, Harvard, John M. Olin Center For Law, Economics, and Business, 10. (2003) “Even without considering the contribution of cross-holdings to disproportionality, these figures suggest that no more than 12.5% of EU public firms with disproportional capital structures will be affected by the BTR.”
published in 2007. Later in 2007, the European Commission released an impact assessment in which they listed two options to deal with the situations found out in the study, and prohibition of control-enhancing mechanism (CEM) was one of the two options. The ISS et al. (2007) study found out that, of all the 464 European companies considered, 44% have one or more corporate CEMs. The mostly used mechanisms are pyramid structures, multiple voting rights shares, and shareholder agreements, and the former two are among the list that investors perceive most negatively. The EC then proceed and analyze whether it should adopt actions to reduce the incentive for extraction of private benefits at the expense of non-controlling shareholders, and they wrote that “[i]n the absence of empirical evidence on the existence and extent of shareholder expropriation, adopting further measures could entail a risk of imposing significant costs to issuers and controlling shareholders without a proportional benefit”62. In the end, the 2007 EC Assessment Report concludes that it does not have sufficient incentive to harmonize and make one-share, one-vote as a compulsory rule.

PART III THEORETICAL UNDERPINNING OF ONE-SHARE-ONE-VOTE RULE

A. Why Equal Voting: Learn from One-person, One-vote

We all make decisions everyday. Normally, it is not difficult for you to decide what to wear, or where to eat when you are on your own. Things get a little more complicated when you need to meet someone, because the two of you should choose a time that fits both schedules, or find a restaurant that suits both appetites. Anyone who has experience in arranging an activity, be it a party with friends or an official meeting between groups, would get the same feeling that, the more people there are, the more difficult it is to come to an uniform decision that satisfies all. Under most circumstances, the best result is to find a common ground that meets the desire of majority of the audience. How to do it then? The key to solve this puzzle lies in a

so-called “social choice” function\(^{63}\), which is a mechanism that transfers individual preferences into group decisions. There are certainly different kinds of social choice functions, but one that is commonly shared by most democratic institutions is voting\(^{64}\).

Voting, as a democratic way to reach group preference, has been adopted widely both in political and corporate arena. It is believed that the modern “one-share, one-vote” theory was inspired by the political democracy, namely the “one-person, one-vote”\(^{65}\). In political election, each person who has the right to vote is given equal chance and weight (one vote) to express their interest in the outcome of the election. For companies, this decision power usually stays in the hand of shareholders, who are given the right and power to cast their votes upon holding shares of the company. As early as seventeenth century, there has been debates on whether voting should be by ballot (where every member is entitled to one vote) or by share\(^{66}\). Many companies put “one vote per person” in their charters as corporate governance rule, and one-person, one-vote was considered as a default rule in common law system for a very long period of time\(^{67}\). The nineteenth century witnessed the emergence of one-share, one-vote rule, represented by Statutes in many American States, for example New Jersey\(^{68}\). However, one-share, one-vote theory did not begin to play a major role until the early twentieth century\(^{69}\). In Europe, one-share, one-vote was a common practice, and it was widely considered to be a fairer and more democratic


\(^{65}\) See for example Arman Khachaturyan, *The One-Share-One-Vote Controversy in the EU*, ECMI Paper No.1/August. (2006)


\(^{68}\) New Jersey specifies that shareholders should have one vote per share unless otherwise specified by corporate charter. See Section 11, [1846] N.J. Laws 66.

\(^{69}\) Bainbridge (1991), see supra note 30, at 565- 569.
approach\textsuperscript{70}. Now that we see both fields choose voting as their way of gathering and balancing group preferences, and political equal voting has greatly influenced corporate voting system, the question is, why do people insist equal votes and what makes them to choose equal and one vote for every person (at least in the beginning) instead of using other standards?

Equal voting is a representation of democracy in the sense that everyone who has interest in the outcome of voting should be given equal chance to express his preference. Oxford English Dictionary defines democracy as, a system of government in which all the people of a state or polity ... are involved in making decisions about its affairs, typically by voting to elect representatives to a parliament or similar assembly. “One-person, one-vote” rule is a fair, objective, and easy standard of review to measure and remedy for any deviation from disproportionate representation in the political system\textsuperscript{71}. This argument was supported by a scholar in his ECMI working paper, who further explained that democracy could be realized upon fulfilling principles of democratic faith, fairness, objectivity and morals, and though a non-discriminatory participation by granting a right to vote\textsuperscript{72}. It has also been confirmed in common law system that, “the conception of political equality...can mean only one thing – one person, one vote\textsuperscript{73}.

Answer to the second question is quite straightforward: manageability. You can choose numerous ways as the base of each vote, for example assets, amount of tax paid, contribution, but just as one scholar has pointed out, the difficulty lies in how well particular proxy matches up with voter’s interest, and whether it is realistically workable in the sense that it is neither too costly or too easily manipulated that it can

\textsuperscript{70} See Colleen A. Dunlavy, Corporate Governance in Late 19th Century and the U.S.: The Case of Shareholder Voting Rights, 5 Comparative Corporate Governance, 32. (1998)


\textsuperscript{72} Khachaturyan (2006), supra note 65, at 2.

\textsuperscript{73} Gray v. Sanders, US 368, 381 (1963)
prevent the proxy from accurately reflecting the preference strength of voters. In Avery v. Midland Country, the court simply held that the one-person, one-vote standard is nothing more than easily manageable: one just needs to be able to count and divide.

However, as much as one-person, one-vote can serve the purpose of workable administration, it is not always the best way to provide equitable strength to those who has more interest in, and thus are more affected by the outcome of voting. In a US case, the court recognized “one-acre, one-vote” as a fair foundation of voting, because the decision will shed unequal influence on each landowner, and it will affect them in proportion to the amount of land they owned. In companies, shareholders gain profits or bear losses based on the amount of shares they hold. In other words, the more shares s/he holds, the more s/he is affected by the outcome of the voting. Therefore, it seems more proportionate to weigh voting on shares than actual number of shareholders.

**B. Efficiency in Corporate Voting: Economics of Law**

Economics and Law was believed to first emerge in the late 1950s and early 1960s, represented by the Journal of Law & Economics founded by Aaron Director in 1958 and an article written by Ronald Coase in 1961: The Problem of Social Cost. The Coase Theorem states that if trade in an externality is possible and there are sufficiently low transaction costs, bargaining will lead to an efficient outcome regardless of the initial allocation of property. The theorem set up a foundation to analyze legal issues in an economic way by putting legal system and allocation of resource on the same table and by suggesting that well-defined property rights could

---

75 390 U.S. 474, 510 (1968)
76 Salyer Land Co. v. Tulare Lake Basin Water Storage District, 410 U.S. 719 (1973)
77 See http://en.wikipedia.org/wiki/Coase_theorem
overcome the problems of externalities.\textsuperscript{78}

Since the beginning of 1970s, the Economics of law began to spread the legal academy and became one of the most popular researching topics. The trend led to a fruitful article and researching papers from a lot of scholars including Richard A. Posner, Robert Cooter, Thomas Ulen, David Friedman, Henry Manne, William Landes, and A. Mitchell Polinsky. The most well known masterpiece of Economics and Law by then is the *Economic Analysis of Law* written by Richard A. Posner\textsuperscript{79}. The Economic Approach of Law did not stop in academy, but also influenced legislature and judicial practice. In 1981, US President Reagan nominated three top economic legal scholar, including Posner, to be judges of the United States Court of Appeal; in the same year, the President also signed Executive Order 12291, in which he required that major regulations must satisfy a cost-benefit analysis, unless such an analysis is precluded by statute.

It is amazing how fast the Economic Analysis of Law theory developed and dominated the legal study. Posner believed that it was because Economy is inherent in the logic of law\textsuperscript{80}, while Robert Cooter and Thomas Ulen wrote in their book, *Law and Economics*, that despite the difference between legal approach and economic approach, it is common that both approaches will lead to the same conclusion\textsuperscript{81}. Other scholars targeted a problem-solving-oriented approach as the main cause of the popularity of the Economic Theory of Law\textsuperscript{82}. The reason why Economics and Law caught people’s eye and grow so quick might as well due to the ever-increasing number of disputes and the need to settle them in an efficient way. “Efficiency” is the key word in this theory, although it could be argued that the real world is way more complex than economic formulas, and that it is too formulated to understand the

\textsuperscript{78} See http://en.wikipedia.org/wiki/Ronald_Coase
minor difference between each case, let alone to provide theoretically guidance to solve the problem, scholars have proven that if you take an assumption to simplify certain elements, the economic analysis will lead you right to the end of the road, which at least satisfies the social efficiency principle, if not legally correct.

However, is “efficiency” the ultimate end and means in law? Apparently, what legislators and judges have been pursuing in law for all these centuries is more than just efficiently end the dispute, but bring fairness and justice to the parties. What if efficiency cannot bring about a fair outcome to the case? What if the result is reached at the cost of justice? In the Eddie Electric Company case, presume there is no possibility to negotiate, and the result must go one way or the other, if the court rule that laundry shop, who suffered pollution from the smoke of Eddie Electric Company, should put on filter in the shop instead of asking the polluting company to reduce pollution at the reason that a filter cost less and is economically more efficient for the aggregate sum of benefit, then the laundry shop would not be duly remedied for the damage it suffered. The best way should be that the court takes a step back and let the parties settle the disputes between themselves. There are numerous examples which economically correct solution may not lead to a legally justified conclusion. The limitation has been accorded by Posner himself: “the term ‘efficiency’, when used as in this book to denote that allocation of resources in which value is maximized, has limitation as an ethical criterion of social decision-making.”

The economic approach that Posner has chased after was harshly criticized as materialistic, because based on Posner’s theory, those who have more capital will embrace more opportunity to breach a contract, and law has turned into a tool working only for the rich. “Rich people, because they have more money, are ‘entitled’

---

84 Peixin Luo (2006), ibid.
85 The other way around will be ask Eddie Electric Company to bear all the cost of reducing pollution, which will be a huge sum of cost to do so, which is why either way will impede economic efficiency or justice, one or the other. Robert Cooter and Thomas Ulen (2002), supra note 82, at 5.
to breach a contract, to discriminate against minorities... as long as they are able to maximize the social wealth\textsuperscript{87}.

In the modern corporate law theory, efficiency has become a dominant theory, and that corporate law studies has made it the founding element of its jurisprudence\textsuperscript{88}. Although the role of law sits on many different kinds of value (fairness, morality, etc.) in general, in corporate field, however, efficiency is still the prior value because in the wild jungle of commercial transaction, what corporates do is to seize benefit from their transactions, and to pursue the goal of maximizing their profit. Although some may argue that pursuing for maximization of shareholder’s wealth may lead to a lack of social responsibility\textsuperscript{89}, Jensen believed that social welfare is maximized when each firm in an economy maximizes its total market value\textsuperscript{90}. He elaborated a detailed explanation to link shareholder wealth maximization to social welfare:

“A firm taking inputs out of the economy and putting its output of goods and services back into the economy increases aggregate welfare if the prices at which it sells the goods more than cover the costs it incurs in purchasing the inputs. Clearly the firm should expand its output as long as an additional dollar of resources taken out of the economy is valued by the consumers of the incremental product at more than a dollar. Note that the difference between these revenues and costs is profits. This is the reason (under the assumption that there are no externalities or monopolies) that profit maximization leads to an efficient social


Economics in Law theory is in one way reflected by shareholder primacy in corporate law. Gordon Smith describes shareholder primacy as “the structure of corporate law ensures that corporations generally operate in the interests of shareholders”\(^92\). What he was saying is that corporations shall exist for the purpose of producing interests of shareholders. In other words, the theory mandates that the corporation be run with the goal of maximizing shareholder wealth\(^93\).

C. Why Shareholders Vote and Why Only Shareholders Vote: Nexus of Contract and Residual Claims

“One-share, one-vote” literally means, for every share that shareholders have in the company, they gain one/equal point in their voting power. It is easy to understand at first glance, but if anyone puts a second thought, questions may rise. For example, why do shareholders vote, not other corporate constituents? Or how is it proper to for companies to distribute voting power by shares?

1. Why do shareholders vote?

Nexus-of-contract theory believes that corporate is formed by a contract entered into by various parties, and shareholders are just one party among many others. Alchian & Demsetz described that corporate are not watched over by some superior authoritarian directive or disciplinary power, but functions in a team use of inputs and a centralized position of some party in the contractual arrangements of all other inputs\(^94\). Jensen & Meckling defined an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf, which involves delegating some decision making authority to the

\(^91\) Ibid
\(^93\) Hayden &Bodie (2008), supra note 43, at 472.
\(^94\) Armen Alchian & Harold Demsetz, Production, Information Costs, and Economic Organization, 62 Am. Econ. Rev. 778. (1972)
agent. Easterbrook and Fischel think of corporations as a division of labor. From an economic perspective, a corporate is just a name for a great web of contractual arrangements.

Nexus of contract theory ends inevitably with the impossibility for shareholders to make everything included in a contract, which leads to the incomplete contract theory. The contradictory concept of Complete Contract refers to the idea that parties can specify all their rights and obligations parties in the contract, which will contain all matters that are happening currently and will happen in the future. If all the contracts are complete, then parties are capable of a) fully foreseeing all the future contingencies; b) stating the course of action with respect to each contingency; and c) writing comprehensive contracts at zero cost. Under such circumstance, voting is not necessary, as everything has been written down completely, and all that directors and managers need to do is to follow the definite protocol. However, “it seems improbable that a firm would emerge without the existence of uncertainty”. As company is form in a nexus of contract where “those who have money but not managerial skills [join] forces with those who have managerial skills but not capital” to obtain returns at lower total risk, shareholders would only focus major issues of the corporate, and pay rational ignorance to many other daily management affairs and delegate them to skilled expertise.

However, the scope of delegation can never be capable of specification. Business strategy need to change according to the market to lower cost, and different situations would occur that requires decision from time to time. Voting serves a way of managing or examining the ways to which inputs are used in team production and a

---

100 R. H. Coase (1937), supra note 98, at 392.
method of metering the marginal productivity of individual inputs to the team’s output\textsuperscript{102}. Shareholders do not run the company directly. Instead, they elect directors who connect them to the management of the companies. Velasco described that the function of shareholders’ election of directors is to contract with other stakeholders on their behalf\textsuperscript{103}. The voting mechanism allows shareholder to participate in corporate business and maximize their profit by delegating such power to directors\textsuperscript{104}. As a result of the incapability of delegation specification, voting exists so that someone will hold the residual power to act (or to delegate) when contracts are not complete\textsuperscript{105}, and the specialist who receives the residual rewards will monitor the members of the team to, for example, manage the use of cooperative inputs\textsuperscript{106}.

2. Why Shareholders Alone Have Voting Power?

Corporates are legal fictions. Shareholders put money into this entity, and expect to earn return (or sometimes bear losses) from their investment. However, shareholders are not the only one who contributes to the health of a corporate, for example, managers provide their managerial skills, employees work to keep the big machine running, suppliers provide raw materials that products rely upon, and creditors lend money so that the company has a better cash-flow performance. Neither are shareholders the only group who has interest in the corporate, in fact, every stakeholder receives benefits or burdens risks depending on the performance of the corporate, for example: creditors, in the risk of default, and customers, in the value of warranty\textsuperscript{107}; even employees of the companies, in job security\textsuperscript{108}. If voting power should be granted to whoever has an interest in the outcome of voting, and to exclude someone from the voting, one should prove that “all those excluded are in fact

\textsuperscript{102} Alchian & Demsetz (1972), supra note 94, at 782.

\textsuperscript{103} Julian Velasco, Shareholder Ownership and Primacy, University Of Illinois Law Review, 923, (2010).


\textsuperscript{105} Id., at page 67.

\textsuperscript{106} Alchian & Demsetz (1972), see supra note 94, at 782.

\textsuperscript{107} Velasco (2010), supra note 103, at 897. (2010)

\textsuperscript{108} Margaret M. Blair & Lynn A. Stout, Specific Investment: Explaining Anomalies in Corporate Law, Cornell Law Faculty Publications, 739. (2006)
substantially less interested or affected than those [included]"\textsuperscript{109}, then all stakeholders shall have the right to vote. To put it in an exaggerate way, in the eyes of communitarians, who believes that corporations should run in the interest of the society as a whole\textsuperscript{110}, anyone in the society can be hardly driven away from the voting rights. However, it is not true, not even realistic.

Easterbrook and Fischel gave explanation in their book, \textit{The Economic Structure of Corporate Law}, on why shareholders alone should have voting rights:

\begin{quote}
"The reason is that shareholders are the residual claimants to the firm’s income. Creditors have fixed claims; and employees generally negotiate compensation schedules in advance of performance. The gains and losses from abnormally good of bad performance are the lot of the shareholders, whose claims stand last in line."\textsuperscript{111}
\end{quote}

Such explanation persuaded some scholars, especially from the perspective of creditors\textsuperscript{112}, however, it did not buy everyone - the scope of residual claimant has been under debate. It is argued, “shareholders are only one of several groups that can be described as ‘residual claimants’… in the sense that they expect to enjoy benefits (and sometimes to endure burdens) beyond those provided in their explicit contracts"\textsuperscript{113}. According to the Nexus of Contract Theory, shareholders have no


\textsuperscript{111} Id, at page 68.

\textsuperscript{112} See Lucian Aye Bebchuk, Reinier Kraakman, and George Triantis, Stock Pyramids, Cross-Ownership and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control From Cash-Flow Rights, Concentrated Corporate Ownership (R. Morck, ed.), 445-460. (2000) They see debt holders different from shareholders in two ways: 1) they have priority rights of repayment of debt; and 2) contractual protection of creditors over enforcement and sanction for breach.

\textsuperscript{113} See Blair & Stout (2006), supra note 109, at 738-739.
special role in the corporation; their rights to, for example, put investment in the company in exchange for a return, like every other parties, are limited to those concluded by contract.\textsuperscript{114}

Blair & Stout continued to use a study conducted by Lynn M. Lopucki to support their opinion, and concluded that “corporate law does not... treat the shareholders of a corporation that is not in bankruptcy as the corporation's sole residual claimants”\textsuperscript{115}. Velasko interprets the article in a different way, who reads that Lopucki only demonstrated the difficulties encountered in the administration of bankruptcy, before any final resolution\textsuperscript{116}. It is clear that this article found residual claims are often shared by many parties in bankruptcy, however, it also found that up to 38% of all the cases, there remains a single residual claimant.\textsuperscript{117} It should be noted that bankruptcy law is different from corporate law, in the sense that it only reflects administration of a particular period of corporate status. In normal corporate administration, shareholder remains at the end of queue to accept whatever is left.

Residual claims also links to the reason why shareholders are considered the best candidate among all corporate constituents to hold voting rights, since after giving away compensation and paying off debts, what is left, either marginal profits or marginal cost, goes to the shareholders. It is reasonable to expect them to make the best choice for the company when exercising their discretion\textsuperscript{118}. Shareholders have


\textsuperscript{115} Lynn M. Lopucki, \textit{The Myth of the Residual Owner: An Empirical Study}, 82 Washington University Law Quarterly, 5. (2004) “If, for example, a firm is close to insolvency, the interests of both shareholders and creditors might be affected by the same decision...No single residual owner would exist”\textsuperscript{116}

\textsuperscript{116} Velasco (2010), supra note 103, at 914.

\textsuperscript{117} Lopucki (2004), supra note 115, at 24. (“As a result, this study’s finding of single residual owners in 38% of reorganizing firms probably overestimates substantially.”)

\textsuperscript{118} George G. Triantis & Ronald J. Daniels, \textit{The Role Of Debt In Interactive Corporate Governance}, 83 California Law Review, 1100 (1995) (“The neoclassical model of the firm proposes that, given an imperfect world, the optimal solution is to vest decision making authority with the residual claimants, who gain or lose at the margin from the actions of the firm.”) See also Thomas H. Jackson, \textit{The Logic And Limits Of Bankruptcy Law}, Harvard University Press, 168. (1986) (“The Only Way That [A Borrowing] decision can be made without bias is for it to be made by the group that will reap the benefits of a successful decision and pay the costs of an unsuccessful decision. That group consists of the residual claimants, who in the case of an insolvent company are almost always the unsecured creditors. It is they that should determine whether a loan is worthwhile and whether its terms are the
higher interest in share value and thus equally will vote to promote that interest so as to maximize the value of the company\textsuperscript{119}. I will discuss further on this issue in the following Part.

**PART IV DEBATE OVER ONE-SHARE, ONE-VOTE**

From the last Part, we can see that the most fundamental reasons behind one-share, one-vote rule is the representation of the notion of equal voting rights, presumption of economic efficiency and shareholder primacy in corporate governance, and also selection of the most appropriate group of persons to make major decisions of corporate issues. However, most nations in the world only adopt one-share, one-vote principle as a default rule, and favor of deviation tools never goes down. Although the Chinese Corporate Law started by following equal voting\textsuperscript{120}, nevertheless it seems to lean towards dual class shares by re-allowing the issuance of preferred shares. Still, it remains to be seen whether China would be willing to adopt other methods of dual class voting systems, for example multiple voting shares. Therefore, it is necessary to give a deeper look on how one-share, one-vote rule works in the way that it maximizes the corporate wealth, or whether it is the optimal means towards corporate performance. Is it possible that deviation from one share, one vote principle may serve at a better way?

**A. What is So Good About One-Share, One-Vote?**

If a corporate applies the one-share, one-vote rule, every share of the company will weigh the same as all other shares in terms of voting power. Then in spite of the fact that corporate control and cash flow are separate elements in the company, under such circumstance, they are closely linked to each other in a way that voting power is “equal” to residual claims.

When arguing why shareholders should vote alone, instead of having other

\textsuperscript{119} Khachatryan (2006), supra note 65, at 5.
\textsuperscript{120} See supra Part II about Chinese Law
stakeholders participate in decision-making process, Professor Easterbrook and Fischel stated that:

“[O]nly one group [shall] hold voting right at a time. The inclusion of multiple groups (say employees in addition) would be a source of agency costs...[W]hen voters hold dissimilar preferences it is not possible to aggregate their preferences into a consistent system of choice. If a firm makes inconsistent choices, it is likely to self-destruct. Consistency is possible, however, when voters commonly hold the same ranking of choice (or when the rankings are at least single-peaked).”

Although Professor Easterbrook and Fischel were distinguishing shareholders from other stakeholders as the best candidate for corporate voting, it is also clear from this statement that the group who takes charge of corporate decision-making shall be one with same interest. In the corporate with dual-class voting system, different classes of shareholders may have various interests that give them incentive towards diverse choices. They went on in the book: “The preference of one class of participants are likely to be similar if not identical...[F]irms with single classes of voters are likely to be firms with single objectives, and single objective firms are likely to prosper relative to others.”

Residual interest is used to explain why vote buying is not allowed, or why irrevocable voting trust is forbidden. It is believed that when one or several shareholders are given unequal power against their residual interest, they may make suboptimal decisions because votes follow the residual interest, and disproportionate voting power will allow them to make favorable decision without bearing equivalent risks. Research also has shown that countries where there are more conflict between minority and majority shareholders are usually having a more severe

---

122 Id, at 70.
separation of voting power and cash flow\textsuperscript{125}, therefore has caused more agent costs. Dual Class Shares are similar to vote buying in a way that there’s one class of shares that are given relative more voting power as compared to the other class, as a result, those who have more voting power will have the incentive to make suboptimal decisions at the cost of the other class. As a consequence of voting power attaching to residual interest, those shareholders without a commensurate economic stake in the corporation are more likely to "tunnel" away a disproportionate part of firm value\textsuperscript{126}.

In a dispersed ownership structure, the one share, one vote rule can be used as an instrument among other core and supporting institutions of corporate governance to mitigate the agency costs of monitoring and the effects of divergent incentives between shareholders and managers\textsuperscript{127} Under the assumption of proxy rules\textsuperscript{128}, shareholders have the intention to vote on corporate business and hence require more information. However, if such assumption would be true, a dispersed ownership will usually bring along a so-called collective action problem\textsuperscript{129}, under which theory, all individual shareholders would make rational moves that would be ideal from their own perspective, but collectively does not lead to an optimal outcome. Suppose in order to make rational decision for a voting that worth EUR 1,000, but would require information that amount to EUR 500, since as a minor shareholder that only holds a small fraction of corporate share, his votes would not make a difference to the


\textsuperscript{127} Khachatryan (2006), supra note 65, at 8-9.

\textsuperscript{128} According to Easterbrook and Fischel, Proxy rules depend on the following two principal assumptions; that shareholders demand more information about corporate matters than managers provide voluntarily and desire to be more involved in setting corporate policy than state law allows. Unless they are given the type and accuracy of information that is carefully specified, shareholders tend to be easily misled and will vote contrary to their interest.

\textsuperscript{129} Collective Action Problem is represented by the well known “prisoner’s dilemma”, where two prisoners are accused of a crime. If one confesses the crime, he will be released immediately while the other (the one who join the crime together but refused to confess) will have a 20 years sentence. If neither confesses, both will be held for a few months. If both confess, then both of them will stay in the prison for 15 years. It seems that if both of them denied would bring the optimal outcome, but as neither of them would know whether the other would confess, both will confess but lead to a suboptimal result of 15 years prison.
outcome of the decision, shareholder would pay rational ignorance\textsuperscript{130} to the voting issue and choose to accord with the management, who has more expertise in running the business. This delegation creates a conflict of interest between those who make decisions and those who bear the consequences, which may be mitigated by giving management a claim to the firm's profit\textsuperscript{131}. Furthermore, shareholders will tend to depend on those who is willing to incur cost on monitoring, which would lead to a disproportionate distribution of cost and benefit towards the voting – the free rider problem. The lack of monitoring will further exacerbate the conflict of interest between minority shareholders and the board by effectively allowing managers to benefit from diverting corporate resources by, for example, engaging in related-party transaction, undertaking projects targeted to their needs and ends, pursing visionary projects or enhancing their human capital\textsuperscript{132}. One-share, one-vote rule can serve as a legal tradeoff to monitor managerial power and to reinforce shareholder primacy. Bernard Black & Reinier Kraakman consider one-share, one-vote rule as to match economic incentives with voting power and to preserve the market for corporate control as a check on bad management\textsuperscript{133}. Professor Grossman and Hart have also proven in their work that, when the buyer’s private benefit is smaller or the same as the incumbent’s, one-share, one-vote rule is the optimal voting rule\textsuperscript{134}.

In a concentrated ownership structure, controlling shareholder are given the power and benefits of control to effectively monitor the management and minimize its problem as a free rider, however, it has caused the another kind of agency problem between majority shareholder and minority shareholder. Where a company has a controlling shareholder, they can, through election of board and have dominant power over major company issues, deprive minority shareholders from monitoring business in the company. Many company apply majority rule when it comes to shareholder

\textsuperscript{130} See Easterbrook & Fischel (1991), supra note 104, at 83.
\textsuperscript{132} See Khachaturyan (2006), supra note 65, at 8.
\textsuperscript{134} See Grossman & Hart (1988), supra note 131, at 1-5.
voting, therefore only slightly over half of the voting rights would be ample to take charge of the company. For example, in companies where one share, one vote rule applies, major shareholders need only 51% of shares to dominate the firm. Hence, many counter-balancing schemes such as cumulative voting rights have been invented to protect minority shareholders from losing its voice. A dual class structure would amplify the fact that controlling shareholder could actually control the company with less shares.

B. Should We Lean Away From One-Share, One-Vote Rule?

1. Efficiency

As mentioned above, one-share, one-vote is considered the optimal solution of corporate voting system by Professor Easterbrook and Fischel because they believe while dissimilar preference leads to self-destruct, single ranking choice brings prosperity\textsuperscript{135}. Such theory is based on the assumption that under a uniform class of shares, all shareholders are chasing after a similar goal; therefore, the final decision is single peaked. However, what if the assumption is no longer valid, or what if the statement that "preferences of [shareholders] are likely to be similar if not identical"\textsuperscript{136} is simply not true?

When Professor Easterbrook and Fischel talked about similarity, they took into account the different efforts from shareholders who are holding different amount of corporate shares at a varied period time. Despite the fact that shareholders may have diverse approach towards what they expect from the corporate, revealed by their votes, since they will receive marginal gains or costs in proportion to their shares, they will have appropriate incentive to vote in their favor and input rational monitor, hence, the votes will inevitably aim at a single direction\textsuperscript{137}. Another fact that contributes to the

\textsuperscript{135} Easterbrook & Fischel (1991), supra note 104, at 69, 70.
\textsuperscript{136} Id, at 70.
\textsuperscript{137} Ibid. “Shareholders do not always have equal power. Sometimes stable coalitions may hold effective control for long periods...It is not troublesome if the gains from corporate action are divided proportionally among all shareholders... As long as each share has an equal chance of participating in a
similarity comes from such believing that “it is not possible to separate the voting rights from the equity interest”\textsuperscript{138}. However, even under the system where shareholders have equivalent voting power, shareholders may still have very different financial interests due to their preference or status. As much as they would like to bind votes to equity interests, the modern equity derivatives make it rather easy to depart a vote from its economic returns; for example, parties can take in certain amount of stock from a company and sell right away all his equity derivatives representing short position in that stock\textsuperscript{139}. When one particular shareholder holds at the same time common shares of the corporate and equity derivatives that would only benefit him when the company loses its profit, his willingness to pursue an increase in stock value of the company is traded off by an decrease of value in the equity derivatives, therefore, single class of shareholders may also lead to various peaked choice.

Martin and Partnoy, in their work “Encumbered Shares”, gave an explicit demonstration of circumstances under which shareholders would have different incentives towards their votes\textsuperscript{140}. They called those shares whose value is offset by another type of financial engineering the “economically encumbered” shares\textsuperscript{141}. The demonstration starts off with a basic setting of two shareholders A and B, and they both have ten common shares. A will hold still all his shares while B will involve himself in buying or selling equity derivatives. Based on their analysis, when the shareholder holds a certain amount of stock and sells short an equivalent amount of option that he borrowed from a broker who obtained them from the account of some other shareholders, he would be no less indifferent to whether a proposal would bring

\textsuperscript{138} Id, at 75.
\textsuperscript{139} Frank Partnoy, Some Policy Implications of Single-Stock Futures, Futures & Derivatives Law Report, 8. (2001)
\textsuperscript{140} Martin & Partnoy (2005), supra note 23, at 789-792. They listed seven different types of circumstance where shareholder holds common shares and equity derivatives at the same time, and analyzed each case one by one on how it my affect the shareholder’s preference of voting compared with a shareholder that holds only common shares.
\textsuperscript{141} Id, at 780.
an increase to the value of the corporate than any other non-shareholders\textsuperscript{142}. When the shareholders has more equity derivatives than shareholdings which would bring him extra value when there is a loss in the corporate, before his options expires, he would oppose those proposals that will increase the corporate value\textsuperscript{143}. Even when the equity derivatives are aiming at the prosperity of corporate, holding equity derivatives can also affect a person’s judgment on his short-term incentives, reflecting by the pursue of maximizing his own wealth, which might be at the cost of corporate’s long term interest\textsuperscript{144}. Hence, encumbered shareholders will not always vote for the optimal choice for its company and their incentives are thus apart from those of pure shareholders.

2. Market for control

One main criticism over dual class structure is that it levels up the agency cost, as those who obtain corporate control disproportionate to their cash flow rights tend to have more incentive to seize private benefits\textsuperscript{145} over security benefits\textsuperscript{146}. Bebchuk, Kraakman and Triantis’ found that for Controlling Minority Structure (CMS) controllers, as the fraction of cash-flow rights they hold in the firm declines, they can externalize progressively more of the costs of their moral hazard and as a result, the agency costs of CMS firms increase at a sharply increasing rate\textsuperscript{147}. Moreover, as the

\textsuperscript{142} Id, at 789. See example one.
\textsuperscript{143} Id, at 790-791. See example two: buying put options and example three: selling call options.
\textsuperscript{144} For example, when a shareholder sells put option or buys call option, although both financial tools are expecting an up-rise in the stock price, hence from this aspect is no different from any other common shareholders, encumbered shareholders would prefer a maximization of corporate value during the period he holds such option, and indeed he has the power to influence the decision by casting his votes. However, pursuing for a volatility of price may not be the best option of corporate operation, because these shareholders would prefer a proposal that seems more profitable in short run over one that would take a longer period of time to reveal itself but is certainly more beneficial to the company from a longer vision. See example four and five and analysis of Encumbered Shares, id, at 791-792.
\textsuperscript{145} Definition of “private benefit” see Grossman & Hart (1988), supra note 131, at 2. Private benefits of control refer to benefits of the current management or the acquirer obtains for themselves, but which the target security holders do not obtain, including synergy benefits realized by the acquirer, perquisites of control, and diversion of resources from the security holders to subsidiaries of management or the acquirer.
\textsuperscript{146} Definition of “security benefit” see ibid. The security benefits refer to the total market value of the corporation’s securities.
\textsuperscript{147} Bebchuk, Kraakman and Triantis (2000), see supra note 112, at 8.
fraction of cash-flow rights declines, the difference in value between two projects will become less important to the controllers relative to the difference in private benefits of control.\textsuperscript{148} Empirical studies have supported such theory. CMS structures are more common in countries where the legal protection of investors is relatively low.\textsuperscript{149} Research found that the difference between cash-flow rights and controlling rights is linked with the corporate value and creates a “discount [that] generally increases with the size of the wedge between control rights and cash-flow rights”\textsuperscript{150}. Some scholar also shows that the wedge between the voting and the cash-flow rights would influence corporate performance in the market from a negative way.\textsuperscript{151}

However, substantial means of corporate control is an effective way against hostile take-overs. Take Baidu, a Chinese Software Company, which is listed in the United States as an example. It issued two classes of shares. Class A offers shares which are issued after its listing and open to the public and has one vote attached to each share, while Class B contains only original issue stock, which are offered only to the founders of the company, and these original issue stock is attached with ten votes per share. It was also agreed that the Class B Shares are not open to free circulation, and as soon as the Class B Shares are transferred to other people in the Stock Exchange, the voting rights will immediately drop to one vote on each share, the same as the other Class A Shares. When a company is operating like this, it is very unlikely that it can be taken over by a hostile third party; therefore, dual class shares can be an effective measure of defense over hostile take-overs.

Professor Grossman and Hart have proven in their work that despite the fact that under certain circumstance, one-share, one-vote rule is the optimal voting rule, when departing from these specified situations, dual class structure may be more

\textsuperscript{148} Id, at 9.
\textsuperscript{149} La Porta et al (1999), supra note 125, 498-502.
preferable\textsuperscript{152}. They found out that when both the acquiring party and the incumbent have private benefit over the target company, and the acquirer’s private and security benefits are higher than the incumbent’s, the acquirer would need to pay a higher price under the dual class structure\textsuperscript{153}, hence dual class shares would be more beneficial on the incumbent’s side to secure corporate control. Moreover, after examining how voting structure, asymmetric information and private benefits can affect the takeover outcome, Burkart and Lee discovered that generally one-share, one-vote is not optimal in terms of promoting more value-increasing bids\textsuperscript{154}. It is also believed that such dual class structure before public offering should not be interfered with because the initial shareholders bear the cost of limited voting structures\textsuperscript{155}.

Moreover, agency cost can be constrained in a number of ways. As La Porta, Lopez-de-Silanes, and Shleifer revealed in their research, families are the most common controlling shareholders in Controlling Minority Structure\textsuperscript{156}. It is reasonable to believe that the large shareholders would constrain their incentive to extract private benefit from the corporate to save and promote a more sustainable and long-lasting growth for the sake of their offspring. Therefore, reputation can be considered as a powerful restriction imposed upon those who own the corporate as a family\textsuperscript{157}. The other constrains comes from legal protection, for example mandatory disclosure for minority shareholders and public investors.

C. No Absolute One-Share, One-Vote

For quite a long period of time, and even till today, legislators and academy tend to have a mixed feeling towards the one-share, one-vote principle. The fact that both the United States and EU have attempted to regulate corporate voting system and to make

\cite{152} See Grossman & Hart (1988), supra note 131, at 1-5.
\cite{153} Id., at 6.
\cite{155} Guido Ferrarini (2006), supra note 54, at 24.
\cite{156} La Porta et al. (1999), supra note 125, at 498-502.
\cite{157} Bebchuk, Kraakman and Triantis (2000), supra note 112, at 16.
equal voting rights a mandatory rule is a good reflection of such controversy. While scholars are debating on the pros and cons of one-share, one-vote, and still cannot reach a uniform answer, empirical studies give a look at the equal voting from a different angle. Depending on the fact that most regulations only focus on direct limitation on different voting rights, for example prohibiting dual class shares, clever and resourceful controlling shareholders could easily find solutions to bypass the rules and set them aside and powerless.

Pyramid Structure is a commonly used way to deviate from one-share, one-vote without having to use dual class structure. When EU adopted the breakthrough rule, scholars argued that such rule would have little effect on takeover bids for companies that will go public in the future\textsuperscript{158}, because shareholders can increase their shareholding to 25 percent so that there is no way that public investor can reach the 75% threshold, or even easier, they can simply stop using dual class and adopt pyramid structure which is not covered by the breakthrough rule. In empirical studies, La Porta, Lopez-de-silanes and Shleifer researched ownership structures of companies in 27 “generally richest countries”; one major purpose of the research is to figure out how shareholders own the companies\textsuperscript{159}. They picked the 20 largest traded firms in each country as well as some other smaller firms to get a better view on contrast in size. They found out that multiple voting classes of shares are not the major mechanism to separate ownership from control, while pyramids serves the means: “fully 26 percent of firms that have ultimate owners are controlled through pyramids. That fraction is 18 percent in countries with good shareholder protection, and 31 percent in countries with poor protection.”\textsuperscript{160} Not like dual class structure, pyramid structure can make the separation of ownership and control less visible, and possibly at a cheaper price. Such approach will help large shareholders to better expropriate interest from minority shareholder, and pushing shareholders to establish an empire would make “creating a level play field” even less likely to happen. From such

\textsuperscript{158} Bebchuk and Hart (2002), supra note 60, at 2.
\textsuperscript{159} La Porta et al. (1999), supra note 125, at 472.
\textsuperscript{160} Ibid, at 499-500.
perspective, pyramid structure deserve more attention from legislature for a ban, however, it is quite difficult to identify pyramids to set limitation on their use, besides, limiting pyramids would also lead to negative effect of build-up of industrial groups.\footnote{161}

Apart from pyramid structure, there are other mechanisms that can reach a similar effect. Shareholders can indirectly enhance its controlling power while maintaining its cash-flow rights, such as having a cross-shareholding structure. Under such structure, large shareholders can through holding shares of another company, indirectly involve in the management of its own company. Or they can instead decrease the cash-flow risks by lending off stocks, having equity swaps, or conducting direct or indirect hedges\footnote{162}. Through equity derivatives, shareholders can easily outsource some of the cash-flow risks while still retain their control. Research has indicated that very few countries have restricted cross-shareholding structures\footnote{163}, and it is more difficult if not impossible to prohibit all equity derivative mechanisms in a vivid market economy. The 2007 EU Impact Report on one-share, one-vote has also reached the same conclusion not to harmonize such rule. Since there is no absolute way to prohibit all deviation from one-share, one-vote, it might be more important to study and explore means to counterbalance the negative effects coming from such deviations.

\section*{PART V ENLIGHTENING THE FUTURE OF CHINA’S DUAL CLASS VOTING STRUCTURE}

The Chinese academy has started to pay attention to the rationale of one-share, one-vote principle long before the new regulation of preferred shares\footnote{164}, but it was not a popular topic by then since legislation did not leave doable room for deviations from one-share, one-vote. The subject came back with an announcement of a possible

\footnote{161}{For a similar approach, see Khachaturyan (2006), supra note 65, at 13.}
\footnote{162}{See ibid, at 14; see also Bettis, J., J. Bizjak and M. Lemmon, Managerial Ownership, Incentive Contracting, and the Use of Zero-Cost Collars and Equity Swaps by Corporate Insiders, 345, Journal of Financial and Quantitative Analysis, Vol. 36, No. 3. (2001) for examples of hedges and collars}
\footnote{163}{La Porta et al. (1999), supra note 125, at 500. Although it is interesting to see that cross-holding structure is more common in those countries where cross-shareholdings are restricted.}
\footnote{164}{Peixin Luo (2006), supra note 83.}
reopening of preferred shares in 2013, and people begin to wonder whether China should even open up the gate wider to allow more deviations. If non-voting preferred shares is the first step towards dual class shares structure, is it possible to anticipate other types of dual class shares, such as different classes with multiple voting rights?

Despite the fact that dual class shareholding structure has gone through several up and downs in other countries, and has been widely discussed from different perspectives by scholars in both common law and civil law countries, it still deserves a special look in the Chinese market before copy and paste theories and experience from academic and empirical fields.

A. Ownership of Chinese Listed Companies

1. Ownership Structure of Listed companies in China

Compared to many other countries in the world, Chinese listed companies have a high percentage of state ownership. In a research on the ownership structure of public-traded companies, Chinese scholars found out that, among all 4845 sample companies, 16.8% of all companies were controlled by State-owned Asset Management Companies, 13.8% were controlled by State-owned Enterprises under the control of Central Government, 51% were controlled by State-owned Companies under the control of Local Government, which amounts to a total percentage of 81.6% companies in the sample, and only 18.4% are controlled by private equities. This result is different from western studies, for example La Porta et al. (1999), in which it was found, in contrast, that an average of 18.3% companies of all are controlled by states, while a large number of companies are owned by families or have a dispersed ownership.

---

166 La Porta et al. (1999), supra note 125, at 492.
The difference between ownership is vital as it leads to different business goals. For a common commercial entity, the ultimate goal is often to maximize its wealth. The controlling shareholders tend to make decisions that will help the company to have a better performance so as to extract more return from his or her investment. However, when the State acts as the controlling shareholder of a company, they will put more concerns on communitarian benefits, such as employment, social welfare, financial balance and so on. In other words, they will not always make optimal decisions for the development of the company.

2. High Concentration of Shareholding

In the same Chinese research, they studied how much percentage of shareholding the largest shareholder has, and under one-share, one-vote system, this number is equal to the amount of voting rights. As turned out from the statistic report, when the State is involved in the corporate shareholding, it usually holds a high percentage of shareholding in the company. The State holds an average of 42.05%, 52.60% and 48.95% of shares in State-owned Asset Management Companies, State-owned Enterprises under the control of Central Government, and State-owned Companies under the control of Local Government respectively, and the median average is 39.37%, 54.91% and 50.36% respectively. Therefore, we can conclude that when the State becomes the ultimate large shareholder, under more than half of the situations, they have a majority of votes, which makes it almost impossible for public investors to counterbalance the decision of the State under the current equal voting system. As to listed companies owned by private shareholders, the largest shareholder owns an average of 45.64% of all shareholdings, which amounts to 45.64% voting power; the median average stays around the same, at 45.43%. We can see from this number that situation in private-owned listed companies is relatively better in terms of majority rule, but it is still clear that the largest single shareholder has a concentrated

---

167 Xu, Xin and Chen (2006), supra note 165, at 92.
168 Ibid.
169 Ibid.
control over corporate business.

3. Monitoring and Supervision

There’s another figure that worth mentioning in the research, which is the number of significant shareholders in the listed companies. The definition of significant shareholder under Chinese Law means shareholders who hold at least 5% of the company’s shares. Research found out that in many cases where the State controls the listed companies, there’s no second significant shareholder in the company, and even when there is another significant shareholder, it holds a relatively much smaller portion compared with the largest shareholder, at around 20% of the shareholding of the largest shareholder\(^{170}\). For example, in the case where the State acts as the controlling shareholder and has 50% of the shareholdings, the second largest shareholder, who is also the only other significant shareholder in the company, has only around 10% of the shareholding of the company. In fact, the statistics showed that the average shareholding of second largest shareholder ranges between 6.15% to 7.53%, which depends on what type of State-owned entity is the controller of the listed company.

For private-owned companies, there is usually one other significant shareholder in the listed company, and the second shareholder holds an average shareholding of 14.68% of the corporate shares, and the median average is 13.82%.\(^{171}\) The second shareholder usually holds half the amount of shares that the largest shareholder has. Compared with State-owned listed companies, private-owned enterprises clearly have a better performance. However, it is still quite difficult to influence the decision of majority shareholders.

La Porta et al. found a similar result in their 1999 research. It was surprising to see that, of all 27 countries, in 75 percent of the cases, the controlling shareholder does

\(^{170}\) Ibid.

\(^{171}\) Ibid
not have another large shareholder in the same firm, and even in family-owned companies, this number is 71 percent\textsuperscript{172}.

However, despite that China shares a similar figure as many other countries and regions, due to cultural difference in business management, the domestic stock market in China has a worse environment in terms of monitoring and supervising large shareholder. People prefer a harmonious environment, and minorities are often not eager to raise different opinions. Furthermore, due to the fact that China has a weak Union, employees are generally more reluctant to disobey the will of large shareholders in China, especially in State-owned enterprises. Those employees who are elected to the supervisory board tend to feel being trusted by their boss instead of the willingness to fight for the benefit of other employees; therefore, it makes the monitoring from employee’s level also a hard task.

Therefore, based on the fact that China has a concentrated shareholding structure, and a weak monitoring environment both on the shareholding and cultural basis, we should focus more on measures to protect minority shareholders’ interest, rather than shareholder interest vis-à-vis management in general.

B. Performance of Chinese Listed Companies

Theoretically, absolute power leads to absolute corruption, and so is the case in corporates where lacks monitoring from minorities. When a company is controlled by a large shareholder instead of being widely held, the controlling shareholder is likely to seek private benefits at the cost of other minority shareholders. They can tunnel away benefits through self-dealing transaction, expropriate corporate opportunities, or increase his shares through dilutive share issues, minority freeze-outs, creeping acquisitions that discriminate against minorities\textsuperscript{173}. Nagar, Peroni and Wolfenzon found that when a company has several shareholders that hold a similar amount of

\textsuperscript{172} La Porta et al. (2009), supra note 125, at 505.
shares in it, they would monitor each other from taking away corporate benefits and hence improve corporate performance. Shleifer and Vishy showed that although increasing large shareholder’s proportion can increase the price of the firm’s shares in a take-over, a pre-monitoring purchase of shares raises the firm’s expected profits. However, the Chinese empirical research on listed companies saw a different outcome.

They found out that, in companies where there is a second large shareholder to balance the power of the largest shareholder, surprisingly, the corporate actually has a less satisfying performance than corporates without such “monitoring”. The researchers attributed the interesting phenomenon to the fact that not all corporates with a second large shareholder would really exercise their monitoring power due the reasons mentioned above. Even when there is a counterbalancing power, the second large shareholders may also involve themselves in a battle over control to extract private benefits from the company. There was one famous case in China back in 2004, where the two groups of shareholders fought for control in the Board against each other, and led to a plunge in the corporate stock price. In 2003 when the battle over control went ugly, shareholder lost 84 cents for every share they owned. Both groups had a chance to control the board, but they all took it as a chance to maximize their private benefits, as a result, Hongzhi, the listed company, lost an amount of value equal to 25 million Euro in the fight.

The Chinese research further showed that in private-owned listed companies, financial institutions as outside block-holders brought up significant effect on the

---

176 Xu, Xin and Chen (2006), supra note 165, at 93-96. They understand that there are a lot of ways to measure performance, therefore, in their research, they try to analyze from 9 different figures including return on assets, return on sales, asset turnover and sales growth rate
177 Ibid
corporate value from a negative way\textsuperscript{179}. Such impact may due the different investment goal of such institutions, as most of the financial institutions invest for capital return instead of a strategic approach. They are more willing to observe volatility in stock price than long-term shareholders, or use inside information to attract more return from their investments\textsuperscript{180}.

Concentration of control does not always lead to evil management or tunneling for private benefits. Compared with a dispersed controlling structure, a large shareholder could effectively solve the collective action problem, and they are more willing to monitor the management to achieve a better performance of its firm\textsuperscript{181}. A long-term large shareholder would also enhance corporate performance by providing a stable strategy. One rationale behind tag along right is established on the trust of the incumbent large shareholders, because many public investors tend to trust the current strategy. Therefore, we cannot promise a healthy company merely from a dispersed controlling system, and a concentrated controlling system is not always harmful to the development of a corporate.

C. Status Quo of China Concept Stock in NASDAQ

At the end of 2014, the Shenzhen Stock Exchange, one of the major exchanges in China, conducted a research on the current situation of China Concept Stock in NASDAQ\textsuperscript{182}. According the research, by the end of October 24\textsuperscript{th}, 2014, there were a total number of 114 China Concept Stock listed in NASDAQ Exchange. They went through the prospectus of 91 companies out of the 114 in total, which covered around 80\% of the number, and analyzed the percentage and the distribution of dual or multiple voting structured companies; they also looked into the magnitude of separation between voting rights and cash-flow rights. They found out that, there are in total 15 companies that has a dual or multiple voting structure, which takes up 16\%.

\textsuperscript{179} Xu, Xin and Chen (2006), supra note 165, at 97.
\textsuperscript{180} Ibid, at 97-98.
\textsuperscript{181} Shleifer and Vishny (1986), supra note 175, at 464.
\textsuperscript{182} Feng Xiangqian, Study on Introducing Multiple Voting Structure to the Shenzhen Stock Exchange, Stock Market Herald Journal. (2014) (冯向前, 创业板引入多重股权架构的探讨, 证券市场导报 2014年 12月号)
of the total sample.

1. Distribution

The 15 companies that set up dual or multiple class of voting are distributed among five types of industries: Software and Service, Retailing, Media, Customer Service, and Medical and Health Related Equipment and Service. The most common one lies in the Internet Service Industry, which takes up more than half of all the samples at a number of eight. Retailing follows and ranks the second, and contains three companies at a percentage of 20% of all dual/multiple class companies. Consumer Service Industry has two companies under its category and the rest two has one each within it.

2. Voting Rights / Cash-flow Rights

The 15 dual/multiple class companies set up different times of voting rights against cash-flow rights. The range covers from 3 times to 20 times depending on the company. Xin Lang, an Internet Company that runs a website similar to twitter stood the lowest among all, at 3 times of the cash-flow rights, while the most diverse one comes from Jin Dong, a company that runs online-shopping (similar to Amazon), at 20 times. The most common magnitude is ten times, which covers 8 out of 15 companies. Most of them come from the Internet Service Industry, while the other two rests in the Consumer Service Industry. Apart from 3 times, 10 times and 20 times, there are also 5 times and 15 times of voting rights over cash-flow rights, each category has two companies within it.

We can see from this report that, among those who choose to deviate from single class of shares, they prefer to have a wide separation between voting rights and cash-flow rights, which indicates their willingness to control the corporate decision power. Most of these companies are from Internet-based sector, which usually don’t have a lot of assets and are more vulnerable against hostile takeovers. All 15 companies in this list are very famous companies in China, and they are certainly the leading ones in their
industry. It is likely that they go abroad for listing because the domestic stock market does not allow them to issue multiple voting shares, which forces them to get away from the Chinese market, just like what happened to Alibaba.

D. Dual Class Shares Structure

Dual Class Shares Structure is common in many parts of the world. According to a research in 2001, more than 80% of Canadian Companies have a dual class shares structure \(^{183}\). In EU, 44% companies have one or more corporate controlling-enhancing mechanisms \(^{184}\). Dual Class Shares Structure is more popular in continental European countries, Canada, Mexico, Brazil and Korea, while it is less seen in common law countries such as US, UK, Australia \(^{185}\). Stock Exchanges in Mainland China and Hong Kong do not allow dual class shares structure \(^{186}\), which is the main reason why Alibaba turned to NYSE for listing.

Companies apply a diverse magnitude of voting rights to its superior class, ranging from double voting rights to more than 500 votes attached to one share. Starting from March 2014, unless agreed otherwise by shareholders, French companies shall grant an automatic double voting rights to any shares held in a registered form by the same shareholder for at least two years \(^{187}\). Shaw Communications Inc. was controlled by a superior class holding only 4.9% of the capital, while super-voting shareholders in Sceptre Investment Counsel Ltd. grabbed all voting power with only 0.066% of the

---


\(^{184}\) European Commission, Impact Assessment on the Proportionality between Capital and Control in Listed Companies, supra note 63.


\(^{186}\) Article 588(4) of Hong Kong Companies Ordinance (Cap 622) allows incorporation of companies with different voting rights, however, Hong Kong Listing Rules explicitly prohibit companies with a disproportionate setting between capital and control to be listed in Exchanges, except under very special circumstances. However, the Hong Kong Stock Exchange has not approved a single case yet. See Concept Paper on Weighted Voting Rights, Hong Kong Exchanges and Clearing Limited, August 2014.

corporate shares\(^{188}\).

Internet-based Tech Companies seem to prefer a dual class shares structure, for example Google, Groupon, Facebook all adopt a dual class of shares, and Chinese companies such as Baidu, a company providing online searching engine, and Jingdong, which focuses on online-retailing like Amazon are in favor of such structure as well. Dual class shares become prominent also at media companies such as the New York Times, Washington Post and News Corp.

In spite of the many disadvantages mentioned above on separation of capital and control, it is vital to realize that dual class shares are catching more and more attention from many well-performing companies. It is important to understand why they would opt for such structure, and what has indeed make dual class a popular mechanism nowadays. As mentioned before, high concentration of voting power is an effective defensive measure against hostile take-overs\(^{189}\). However, super-voting power means more to controlling shareholders than merely economic benefits. A dual class of shares would enable the controlling shareholders to solicit abundant equity without worrying dilution of corporate control, as a result, the management can focus on uniformed and long-term strategy that would benefit the corporate development from a long-run while alleviate it from influence from investors who are seeking profit from a volatile stock price\(^{190}\). Since the high concentration of control prevents hostile takeovers, which helps to lengthen the lifespan of these companies for around 50%\(^{191}\), the long period of holding a single business entity would, in return, enhance the emotional attachment of the controlling shareholder to his companies and encourage him to care more for the benefit of the company itself\(^{192}\). Besides, it is


\(^{189}\) See Section IV-B-2 on Market of Controls.


\(^{192}\) Gompers, Ishii and Metrick (2003), *Incentives vs. Control: An Analysis of US Dual Class Firms*,
simply wrong to assume that all shareholders want is only economic returns and controlling would absolutely lead to extraction of corporate value. Journalistic integrity at newspaper, corporate strategies at a software company and brand identity at a consumer company are so vital that they can easily outweigh financial losses\textsuperscript{193}. In the cases where the company is owned by a family, reputation and willingness to pass on a company with promising sustainable development can also serve as a strong motive to run the corporate businesses.

Unlike many theoretical studies have shown, dual class shares structure do not always lead to a bad performance. On the contrary, many high market value companies with relatively low debt ratio choose to apply dual class shares\textsuperscript{194}. Other study has shown that when a single class company converts into a dual class shares structure, it actually embraces a better performance\textsuperscript{195}. After an analysis of company performance in the Toronto Stock Exchange, scholar found that companies with a dual class shares structure take up 17.5\% of the 200 best performing companies, while only 6.9\% of all companies in such Stock Exchange hold a structure with dual classes of shares\textsuperscript{196}.

We can conclude from Section B, Section C and Section D that a concentrated controlling system will not always damage the corporate value, in many cases, an uneven playing field that favors a single controlling shareholder can also bring about better performance of the company. The fact that many leading Chinese companies went listing abroad and adopt dual class shares structure is a strong evidence of the eager of Chinese companies for such structure. Therefore, it is unnecessary to stick to one-share, one-vote rule. Although we cannot come to a conclusion that dual class shares structure is better than one-share, one-vote, state may still provide companies the possibility to choose a dual class shares structure. It is undeniable that such

\textsuperscript{193} Gompers, Ishii and Metrick (2008), supra note 191, at 41.
\textsuperscript{195} Valentin Dimitrov and Prem Jain, Dual class recapitalization and managerial commitment: Long-run stock market and operating performance, Working Paper, Georgetown University. (2001)
\textsuperscript{196} Wei (2012), supra note 185, at 116.
structure has its shortcomings, but we should open our mind and make rooms where dual class shares structure would be allowed and exercised in a healthy way. It is very important to establish an environment to protect minority shareholders from being expropriated by the controlling shareholder(s), because appropriate protection schemes serve as the pre-condition for large shareholder(s) to perform at a more positive way.\footnote{Andrei Shleifer and Robert W. Vishny, \textit{A Survey of Corporate Governance}, LII The Journal of Finance, 773. (1997)}

**E. Legal Protection of Minorities**

Before 2014 when there was still no clear regulation on whether and how China should proceed with a preferred shares scheme, scholars were not confident in the future of a dual class shares structure in China. The toughest question sticks with whether dual class shares structure can break the strict ban of unequal voting rights mentioned in Article 103 of Company Law. However, as demonstrated in Part I, we now see a first step from the State to deviate from the one-share, one-vote rule, which leaves the possibility for a wider open in the future. Moreover, we have a much clearer picture on the procedures of how other dual class instruments would be implemented in the country. There are no obvious legal or procedural obstacles observed to prevent dual class shares. However, due to the various problems caused by separation of ownership and control, a counter-balanced power is getting even more essential in a dual class shares structure. Therefore, in this section, I will take a brief look at some of the minority shareholder protection instruments in China. This is not a thorough list, but merely to see if China could improve its current system or introduce more instruments to better protect minority shareholders under a dual class shares structure.

1. The Right to Information

Article 97 of the current Company Law provides shareholders the right to refer to the
corporate charter, register of the shareholders, counterfoil of corporate bonds, records of the shareholders' assemblies, records of the meetings of the board of directors, records of the meetings of the board of supervisors and financial reports. It is a very important rule to keep shareholders, especially minority shareholders, informed of what is going on in the company. It will also serve an important means in protecting inferior class shareholders in a dual class shares structure company.

2. Classified Voting

The 2013 Guiding Opinion on Preferred Shares asks companies who issue preferred shares to adopt a classified voting under the following circumstances: 1) issue new preferred shares; 2) change any rights or obligations attached to preferred shares; 3) reduce more than 10% company registered capital by a single resolution or on cumulative basis; 4) when deciding on corporate merger, division, dissolution or a change of corporate form; 5) other matters agreed in the corporate charter. It provides inferior class shareholders the right to participate in resolutions that have significant impact on their rights as shareholders. Classified voting can also be applied to other classes of shares with voting rights, but the scope of such instrument could be different.

3. Extraordinary Shareholder’s Meeting

The Chinese Company Law provides shareholders the right to convene extraordinary shareholder’s meetings within two months when certain situation occurs or under the initiative of shareholders holding at least 10% shares\(^{198}\). Article 101 writes: “If the board of directors or the executive director is unable or fails to fulfill the obligation of convening the shareholders' assembly, the board of supervisors shall convene and preside over such assembly. If the board of supervisors does not convene or preside over such assembly, the shareholders separately or aggregately holding 1/10 or more of the shares may convene and preside over such assemblies on their own.

\(^{198}\) See Article 101.
initiative."\(^{199}\)

The right to convene additional shareholder’s meeting is an important method to protect shareholders from the board’s abuse of power. It did not become a rule until the 2005 amendment. In 2004, the largest shareholder of Hongzhi, the listed company mentioned above, was held by court unable to initiate a shareholder’s meeting on his own, and he could not take back control even with an holding of nearly 20% of corporate shares. The rule is nevertheless criticized, mainly because the mandatory sequence has dramatically lengthen the procedure, and would be too late to recover shareholder’s claim, hence render the right useless.\(^{200}\)

4. Derivative Action

Article 151 of the 2013 Company Law provides shareholders the right to initiate actions at their own name to prevent the company from serious damages due to inappropriate behaviors of directors, supervisors and senior management. Article 151 writes that where any director or senior manager violates any law, administrative regulation, or the bylaw during the course of performing his duties, shareholder(s) separately or aggregately holding 1% or more of the total shares of the company for 180 consecutive days or more may request in writing the supervisory board to initiate a lawsuit in the people's court. If a supervisor is under the circumstance as mentioned above, the aforesaid shareholder(s) may request in writing the board of directors to initiate such action. If the board of directors or the supervisory board refuse or fail to initiate the action within 30 days of the written request, or if, in an emergency, the failure to lodge an action immediately will cause unrecoverable damages to the interests of the company, the aforesaid shareholder(s) can may, on their own behalf, directly lodge a lawsuit in the people's court.

\(^{199}\) See Paragraph 2.
Derivative action is not widely used in China despite the right granted. The main reason is because the initiating shareholder shall bear the litigation fee in advance. The 2009 Guiding Opinion on Company Law Issues by the Supreme Court asks the defendant to reimburse the litigation fee to the initiating shareholder(s) when the court accepts the claims from the initiating shareholder(s). When the shareholders win the case, the court will of course give back all the litigation cost, therefor the litigation fee shall include other costs such as legal attorney’s fee and transportation fee\(^{201}\); however, the scope of such litigation fee remains unclear. Based on the legal words of the 2009 Guiding Opinion, the court does not protect the shareholders to get back their litigation cost as a counterbalance of abuse of power, however, the risk of losing the case has even lower the incentive of minority shareholders to apply such protection scheme.

5. Cumulative Voting Rights

Cumulative Voting is currently allowed under Chinese Law. Article 105 of the latest Chinese Company Law specifies cumulative voting rights as a default rule in Joint-Stock Limited Companies. Contrast to Esterbrook & Fischel, “Cumulative Voting is rare in publicly traded firms and while most state statutes contain a presumption against cumulative voting”\(^{202}\), the Chinese Administrative Code for Listed Companies encourages Cumulative Voting in listed companies, and it writes “listed companies with a controlling shareholder who holds more than 30% of the corporate shareholding shall apply cumulative voting in its corporate governance”\(^{203}\). Non-listed public companies do not have cumulative voting as a mandatory rule, however, it also requires explicit writing in its corporate charter if the corporate decides to apply such mechanism\(^{204}\).


\(^{202}\) Easterbrook & Fischel (1991), supra note 104, at 73.

\(^{203}\) See Article 31.

\(^{204}\) See Article 15, No.3 Guidance of Non-listed Public Companies – Charters.
Under one-share, one-vote rule, cumulative voting is an essential way to prevent majority shareholders to dominate the board of directors. However, cumulative voting tends to have a much more limited effect on balancing majority shareholders when it comes across the situation of super-voting shares. In most of the Chinese Concept Stock that applied 10 votes to its superior voting class, large shareholders could easily hold super-voting shares that amount to only 10% of all shares and still get a majority of seats in board. Therefore, it might provide better protection for inferior class shareholders to further allow certain number of directors from each class and use separate voting in electing their own directors, or to require at least one director from each class.

We can see that among the listed Chinese minority shareholder protection instruments, some are as important in dual class shares structure, some require modification while others may have a much less of usage when super-voting shares are involved. Stepping from a single class of shares to dual class shares structure where there can be a greater conflict between majority and minority shareholders, China will certainly need to modify its legislature to add and enhance minority protection instruments to counterbalance the super-voting power and subsequent situations led from it. Apart from the above-mentioned ways, there are two more protection schemes that I think are also useful:

1. Information Disclosure

It is clear that there is no uniform in types of investors. Dual class shares structure provides a platform where investors holding different incentives are allowed to choose the investing instrument that best suit its expectation. Proper information disclosure can help investors to quicker locate the companies with the right type of controlling structure they want. From a protection point of view, it is essential for outside investors to know the controlling power and economic return of the shares they intend to buy, so that they can better decide in advance. To achieve such purpose, I think it is necessary to require mandatory disclosure on the voting structure of the
company, along with detailed information of the voting power and return rate attached to each class of shares, as well as the existing shareholding in every class.

2. Coattail Clause

Coattail clause can serve as an effective way to protect minority shareholders in takeovers. Coattail clause is an equal treatment mechanism in dual class companies. The coattail clause enters into force when the acquirer acquires a certain amount of shares from the superior class, usually at 50%. For example, when the acquirer gets 51% of the shares in the super-voting class at the price of EUR 10, the shareholders in other classes with restricted voting rights are entitled to sell their shares at the same price. Under the coattail provision, minority shareholders are provided with a better protection of quitting the company at a fair price.

PART VI CONCLUSION

Debate over one-share, one-vote rule has been held all over the world for more than a century. Equal voting right has many advantages such as alleviating expropriation of corporate value at the cost of minority shareholders and reducing agency cost, however, one-share, one-vote rule does not solve every problem in corporate governance and makes company relative more vulnerable against hostile takeovers. The modern equity derivative instruments and other control-enhancing mechanisms such as pyramid structure and cross-holding shares has made one-share, one-vote nearly an ideal balance between ownership and control, and it is very difficult if not impossible for legislator to prohibit separation of ownership of control merely by regulating and enforcing a mandatory one-share, one-vote rule. On the other hand, dual class shares structure are accepted by more and more well-performing companies, and such structure has brought many advantages to the company such as a stable strategy aiming at long-term development. Based on the Preferred Shares Scheme, there are no obvious legal or procedural obstacles under Chinese Law to initiate dual class shares. However, there still requires improvement in the existing legal
framework, and we could introduce some new rules suitable for dual class shares structure in the current legal framework to better protect minority shareholders.

There’s no system without flaws. Based on my research, I cannot come to a conclusion that dual class shares structure is absolutely better than one-share, one-vote rule. However, we can see from empirical research that concentrated control in China may not always lead to a bad end, and many Chinese leading private-owned companies go listing abroad and apply a dual class shares structure. Due to the fact that there has never been a promise to a strict proportion of capital and control, I do not think one-share, one-vote should be a mandatory rule, and certainly should not be a block stopping shareholders from the opportunity to choose which structure they prefer. Moreover, I think dual class shares structure’s advantage to allow shareholders to collect more fund without significantly dilute their control may also serve as a good solution in the current mix ownership trend for State-owned companies in the sense that it can relieve government from its debt pressure while still hold control in the companies. This is important for the society as well especially for companies in social welfare industries. At the mean time, because separation of ownership and control can inevitably bring many new issues between majority and minority shareholders, although there should be no obstacle from the perspective of one-share, one-vote, I am not confident that China is ready to allow a share structure that has dual class shares with multiple/low voting rights under the current legal framework. Before we are ready to embrace all the benefits from this structure, legislators should focus on enhancing the existing minority shareholders protection instruments and introducing new ones where appropriate to counterbalance the negative effects that might come along with the dual class shares structure.

***
REFERENCES

BOOKS AND ARTICLES


Berle Adolf A. and Gardiner C. Means (1932), The Modern Corporation and Private Property, New Brunswick, N.J.


Blair Margaret M. & Lynn A. Stout (2006), Specific Investment: Explaining Anomalies in Corporate Law, Cornell Law Faculty Publications.

Bratton W. et al. (2012), Dual-class stock: Governance at the edge, Shareholder Value 2012, Third Quarter, 43.


Program on Corporate Governance, Harvard, John M. Olin Center For Law, Economics, and Business.


Hayden Grant M. & Matthew T. Bodie (2008), *One Share, One Vote and The False
Promise of Homogeneity, 30 Cardozo Law Review.

He Xin (2005), Analysis of Supply and Demand in Academic Fields, Peking University Press.


Luo Peixin (2006), Economics In Legal Study: From the Perspective of Corporate Voting Rules, 5 Legal Studies.


Velasco Julian (2010), *Shareholder Ownership and Primacy*, University Of Illinois Law Review.


Wang Qingsong (2014), *On Separation of Ownership and Control — Learn From the Rise and Fall of the One-share, One-Vote Rule*, 8 Tsinghua University Law
Journal.
Wei Yongqiang (2012), Is Dual Class Shares Structure a Wise Choice? 10 Special Zone Economy.

CASES
Gray v. Sanders, US 368, 381 (1963)
Hall v. Isaacs, 146 A.2d 602 (Del. Ch. 1958)
Salyer Land Co. v. Tulare Lake Basin Water Storage District, 410 U.S. 719 (1973)

ONLINE SOURCES
Civil Law.com http://old.civillaw.com.cn/
Financial Times http://www.ftchinese.com/
International Herald Leader http://news.ifeng.com/
Sina http://finance.sina.com.cn/
The Economic Observer http://www.eeo.com.cn/