ECGI ROUNDTABLE

LOYALTY SHARES

BRUSSELS
JUNE • 18 • 2018
REPORT BY TOM VOS

Executive Summary

The ECGI roundtable on loyalty shares began with a discussion of whether short-termism is a real problem and concluded that there is significant empirical evidence that it is. The debate then centered around the question to what extent loyalty voting shares can solve short-termism. The consensus seemed to be that they do not promote longer holding periods and therefore long-term behaviour with regards to institutional or retail investors. However, they do act as a control enhancing mechanism for controlling shareholders, which can insulate them from short-term market pressures.

Currently, loyalty voting shares are possible in (inter alia) the Netherlands, France and Italy, and the Belgian government recently proposed to introduce them as well. While the legal regime in the Netherlands is not based on statutory law but rather on the contractual freedom for legal practice, statutory law on loyalty voting shares in the other jurisdictions grant double voting rights to shareholders who have held registered shares in the corporation for more than two years.

During the roundtable discussions, empirical evidence in France and Italy was presented that showed that there is a significant demand for loyalty voting shares. It is notable (and quite controversial) that the rules to introduce them in the midstream are usually more flexible than for introducing regular dual class structures. France grants loyalty voting rights as a default, unless this is blocked by a two-thirds majority. In Italy and Belgium, a two-thirds majority is required to introduce them, but there is a transition period of six months where loyalty voting rights can be introduced with a simple majority. In theory, the more flexible regime for introducing loyalty voting rights is justified because each shareholder has an equal opportunity to receive double voting rights. In practice, however, loyalty voting rights mainly benefit controlling shareholders. Empirical evidence in France shows that loyalty voting shares were introduced in many companies in spite of heavy opposition by a majority of shareholders. Empirical and anecdotal evidence also shows that loyalty voting rights are often used by family firms, as well as by the state in trying to unwind its equity stake. Finally, empirical evidence indicates that loyalty voting shares do not increase holding periods and are almost exclusively used by controlling shareholders. There was a consensus at the roundtable that loyalty voting shares were therefore a type of control enhancing mechanism, and that the desirability of the latter should be debated. While some argued at the roundtable that dual class shares in general and loyalty shares in specific should be prohibited or subject to a sunset provision, others disagreed with this proposition.




Introduction

After a welcome by Howard Liebman (Jones Day), Marco Becht (Solvay Brussels School, ECGI and CEPR) introduced the concept of the ECGI Roundtable Series, a new initiative that brings together specialists on a topic (a) on which we have research, and (b) which is relevant. The roundtable began by examining the debate of short-termism, and tried to answer the question "how much short-termism is there actually?". There is a great debate about this, with for example Mark Roe arguing passionately against the idea that short-termism is a problem. Following this, the focus moved to loyalty shares specifically. A first option is to reward shareholders by giving them an extra dividend. The second option of rewarding loyal shareholders is awarding them extra voting rights. Loyalty voting shares are currently available in France and Italy, and Belgium is going to introduce this in its company law reform. In addition, Spain and Switzerland are thinking about introducing loyalty shares as well, according to Becht. During the day, Zsofia Kerecsen from the European Commission also discussed the Commission's view on loyalty shares and their relation with the initiatives on sustainable finance. Finally, the event concluded with a presentation by Kobi Kastiel (Tel Aviv University and Harvard Law School Program on Corporate Governance) on whether the insights from the debate on dual class shares in the United States can be applied to loyalty shares.

   

Briefing 1: Is “short-termism” real?

Zacharias Sautner, Frankfurt School of Finance

To start of the discussion, Zacharias Sautner (Frankfurt School of Finance) presented some of the evidence on whether or not short-termism is present in the stock markets. Short-termism was defined as “taking measures that increase short-term performance at the cost of long-term value”, such as decreasing spending on maintenance of building or R&D. Sautner points out that if markets were efficient, lower future performance would be fully incorporated into current market prices, but as turned out, this was not found in the empirical evidence.

Some authors, such as Graham, Harvey and Rajgopol (2005), have surveyed CFO’s about short-termism. They find that “80% of surveyed CFOs are willing to decrease discretionary spending on R&D, advertising, or maintenance to meet earnings targets”. The question is of course whether these effects are real, regardless of what CFO’s say. Sautner argues that this is the case, based on evidence discussed in two separate papers on respectively short-term CEO incentives and short-term investors.

First, Sautner presents a paper on CEO’s myopic behavior. The hypothesis is that managers would engage in myopic behavior if they benefit in the short term, but face little exposure to the long-term costs. Therefore, the paper compares managers with stock options that vest in the short term, and compare them with managers with stock options with a longer vesting period. The hypothesis is that managers with short-term incentives would behave myopically by cutting investment. The challenge is, however, that vesting periods are set by the board and may therefore reflect different investment opportunities. To counter endogeneity concerns, the authors looked at firms that opted for accelerated vesting of stock options after a change in accounting rules, and exploited the differences in entry into force, which depended on a firm’s accounting year.

The paper finds that firms cut total investment (capex and R&D) by 27% in the year of option acceleration; that in the short-term, accelerators that cut investment earn 5% higher returns than accelerators that do not cut investment; that the CEO's sell 65% more equity and voluntary turnover doubles in year after acceleration; and that in the long-term (two years), accelerators' stocks underperform the market (and non-accelerators) by 10%. These findings are consistent with the idea of managerial short-termism. One of the participants pointed out that many people (especially policy makers) would consider two years hardly "in the long-term", but Sautner points out that one should be skeptical about long term event studies.

One explanation of managerial short-termism raises is that it is driven by short-horizon investors. The second paper that Sautner presented found evidence that this is the case. The theoretical hypothesis was that the arrival of short-term investors would lead to pressure on executives to cut long-term investments, increasing short-term earnings, which would lead to a temporary boost in the stock price, after which short-term investors exit and firm value gradually decreases again to below the original value. The paper found evidence that this is exactly what happens, consistent with the real effects of investor-short termism.

In conclusion, Sautner showed that there is considerable evidence that short-termism is real. In a comment, Genevieve Helleringer tried to reconcile this evidence with Mark Roe's work, which challenges the statement that there is less investment in R&D and capital and more buybacks. His evidence was about worldwide data, while this evidence is solely about listed corporations in the US. Sautner points out that there is no counterfactual for worldwide data, so that we do not really know whether there is an effect. Zsofia Kerecsen (European Commission) pointed out that the topic of short-termism has been on the Commission's agenda for quite some time. Kerecsen refers to the Kay report, which argues that the entire asset management industry is short-term oriented, even though their clients have a long-term horizon. Sautner agrees that the disintermediation in the equity chain is a problem.

Briefing 2: Loyalty shares in the Netherlands

Alessio Pacces, Erasmus University Rotterdam

Taking into account the evidence presented that short-termism is a problem, the debate then moved onto how we can solve this by rewarding long-term shareholders. Alessio Pacces (University of Rotterdam) then described the situation of loyalty shares in the Netherlands, with the help of Titiaan Keijzer (University of Rotterdam).

Pacces first discussed the DSM case, where DSM tried to introduce a loyalty dividend, as has been suggested in a paper by Bolton and Samama (2013). The Enterprise Chamber ruled against it, arguing that it violated the principle of equal treatment of shareholders. However, the Attorney-General appealed in the public interest, and the Supreme Court ruled that this structure was allowed, as only shareholders who are in the same position should be treated in the same way. In the end, however, loyalty shares were never implemented by DSM.

Pacces points out the nominal value constraints to shares in the Netherlands. By default, all shares have equal rights in proportion to their nominal value. Although the articles of association can provide otherwise, there are some limits: every share has to have at least one vote, and shares with different voting rights need to have a different nominal value. Nevertheless, it is possible to introduce almost any form of dual-class structure at the moment of the IPO. In practice, this is done by requiring different contributions on the shares, and particularly a share premium on the lower nominal value (lower voting) shares to compensate the difference with the higher nominal value (higher voting) shares. In this way, the economic rights of the two classes of shares can be identical. In the midstream phase (that is to say, when the company is already listed), there are additional limits because existing shareholders cannot be treated disparately. According to Pacces, this probably means that it would not be allowed to introduce a mandatory conversion provision, where the higher voting shares are converted into lower voting shares if they are traded, because the intent would obviously be to dilute shareholders.

Pacces also explained how loyalty shares are structured in the Netherlands, and how they can even be introduced in the midstream, as all shareholders are created equally. So far, loyalty shares have only been introduced through mergers or demergers. Under a loyalty share scheme, shareholders can register their shares in a loyalty register; after the stipulated amount of years, they will receive additional shares (with voting rights) for free, which they have to hand in again for free if they deregister the shares to trade in them. The loyalty shares have very limited dividend rights, because the company only wants to give additional voting rights.

Pacces then discussed some cases were such a transaction structure was applied. In the CNH (Fiat Industrial) deal, the Agnelli family already had a pyramid structure in place, but they enhanced their control by introducing loyalty voting shares. This way, they retained a similar level of voting power (nearly 42%) with 14,25% of the cash flow rights as opposed to 34,14%, which they had before. In theory, all shareholders were eligible for loyalty voting shares, but in practice, Exor (controlled by the Agnelli family) was the only large shareholder who received loyalty voting shares. Similarly, in the Ferrari deal, a block of 10% new shares were issued in an IPO, but thanks to a loyalty voting structure, new capital could be raised without diluting voting power while even decreasing the Agnellis' cash flow rights from 14% to 12%. Again, in Ferrari, only Exor and Piero Ferrari made use of the loyalty voting scheme. Importantly, these transactions also do not trigger a mandatory bid in the Netherlands, in contrast to the law in other countries. Pacces also discussed the Altice deal, a midstream dual class recapitalization implemented through a cross-border merger, and the Yandex deal, a deal at the IPO stage.

Pacces concluded that loyalty voting shares are easily available in the Netherlands, even in the midstream. However, he noted that this is nothing else than a control enhancing mechanism, because in practice, only the controlling shareholders make use of the loyalty shares. As a comment, Marco Becht noted that this presence of loyalty shares in the Netherlands may have exerted competitive pressure on Italy and now Belgium to introduce loyalty voting shares as well.

Briefing 3: Sustainable finance and investor loyalty

Zsofia Kerecsen, European Commission

After lunch, Zsofia Kerecsen (Policy Officer Company Law, European Commission) discussed the policy of the Commission regarding sustainable finance and the relationship with loyalty shares. Kerecsen notes that the Commission has been working towards better corporate governance and a more sustainable and long-term oriented shareholdership after the financial crisis, where investor short-termism had an impact. The Shareholder Rights Directive was one of the results of this. Following adoption of the Paris Climate Agreement and the UN Sustainable Development Goals, the Commission has also been working on a sustainable finance workstream.

In March 2018, the Commission adopted an action plan on sustainable finance. Most related to loyalty shares is action 10 on “Fostering sustainable corporate governance and attenuating short-termism in capital markets”. Kerecsen distinguished three workstreams under this action: 1) alleviating short-term pressure coming from capital markets and ways to combat this; 2) mandatory due diligence for companies regarding sustainability issues, such as environment and human rights; and 3) the definition of the company’s interest, possibly extending it in order to encompass the interests of stakeholders other than shareholders.

Kerecsen noted that at the moment, the Commission is not doing anything concerning loyalty shares, although it is an obvious candidate to solve short-termism. It has been on the EU agenda twice before. In a public consultation, stakeholders were divided about the benefits of this, with a majority being opposed. It has also been suggested by the European Parliament as part of the negotiations on the Shareholder Rights Directive, but it did not receive sufficient support. Kerecsen mentions, however, that the Commission is extremely interested in loyalty shares and would be happy to learn if this works to tackle short-termism.

In a comment, Pierre-Henri Conac mentioned that the Reflection Group on the Future of EU Company Law has proposed in 2011 that the Commission would recommend to the member states to allow loyalty voting shares and loyalty dividends. At the time, nothing was done with this, but recently, the situation has changed, after the stronger support for loyalty shares in France, Italy and Belgium. Other participants remarked that loyalty shares mainly function as a mechanism for controlling shareholders to enhance control, and fail to stimulate long-termism in other shareholders. This way, they play a role in preventing shareholder activism, but to what extent this is desirable is still up for debate and may depend on the characteristics of each jurisdiction. It also remains to be seen whether short-termism is equally large in Europe as it is in the United States or whether “long-termism” by controlling shareholders is also a problem in Europe. The Commission acknowledges that we don’t know yet whether loyalty shares are good or bad, and is therefore hesitant to come up with strict measures. Genevieve Helleringer noted the contrast between the Commission now considering to introduce loyalty shares, whereas 10 years ago, the Commission was thinking about mandating one share, one vote.

Briefing 4: Loyalty shares in France – overview

Genevieve Helleringer, Essec Business School and University of Oxford

Genevieve Helleringer (Essec and Oxford) then gave an overview of loyalty shares in France after the Loi Florange. In France, the Schweitzer and Ferrand report (2012) and the Gallois report (2012) served as direct inspiration for the Loi Florange. The idea was to stimulate long-term active investors through various kinds of strategies, and especially through loyalty voting shares. Helleringer explained that the general principle under French company law is that profit rights and voting rights are proportionate to the amount of capital contributed, but in practice, it is possible to contractualize this strict legal framework. Helleringer then discussed the history of loyalty shares in France: multiple voting rights were possible before 1903, after which they were banned. After 1933, multiple voting rights were tolerated again, subject to legislative constraints: shareholders could only be granted double voting rights; this only applied to registered shares; there was a minimum two years holding period; the articles of association or the EGM had to provide for it; and the provision should be applied to all shareholders (although foreign shareholders could be excluded, which was later modified to non-EU shareholders). According to Helleringer, these loyalty voting shares were used in 50% of the top 40 listed companies and in 60% of the top 120.

In 2014, the Loi Florange, a protectionist law containing many provisions against takeovers, changed the law on loyalty voting rights by switching from an opt-in to an opt-out system. Loyalty voting rights are now the default option, unless a company opted out with a two-thirds majority. The loyalty voting rights cannot be transferred, unless through merger, divorce or inheritance. Responding to a question from one of the participants, Helleringer clarified that there is no anti-avoidance provision if the shares in a holding company that owns the loyalty voting shares are transferred.

According to the Report from the National Assembly Economic Affairs Commission (2013), the goals of these provisions of the Loi Florange are (1) to increase the weight of long term shareholders over short term investors; and (2) to embed the power of controlling shareholders, as solid investors with a long term commitment. Helleringer added that there are also officious goals underlying the Loi Florange: (1) giving the state the opportunity to further privatize companies while retaining control; (2) to protect companies against takeovers; (3) the identification of institutional investors; and (4) protectionism, as the initial proposal limited double voting rights to persons with French or EU nationality.

Helleringer also discussed some of the criticisms on the Loi Florange, especially by foreign investors and proxy agencies, who strongly value the "one share, one vote" principle. Helleringer concluded that the Loi Florange had a limited effect on the influence of the state on French companies, either because it already have a majority of the shares, or because it remained a minority shareholder, except in the case of Air France KLM. Helleringer stated that around 50% of the companies opt out of loyalty shares in an IPO and proxy agencies also recommend opting out. Finally, Helleringer pointed out that in the future, it will be very likely that the state will reduce its investment in certain companies, while still retaining under control, under the so-called "Loi Pacte".


ecgi
european corporate governance institute
Leading Research
with Global Impact


Sustainable Finance and Investor Loyalty
ecgi


ecgi

Briefing 5: The Loi Florange – a coasian bargain?

Anete Pajuste, Stockholm School of Economics, Riga

After Helleringer's overview of loyalty shares in France, Anete Pajuste (Stockhol School of Economics Riga) presented a paper (co-authored with Marco Becht and Yuliya Kamisarenka) providing empirical evidence on the Loi Florange. The hypothesis of the paper is that the switch from an opt-in to an opt-out system should not matter for firms that do an IPO, because according to the Coase theorem, firms could simply opt out of the default rule. However, the paper found that this was not the case: before the Loi Florange, 36,5% of the IPO firms had loyalty shares, while afterwards, this was the case for 53,5% of the firms. In addition, after the Loi Florange, less firms (although still a majority) applied the loyalty voting rights retroactively. One possible explanation is that the transaction costs for opting out do matter, but the authors did not consider this very likely. Instead, Pajuste suggested an explanation grounded in "libertarian paternalism": the new default rule signals the new governance mechanism preferred by the state ("paternalism"), which nudges corporations to adopt it, but corporations can still opt out ("libertarian").

Secondly, Pajuste also presented evidence on companies that switched to loyalty voting rights in the midstream, where the Coase theorem does not apply, as property rights are changed from a two-thirds majority to a one-thirds majority to introduce loyalty voting rights. The paper found that 14 firms switched from "one share, one vote" to loyalty voting rights after the Loi Florange. In 7 cases, there even was no vote that proposed to retain the "one share, one vote" structure, according to the paper because there was no point in having a vote, as a shareholder had a blocking minority of at least one-third in each of those cases. In the 7 firms that switched to loyalty voting rights, but did vote on whether to retain a "one share, one vote" structure, the vote failed 5 times even though a simple majority of the shareholders had voted in favour of "one share, one vote", because a two-thirds majority is required. The paper also finds that the state was dominant in 6 out of 7 of these cases. In addition, the Probit analysis with a state dummy variable clearly shows that loyalty voting rights is something that the state wanted and used. Pajuste concluded that many firms could not opt out of the new default rule due to the presence of conflicted parties, especially the French state.

Finally, Pajuste also discussed the impact of loyalty voting shares. The paper found that firms with loyalty voting rights did not have lower firm value (as measured by Tobin's Q). However, it did find that firms with lower firm value (even before the Loi Florange) were more likely to switch to loyalty voting rights, which the authors explain through the presence of the state in those firms. The paper also finds that there is no significant difference in the average holding periods between firms with and without loyalty voting shares, and that shareholders in the companies that switch to loyalty voting shares become even less "loyal". Pajuste concluded from this that loyalty voting shares do not really stimulate loyalty to the company, and that loyalty voting shares are only about enhancing the control of the controlling shareholder.

Briefing 6: Loyalty shares in Italy – overview

Ettore Croci, Universita Cattolica Del Sacro Cuore

After the French perspective on loyalty voting shares was discussed, Ettore Croci (Università Cattolica del Sacro Cuore) gave an overview of loyalty shares in Italy. After sketching the broader context in the United States and Europe, Croci discussed the history of control-enhancing mechanisms in Italy: in 1974, non-voting shares were introduced, and in 2014, the "Competitiveness Decree" introduced loyalty voting shares and multiple voting shares in Italy. According to Croci, the goals for introducing loyalty shares were: (1) to facilitate the sale of equity stakes in state-owned companies, while preserving control; (2) to provide incentives to family-owned companies to go public; (3) to discourage short-termism; and arguably (4) to reduce the risk of hostile takeovers.

Croci pointed out that, unlike as in France, a vote at the EGM is needed to introduce loyalty voting shares or multiple voting shares, an "opt-in" regime. Under Italian law, loyalty voting shares do not create a separate category of shares and all shares that meet the requirements of registration in the special register for a period of at least two years, will receive double voting rights. These double voting rights are lost when the shares are transferred. After a question by one of the participants, Luca Enriques clarified that the double voting rights are also lost if control over a holding company that holds the loyalty voting shares is transferred, unlike as in France.

Croci then presented some empirical evidence. In a sample of all listed companies, only 2 of them had multiple voting shares and 35 had loyalty voting shares (19 introduced them in 2015; 8 in 2016; 10 in 2017 and none in 2018, although Marcello Bianchi (Assonime) claimed that there have been 2 new ones in 2018). In addition, Croci found that loyalty voting shares were mainly adopted by family firms, even though they already had control over the company. He also finds that that companies with loyalty firms have fewer directors from minority lists, and that the presence of these directors significantly lowers the probability of the adoption of loyalty voting shares. However, some participants suggest that this needs further research, as almost all companies have some directors from minority lists. Next, Croci presented evidence that stock prices reacted significantly negative to the announcement of the Competitiveness Decree, but slightly positive to the announcement to introduce loyalty voting shares. In addition, the presence of loyalty voting shares did not cause a change in the percentage owned by institutional investors. Finally, Croci found that loyalty shares are negatively associated with the probability to receive a takeover offer as well as to be delisted.

ecgi
Sustainable Finance and Investor Loyalty

Investor Loyalty
European Commission
ecgi
Leading Research
Global Impact

Sustainable Finance and Investor Loyalty

Briefing 7: Italian loyalty shares in practice

Luca Garavoglia, Davide Campari-Milano S.p.A.

After Croci's presentation, Luca Garavoglia (chairman of Davide Campari-Milano S.p.A.) added a practical dimension to the discussion on Italian loyalty voting shares. He argued that loyalty shares are just another form of a control enhancing mechanism, and will definitely not lengthen the holding periods of institutional shareholders. Garavoglia argued that in a controlling shareholder company, the controlling shareholder could benefit from loyalty voting shares because sometimes a supermajority is needed, and because the loyalty voting rights allow the controlling shareholder to build down its stake and avoid dilution in case of a stock acquisition or secondary equity offering. However, in a controlled company, institutional investors would have very few benefits from having loyalty voting rights, according to Garavoglia. On the other hand, in companies with a dispersed shareholder structure, the data confirms that loyalty voting shares are much less common. Even in such a case, institutional investors are unlikely to have loyalty voting rights, as they do not necessarily want to influence governance, but prefer to exit if they do not like management. The only exception, argued Garavoglia, is when an activist investor intervenes, but they are very unlikely to wait two years to obtain loyalty voting rights.

Garavoglia concluded that loyalty voting shares are nothing more than a control enhancing mechanism, although the conclusion may be different for other forms of loyalty shares. Therefore, according him, the debate should focus on the desirability of control enhancing mechanisms. Garavoglia then argued that multiple voting shares should be allowed, provided that the extraction of private benefits is curbed, for example by prohibiting related party transactions. He argued that there are different reasons to allow multiple voting shares: 1) multiple voting shares are more transparent than pyramids; 2) a company should be able to sell any type of security to investors, as long as there is transparency; and 3) some companies would not become listed if they cannot retain control via multiple voting shares.

Finally, Garavoglia pointed out that Italy did not have an exemption for the mandatory bid rule for loyalty voting rights, unlike as in France. This prevented the Italian government from lowering its stake in Enel, for example. After Garavoglia's presentation, the participants debated the midstream introduction of loyalty voting shares in Italy. Luca Enriques pointed out that loyalty voting shares can be introduced by a two-thirds majority, but that for six months after the introduction of the law, loyalty voting shares could be introduced by a simple majority (as is now also the case in Belgium). The government later abandoned the idea of prolonging the simple majority rule in the face of vehement opposition of academics and institutional investors. Pacces raised the question of how many midstream introductions of loyalty voting shares were decided unilaterally. While some, such as Marcello Bianchi, argued that institutional investors in majority supported the loyalty voting shares, others disputed this. The participants agreed that further empirical evidence on this is necessary, but pointed out a methodological difficulty: voting always happens in the shadow of the law, and if it would have been clear that the proposal to introduce loyalty voting shares would pass (for example because of a strong controlling shareholder), institutional investors may not have bothered with voting anyway.

Briefing 8: loyalty shares and the Belgian company law reform

Philippe Lambrecht, Universite Catholique De Louvain

After the Italian perspective, Philippe Lambrecht (Secretary General FEB-VBO and Université catholique de Louvain) discussed loyalty shares under the Belgian company law reform. Lambrecht began by giving a historical overview of multiple voting shares in Belgium, and showed that deviations from the one share, one vote principle were already possible in the Napoleonic Commercial Code (1807-1873) and that this was further liberalized by the Law of 1873. However, multiple voting shares were banned by the Royal Decree of 1934 and this prohibition still applies today, even though loyalty shares were already considered in the 1934 reform. Non-voting shares and profit certificates (possibly with voting rights) are also possible under current Belgian law.

Lambrecht then discussed the introduction of loyalty voting shares under the proposal for company law reform in Belgium, which was introduced in parliament on 6 June 2018. Lambrecht also pointed out that in unlisted NV/SA's and BV/SRL's, there will be almost no limits to the allocation of profit and voting rights. In listed companies, however, loyalty voting shares will be the only possibility for multiple voting shares. According to Lambrecht, loyalty voting shares have two goals: 1) to curb short-termism by rewarding loyal shareholders; and 2) to promote the listing of companies on the stock exchange. They were inspired by the French Loi Florange, but unlike in France, they are not the default rule. Lambrecht also discussed the fact that the required supermajority for the amendment of the articles of association, traditionally 75%, was permanently lowered to a two-thirds majority for loyalty voting shares, and even to a simple majority for a transition period of six months from 1 January 2020 until 30 June 2020, similar to the Italian transition period. The reason behind this, according to Lambrecht, is that it would otherwise be impossible for any of the existing listed companies to make use of loyalty voting rights, as the threshold of 75% would have been too high to reach.

After this, Lambrecht discussed the details of loyalty voting rights: if the articles of association contain a clause on this, all shareholders which have held registered shares for more than two years will have double voting rights. The holding period can also be fulfilled retroactively prior to the amendment of the articles of association. Loyalty voting rights are lost when the shares are transferred, unless this is due to inheritance, donation to an heir, merger, split, etc. Finally, Lambrecht mentioned that the mandatory bid rule is neutralized: for the purposes of calculating the 30% threshold, only the number of shares is counted and not the loyalty voting rights.

Briefing 9: are loyalty shares a viable alternative to the “untenable case for perpetual dual class stock”

Kobi Kastiel (Tel Aviv University and Harvard Law School Program on Corporate Governance)

In the final briefing of the day, Kobi Kastiel (Tel Aviv University and Harvard Law School Program on Corporate Governance) discussed the implications for the loyalty shares debate of his 2017 article on the untenable case for perpetual dual class shares (co-authored with Lucian Bebchuk, Harvard Law School). Kastiel explained that the article introduced the time dimension into the analysis of dual class share structures. In particular, under the theory developed in the article, as time goes by, the benefits of dual class shares are likely to erode, while the costs are likely to increase. Thus, even assuming that a dual-class structure is efficient at the time of the IPO, the risk that it would cease to be efficient can be expected to grow over time. The predictions of the article, Kastiel also explained, were subsequently confirmed by the empirical evidence in Cremers, Lauterbach and Pajuste (2018), Jackson (2018), and Kim and Michaely (2018).

Discussing the Bebchuk-Kastiel theory of how the efficiency of dual-class structures is likely to evolve over time, Kastiel explained that, even if the controlling shareholder possesses superior skills at the time of the IPO, the controller’s advantage is likely to diminish or even reverse over time. In addition, controlling shareholders have a tendency to diminish the fraction of their equity capital over time, which operates to increase the distortions and agency costs arising from the dual-class structure (this problem is further discussed in a companion paper on small-minority controllers by Bebchuk and Kastiel). Furthermore, the potential benefits of a dual-class structure are simultaneously likely to decline or even reverse over time; for example, insulating a controller from short-term market pressures could be beneficial only to the extent that the controlling shareholder would be the right person for this role and, if she is not, such insulation would become counter-productive. Concluding his discussion of the time dimension, Kastiel showed that controlling shareholders have a perverse structural incentive to avoid dismantling a dual class structure even if it becomes inefficient over time, because this would eliminate the controller’s private benefits whereas the efficiency gains would be shared by all public investors.

For these reasons, the paper proposes to remove one option, perpetual dual class structures, off the table. If dual class share structures were to be allowed, public officials should adopt, and investors should urge them to adopt, a sunset provision with a fixed time duration that requires the dual-class structure to expire after 10-15 years. If the dual class structure were remain efficient, it could be prolonged by shareholders unaffiliated with the controller. Finally, Kastiel argued that this reasoning should be extended to loyalty voting shares, noting that the previous briefings viewed loyalty voting shares as akin to dual class shares. He suggested that, even if loyalty shares were to be introduced, a sunset mechanism to address the risk that they would become inefficient over time would be desirable.

Some of the participants in the workshop disagreed with a mandatory sunset provision for introducing loyalty voting shares at the IPO phase, arguing that this can be left to the market. Some also pointed out that it would be difficult to establish the right duration for the sunset provision, as the empirical evidence only concerns averages and the optimal duration may differ for each company. Kastiel argued, however, that shareholders would be able to prolong a dual class structure if such structure would remain efficient. Finally, some also argued that the structure of loyalty voting shares, with its holding period and its limit to double voting rights, protects shareholders more than dual class shares in the US, where an equity stake can be unwound to a much larger extent. However, Kastiel pointed out that, while this provides some protection, it does not solve the problem of increasing-risk-of-inefficiency over time identified and analyzed in his article.

Conclusion of the roundtable on loyalty shares

Marco Becht, Université libre de Bruxelles

After the final briefing, Marco Becht summed up the conclusions of the briefings and the discussions of the roundtable on loyalty shares. First, Zacharias Sautner convincingly argued that short-termism is a problem. Nevertheless, the question remained, how can we stimulate long-termism, and how long is exactly the long term? In the end, Becht noted that a consensus had emerged that loyalty voting shares are a type of control enhancing mechanism. He also noted the commonalities with the debates on dual class shares and pyramid structures. Finally, it is clear that there is a strong demand for loyalty voting shares, but it remains to be seen whether this is also true at the IPO phase.

Becht concluded that it is a topic worthy of further discussion and announced a second ECGI roundtable on this topic in New York on 7 December 2018.

Hosted by:

JONES DAY

with support from:

Solvay Brussels School Economics & Management

ecgi european corporate governance institute

UNIVERSITY OF OXFORD FACULTY OF LAW