Do shareholder excess control rights benefit creditors?

Modern corporate governance centers around the issues associated with the separation of ownership and control. In recent years, an extreme form of such separation occurs in firms that issue multiple classes of shares. Such firms, often called dual-class firms, typically have a superior class of shares held by corporate insiders that give them more voting power per share than shares held by public investors. This allows insiders to retain absolute control of a firm, essentially shutting public investors out of corporate governance. Researchers have uncovered various agency problems associated with a dual-class share structure. And overall, such ownership structure destroys shareholder value. In light of this, it is perhaps surprising that about 15% of companies listed on the Toronto Stock Exchange still have dual-class shares, including some of largest players such as Rogers, Shaw, and Bombardier. Are dual-class firms really that bad?

Not if we shift the perspective from shareholders to creditors.

In my recent paper, I use a large sample of dual-class firms from the U.S. to examine the effect of the dual-class share structure on creditors. I find that, in contrast to the negative effect documented on minority shareholders, dual-class share structures actually benefit creditors. Compared to similar single-class firms, dual-class firms have lower business and financial risk, and they are less likely to default or violate debt covenants. Dual-class firms also enjoy lower interest rates on their loans. These results are robust under a variety of empirical tests, including a difference-in-differences analysis on firms that unified their dual-class shares into a single-class.

> "RESEARCHERS HAVE UNCOVERED VARIOUS AGENCY PROBLEMS ASSOCIATED WITH A DUAL-CLASS SHARE STRUCTURE. AND OVERALL, SUCH OWNERSHIP STRUCTURE DESTROYS SHAREHOLDER VALUE."

Why can an ownership structure that hurts shareholders benefit creditors? This originates from the different payoff structures faced by shareholders and creditors. When a firm goes under, shareholders can resort to limited liability and walk away, leaving creditors holding the bag and incurring the loss of missed debt payments. When a firm prospers, shareholders reap all the benefits, while creditors are still paid the same amount they were promised. Shareholders therefore care about the upside of the firm and benefit from risk-taking. In contrast, creditors are wary of the downside of the firm and are averse to any risk that could jeopardize the survival of the borrower.

In dual-class firms, insiders typically derive private benefits from controlling their firm. They therefore value the firm's long-term survival. If a firm defaults or goes bankrupt, control will be transferred to creditors, ending the stream of future private benefits to insiders. This gives dual-class firm insiders incentives to minimize risk-taking to avoid losing control. Further, by holding superior voting shares, insiders have much lower cash flow rights in the firm than their voting share. This limits their exposure to the value loss associated with risk avoidance. Therefore, a dual-class share structure aligns the incentives of insiders with those of creditors.

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BIOGRAPHY

TING XU is a PhD candidate in finance at the Sauder School of Business, University of British Columbia. He received his B.A. in finance from Renmin University (China) and his M.Sc. in economics from the Hong Kong University of Science and Technology. At UBC, Xu has taught Corporate Finance at the undergraduate level, and has served as teaching assistants for Mergers and Acquisitions, Ventures Capital, and Investment Theory. Xu' academic interests straddle corporate governance and entrepreneurial finance. His research has explored the governance of closely-held firms, boardroom diversity, corporate innovation, crowdfunding, and entrepreneurial experimentation. His research has been presented at major conferences such as the American Finance Association Meetings, Western Finance Associations Meetings, and National Bureau of Economic Research Meetings, and has been published at the *Review of Financial Studies*. He is the recipient of the Robert Bertram Doctoral Research Award from the Canadian Foundation for Governance Research.

TESTIMONIAL

I am very honored to be a two-time recipient of the Canadian Securities Institute Research Foundation PhD Scholarship. This scholarship has benefited me tremendously by reliving my financial constraint and letting me focus on my research. In addition, the funding provided me with means to present my research at several major conferences and to purchase the datasets I need. I definitely recommend this scholarship opportunity to all Canadian PhD students in finance and economics.

What does this mean for practitioners? First, dual-class firms may not be as bad as they are believed to be. Much of the focus in corporate governance has been on shareholders. Yet with other stakeholders playing increasing important roles in modern companies, we need to broaden our perspective to take these stakeholders into account. A majority of firms in the world are financed by creditors. In an economy where debt financing dominates equity, dual-class share structures may bring net benefits. Second, for investors and asset managers who are wary of dual-class firms, my paper provides a novel investment strategy that can hedge their investment risk: investing in the equity and debt of these firms simultaneously. ■