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REINTRODUCING DUAL-CLASS SHARES TO INDIA

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ABSTRACT

The legal framework associated with the issue of dual-class shares in India prohibits public listed companies from issuing shares with superior rights as to voting and dividends. Although the Companies Act was amended in 2000 to permit the issue of dual-class shares, concerns regarding the interests of investors compelled SEBI to significantly narrow down the scope of issue of shares with differential rights, in 2009, to the point of economic unviability. Earlier this year, SEBI released a consultation paper proposing a new framework for the issue of dual-class shares, that broadens the scope of the 2009 amendments to allow the issuance of such shares in limited cases. In light of the proposed framework, it is necessary to review the detrimental impact that the issue of shares with differential voting rights may have on corporate governance and decision-making, as well as, highlight the benefits accruing to certain companies by virtue of such shares. The author argues, that blanket permission for all public listed companies to issue shares with differential voting rights or dividend payments would serve as a striking departure from the standards of corporate governance that have become the norm in Indian corporate law. By examining the operations of companies in jurisdictions that permit the issue of dual-class shares, the author shows that shares

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with differential rights compromise the interests of minority shareholders and lead to corporate mismanagement, by separating voting rights from economic interest and consolidating decision-making power in the hands of the company's promoters and management personnel. However, the author also contends that the issue of dual-class shares can be beneficial for companies at their early-stages, a blanket ban would be counter-effective to the incentives provided for the creation of start-ups. The author further argues that SEBI's proposed framework for the issuance of dual-class shares reaches the right balance between corporate governance and protecting the interests of promoters.

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I. INTRODUCTION

A recent consultation paper[219] released by the Securities and Exchange Board of India [hereinafter "**SEBI**"] proposing a new framework for the issue of shares with Different Voting Rights [hereinafter "**DVRs**"] necessitated a review of both, the detrimental effects of issuing dual-class shares on the interest of minority shareholders' and corporate management, as well as the benefits that may accrue to certain companies by virtue of these shares. To clarify, a dual-class share structure refers to the issue of two or more distinct shares, by a company, distinguishable on the basis of different voting rights or dividend payments associated with each class. Companies that structure their equity into different categories tend to issue a 'normal stock', wherein one share corresponds to one vote, and a class (or classes) of shares with DVRs, which sever the bundle of rights that are associated with a share by separating voting rights from capital promoters. The aim behind such a separation is to consolidate control in the hands of the founders of a company while simultaneously allowing companies to raise capital from the public, by either issuing a class of shares with 'superior' voting rights to the promoters (Google, for example, issued Class A shares comprising one vote per share to the public, and Class B shares with ten votes per share to their executive chairman and founders),[220] or

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219 Securities and Exchange Board of India, "*Consultation Paper on Issuance of shares with Differential Voting Rights",* (March 20, 2019), *available at* https://www.sebi.gov.in/reports/reports/mar-2019/consultation-paper-on-issuance-of-shares-with-differential-voting-rights_42432.html.

220 Floyd Norris, "*The Many Classes of Google Stock",* THE NEW YORK TIMES (April 2, 2014), *available at* https://economix.blogs.nytimes.com/2014/04/02/the-many-classes-of googlestock/?mtrref=undefined&gwh8367A429A7762097AE57495B9424AB3F&gwtpa.

issuing a class of shares with 'inferior' voting rights to the general public (in 2008, for instance, Tata Motors issued a class of securities with one-tenth the voting rights of a normal share to the public, incentivising people to invest by offering a 5% additional payment of dividend.)[221]

Dual-class shares were conceptualised as a means of consolidating the governance of a company in hands of individuals who have a long-term interest in the company's growth. Resultantly, the issue of shares with DVRs accords promoters or management personnel voting rights that are disproportionate to their economic interests in the company. This separation of interests makes it easier for decision makers to consider factors other than shareholder wealth maximisation, owing to their own minimised economic interests, resulting in a lack of alignment between the principles guiding corporate decision making and the interests of stakeholders with larger economic investments in the company's equity. The impact of the issue of dual-class shares on minority shareholder interests and corporate management, hence, need to be examined in greater detail. The last decade of Indian corporate law has emphasised upon the importance of corporate governance procedures that balance the rights of all interested parties and reintroducing dual-class shares would be a departure from this newly-established and welcome norm.

However, the issue of shares with differential voting rights and the consequent concentration of voting power in the hands of promoters and

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[221] Parvatha Vardhini C, "*Why shares with differential voting rights have failed*", THE HINDU: BUSINESS LINE (November 14, 2016), *available at* https://www.thehindubusinessline.com/companies/why-shares-with-differential-voting-rights-have-failed/article9345804.ece. [*hereinafter* "Vardhini C"].

key managerial personnel can be beneficial for companies at their early-stages and start-ups, where the issuance of such shares would allow the company to raise public funding, without the promoters having to divest their ownership or voting rights, thereby allowing them to retain their ability to control corporate decision-making in the nascent stages of the company's growth. An ideal framework for the issuance of dual-class shares would thus be, the one that strikes a balance between the concerns of corporate governance, and the interests of promoters during the company's initial years after conception. This paper argues that the proposed framework outlined in SEBI's 2019 consultation paper, which permits the issuance of shares with superior rights that allow voting or dividend only in primary issues, subject to a sunset clause, reaches a middle ground that prevents long-term promoter concentration and subjective corporate decision-making, while simultaneously allowing companies at early-stages to have control over their initial growth.

Part II examines the history of dual-class shares in India. The beginning of the 21st century saw legislative changes that paved the way for companies to issue stocks with DVRs, only for these rules to be changed significantly by SEBI for public listed companies almost a decade later. This section traces the issue of shares with DVRs by Indian companies in this 9-year period and examines their legal standing post 2009. Part III highlights the contention in support of issuing shares with DVRs, and shows that any harms that dual-class shares seek to protect against are already mitigated by other regulatory frameworks in status quo. Further this section explains how issuing shares with differential rights compromises the management of a company by reducing checks on corporate mismanagement, and impacts minority shareholders by negating their control in the company and deprioritising their economic interests. The section concludes by considering the benefits that shares with DVRs can have for companies in the early stages of their growth, despite their detrimental impacts on corporate decision-making in the long-term. Ultimately, Part IV examines the proposed framework for the issuance of shares with differential voting rights, as outlined in SEBI's recent consultation paper. To conclude, the author argues that while dual-class shares are incompatible with principles of corporate governance, it is beneficial to permit companies to issue such shares to promoters in the initial stages of a company's growth, and that SEBI's newly proposed framework addresses these concerns successfully.

II. DUAL CLASS SHARES IN INDIA

A. HISTORY

Section 86 of the erstwhile Indian Companies Act, 1956 [hereinafter "**the 1956 Act**"] in its original form envisioned two kinds of share capitals – equity share capital and preference share capital. In 2000, the Section was amended[222] to read as follows –

> *"Section 86 - The share capital of a company limited by shares shall be of two kinds only, namely: -*
>
> *(a) equity share capital –*

[222] Companies (Amendment) Act, 2000, § 38.

(i) with voting rights; or

***(ii) with differential rights as to dividend, voting or otherwise** in accordance with such rules and subject to such conditions as may be prescribed;*

(b) preference share capital"[223] *(emphasis added)*

Supplemented by the Companies (Issue of Share Capital with Differential Voting Rights) Rules [hereinafter "**ISCDVR Rules**"], 2001,[224] the newly-inserted Section 86(a)(ii) provided a legal framework for companies to issue dual-class shares. It is pertinent to state that Section 86(a)(ii) allows for the issue of equity shares with differential rights as to dividend, voting, or *otherwise*. Differential rights need not, thus, be restricted to voting power or dividend payments – any similar rights (such as, for instance, pre-emptory rights) may also be allotted on a differential basis. The foundation of the current legal framework for the issue of dual-class shares is found in Section 43 of the Indian Companies Act, 2013, the language of which is identical, *mutas mutandis*, to that of Section 86. Rule 4 of the Companies (Share Capital and Debenture) Rules, 2014 [hereinafter "**SCDR**"], like Rule 3 of the ISCDVR Rules, 2001, outlines the conditions under which companies may issue dual-class shares. Although the current legal framework allows for companies to issue equity share capital with differential rights, the scope of dual-class shares was significantly

[223] Companies Act, 1956, § 86.
[224] Companies (Issue of Share Capital with Differential Voting Rights) Rules 2001, *available at* http://www.mca. gov.in/Ministry/actsbills/rules/TCIoSCwDVRR2001.pdf.

narrowed down by way of a SEBI amendment to the Listing Agreement, as will be discussed subsequently.

Post the introduction of Section 86(a)(ii) to the 1956 Act in 2000, companies were permitted to issue shares with DVRs. However, the first instance of a company issuing shares with differential rights came as late as 2008, when Tata Motors issued a class of securities with inferior voting rights of 1 vote per every ten shares and superior dividend payments at an additional 5%.[225] Initially, investors showed a lack of interest in these stocks, resulting in Tata Motors' promoters having to subscribe to the unsubscribed equity. With time, the option of receiving a higher dividend grew more attractive, and investors began purchasing the shares with DVRs, reducing the proportion of the shares owned by promoters from 84.3% in 2008 to 9.1% in 2011.

In the following few years, Pantaloon Retail (Future Enterprises), Gujarat NRE Coke, and Jain Irrigation joined Tata Motors to become the only four Indian companies that have issued shares with differential voting rights. Pantaloon Retail issued a class of shares with DVRs structured similarly to Tata Motors', carrying one-tenth the voting rights and an additional 5% dividend, in February 2009.[226] In 2010, Gujarat NRE Coke issued a class of securities with inferior votes (one-hundredth

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[225] Vardhini C, *supra* note 221.

[226] Rahul Oberoi, "*How to benefit from shares with differential voting rights",* BUSINESS TODAY: MONEY TODAY (March, 2013), *available at* https://www.businesstoday.in/moneytoday/stocks/how-to-benefit-from-shares-with-differential-voting-rights/story/192706.html [*hereinafter* "Oberoi"].

the voting rights of an ordinary shares).[227] Jain Irrigation in 2011 issued shares with one-tenth the voting rights of an ordinary share.[228]

An analysis of the shares with inferior voting rights issued by the four companies reveals that, shares with differential rights have not performed as well in Indian markets as they have in foreign markets. Dual-class shares often sell at a discounted price compared to ordinary shares. In foreign markets, this difference tends to be between 10-12% in ordinary cases, with some shares trading at an even lesser discounted price or at premiums.[229] The greater awareness about shares with DVRs in foreign markets incentivises investors to purchase these shares and gain through capital appreciation when the discount between ordinary shares and the shares with differential rights reduces. In India, however, the discount between shares with differential rights and ordinary shares is extremely sharp. Tata Motors has reported discounts of as great as 50%, while Pantaloon Retail and Gujarat NRE Coke have seen discounts of 25-35%.[230]

Dual-class shares have, thus, been largely unsuccessful in India. The reasons for this are manifold. At a primary level, it is suggested that the lack of knowledge amongst investors about the nature of instruments

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227 Oberoi, *supra* note 226.
228 *Id.*
229 Vijay Gurav*, "Investor snub makes DVRs issued by Tata Motors, Pantaloon Retail and Gujarat NRE Coke a losing proposition",* THE ECONOMIC TIMES (February 21, 2012), *available at* https://economictimes.indiatimes.com/markets/stocks/news/investor-snub-makes-dvrs-issued-by-tata-motors-pantaloon-retail-and-gujarat-nre-coke-a-losingproposition/articleshow/11969515.cms?from=mdr.
230 *Id.*

with differential rights serves as a disincentive for investment.[231] The companies issuing shares with DVRs failed to market them successfully enough to compensate for the lack of understanding that investors had about dual-class shares. In addition to this, the legal framework itself created hindrances for companies in issuing dual-class shares. Rule 3 of the ISCDVR Rules, 2001, laid down numerous conditions that companies had to meet before they could issue equity share capital with differential rights. For example, only companies with distributable profits in the three financial years preceding the year of issue could issue dual-class shares, resulting in the creation of a track-record system. These strict entry barriers prevented many companies from allotting shares with differential voting rights. While most of these rules remain intact, some of them have since been watered down. For instance, Rule 3 of the ISCDVR Rules, 2001, prevented companies that have been convicted of any offence under the SEBI Act, the Securities Contracts (Regulation) Act, and the Foreign Exchange Management Act, from issuing shares with differential voting rights.[232] In contrast, Rule 4 of the SCDR, 2014, restricts only those companies that have been penalised in the 3 years prior to the issue from adopting a dual-class share structure. [233]

Although investors considered shares with differential rights to be unattractive, the issue of shares with superior dividend rights or voting rights was permissible under the legal framework. In 2009, only a year

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[231] Oberoi, *supra* note 226.
[232] Companies (Issue of Share Capital with Differential Voting Rights) Rules, R 3(5) 2001.
[233] Companies (Share Capital and Debenture) Rules, R 4(1)(h) 2014.

after Tata Motors issued shares with DVRs in India, the issue of shares with differential rights was challenged before the Company Law Board, Delhi [hereinafter "**CLB**"]. Although the CLB upheld the issue of such shares,[234] only months after its ruling, SEBI amended the Listing Agreement – i.e., the contract between a stock exchange and companies listed on it – to limit the scope of such issue. This is discussed in greater detail in the following sub-section.

B. THE SHORT LIFE OF *ANAND PERSHAD JAISWAL V. JAGATJIT INDUSTRIES* (2009) – SEBI'S AMENDMENT TO THE LISTING AGREEMENT

In early 2009, the Company Law Board, Delhi, heard before it a matter[235] concerning the allotment of shares with superior voting rights (in contrast to Tata Motors, Pantaloon Retail, Gujarat NRE Coke, and Jain Irrigation, all of whom issued shares with inferior voting rights). The promoters of Jagatjit Industries had issued to themselves shares with superior voting rights – each share carried with it 20 votes. This resulted in their voting rights increasing to 62% while their shareholding remained at 32%. The minority shareholders of Jagatjit Industries saw this allotment as minority oppression and claimed that the promoters were using shares with superior voting rights as a tool to increase their own control and power. A group of minority shareholders representing 11.5% of the issued share capital of Jagatjit Industries filed a petition under Sections 397 and 398 of the 1956 Act alleging mismanagement and oppression.

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234 Anand Pershad Jaiswal v. Jagatjit Industries, 2010 (1) Comp. LJ 509 (2009) (India).
235 *Id.*

In March 2009, the CLB upheld the allotment of shares with superior voting rights to the promoters of Jagatjit Industries. The bench held there to be no merit in the challenge against the issue of shares with differential rights, as such an issue was permissible under Section 86 of the 1956 Act, read with the ISCDVR Rules. Hence, the CLB approved the issue of dual-class shares, provided that they complied with the existing legislative framework.

A few months after this judgment, in July 2009, SEBI issued a circular[236] whereby it amended the Equity Listing Agreement with the aim of protecting the interests of investors. By way of this amendment, Clause 28A was inserted to the Listing Agreement. The Clause reads as follows –

> "*28A. The company agrees that it shall not issue shares in any manner which may confer on any person,* ***superior rights*** *as to voting or dividend* ***vis-à-vis the rights on equity shares that are already listed.***" *(emphasis added)*

Three things must be noted of this amendment. Firstly, as the amendment was made to the Listing Agreement, it only bound public listed companies from refraining from issuing shares with superior rights as to voting or dividend. Private companies and public unlisted companies, therefore, have greater freedom to structure their equity share capital and can issue shares with superior rights.

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236 Securities and Exchange Board of India, *Circular on Amendments to the Equity Listing Agreement,* (June 21, 2009), *available at* https://www.sebi.gov.in/legal/circulars/jul-2009/amendments-to-the-equity-listing-agreement4367.html.

Secondly, the amendment does not prevent the issue of shares with differential rights – rather, it prohibits public listed companies from issuing shares with *superior* rights as to voting or dividend. A company can, therefore, still issue shares with inferior voting rights without higher dividend payments, or shares with lower dividend payments without superior voting rights, post the amendment. It is unlikely, however, that such shares would be profitable, as they provide investors with no incentive to purchase these shares – although legally permissible, they have no practical viability.

Thirdly, Clause 28A clarifies the scope of the term 'superior', by stating that companies may not issue shares with superior rights as to voting or dividend vis-à-vis the rights on equity shares that are already listed. This implies that the understanding of 'superior' is not normative and does not necessarily refer to any voting or dividend rights greater than the typical ratio of one vote to one share for a 'normal share'. Rather, it sets a *relative* standard, by prohibiting shares that confer upon the shareholder rights that are superior to the rights on equity shares that are already listed. This raises several interpretative questions. If the shares already listed by a company are shares that confer superior voting rights or dividend payments (say, a share that confers 10 voting rights per share, or offers an addition 5% dividend payment), do these shares operate as the benchmark, thereby allowing public listed companies to continue to issue these superior shares? Taking this further, can companies issue stocks that confer 5 voting rights per share? While these shares may confer greater voting rights than normal stock, the voting rights are not superior to the already-listed shares conferring 10 voting rights per share.

Similarly, if the shares already listed by a company are shares with inferior voting rights (say, shares that possess one-tenth the normal voting rights), does this mean companies cannot issue shares that follow a one vote per share ratio, as these would confer rights superior to those associated with the inferior shares already listed? A purposive approach to interpreting Clause 28A leads us to the conclusion that the amendment to the Listing Agreement was not intended to prevent companies who have listed shares with inferior voting rights from issuing normal shares. The question of whether a company that has already listed shares with superior rights as to dividend or voting may continue to issue similar shares, or shares with voting rights intermediate to these superior shares and normal shares, remains unanswered.

To summarise, the result of the developments between 2000 and 2009, is that companies may issue shares with differential voting rights, subject to the condition that public listed companies cannot issue shares with superior rights as to voting or dividend. Whether allowing the issue of such shares is desirable remains to be seen. The next section will examine the impact of dual-class shares on corporate management and the interests of minority shareholders, to conclude that allowing the issue of such shares is antithetical to the culture of corporate governance that has shaped most of the legislative change in India in the last decade, but an exception should be carved out for companies raising capital from the public for the first time.

III. DUAL CLASS SHARES AS A DEPARTURE FROM STANDARDS OF CORPORATE GOVERNANCE

A. COMMON ARGUMENTS IN SUPPORT OF ISSUING SHARES WITH DIFFERENTIAL RIGHTS

Before examining the impact of dual-shares on standards of corporate governance, it is worthwhile to analyse the most common arguments in support of issuing shares with differential rights. Firstly, it is contended that the concentration of voting power in the hands of the promoters regardless of the corresponding economic interest protects companies from sudden takeovers - since the accumulation of equity in the company no longer provides corresponding decision-making power, companies remain protected from takeovers due to the issue of shares with differential rights. This argument based on the desirability of dual-class shares rests on the presumption that shares with differential rights are the *only* way to protect companies from takeovers – or, rather, that companies cannot be shielded from takeovers without the issue of dual-class shares. The development of strong regulatory frameworks such as the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 [hereinafter "**Takeover Code**"] renders this argument unviable. The Takeover Code was established to regulate the acquisition of equity in a public listed company, thereby ensuring that the interests of investors and members are not jeopardised by sudden takeovers. The issue of dual-class shares to prevent against takeovers is, thus, unnecessary.

Proponents of dual-class shares also argue that shares with differential rights allow for voting power to be concentrated in the hands of the promoters or founders of a company who have long-term interests in the growth of the company. It is however unclear, why the interests of promoters should be prioritised over the interests of shareholders. Economic investment in a company is sufficient basis for the interests of shareholders to be considered in corporate decision-making. As will be discussed in greater detail subsequently, adopting the perspective that voting power must be concentrated in the hands of the promoters, side-lines minority shareholder interests and is a departure from the emphasis of corporate governance processes on the protection of minority shareholder interests. The concession that must be made, however, is that concentrating voting power in the hands of the promoters of a company, thereby allowing them to make all major decisions concerning the company's growth and direction while simultaneously generating capital from the public, is desirable in the case of start-ups. The benefits of allowing companies to issue shares with differential voting rights in the initial years of their growth will be discussed later in this section.

An analysis of these justifications for the issue of dual-class shares leads us to the conclusion that there is no compelling principled benefit allowing the issue of shares with differential rights. An examination of the dual-class shares issued thus far in India, by Tata Motors, Pantaloon Retail, Gujarat NRE Coke, and Jain Irrigation shows that the economic benefits accruing from issuing shares with DVRs are minimal. As discussed earlier, the primary reasons for the lack of attractiveness associated with shares with differential rights, was a dearth of investor understanding and strict regulations preventing a large number of companies from issuing dual-class shares. Although investor awareness may have increased in the last decade, or can be increased through better marketing strategies from companies intending to issue shares with differential rights, the regulatory mechanisms cannot be worked around. Rule 4 of the SCDR, 2014, lays down an extensive list of conditions that companies must meet to be eligible to issue shares with differential rights. These conditions are likely to exclude a number of companies – especially start-ups – from issuing dual-class shares. Hence, such shares appear to have limited economic viability in India, in status quo.

The lack of economic viability or any principled justification for the issue of shares with dual-class rights leads us to believe that such shares offer no concrete benefits. The analysis in the subsequent section shows that the issue of dual-class shares in fact leads to mismanagement and harms minority shareholder interests, hence justifying the prohibition on public listed companies issuing shares with superior voting rights and dividend payments.

B. DUAL-CLASS SHARES – COMPROMISING MANAGEMENT AND MINORITY SHAREHOLDER INTERESTS

That minority shareholders are side-lined in the corporate decision-making process, and that their interests are deprioritised by promoters or larger shareholders, has been sufficiently established. Most countries have witnessed developments in corporate law jurisprudence tailored at rectifying the imbalance between larger shareholders and minority shareholders, clothing the latter with some layers of protection. The Indian Companies Act, 2013 [hereinafter "**Companies Act**"], has incorporated such principles of corporate governance. The JJ Irani Committee, in its 2005 report[237], emphasised the need to strike a balance between the 'rule of the majority and the rights of the minority'[238], dedicating an entire chapter of the report to the protection of minority shareholder interests[239]. This balancing principle runs through the 2013 Act. For instance, minority shareholders dissenting in a vote to change the objects of the prospectus of a company are statutorily required to be provided with exit options,[240] upon the fulfilment of certain conditions[241]. Similarly, shareholders may file an application for relief before any Tribunal when they feel that the affairs of the company are being conducted in a manner that is prejudicial and oppressive to their interests.[242] The protection of minority interests is, thus, an integral principle that runs through the Companies Act, 2013.

In a similar fashion, the Companies Act has been drafted with the intention of improving corporate management. Section 149 of the Act, for instance, requires one-third of the members of the board of any

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[237] JJ Irani Committee, *Report on Company Law,* MINISTRY OF CORPORATE AFFAIRS (May 31, 2005), *also available at* http://www.primedirectors.com/pdf/JJ%20Irani%20Report-MCA.pdf.
[238] *Id.* at 41.
[239] *Id.*
[240] Companies Act, 2013, §§ 27(2), 13(8).
[241] SEBI (Issue of Capital and Disclosure Requirements), Schedule XX (2018).
[242] Companies Act, 2013, § 241.

company to be independent directors[243], to improve corporate credibility and standards of corporate governance. The Act also mandates internal audits for some companies[244] and the setting up of audit committees.[245] Efficient corporate management thus constitutes an essential component of the Companies Act.

The introduction of the Companies Act and its corresponding rules have created well-established corporate governance procedures that emphasise the protection of minority shareholders' rights and efficient corporate management. This section argues that the issue of shares with differential rights as to voting or dividend would serve as a departure from the norm of good corporate governance. An analysis of companies with dual-class structures in other jurisdictions leads to the conclusion that the issue of shares with differential rights is undesirable in India.

The deprioritization of minority shareholder interests is common to all companies, regardless of how their equity share capital is structured. In companies with a dual-class structure however, the separation of voting power from economic interest makes it harder to maintain checks over corporate mismanagement and minority shareholder oppression. Take, for instance, the appointment of CEOs, CFOs, and other key personnel in a firm. The phenomenon of 'separation of ownership and control'[246] describes the position of most public listed firms, wherein the company is

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243 Companies Act, 2013, § 149(4).
244 Companies Act, 2013, § 138.
245 Companies Act, 2013, § 177; Companies (Meetings of Board and its Powers) Rules, R6-7 (2014).
246 ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 4 (1933).

owned by numerous shareholders and no single shareholder manages the operations of the corporation. In this situation, the shareholders vote to elect a Board of Directors, who in turn appoint the management personnel of a company. This process of separating ownership and control has become an integral component of efficient corporate governance. In companies with dual-class shares, however, the promoters and founders are the largest shareholders and hence have the greatest say in electing the Board of Directors, their votes are cast with the aim of appointing a Board that will, in turn, appoint them to key managerial positions. The lines between ownership and control eventually blur, and minority shareholders' votes become redundant. Due to the control that CEOs and CFOs can exercise over the appointment of the Board of Directors of a company, directors have an incentive to appoint the people who elect them to key positions, and vote in alignment with the majority shareholders. This consolidation of voting power and resultant control over the Board of Directors ensures that CEOs will continue to hold their positions, even when they have performed poorly.

Consider Facebook, in 2018, the social media company was embroiled in controversy. Amidst the Cambridge Analytica data breach, allegations that the platform was facilitating Russian interference in American democratic processes, further New York Times reported[247] that Facebook provided companies like Netflix and Spotify with users'

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[247] Gabriel J.X. Dance, Michael LaForgia & Nicholas Confessore, *As Facebook Raised a Privacy Wall, It Carved an Opening for Tech Giants*, THE NEW YORK TIMES (December 18, 2018), *available at* https://www.nytimes.com/2018/12/18/technology/facebook-privacy .html.

personal messages and other personal data, CEO Mark Zuckerberg's leadership over the company was called into question. In a single-stock company with a correlation between economic interest and voting power, it is, perhaps, unlikely that a CEO under whom share prices tanked by almost 40% from their peak in the span of 4 months[248] would retain control over the operation of the company.[249] Facebook, however, structures its equity share capital into two classes – Class A shares, issued to the public, carry single votes, while Class B shares, controlled by Zuckerberg and a handful of other individuals, carry ten votes per share. As a result of his ownership of these Class B shares, Zuckerberg, while owning only 16% of Facebook's issued share capital, possesses 60% of the voting rights.[250] As he has the final say in all matters that are voted upon by shareholders, any resolutions that pose a challenge to his position as CEO will never succeed – nor did they, in 2018, when Facebook's shareholders, justifiably, questioned his leadership.[251]

Similarly, Rupert Murdoch possessed a majority of the voting rights in News Corporation, despite owning only 12% of the company's

[248] Salvador Rodriquez, *Here are the scandals and other incidents that have sent Facebook's share price tanking in 2018*, CNBC (November 20, 2018), *available at* https://www.cnbc.com/2018/11/20/facebooks-scandals-in-2018-effect-on-stock.html.
[249] Emily Stewart, *Mark Zuckerberg is essentially untouchable at Facebook* VOX (December 19, 2018), *available at* https://www.vox.com/technology/2018/11/19/18099011/mark-zuckerberg-facebook-stock-nyt-wsj [*hereinafter* "Stewart"].
[250] *Facebook and the Meaning of Share Ownership*, THE ECONOMIST (September 30, 2017), *available at* https://www.economist.com/business/2017/09/30/facebook-and-the-meaning-of-share-ownership.
[251] Stewart, *supra* note 249.

equity.[252] Shareholder attempts to remove various members of Murdoch's family from positions of power in the company, after news broke of the phone-hacking scandal that Murdoch was implicated in, were successfully thwarted because of Murdoch's control in the company. News Corporation structured its equity into two classes – Class A shares with no voting rights which were issued to the public, while Class B shares with voting rights were, for the most part, allotted to Murdoch and an ally. By employing a dual-class share structure, Murdoch was able to consolidate his voting power, and protect his and his family members' roles in the company against shareholder action, despite his involvement in a scandal that cost the company several billions in share value.[253] In companies with single-class shares, however, shareholders are able to exercise more control over the appointment and removal of management personnel, in a manner proportionate to their ownership of the company, thereby creating a system of checks that ensures efficient management. The consolidation of voting power in the hands of these key personnel, made possible by the issue of dual-class shares, allows CEOs to abuse their positions with no consequences.

The concentration of voting rights in the hands of the promoters in companies that structure their equity share capital into dual classes also ensures that minority shareholders cannot ever change the capital structure to a single class of stocks, as promoters are unlikely to vote

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[252] Ed Pilkington, *Investors call on News Corp to loosen Murdoch family's grip*, THE GUARDIAN (December 22, 2011), *available at* https://www.theguardian.com/media/2011/dec/22/news-corp-investors-shares-murdoch [*hereinafter* "Pilkington"].
[253] Pilkington, *supra* note 252.

against the system of capital structuring that benefits their interests. In 1999, shareholders of Tyson Foods attempted to change the company's dual-class structure, arguing that the concentration of voting power in the hands of the founding family had resulted in the company consistently underperforming for years. The vote was defeated due to the voting rights that the Tyson family possessed.[254] Hence, efforts to restructure the capital of companies with a dual-class structure into a single-class of shares are futile. Minority shareholders are left with no say in capital restructuring in companies that issue dual-class shares for the benefit of the promoters.

Even when the dual-class structure of a company is unified into a single class of shares, the holders of the shares with superior voting rights or dividend payments are offered huge pay-outs to allow their shares to be converted into normal stock. Consider the example of Canadian company Magna International. When the company decided to collapse its dual-class structure into a single class of shares, the founder of the company, who possessed a majority of the shares with superior voting rights, received almost $900 million in shares and $300 million in cash in return for giving up his shares, with a number of Magna International's institutional shareholders labelling this deal 'unreasonable' and 'fundamentally unfair'.[255] Hence, shareholders of a company that issues shares with

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[254] Bill Mann, *Dual-Class Shares, Second-Class Investors*, MOTLEY FOOL (April 14, 2004), *available at* https://www.fool.com/investing/general/2004/04/14/dualclass-shares-secondclass-investors.aspx.

[255] *Court Approves Magna Payment to Stronach*, THE NEW YORK TIMES: DEAL BOOK (August 18, 2010), *available at* http://dealbook.nytimes.com/2010/08/18/magna-payment-to-stronach-approved.

differential rights are left to choose between retaining a dual-class share structure, or restructuring the company's equity share capital by paying promoters large amounts in exchange for their controlling shares – a lose-lose situation for the shareholders.

While one clear consequence of the disproportionate voting rights that promoters and key management personnel have is the mismanagement of the company's operations and affairs and a lack of accountability of CEOs and CFOs to shareholders, the concentration of voting power also reduces the say of minority shareholders in the management of the company, despite their economic interests. When promoters have most of the voting power through the issue of shares with superior voting rights, the votes of minority shareholders who are also owners of the company, are rendered redundant. Corporations with a dual-class structures recognise this. When Google decided to issue a class of shares with no voting rights, it held an annual meeting for shareholders to vote on the proposal, that they themselves acknowledged as being nothing more than perfunctory – speaking of the company's executive chairman and founders, Google's general counsel wrote in a letter to the shareholders announcing the vote, "Given that Larry, Sergey and Eric control the majority of voting power and support this proposal, we expect it to pass."[256]

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[256] Andrew Ross Sorkin, *Stock Split for Google That Cements Control at the Top*, THE NEW YORK TIMES: DEAL BOOK (April 16, 2012), *available at* https://dealbook.nytimes.com/2012/04/16/stock-split-for-google-that-cementscontrol-at-the-top.

The separation of voting powers from economic interest when companies adopt a dual-class structure through which they allot shares with superior voting rights to promoters or shares with inferior voting rights to the general public also results in a deprioritization of minority shareholders' interests. It is important to remember that members of the public who invest in companies do so with the intention of making returns. Hence, their interests in the company are largely economic. As owners of the company who have invested in its growth, these are interests that they are entitled to, and that form the basis of the relationship of obligations between a company and its shareholders. Some commentators view companies as agents of the shareholders – as the company is using the investors' money, it must do so with the aim of providing the greatest returns to the shareholders.[257] Companies must, therefore, place the economic interests of its shareholders on a high pedestal.

In companies with a single class of stocks, shareholders are able to vote on resolutions and direct corporate decision-making to proceed in a manner that prioritises economic returns, as they have voting rights commensurate to their ownership in the company. In companies with a dual-class share structure, however, the parties with vested economic interests do not possess voting rights that are proportionate to their ownership. Rather, the parties with significant voting rights, namely the promoters, founders, or key management figures, are those with fewer

[257] Milton Friedman, *The Social Responsibility of Business is to Increase its Profits,* THE NEW YORK TIMES MAGAZINE (September 13, 1970), *available at* http://umich.edu/~thecore/doc/Friedman.pdf.

economic interests compared to their voting power. As a result of their disproportionate economic interests, their voting decisions are often guided by factors other than shareholder wealth maximisation, which is the primary interest of most shareholders. By allowing interests other than those that are central to the investors of a company to guide its actions, companies falter in their obligations to their shareholders. A dual-class share structure reduces the checks that prevent decision-making from being guided by principles other than maximising economic returns. Thus, minority interests are often compromised upon in companies that issue shares with differential rights.

As discussed at the beginning of this section, an emphasis on corporate governance processes that balance the rights of the company and its shareholders while striving for efficient management of companies has guided the creation of the new corporate law regime in India. In a welcome development, these standards of corporate governance have become the norm in Indian corporate law. The issuing of dual-class shares leads to corporate mismanagement and deprioritises minority shareholders – it is, thus, incompatible with principles of corporate governance.

C. THE ISSUE OF DUAL-CLASS SHARES BY EARLY-STAGE COMPANIES

An argument often made by proponents of dual-class shares is that these shares and the superior voting rights that they carry can serve as a beneficial tool for promoters to control the growth of a company in its initial stages. The promoters of new ventures are often forced to choose between retaining control over the affairs of the company and being able to raise money from the public to allow for the continuation of their day-to-day operations. As both strategic decision-making and funding are crucial to the success of a company in its early stages, this places promoters in an impossible situation. Studies show that 90% of Indian start-ups fail within five years of their inception[258] - one of the biggest reasons cited for this high failure rate is the lack of funding received by early-stage companies. Allowing founders of new ventures to raise capital from the public without divesting their ownership in the company and retaining the power to make critical corporate decisions incentivises the creation of start-ups and encourages early-stage ventures to go public. In a developing country like India, boosting the entrepreneurial eco-system can go a long way towards job creation, technological innovation, and economic growth. Hence, allowing start-ups to issue shares with differential voting rights would be a positive step.

The question that arises next is, what happens when a start-up becomes commercially advanced, and enough time has passed that it can no longer be considered an early-stage company? If promoters are permitted to retain shares with superior voting rights in perpetuity, the corporate governance concerns discussed previously arise. After a certain point in a company's existence as a public entity, when its operations are profitable and it has generated a name and reputation for itself, it ceases

[258] *90% Indian start-ups fail within 5 years of inception: Study*, MONEY CONTROL (July 9, 2018), *available at* https://www.moneycontrol.com/news/business/90-indian-startups-fail-within-5-years-of-inception-study-2689671.html.

to be legitimate to compromise concerns of corporate decision-making and minority oppression, or protect promoter ownership of the company. Hence, it has been argued by opponents of shares with differential voting rights that when start-ups are permitted to issue such shares, they should have a sunset clause – i.e., after a pre-decided period of time has passed, shares with superior voting rights will be converted to 'normal' shares. The proposed framework outlined in the SEBI consultation paper released in March 2019 adopts such a model. As will be discussed in the next part, SEBI's recommendations reach a balance between allowing start-ups to harness the benefits of shares with differential voting rights and preventing the misuse of the power that is consequently concentrated in the hands of promoters.

IV. THE 2019 SEBI CONSULTATION PAPER

In the decade since SEBI amended the Listing Agreement to prevent companies from issuing shares with superior rights as to voting or dividend – a ban that also finds a place in the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015[259] – opinion has been divided as to the attractiveness of shares with differential voting rights. Some argued that promoter control can be beneficial for a company, some called for exceptions to the ban to be made for companies at an early-stage, while some argued that a complete ban on dual-class shares with no exceptions was required to maintain standards of corporate governance and protect minority shareholder. In December 2018, SEBI

[259] SEBI (Listing Obligations and Disclosure Requirements) Regulations (2015), Regulation 41(3).

chairman Ajey Tyagi announced that a committee had been set up to analyse the viability of allowing public listed companies to issue dual-class shares.[260] The consultation paper released by the committee in March 2019 proposes a framework that reaches a balance between concerns of corporate governance and promoter interests.

SEBI's proposed framework would permit two kinds of shares with differential voting rights – shares with superior voting rights, which confer upon a shareholder voting rights in excess of one vote per share, and shares with fractional voting rights, which confer upon a shareholder voting rights less than one vote per share. The issue of shares with superior voting rights would only be permitted for unlisted companies going public for the first time, while shares with fractional voting rights could be issued during secondary listings. Upon listing, a company may no longer issue shares with superior voting rights. Shares with superior voting rights can only be issued to the promoters of the company. These shares would be locked-in, thereby preventing promoters from transferring. They would, further, be subject to a sunset clause – after five years, shares with superior voting rights would be converted to normal shares. This period of five years may be extended by a further five years through a special resolution of all the shareholders of the company, with each shareholder voting in a 1:1 ratio relative to their shareholding. Additionally, SEBI has proposed that FR shares cannot confer lower

[260] Reena Zachariah, *SEBI sets up panel to look into issue of DVRs*, THE ECONOMIC TIMES (December 19, 2018), *available at* https://economictimes.indiatimes .com/markets/stocks/news/sebi-sets-up-panel-to-look-into-issue-ofdvrs/articleshow/6 7156164.cms.

voting rights than one vote for every ten shares, and that SR shares cannot confer higher voting rights than ten votes per share.

If such a framework were to be adopted, companies listing for the first time would be permitted to raise capital without promoters having to divest their ownership in the company – at the same time, these promoters would be prevented from maintaining their superior voting rights after a certain period of time has passed. The author believes that the proposed framework offers sufficient protection to minority interests and corporate decision-making, while simultaneously benefiting early-stage companies and incentivising the growth of start-ups. However, as many have argued, SEBI should have introduced higher corporate governance standards for companies issuing shares with superior voting rights, to prevent the misuse of the concentration of voting power in the hands of promoters of the company.

V. CONCLUSION

India has had a legal framework in place for the issue of dual-class shares since the Companies (Amendment) Act, 2000, inserted Section 86(a)(ii) to the Companies Act, 1956. In the decade that followed before SEBI narrowed down the scope of the issue of shares with differential rights to the point of economic unviability for public listed companies, the development of dual classes of securities was extremely slow. Only four Indian companies opted to issue shares with differential rights, with these shares quoting at sharp discounts in contrast with the company's normal shares. The lack of attractiveness of shares with DVRs in India has been attributed to both a lack of investor awareness and a regulatory framework that prevented some companies from being able to issue such stocks.

In 2009, the Company Law Board, Delhi, upheld the issue of shares with superior voting rights, only for SEBI to amend the Listing Agreement a few months later to prohibit public listed companies from issuing shares with superior rights as to voting and dividend. The plaintiffs in Anand Pershad Jaiswal v. Jagatjit Industries[261] argued that the issue of shares with differential rights amounted to minority oppression; a few months later, the SEBI circular announcing the amendment to the Listing Agreement cited the protection of investor interests as the rationale behind prohibiting the issue of shares with superior rights for public listed companies. An analysis of companies in jurisdictions whose legal frameworks allow for the issue of dual-class shares reveals that SEBI's concern is well-founded. Shares with differential rights pave the way for the deprioritization of minority interests by promoters, and render minority shareholders' votes redundant to the extent that such investors are unable to assert their own interests. In addition to failing to protect minority interests, the issue of dual-class shares results in the mismanagement of corporate affairs and operations, and vitiates the system of checks that holds key personnel accountable. These shares prove beneficial, however, to start-ups and companies in their nascent stages of growth and development.

261 Anand Pershad Jaiswal v. Jagatjit Industries, 2010 (1) Comp. LJ 509 (2009) (India).

The last decade has witnessed a shift in approach in Indian corporate law jurisprudence. The Companies Act, 2013, represents the new norm of corporate governance that emphasises the interests of all the shareholders of a company. Allowing the issue of shares with superior voting rights as to dividend and voting would have been a stark departure from these standards. Instead, SEBI has proposed that only companies listing for the first time be permitted to issue shares with superior voting rights to their promoters, subject to a sunset clause. By permitting promoters to hold shares with superior voting rights only for a fixed period of time after the company has been listed, the proposal allows for promoters to make decisions concerning the growth of a company without factoring in the short-term interests of investors, while simultaneously considering the impacts on minority shareholders' interests and corporate decision-making that allowing promotors to retain control over the company in perpetuity despite holding a correspondingly smaller number of shares would have. The implementation of such a framework would adhere to established principles of corporate governance and protect minority interests, while simultaneously incentivising the creation of start-ups, and would be a welcome change to the regulatory framework for the issue of the dual-class shares in India.