

Sunset Clause in the Dual Class Share Structure

Zhi Li

Abstract—In a dual class share structure, the founders of a public company own special voting shares, so they can control a large company with a small number of shares. Although the dual class share structure has the outstanding advantage of helping entrepreneurs to achieve idiosyncratic vision, there is no good mechanism to address the infringement of interests caused by the loss of voice of other shareholders in the dual class share structure itself. The sunset clause as a governance tool has proven to be useful in curbing the negative effects of dual class share structure. China, as a country that has only recently liberalized the listing of dual class share companies, has taken a conservative approach towards formulating its listing rules and has not imposed a time-based sunset. Given the increasing number of publicly listed DCS companies, the Chinese financial regulators should consider adopting the time-based sunset clause to curb permanent DCS. However, when there is a choice to be made between statutory and liberal options concerning the timing of sunset, China could creatively introduce the UK "comply or explain" principle for the application of time-based sunset clauses.

Index Terms—Dual class share, sunset clause, Chinese listing rules, comply or explain.

I. INTRODUCTION

HKEX (Hong Kong Exchanges and Clearing Limited) and SSE (Shanghai Stock Exchange) allowed the listing of dual-class share (DCS) structure companies in April 2018 [1] and April 2019 [2] respectively, and the FCA (The Financial Conduct Authority) in the UK launched a consultation on the adoption of DCS for the premium segment in July 2021 [3]. In order to attract more companies to list in their countries or regions, national stock exchanges have adapted. They are adopting more inclusive listing rules to create the possibility of listing companies with DCS structures. However, some scholars have pointed out that the exchanges will give in to capital and keep lowering the threshold for listing, which may lead to a "race to the bottom" situation [4]. But whether public companies should be allowed to adopt DCS continues to be widely debated in the academia [5], [6]. Scholars have looked at "idiosyncratic vision" [7] and "the prejudice of other shareholders' interest" [8], analyzed the pros and cons of DCS, and discussed around the necessity of the existence of DCS. However, in light of the current situation, in which financial regulatory agencies in several countries have liberalized the listing of DCS companies, academics' focus has shifted to how to limit DCS in a reasonable way [9]. The sunset clause has been taken seriously by scholars as one of the measures to restrict DCS [10]. In mainland China, the 2019 amendments to the Rules Governing the Listing of Stocks on the Science and

Technology Innovation Board of Shanghai Stock Exchange (the Listing Rules) adopted the Sunset clause to set limits for special voting shares [11]. How is the sunset clause of China DCS designed? Is it able to meet the purpose of the system design? What are the problems and how to solve them? However, academic study in China on these issues is still in its early stages, and this article will address these issues using corporate governance and listing experience from developed countries.

II. BACKGROUND: PROS AND CONS OF DCS

DCS is essentially a mechanism for differential voting arrangements, which means that public shareholders still enjoy "one share, one vote", while each share of inside shareholders enjoys a multiple of the voting rights of each share of public shareholders [12]. This means that in a DCS, the will of the special voting shareholders will play a crucial role in the company's decisions. Entrepreneurs or founders will no longer have to be concerned about their control of the firm being shattered, especially when confronted with an inflow of public shareholders following the IPO. Although DCS has the advantage of optimizing corporate governance by increasing the weight of the founder's voice to fully motivate the founder's initiative, these advantages may also put the company in governance trouble such as regulatory failure and founder self-interest. As a result, scholars have yet to reach a definite judgment on the usefulness of DCS. As a prelude to discussing the sunset clause, the authors briefly review the academic debate surrounding the advantages and disadvantages of DCS.

A. Advantages of Corporate Governance Brought by DCS

Starting from the idiosyncratic vision theory, the institutional framework of centralized control makes it easier for entrepreneurs to achieve their pursuit of high-return strategies for the company and to achieve their vision to create greater value for the long-term growth of the company [13]. The theory explains more directly the following advantages of DCS.

1) Reducing governance costs

In both single-tier and DCS structures, "foot-voting shareholders" are hardly the ones who contribute to the company's thinking, but their random or herd-based votes often have a critical impact on corporate decisions. The paradox is that in a single-tier equity structure, they have the same voice as shareholders with many ideas. This makes the optimal allocation of voting power among shareholders difficult and makes corporate decision-making inefficient [14]. As a result, firms may respond flexibly to the investment preferences of various investors by distinguishing equity rights [15].

2) Reducing governance costs

The ability of DCS to realize the company's long-term value may be assessed in terms of fending off hostile takeovers and fending against short-termism. After a business goes public, its stock may be traded freely, and control of the firm can potentially be transferred with or without the permission of the company's controllers as long as a sufficient amount of equity is acquired. The founders are likely to be out of the picture after a reorganization of the company's top management, which can make some companies reluctant to go public, such as family businesses. Similarly, when aggressive investors and short-sighted shareholders face short-term fluctuations in share prices, the short-sighted bias of company managers can significantly affect corporate investment behavior and force them to give up the long-term interests of the company [16], [17]. And the separation of voting rights from cash value can impede the flow of control and effectively solidify the dominant position of the founder, which provides a stable atmosphere for the founders to make logical decisions and fulfill the company's goal [18].

B. Corporate Governance Dilemma under DCS

From the perspective of founders and entrepreneurs, DCS is an efficient governance structure. But when there is an imbalance of power between the founders and other shareholders, it may lead to an increased risk of victimization of other shareholders. The disadvantages of DCS are reflected in the following aspects.

1) Increasing the agency cost

From a property value perspective, there is no difference between special voting shares and common shares. When the founder controls the company with a small amount of equity, a state of low dividends, low losses and high concentration of control is created. Therefore, with the imbalance of rights and obligations, the founders may engage in more risky activities at the expense of the shareholder. Even, this will trigger moral hazard for special voting shareholders. They may tend to use their voting rights to maximize their private interests rather than maximize the value of the firm [19].

2) Leading to the failure of market regulation mechanisms

Although the solidification of control can provide founders with the conditions for independent decision-making, it will be difficult for the market to exert influence on the corporate governance structure if control cannot be exchanged through traditional ways. As Daniel Fischel points out, "the cost of dual-class common stock is that the effectiveness of the market for corporate control as a monitoring device is reduced." Because the effectiveness of the control market depends on the freedom of shareholders to accept hostile takeover bids [20]. Since DCS weakens other shareholders' positions by securing control of the business, it decreases the risk of a hostile takeover, and management may then fail to fully consider the interests of other shareholders. Thus DCS can lead to a failure of the market regulation mechanism.

3) Failing of idiosyncratic vision

Idiosyncratic vision emphasizes the value of the

entrepreneur to the company and is highly dependent on the founder's own condition, such as business judgment, physical condition, and maintenance of entrepreneurial spirit. However, when the founder's own condition changes, such as death, incapacity, or departure, it will be difficult to ensure that value will still be created for all shareholders. In addition, there are empirical studies showing that DCS does not always bring high returns, and that after 6-8 years DCS returns can be even lower than those of a one-share-one-rights company [21]. The "Sumner Redstone phenomenon" in the United States is a typical example of a failed idiosyncratic vision. Sumner Redstone, a man in his 90s, holds nearly 70 percent of the voting rights through his 8 percent stake in Viacom and CBS. When faced with the lawsuit, he could no longer stand, walk, write or speak fully.

C. A Compromise View: Allowing Conditional DCS

Even though the debate on the effectiveness of DCS is still ongoing, in order to deal with the reality of DCS that is already allowed to be listed, a new governance tool needs to be introduced to place reasonable limits on the aforementioned drawbacks. The purpose of this governance tool is to achieve the goal of DCS adoption by the founders, but in a moderate manner, and to properly protect the interests of common shareholders by giving them a voice, but without interfering with the management of the company. And the sunset clause can make the special voting shares convert to common shares or eliminate DCS by special events provided by law or by the bylaws, restrict the exercise of the rights of special voting shareholders, protect the interests of minority shareholders, and promote the sound operation of DCS.

III. SUNSET CLAUSE

A. Sunset Clause and Its Functions

Sunset clause require some or all of the high vote shares to automatically convert to low vote shares upon the occurrence of certain events [22]. In the face of the negative effects of founders caused by the separation of voting rights from cash flow rights and the separation of voting rights from identity attributes, the function of sunset clause is actually an effective response to the shortcomings of the DCS system. Some empirical studies have shown that over time graphs, DCS with sunset clauses are significantly higher in terms of firm value than DCS without sunset clauses. Constructing a constraining framework for DCS can take the form of limiting disproportionate voting and cash flow rights, critically assessing the achievement of idiosyncratic vision for special voting shareholders capacity, and setting a duration for the DCS. Therefore, there are different types of sunset clauses to carry these functions.

B. Types of Sunset Clauses

Different scholars have shown different classification patterns for the types of sunset clauses. For example, Winden classifies sunset clauses into six types: Time-Based Sunsets, Dilution Sunsets, Divestment Sunsets, Death and Incapacity Sunsets, Separation Sunsets, Transfer Sunsets. Bebchuk classifies sunset clauses into three types: fixed-Time Sunset, Triggering-Event Sunset,

Ownership-Percentage Sunset. Although the two scholars have different ways of classifying sunset clauses, both of them have well explained the functions of them. In this paper, the classification patterns of the two scholars are integrated from the perspective of facilitating the connection with the Listing Rules.

1) *Dilution sunset*

In order to alleviate the problem of self-interest of special voting shareholders that may arise from the disproportionate separation of voting rights and cash flow rights, dilution sunset requires special voting shareholders to hold a certain percentage of equity. If the number of shares held by a special voting shareholder falls below the amount specified by dilution sunset, then all of the special voting shares of that shareholder will automatically be converted into common shares. For example, Baidu's prospectus specifies that Robin Yanhong Li and his proxy holders will automatically convert all of their Class B shares into Class A shares if their combined holdings of Class B shares fall below 5% [23]. This is a typical dilution sunset.

2) *Transfer sunset*

The transfer sunset is triggered when special voting shares flow from the founders to the non-founder shareholder, and the transferred special voting shares will automatically become common shares. In the United States, transfer sunset are not required by law, but are freely chosen by the company. It is usually written in the Articles of Association. If transfer sunset is used, holders of high voting share are typically permitted to voluntarily convert their high vote stock to low vote stock at any time to obtain liquidity, but cannot transfer high-voting shares directly to others. The reason for this clause is to keep high voting shareholders in the company by limiting the transfer of equity and to pursue long-term value [24]. This is well understood because special voting shares have a close personal attachment to the founders. In other words, it is the founder who is in tune with the vision of the company and not the transferee of the equity.

3) *Triggering-event sunset*

Also based on personal attachment, when the founder loses the possibility of realizing the idiosyncratic vision, for example, when the founder dies, becomes incapacitated, ceases to hold decision-making positions or is no longer fit to make decisions, the equity held by him becomes common stock. The famous Sumner Redstone case is a good example of why this provision exists [25].

4) *Time-based sunset*

This type of sunset clause means that when a certain point in time is reached, the DCS will automatically or by shareholder vote revert to a "one share, one vote" status. The concept behind a time-based sunset is that it provides a period of time for the founder to realize his idiosyncratic vision. Unlike the first three types of sunset clauses, which sunset the rights of special voting shareholders, the time-based sunset eliminates the DCS, i.e., compared to the other three types of sunset clauses that trigger uncertainty, the time-based sunset is the sunset clause that actually directly transfers the DCS to a one-share structure. In practice, the time-based is the most widely supported of all

types of sunset clauses [26]. Time-based "sunset clauses" require a DCS structure to lapse after a specified period of time, particularly when agreed upon in the IPO phase charter [27]. In the 2017 U.S. IPO market, 23 public companies set up a DSC structure, and 6 of them used time-based sunset [28].

IV. CURRENT STATUS OF SUNSET CLAUSE IN MAINLAND CHINA

A. *Current Status*

Listing Rules 4.5.3 and 4.5.9 together form the sunset clause [29]. China limits the difference between voting rights and cash flow rights to 10% and sets limits on the transfer of control of the company and the special voting shareholders' own circumstances. These are necessary to set sunset clause. In Table I, the authors summarize and sort out 4.5.3 and 4.5.9.

TABLE I: PRESENTATION OF SUNSET CLAUSE IN LISTING RULES

§ 4.5.9	Types	Shareholders' rights sunset	DCS sunset
(1)	Triggering-Event	✓	
(2)	Dilution	✓	
(3)	Transfer	✓	
(4)	Dilution		✓
(1)~4.5.3	Dilution		✓

B. *Problems*

1) *There is no time-based sunset clause in the listing rules*

The Listing Rules do not include a time-based sunset clause, which, as previously stated, is the sunset clause that most directly affects the containment of the negative impact of DCS. The prospectus of Ucloud, which is already listed on the SSE, does not have a sunset clause but rather a permanent DCS, i.e., "the issuer's special voting rights will continue to operate on a permanent basis unless the special voting rights arrangement is terminated by a resolution of the issuer's shareholders in general meeting" [30]. Yvan Allaire believe that it would be "one size fit all" to set a time-based sunset clause directly in Rules. Because each company has a different growth cycle, it would be arbitrary to set a uniform sunset time for companies [31]. Moreover, in the face of a cliff sunset, the founders may transfer control at a high premium or take advantage of the situation in a hidden way [32]. Chinese regulators may consider that they cannot arbitrarily set sunset clauses without empirical studies. In addition, the DCS issue could be offset by a shareholder representative suit system. However, in the face of the huge volume of 15 billion yuan of Ucloud's market capitalization, the regulator responded with a weak regulatory attitude by allowing a permanent DCS structure to be set up within it. When the regulator authorizes the company to set time-based sunset clauses completely on its own, it will cause great harm to the small and medium shareholders in case of self-interested behavior of the controller.

2) Dilution sunset clause alone can't work to eliminate the dual class share structure

Except for time-based sunset clauses, there is uncertainty whether other types of sunset clauses will be triggered. In particular, some scholars argue that whether a dilution sunset clause is triggered depends on whether the special voting shareholders voluntarily give up control of the listed company. If the high-voting shareholders do not give up control of the listed company, such clauses lack the possibility of being triggered". This means that in essence there is no effective sunset clause to protect the interests of minority shareholders.

V. SUGGESTIONS FOR REFORM

A. Time-Based Sunset Are Required for Listed DCS Companies

1) Reason

On a theoretical level, companies and entrepreneurs have a life cycle. As founders get older, their innovation and judgment deteriorates, and allowing them to continue to own special voting shares at this time may instead undermine the interests of common shareholders. In addition, there are empirical studies to support that the yield of DCS is not higher than that of the one-share-one-rights structure after a certain number of years.

From the actual situation in China, Listing Rule 2.1.4 stipulates the market capitalization and profitability conditions for DCS companies to be listed [33]. Compared to other countries, the listing threshold of 10 billion yuan or 5 billion yuan with profitability attached is good, which means that DCS companies that can be listed on SSE are giants. When a corporate governance dilemma arises, it poses a significant risk to both the interests of small and medium-sized shareholders and the financial market's stability, hence China need more time-based sunset clauses to ensure that DCS tend to be stable.

2) Specific time

One challenge with sunsets is identifying the appropriate length of time before the sunset is triggered. In CII's data of twenty-four companies that have gone public with time-based sunset provisions, there is little consistency in the sunset period—10.5% of sunsets were five years; 31.6% were seven years; 36.8% were ten years; and 21.1% were longer than ten years. The Council of Institutional Investors in the U.S. has recommended that the NYSE and NASDAQ should include in their listing rules that the maximum duration of a two-tier equity structure should not exceed seven years. After seven years, it can be extended for another seven years, but it should be up to the common shareholders to decide whether to continue the double-tier structure, otherwise such companies will not be allowed to be listed and traded [34]. The Canadian Coalition for Good Governance recommends a five-year sunset clause with a minority shareholder majority renewal mechanism [35].

As to when DCS should sunset for Chinese companies, the authors argue that a judgment needs to be made based on China's own circumstances, and that a large number of empirical studies are needed to reach a more credible

conclusion. The impediment now is: On the one hand, the Listing Rules have only been in effect for two years, and listed firms have yet to complete their corporate life cycle; on the other hand, due to the high listing criteria, only a small number of DCS firms may be listed in SSE, resulting in a tiny sample size. However, the authors believe that this will be a very valuable topic in the coming years.

B. How to Apply the Sunset Clause

1) Market decision or statutory

Proponents of market decision argue that there is an offsetting issue between functionality and security as to whether a two-tier equity structure requires a mandatory sunset clause. Trait visions may emerge at any time and may be obtained from non-founders. Many sophisticated market participants often voluntarily adopt sunset clauses through market negotiations [36]. For example, the U.S. does not force companies to set sunset clauses. 86 of the 157 companies that have gone public in the last 15 years still maintain permanent DCS structures. Some scholars suggest that mandatory time-based sunset clauses cannot solve the problem of DCS structure, and there are shortcomings such as arbitrary term selection, moral hazard and public shareholders' tendency to end the double-tier shareholding structure. Especially when faced with a cliff sunset, it is easier for founders to breed moral hazards.

Scholars supporting Statutory argue that a mandatory fixed-term sunset clause prevents the possibility of the continuation of a two-tier equity structure after the initial rationality of the structure has disappeared. Relying exclusively on private order does not ensure the continued protection of the interests of low-voting shareholders, and there is a risk that high-voting shareholders will seek to obtain the benefits of private control to the detriment of low-voting shareholders [37].

2) Applying the "comply or explain" principle in the Chinese context

From the above analysis, the need for a time-based sunset clause and statutory or liberty has not ceased to be discussed in academic circles. In the face of the huge risks that may be posed by the huge size of Chinese DCS companies, the authors argue that a time-based sunset clause is needed to restrict DCS. Further, the author argues for a compromise approach - the creative use of the "comply or explain" principle - to the current situation of statutory and liberal indecision. When a company reaches the time specified in the time-based sunset, the company either chooses to comply with the requirement to convert to a single-tier equity structure or is obliged to explain to the regulator why conversion to a single-tier equity structure is still not appropriate when it expires.

VI. CONCLUSION

While the debate on the effectiveness of double-tier equity has been ongoing in academia, most of the arguments revolve around the vision of corporate controllers and the interests of other shareholders. As competition in national stock exchanges has intensified and DCS companies have gradually been allowed to be listed in various countries, the

new problem we face is how to reduce the negative impact of DCS that evade market constraints and harm the rights of minority shareholders to a manageable level. Empirical studies show that sunset clause is an effective tool to curb DCS, and among various types of sunset clause, time-based sunset is the most direct and effective one to bring DCS back to a one-share ownership status. By analyzing China's Listing Rules, the authors find two problems: the absence of time-based sunset and the lack of substantive constraints on DCS make the existing sunset system null and void. Therefore, the authors suggest adding a time-based sunset and innovatively adopting the "comply or explain" principle in China, transposing the legislative techniques of developed countries to the field of financial regulation.

CONFLICT OF INTEREST

The author declares no conflict of interest.

AUTHOR CONTRIBUTIONS

This study was done solely by Zhi Li.

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