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A threat to dual-class shares
The recommendation of the breakthrough rule fails to recognize its broader implications

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The report of the high-level group of company law experts contains much that is sensible about takeover policy. However, there is one element of the report--the break-through rule--whose import goes well beyond the regulation of takeovers. Much of what the report seeks to accomplish would not require this rule. Moreover, the rule would have major and possibly undesirable consequences for ownership patterns.

Under the group's recommendations, a bidder that has acquired 75% of the risk-based capital of a company (essentially, the company's cash flow rights) should be able to gain control and to this end "break-through" any mechanisms and structures that have been established by the company's articles or otherwise. Even if the company has established a dual-class structure and the bidder has acquired shares with inferior or no voting rights, the bidder will still be able to cast votes in proportion to the fraction of risk-capital that it has acquired.

Consider Ericsson, which has two classes of shares. A shares have 1000 times as many votes, but the same cash flow rights, as B shares. A shares altogether have the overwhelming majority of votes but less than 10% of the cash flow rights. Under prevailing rules, the A shares would have a decisive say on whether Ericsson should accept an acquisition offer. Under the group's proposal, however, a bidder that acquires all the B shares would be able to gain control. The group justifies the rule on grounds of a "proportionality principle." On an important decision such as whether to accept a takeover bid, the group believes that the A shares, which represent less than 25% of the cash flow rights, should not have disproportionate power, but rather a weight in accordance with their fraction of cash flow rights. It is not clear, however, why the group singled out the takeover decision as one for which this principle is applicable. Why shouldn't the B shares also have a decisive say on whether to dissolve the company or on which management team should run it?

Actually, upon closer inspection, it turns out that, even though this is not what the group intended, the break-through rule would enable the B shares generally to have their way. Indeed, the rule would enable the B shares to take the superior voting power away from the A shares.

Ericsson's A shares are worth more, and generally trade at a premium to B shares, because of their superior voting power. If the break-through rule were adopted, however, Bebchuk and Hart could set up a shell company BH with the same total number of shares as Ericsson and make a takeover for all of Ericsson's A and B shares, offering each shareholder of Ericsson shares in BH on a one-for-one basis. BH also would promise that should it gain control of Ericsson, it would retain management.

All holders of B shares should accept this offer since they will get shares with the same cash flow rights in Ericsson's assets and proportionate voting rights, in place of shares with inferior voting rights. The offer would succeed since BH would obtain most of the cash flow rights of Ericsson and according to the break-through rule would have control. Thus, the dual-class structure

would be undone, and the A shareholders would lose their control premium.

Note that the break-through rule would not prevent the separation of voting rights and cash flow rights in firms that go public in the future. Such firms will simply no longer use a dual-class for this purpose. Instead they will use pyramidal structures, which would not be subject to the group's break-through rule. The group's report notes that pyramids produce similar situations to dual-class. But it does not recognize that, as long as pyramids are not covered, applying the break-through rule to dual-class would have little effect on takeover bids for firms going public in the future. Instead, the rule would affect such companies primarily by causing a shift from dual-class to pyramids.

In summary, the break-through rule would have major consequences for ownership structures throughout Europe. Established dual-class structures would be undone or at least lose much of their significance. In firms going public in the future, pyramids would largely replace dual-class. The group's report does not recognize these consequences. We believe that an examination of whether and how Europe should regulate the separation between votes and cash flow rights is warranted. Until such an examination is conducted, however, the proposal for a break-through rule should be put aside.

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