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Protection of Minority Shareholders' Rights under Dual-Class Share Structure

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Abstract

Under the dual-class share structure, the property rights and voting rights of shareholders are separated, and the different allocation of voting rights results in special voting shares and ordinary shares. Compared with the traditional share structure, minority shareholders of listed companies' ordinary shares bear more risks and require more institutional protection. Currently, due to the lack of effectiveness in information disclosure, insufficient sunset clause effectiveness, and imperfect litigation mechanisms, the protection of minority shareholders' rights is limited. It is necessary to improve the information disclosure system, supplement time-based sunset clauses, and enhance the securities class action system to promote the construction of minority shareholders' rights protection mechanisms.

Keywords

Dual-Class Share Structure; Minority Shareholders; Rights Protection.

1. Introduction

In the traditional homogeneous equity theory, the heterogeneous equity theory has emerged. With the continuous development of the heterogeneous equity theory, the dual-class share system has emerged. From 2018 to 2019, the China Securities Regulatory Commission and the Shanghai Stock Exchange successively issued relevant regulatory documents, formally establishing the dual-class share structure in China, and subsequently, some companies adopted the dual-class share structure for listing. The dual-class share structure can effectively protect companies from hostile takeovers during operations, helping companies achieve long-term development. However, the essence of the dual-class share structure, which separates property rights and voting rights, inevitably leads to the company's management control being firmly held by the founders. Compared with companies that implement the "one share, one vote" principle, minority shareholders under the dual-class share structure have more limited voice and voting rights, unable to vote on matters related to their interests, yet they bear the risks of the founders' decisions, which contradicts the fairness principle of company law. Therefore, under the dual-class share structure, properly protecting the rights of minority shareholders is a practical issue.

2. Overview of Dual-Class Share Structure

The dual-class share structure originates from common law countries (regions). Unlike the traditional single-class share structure, it is a company equity configuration model that assigns multiple rights and functions to shares within the same equity structure. For example, dual-class share structure companies replace the traditional "one share, one vote" form with Class A and Class B shares. The voting rights of Class A and Class B shares are inconsistent, with Class B shares having far greater voting rights than Class A shares, hence Class B shares are also known as special voting shares. Based on the characteristics of Class B shares, the "Science and Technology Innovation Board Listing Rules" make special provisions: 1) The multiple

ISSN: 2710-0723

relationship between special voting shares and ordinary shares, i.e., it shall not exceed ten times; 2) Shareholders of special voting shares can obtain more than 10% of the economic benefits. The dual-class share structure classifies the voting rights contained in company shares, facilitating company founders to control company management while obtaining equity investments, meeting the practical needs of shareholder heterogeneity and realizing the company's financing function.

Compared with the traditional share structure, the dual-class share structure has the following characteristics: 1) Separation of property rights and voting rights. As mentioned earlier, Class A and Class B shares, the amount of capital is not the only factor determining the size of voting rights. Shares with the same property rights, Class B shares have a heavier voting weight. Therefore, the most important feature of the dual-class share structure is breaking the proportional relationship between property rights and voting rights, allowing company founders to control company management with a smaller share, meeting the company's listing needs. 2) Special voting shares are restricted, mainly in terms of the holders of special voting shares. Generally, special voting shares are held by company founders. Once the founders transfer special voting shares to other shareholders, the shares lose their special voting rights and become ordinary shares. This is mainly because transferring the founders' special voting shares to transferees, who do not have the same trust basis as other shareholders in the founders, results in the special voting shares losing their special voting rights and becoming ordinary shares.

The contradiction between the diverse needs of capital market entities and the insufficient supply of relevant systems in practice is the decisive factor for introducing the dual-class share structure in China. Among market entities, technology innovation companies are typical representatives of the above contradiction. Generally, new technology innovation companies have the following two characteristics: 1) The company's core is technical talent, and the founders are closely linked to the company's development; 2) Lack of physical assets. Companies with the above characteristics face great difficulties in developing under China's traditional share structure model. This is because such companies need to grow through equity financing, but equity financing dilutes the founders' shares, leading to the weakening or even deprivation of the founders' control over the company, resulting in the company's decline. The dual-class share structure separates property rights and voting rights, allowing founders to control the company's development direction while having sufficient funds. Therefore, for building an innovative country, it is very necessary for China to introduce the dual-class share structure. The heterogeneous equity theory holds that different shareholders, in addition to having obvious differences in the number of shares held, are also different in many aspects. For example, they have different professional backgrounds, investment motivations, and ways of exercising equity, so their interest demands and attention to the company are different. This theory provides a legitimate internal theoretical support for the dual-class share structure. In summary, with both theoretical support and practical needs, the dual-class share structure replacing the traditional share structure is inevitable. However, the dual-class share structure causes minority ordinary shareholders to lose some voting rights, and companies should more actively improve their internal structures to protect the rights of minority shareholders.

3. Issues in Protecting Minority Shareholders' Rights under Dual-Class Share Structure

The main operating rules of China's dual-class share structure are set out in the "Shanghai Stock Exchange Science and Technology Innovation Board Listing Rules". According to the "Science and Technology Innovation Board Listing Rules", the existing rules for protecting minority shareholders' rights are mainly reflected in the following aspects. 1) Information disclosure.

ISSN: 2710-0723

The information here includes the arrangement of special voting rights at the time of listing and significant changes in differentiated voting rights. Information disclosure must be continuous. 2) Restrictions on special voting rights holders. Special voting rights shareholders must have the corresponding qualifications and meet the minimum capital contribution ratio. 3) Restrictions on special voting rights. The company's articles of association must specify the voting rights ratio of special voting shares, which cannot exceed ten times that of ordinary shares. In addition, matters that require voting according to the "one share, one vote" principle are specified. 4) Restrictions on the issuance, transfer, and termination of special voting shares. Except for the initial public offering and listing, special voting shares cannot be issued at any other time. Special voting shares cannot be traded on the secondary market, but under specific circumstances, they can be converted into ordinary shares for transfer at an equivalent ratio. The sunset clause stipulates that when special voting rights shareholders lose their qualifications, special voting shares are converted into ordinary shares. 5) It is stipulated that the proportion of ordinary voting rights in listed companies shall not be less than 10%. Although the "Science and Technology Innovation Board Listing Rules" set the above rules to protect minority shareholders' rights, there are still loopholes in the protection of minority shareholders' rights.

3.1. Lack of Effectiveness in Information Disclosure Mechanisms

Although the "Securities Law" and the "Science and Technology Innovation Board Listing Rules" both have provisions on information disclosure, the latter has more detailed provisions on information disclosure for companies implementing the dual-class share structure, but there are still shortcomings. First, the risk warning of the dual-class share structure is insufficient. Equity investment is essentially a contract, and investors need to understand and examine matters related to their interests before signing the contract to become shareholders. The agency cost risk of the dual-class share structure is much higher than that of the "one share, one vote" structure. Compared with the traditional share structure, investors should be made aware of the risks as much as possible to ensure the stable operation of the company. Second, the content of information disclosure is not differentially designed. Under the dual-class share structure, there is information asymmetry between special voting rights shareholders and ordinary shareholders. Founders control company management and can timely understand and control the company's operating status, while other shareholders can only understand the company's development status through disclosed information. Special voting rights shareholders may use the advantage of information asymmetry to manipulate the stock market, harming the interests of minority shareholders. For institutional investors, individual investors are not professional, and their ability to obtain and interpret information is extremely limited, making it difficult to ensure individual investors' control over risks.

3.2. Insufficient Effectiveness of Sunset Clauses

The sunset clause is a termination clause that stipulates that companies adopting the dual-class share structure will terminate special voting rights after triggering a certain event. Its essence is the separation of control rights and income rights. The "Science and Technology Innovation Board Listing Rules" stipulate three situations in which special voting shares lose their special voting rights. These three situations can, to a certain extent, constrain special voting rights shareholders and protect the rights of minority shareholders. However, there are still some problems with the sunset clause. First, the sunset clause is single and incomplete. According to the fiduciary duty theory, the voting rights of special voting rights shareholders far exceed those of ordinary shares, which are derived from the transfer of voting rights of minority shareholders. The transfer is based on the trust of minority shareholders in special voting rights shareholders. Once minority shareholders lose trust, the voting rights of special voting rights shareholders lose their basis, and special voting shares should be converted into ordinary

ISSN: 2710-0723

shares. China's provisions on the conversion of special voting shares into ordinary shares do not include this situation, and cannot accurately cover the scope of restrictions on special voting shares. Second, the sunset clause lacks corresponding penalties. The consequence of special voting rights shareholders triggering the sunset clause is only that their special voting shares are converted into ordinary shares, and the restrictive effect is very limited. Founders can completely avoid triggering situations in various ways, long-term retaining special voting rights, and minority shareholders still cannot realize their rights and claims.

3.3. Imperfect Litigation System

There are many individual investors (commonly known as retail investors) in China's securities market. After individual investors purchase ordinary shares of a listed company, they become minority shareholders of the company. Compared with investment institutions, these entities lack professionalism and are extremely scattered, with incomplete access to company information, and are in a very weak position among company shareholders, but these entities still have to bear the decision-making risks of the founders. China's company law stipulates two litigation systems: direct shareholder lawsuits and shareholder representative lawsuits. When the rights of minority shareholders are damaged, minority shareholders can file lawsuits in these two forms. However, due to the lack of management ability and high litigation costs, minority shareholders cannot file lawsuits in the two forms stipulated by the company law. Since the implementation of the new "Securities Law" in March 2020, the Chinese characteristic "implied participation, explicit withdrawal" securities class action system has been gradually established. Securities class actions can effectively remedy the loss of rights of minority shareholders under the dual-class share structure and are a legal and effective way. However, it cannot be ignored that there is only one direct provision on securities class actions, and overly simple provisions mean a lack of specific implementation rules and weak operability. In practice, some local courts have issued relevant litigation system provisions, but they are extremely scattered.

As mentioned earlier, China's sunset clause is event-based, and the penalties for special voting rights shareholders are not strong. Special voting rights shareholders control the company's development, and once they abuse their voting rights, it will cause devastating damage to the rights of minority shareholders. Therefore, it is necessary to establish a perfect relief mechanism to provide civil compensation for minority shareholders whose rights are infringed, thereby more properly protecting their rights. However, at this stage, for securities violations, the cost of violations is mainly reflected in the administrative field, with relatively few provisions in the civil field and unclear specific compensation measures. For example, for securities fraud cases, although Chinese law stipulates that the infringed have the right to claim compensation, it is only a general provision, without a specific operating system, resulting in the infringed not being able to obtain timely and effective relief.

4. Paths to Improve the Protection of Minority Shareholders' Rights under Dual-Class Share Structure

4.1. Improve Information Disclosure Provisions

Information disclosure is the main way for companies to disclose company information to the outside world. Investors decide whether to invest based on the disclosed information, and company shareholders protect their right to know through information disclosure. As the most important information disclosure system in the securities market, the time, method, and content of company information disclosure are all specified in detail. Under the dual-class share structure, minority shareholders' participation in company management is weakened, and their expression on matters related to their interests is also weakened. At this time, it is

ISSN: 2710-0723

particularly necessary to fully protect the right to know of minority shareholders. The information disclosure system can be improved from two aspects.

First, increase special risk warnings. Under the category share system, special warnings should be given to the investment risks of the category share system. In practice, the effectiveness of information disclosure is somewhat lacking, and both professionalism and effectiveness need to be strengthened. Under the dual-class share structure, the risk of conflicts of interest between shareholders and between shareholders and the company is more special and complex. Among the prospectuses of 20 companies listed on the Science and Technology Innovation Board, only 11 explained the common risks that the company may face, such as the inability to pay dividends and stock market fluctuations, indicating that the company's risk warnings are not in place. Based on the effectiveness of information disclosure, the investment risks in the conflicts of interest under the dual-class share structure should be the focus of information disclosure, as an accurate basis for investors' investment decisions, reducing investors' investment risks.

Second, establish a hierarchical disclosure system. In the securities market, individual investors and investment institutions have different needs for corporate information. For professional investment institutions, documents such as prospectuses, temporary reports, and annual reports containing disclosed information are of little use for their risk assessment. On the contrary, these documents can help individual investors understand the company's equity structure and basic operating status, helping individual investors conduct risk assessments. Therefore, companies should identify investors and divide the scope of information disclosure to improve the effectiveness of information disclosure.

4.2. Improve Sunset Clauses

Sunset clauses can, to a certain extent, prevent special voting rights shareholders from controlling the company for a long time and protect the rights of minority shareholders. China only stipulates event-based sunset clauses, and should diversify the provisions of sunset clauses. First, expand the application of sunset clauses. With the development of the enterprise, special voting rights shareholders may lose the trust of ordinary shareholders due to factors such as knowledge, ability, and age. Special voting rights shareholders lack the ability to achieve corporate governance goals but still enjoy a majority of voting rights, which will undoubtedly exacerbate conflicts of interest between shareholders. Therefore, it is necessary to set time-based sunset clauses to terminate special voting rights and protect the rights of minority shareholders. However, mandatory provisions for dual-class share structure companies to apply a certain type or two types of sunset clauses violate the principle of private company law. Dual-class share structure companies can choose the type of sunset clause to apply. Specifically, if the company chooses to apply two types of sunset clauses, a shareholders' meeting should be held before the date specified in the time-based sunset clause to vote on whether to continue to apply the dual-class share structure. Of course, this voting matter should be stipulated in the company's articles of association as a voting matter that implements the "one share, one vote" principle. There is considerable controversy over the time limit of the time-based sunset clause, but according to existing data model calculations, the dual-class share structure will no longer have advantages after six to nine years, so it is appropriate to set the time limit at six to nine years.

4.3. Improve the Securities Class Action System

The new "Securities Law" stipulates the securities class action system, which is not shelved. The Kangmei Pharmaceutical securities misrepresentation liability dispute case is a perfect practice of China's securities class action system. However, the litigation system is in its initial development period and needs to be continuously improved according to the characteristics of China's securities market. To improve China's securities class action system and ensure that minority shareholders can smoothly exercise their relief rights, the following points need to be stipulated or clarified. First, the investor protection institution should have the right to special authorization. This content is not stipulated by law. In practice, if the investor protection institution needs to separately obtain the authorization of minority shareholders, it will inevitably slow down the entire litigation process. Therefore, the investor protection institution, as the litigation representative, should have the right to special authorization. Second, correctly delineate the scope of rights holders in securities class action cases. According to the system, the investor protection institution will default minority shareholders as the rights holders of the litigation, which will expand the scope of rights holders in litigation cases and is not conducive to the progress of the case. Finally, grant lawyers the right to participate in group litigation. China has established the investor protection institution as the main body of securities class actions, which is conducive to protecting the relief rights of minority shareholders. However, compared with lawyers specializing in securities disputes, the professionalism of the investor protection institution is obviously inferior. Moreover, the participation of lawyers in securities class actions can also reduce government responsibility and risks.

Litigation is only a means, and seeking compensation is the ultimate goal after the rights of minority shareholders are damaged. Therefore, a perfect litigation relief system, but without a corresponding civil compensation system, the relief efficiency of the litigation system will be greatly reduced. According to legal provisions, only for losses caused by the company's securities misrepresentation can minority shareholders claim civil damages. For other securities market torts (such as insider trading), clear provisions should also be made to protect the relief of minority shareholders' rights.

5. Conclusion

The capital market is constantly changing, and relevant systems need to be iteratively updated. The introduction of the dual-class share structure into China's securities market is inevitable. However, it must also be seen that the dual-class share structure exacerbates the conflict risks between controlling shareholders and minority shareholders in listed companies under the traditional "one share, one vote" structure. How to protect the interests of minority shareholders is a problem that must be solved to further expand the application of the dual-class share structure in listed companies. This article improves the protection path from three aspects: pre-defense---protecting the right to know of minority shareholders, during---expanding the application types of sunset clauses, and post-relief---improving the securities class action mechanism, in order to protect the rights of minority shareholders under the dual-class share structure. The dual-class share structure is a new thing for China, and there are many existing difficulties that require continued establishment and improvement of relevant legal systems.

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ISSN: 2710-0723

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