INVESTOR PERSPECTIVES

Snap's Not Looking to Chat With Shareholders

How the parent of mobile-messaging app SnapChat's new stock structure will undermine investors, corporate governance and the courts.

BY CHARLES M. ELSON AND CRAIG K. FERRERE

Increasingly, company founders have been opting to shore up control by creating stock ownership structures that undercut shareholder voting power, where only a decade ago almost all chose the standard and accepted one-share, one-vote model.

Now the Snap Inc. initial public offering (IPO) takes it even further with the first-ever solely non-voting stock model. It's a stock ownership structure that further undercuts shareholder influence, undermines corporate governance and will likely shift the burden of investment grievances to the courts.

By offering stock in the company with no shareholder vote at all, Snap — the company behind the popular mobile-messaging app Snapchat that's all about giving a voice to the many — has acknowledged that public voting power at companies with a hierarchy of stock ownership classes is only a fiction. And it begs the question: Why does Snap even need a board?

Snap's stock has taken a beating since the IPO with losses mounting. In a conference call with analysts, CEO Evan Spiegel "acknowledged he misjudged demand for Spectacles, the video-recording sunglasses," according to a recent *Wall Street Journal* article.

Without the ability for shareholders to vote for directors and maintain accountability, directors are in the end just products of the company managers; managers who have already admitted to fumbling.

Control until death?

Snap's multi-class, non-voting capitalization gives Spiegel and Robert Murphy, the company's founders and holders of 10-vote shares, a perpetual lock on control, without the need to hold an expensive ownership position. They exercise a decisive 89% of the voting power, despite holding only about 44% of the company's total equity.

Dual- and multi-class capitalizations — in which founders and other insiders retain a class of high-vote shares while selling low-vote shares to the public — are nothing new for controlled companies. This mechanism has long allowed founding individuals and families to leverage minority economic ownership positions — say 10% or 20% — into total voting control of large companies such as Snap, Facebook and Google.

But the Snap plan stretches this logic to its limit — with no-vote shares, founders can sell off all but one voting share and nonetheless control every aspect of company policy.

With zero-vote IPO stock, the logic of leveraging control from a minority interest through the dual-class structure has now reached its illogical conclusion. With non-voting shares, a founder can now advise investors plainly, without any pretense or suggestion otherwise, that he or she will take their money but not their advice.

The dual-class zenith has been reached, and in its wake is the normalization of the disenfranchisement of public shareholders through dual- and multi-class structures.

Today 9% of the S&P 100 — representing a staggering $2.26 trillion in market capitalization — is dual-class. In the Russell 3000, such companies represent 8.2% of the index. The phenomenon extends well beyond the technology and media industries. Significant dual-class companies include AMC Entertainment, Box, Nike, Ralph Lauren, Tyson Foods and Under Armor. Dual-class controlled companies are steadily increasing in prominence, so hard thinking about the importance of the shareholder vote is due.

While the structure is recognized as problematic for ordinary investors, its effect on how the courts should treat director decision-making in these companies has not been explored. Ultimately, no-vote stock requires courts to abandon the director-protective business judgment rule barring courts from second-guessing the business judgment of an effective board of directors for these entities, because without the voice of shareholders there is no real board oversight. That would lead to the demise of the multi-class, non-voting stock structure.

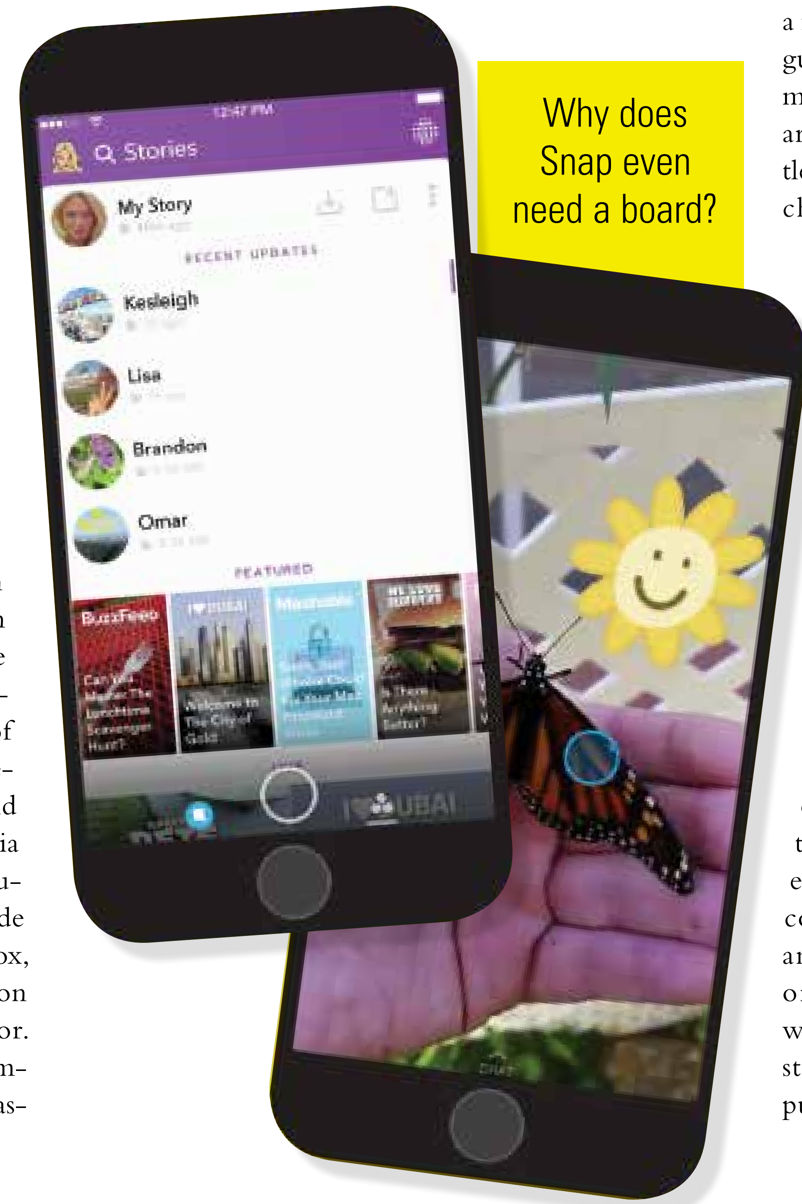
Voting power trends

Not long ago, even simple dual-class capital structures were the anachronistic refuge of either media conglomerates or old-style industrial titans.

The structure was used when the requirements for journalistic integrity and independence from the market demanded a safe-harbor fortified by an impregnable curtain of voting control —the New York Times Company, News Corp., and the *Washington Post* are the representative adopters.

It was also used when a company had been built by a founder through such singular achievement that the market could be strong-armed into accepting little-to-no protection in exchange for the capital it was giving, in trust, to a "genius." The Ford Motor Company, Berkshire Hathaway and The Estée Lauder Companies are some well-known examples.

A 21st-century trend, begun by Google in its 2004 IPO, is driving the dual-class capital structure out of the uncommon and into the mainstream. Increasingly, founders are opting to bolster control through highly leveraged voting structures, compared to the standard and accepted one-share, one-vote structure that was a constant for fear of a stock-market revolt and a public relations maelstrom.



Why does Snap even need a board?

More than one-in-nine of the new companies being added to the Russell 300 index ranks through IPOs is dual-class. In 2015, 13.5% of the 133 IPOs listed dual-class shares, compared to just 1% in 2005.

As dual-class listings have proliferated, many companies have taken Google's example and pushed the envelope even further. Zynga, which went public in 2011 raising over $1 billion, had a founder-only class of stock with a staggering 70 votes per share.

Snap's issuance of shares with no vote was unprecedented: instead of having no effective voting power, its new shares have no *actual* voting power. The no-vote structure will allow its co-founders Spiegel and Murphy, 26 and 28 years old respectively, to control the company until the day both are dead.

Its board, totally controlled by them, instills little confidence amongst the non-voting shareholders. In this circumstance, why even have a board? Of course, the law and its desire to protect other investors, however limited its ability is, suggests otherwise.

Some in the investment community are pushing back. Index provider MSCI announced in early November it was temporarily leaving Snap out of its indexes because of what it deems an unfair shareholder voting structure, joining a growing chorus of skeptics who see such models as an insider boon.

"MSCI will temporarily treat any securities of companies exhibiting unequal voting structures as ineligible for addition to the MSCI ACWI Investable Market Index and MSCI US Investable Market 2500 Index," the company said in a statement.

The growing number of dual-class companies in the American economy also raises serious questions about how the courts will view transactions involving these companies in light of the accountability that a meaningful shareholder vote provides.

Judicial quandary

While contemporary criticism of dual-class capitalizations has focused on the resulting reduction in accountability, the effect of this lessened accountability on the approach courts must take in reviewing the actions of these companies and their boards has not yet been considered. But this unexamined issue presents the most significant problem with permitting the use of dual-class structures.

The long-settled policy of judicial restraint, wherein courts have concluded that with regards to business judgment, management action will not be reviewed at all, must be reconsidered. American courts may decide that more active judicial intervention is necessary — because without a vote shareholders can't provide oversight of the boards and thus management — and take on a greater responsibility for shareholder protection at these companies.

In most circumstances, when a board of directors has acted in "good faith" and "with reasonable care" its decision will be considered a business judgment and not be interfered with by a reviewing court. This rule expresses the judicial reticence to second-guess the complex, real-time decisions of management.

Courts will need to confront this challenge to traditional business law doctrine.

Without the board and market forces to protect shareholder interests, the burden of monitoring investments and dealing with problems will end up in the courts. If courts must take up heightened review of dual-class companies, that means adding to the costs placed on society by engaging the judicial system.

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This alone presents an important, and not previously discussed, reason for eliminating dual-class structures.

If not, we may end up with a governance snap-judgment day. ■

Charles Elson *is the Edgar S. Woolard Jr. Chair in Corporate Governance and director of the John L. Weinberg Center for Corporate Governance, University of Delaware. He can be contacted at elson@udel.edu.*

Craig K. Ferrere *served as the Edgar S. Woolard Jr. Fellow in Corporate Governance at the Weinberg Center from 2010-2014.*