CORPORATE LITIGATION

Non-Voting Shares and Judicial Scrutiny

Non-voting shares made their first public debut in Snap Inc.'s March 2017 IPO, generating plenty of governance concerns. In addition, an unanswered question is what standard of review the Delaware courts will apply when evaluating the actions of Snap's board going forward.

By James Moloney, Sean Sullivan, and Alon Sachar

On March 1, 2017, Snap Inc. (Snap or Company), the creator of popular social media platform Snapchat, priced its highly anticipated initial public offering (IPO). With 200 million shares sold at $17 per share, the IPO raised approximately $3.4 billion, making it the largest IPO of any U.S.-based company since Facebook's public offering in 2012. The shares offered by Snap did not come with customary voting rights, eliciting unfavorable reactions from investors and widespread discussions about the impact of non-voting shares on corporate governance. Less discussed, but no less important, is how the non-voting share structure may impact Snap's ability to avoid heightened judicial scrutiny in the event of contested corporate transactions.

Snap's Non-Voting Shares

Attempting to preserve control through non-traditional voting structures is not a new concept for companies, especially in the technology sector. Many technology companies have dual class structures, in which founders and sometimes other early-round investors hold higher vote shares (typically ten votes per share) and others hold low vote shares (typically one vote per share). In the last several years, a number of companies including Alphabet (Google's parent company), Facebook, Zillow and Under Armour have introduced non-voting shares into their capital structures in order to delay the loss of voting control of their founder(s). Indeed, for Russell 3000 companies holding their first annual shareholder meeting in 2016, 20 have classes of shares with different voting rights.[1] But, Snap's move to offer non-voting shares is unprecedented in an IPO.

As described in Snap's IPO prospectus,[2] the Company has three classes of shares: Class A common stock, the publicly traded shares; Class B common stock, reserved for early investors and executives; and Class C common stock, owned solely by the Company's co-founders, Evan Spiegel and Bobby Murphy. Class A shares are not entitled to vote, while Class B and Class C shares are each entitled to one and ten votes, respectively, and vote together as a single class. Given this structure, even before shares were sold in the IPO, 88.5 percent of the voting power of the Company remained concentrated in its two founders. Class B shares lose their voting privileges when sold or transferred. Moreover, Spiegel's and Murphy's control of the Company through their Class C shares will not diminish, in certain circumstances, even if either or both leave Snap.[3]

Companies employing the multiple-class structure believe it contributes to stability and long-term returns for shareholders. Backers of Snap's move have said that the incorporation of non-voting shares in the capital structure serves to protect companies from activist investors, which may help some issuers overcome a general reluctance to go public and revive the sluggish IPO market.

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Criticism of Snap

There has been a fair amount of criticism of Snap's move to exclusively offer the public shares that do not include voting rights. Just prior to Snap's IPO, top fund managers including BlackRock, Vanguard, and T. Rowe Price urged companies to allocate voting rights to shareholders "in proportion to their economic interest."[4] The Council of Institutional Investors (CII) sent a letter to Snap urging its board to adopt a single-class voting structure and is now leading an initiative to exclude Snap, and any other company that seeks to sell non-voting shares to investors, from market indices managed by S&P, Dow Jones and MSCI Inc.[5] In a March 9, 2017 CII Governance Alert, CII noted that it

> also plans to renew its 2012 request to the NYSE and Nasdaq to bar listings of companies with multiple share classes with unequal voting rights. At a minimum … the exchanges should set standards for regulating dual-class companies, such as reasonable sunset provisions for multiple share classes.

Kurt Schacht, the Chair of the Securities and Exchange Commission's (SEC) Investor Advisory Committee, described the structure as "a significant concern" and a "troubling development from the perspective of investor protection and corporate governance," if it were to spur a new trend for technology or other companies going public.[6] SEC Commissioner Kara Stein, a Democrat, said that regulators need to "critically assess" the IPO regime following the Snap IPO, noting that "[t]he current structure is premised on taking investor capital while giving that investor the rights that help hold a company's management accountable [for] the use of the capital."[7]

How the SEC will proceed, however, will depend largely on the views of Jay Clayton, President Trump's recently confirmed appointee to head the Commission. In his confirmation hearing before the Senate Banking and Finance Committee on March 23, Mr. Clayton did not indicate the posture the Commission would take on this issue under his leadership if confirmed by the full Senate. He said he was not sure if insider control and the multiple-class structure is "a good thing or a bad thing, but it is a change in the balance," noting that "there is so much thirst for public companies that it is easier for a company to set a particular set of governance requirements than there may have been in the past."[8]

Future Transactions and Heightened Scrutiny

Absent from the ongoing debate over Snap's capital structure is the potential impact of non-voting shares on future transactions entered into by the Company and its insiders. Snap's non-voting shares raise some interesting questions as to when a shareholder vote may be necessary. The NYSE, NASDAQ, and other self-regulatory organizations have rules requiring the submission of certain transactions to a shareholder vote, such as change of control transactions[9] or certain issuances of more than 19.9 percent of the company's outstanding shares.[10] With most shareholders lacking any voting rights altogether, how Snap and other companies in a similar situation will seek required approvals remains an open question. Also uncertain is whether Snap may find itself subjected to heightened judicial scrutiny and, consequentially, drawn out shareholder litigation if and when it engages in transactions that would otherwise trigger a vote of the public minority shareholders.

When reviewing disputed business transactions in the context of damages, courts generally apply one of two basic standards of review: business judgment or entire fairness.[11] A similar analysis also may apply in the context of an injunction, if shareholders seek to prevent the consummation of a transaction. The Delaware Supreme Court has stated that the business judgment rule

> is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the company.[12]

The business judgment rule typically applies to arm's-length transactions, creates a rebuttable presumption in favor of the corporation and protects directors from after-the-fact judicial second-guessing of business decisions in litigation proceedings, even when those business decisions are judged in hindsight to be suboptimal.

Most companies take great effort to protect themselves from the risk of an entire-fairness review.

Entire fairness, on the other hand, can apply to those transactions involving interested directors, officers, or controlling shareholders.[13] The standard is more exacting because the corporation bears the burden of convincing the court that a challenged transaction is entirely fair to its shareholders both in terms of process and price.[14] Directors, officers, and controlling shareholders are found to be interested if they

> appear on both sides of a transaction or expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally.[15]

And, when evaluating whether a shareholder exercises the requisite control, Delaware courts will evaluate whether the shareholder controlled the board "such that the directors … could not freely exercise their judgment" with respect to a transaction.[16]

The burden of proving such a conflict initially rests with the shareholder-plaintiff bringing suit. But with 88.5 percent of Snap votes in the hands of two individuals – a number which will only grow over time as Class B holders, representing the remaining 11.5 percent vote, lose voting privileges when their shares are transferred – plaintiffs seeking to prove a conflict may not face a high bar.

Entire-fairness scrutiny can be lengthy, costly and have uncertain outcomes. Indeed, the Delaware Supreme Court has recognized that "[t]he choice of the applicable 'test' to judge director action often determines the outcome of the case."[17] For that reason, most companies take great effort to protect themselves from the risk of an entire-fairness review through well-established procedural safeguards. Those include making full and complete disclosure of all material facts, obtaining a "majority-of-the-minority" (sterilized vote) approval from shareholders[18] and a majority of disinterested directors, or negotiating with and securing approval from a special committee of independent, empowered, and disinterested directors.

In its IPO prospectus, Snap explained that its co-founders Spiegel and Murphy "have the ability to control the outcome of all matters submitted to our shareholders for approval, including the election, removal, and replacement of directors and any merger, consolidation, or sale of all or substantially all of our assets"[19]—the very transactions that will frequently trigger litigation where the courts must then determine the appropriate standard of review. Other companies employing multiple-class voting structures solicit *some* votes from public shareholders, even if those votes have proportionately unequal or low impacts on outcomes.[20] While the presence of non-voting shares does not itself preclude a review under the business judgment standard, it seems one practical effect of Snap's voting structure is that it may deprive the Company of the basic mechanisms and tools to implement procedural safeguards, such as subjecting a proposed transaction to a vote of the minority public shareholders (*e.g.*, "majority-of-the-minority" approval). Such mechanisms would help shield some future business decisions from heightened judicial scrutiny.

Conclusion—Uncertain Review Ahead

Snap exclusively offering non-voting shares to the public presents novel legal issues that most certainly will play out over time. The logic behind their approach was no doubt, in part, to permit

the founders to maintain control and avoid the nuisance and headaches often associated with activist investors. In the end, however, Snap may have substituted one nuisance for another: frequent and protracted litigation under potentially heightened judicial scrutiny.

Notes

1. *https://corpgov.law.harvard.edu/2017/02/07/snap-inc-reportedly-to-ipo-with-unprecedented-non-voting-shares-for-public/*.
2. *https://www.sec.gov/Archives/edgar/data/1564408/000119312517029199/d270216ds1.htm.*
3. "If Mr. Spiegel's or Mr. Murphy's employment with us is terminated, they will continue to have the ability to exercise the same significant voting power…Either of our co-founders' shares of Class C common stock will automatically convert into Class B common stock, on a one-to-one basis, nine months following his death or on the date on which the number of outstanding shares of Class C common stock held by such holder represents less than 30% of the Class C common stock… Should either of our co-founders' Class C common stock be converted to Class B common stock, the remaining co-founder will be able to exercise voting control over our outstanding capital stock." *Id*.
4. *http://www.reuters.com/article/us-snap-ipo-votingrights-idUSKBN15I2W7.*
5. *http://www.cii.org/files/issues_and_advocacy/correspondence/2017/02_03_17_SNAP_IPO.pdf; https://www.cnbc.com/amp/2017/03/06/reuters-america-investor-group-seeks-to-bar-snap-from-indexes-over-voting-rights.html.*
6. *https://www.sec.gov/Archives/edgar/data/1564408/000119312517029199/d270216ds1.htm.*
7. *http://pipeline.thedeal.com/31/14035132/20898116.t?d=3&cmpid=em:CA030917#14035132.*
8. *http://pipeline.thedeal.com/article/14057598/index.dl.*
9. *See* Nasdaq Rule 5635(b) and NYSE Rule 312.03(d).
10. *See* Nasdaq Rule 5635(d) and NYSE Rule 312.03(c).
11. *See* "Determining the Likely Standard of Review Applicable to Board Decisions in Delaware M&A Transactions," as originally published on November 18, 2014 and updated on February 8, 2016 and April 12, 2017, at *http://www.gibsondunn.com/publications/Pages/MAReport-Determining-Likely-Standard-of-Review-Applicable-to-Board-Decisions--Delaware-MA-Transactions-Apr2017.aspx.*
12. *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984)
13. *Texlon Corp. v. Meyerson*, 802 A.2d 257, 264 (Del. 2002)
14. *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983)
15. *Aronson*, 473 A.2d at 812
16. *In re KKR Fin. Holdings LLC S'holder Litig.*, 101 A.3d 980, 993 (Del. Ch. 2014)
17. *Stroud v. Grace*, 606 A.2d 75, 90 (Del. 1992)
18. A stockholder is a controlling stockholder under Delaware law where the stockholder (1) owns more than 50 percent of the voting power of a corporation or (2) exercises control over the business affairs of the corporation. *Kahn v. Lynch Commc'ns Sys. (Kahn I)*, 638 A.2d 1110, 1113–14 (Del. 1994)
19. *https://www.sec.gov/Archives/edgar/data/1564408/000119312517029199/d270216ds1.ht.*m
20. Some companies include non-voting shares in their capital structure. For example, Alphabet, Google's parent company, has publicly held Class C non-voting shares. At the same time, and unlike Snap, the company also has publicly held Class A shares that come with voting rights.