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COMMENT

THE FACEBOOK IPO'S FACE-OFF WITH DUAL CLASS STOCK STRUCTURE

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The Facebook initial public offering ("Facebook IPO") is premised on a dual class stock structure, which the media criticizes as a circumvention of regulations designed to protect shareholders. I argue that Facebook's use of dual class stock not only is likely to benefit its shareholders, but also follows in the footsteps of seasoned, influential companies like Google.

A. THE FACEBOOK IPO

The Facebook IPO is one of the most widely discussed and anticipated events in the U.S. financial and technology industries. Much media attention is devoted to the IPO's positive economic and social impact—revitalizing the stock market and attracting young adults as potential investors are just a couple examples of such impact.[1] There is a small but noticeable concern, however, regarding the future of Facebook's corporate governance—specifically, Mark Zuckerberg's control of the company following the IPO.[2]

While most private companies that go public choose a single-class share structure whereby each share equals one vote, Facebook will emerge from the offering with its CEO as the

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1. Michael Giles, *Facebook IPO Will Bring a Whole New Generation to the Stock Market*, HUFF POST MONEY (Mar. 6, 2012, 12:34 PM), http://www.huffingtonpost.com/michael-giles/facebook-ipo_b_1290659.html.

2. *See* Leena Rao, *Facebook's S-1 and the Largest Shareholders*, TECH. CRUNCH (Feb. 1, 2012) [hereinafter Facebook's S-1], http://techcrunch.com/2012/02/01/facebooks-s-1-and-the-largest-shareholders-who-owns-what/; Claire Moore, *Facebook IPO Slated to Be the Largest in History of Silicon Valley*, ARRIVE PREPARED (Feb. 7, 2012), http://blog.highbeambusiness.com/ 2012/02/facebook-ipo-slated-to-be-largest-in-history-of-silicon-valley-but-will-it-make-you-rich/.

controlling shareholder.[3] Now that its financial statements are public (due to the Form S-1 that Facebook filed in compliance with federal securities regulations), all potential investors have access to information on Facebook's current shareholder breakdown.[4] Zuckerberg stands as, unsurprisingly, the largest shareholder with 28.2% of the company. Even though Zuckerberg will ultimately own only about a quarter of the company, SEC filings reveal he will still hold 57.1% of Facebook's voting control after the IPO. He made this possible by first classifying Facebook as a "controlled company" and subsequently converting his shares into super-voting stock.[5] This maneuver has spawned some controversy among followers of the Facebook IPO. Some applaud Zuckerberg's actions as an enlightened corporate decision while others denounce it as risky, bringing up "the chance he'll become some Mad King, succumbing to erratic rule somewhere down the line."[6]

The more immediate concern, however, is the impact this dual class voting structure will have on Facebook's newly minted shareholders following the IPO. It will likely cause companies to divide ownership interests into different camps, with the possibility that "[t]hese early fractures can widen into fault lines, eventually resulting in a costly, distracting, and potentially unpopular restructuring."[7] In fact, as the influential proxy advisory firm Institutional Shareholder Services (ISS) warns, "the problems for both boards of directors and institutional investors … will begin the morning after the IPO, when divergent interests within the shareholder base have been institutionalized … ."[8] In addition to preventing shareholders from voicing their opinions in a meaningful way, dual class structures highlight the collective

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3. *See* Charley Moore, *Should Mark Zuckerberg Think Twice About Establishing a Dynasty*, TECH. CRUNCH (Feb. 11, 2012), http://techcrunch.com/2012/02/11/mark-zuckerberg-dynasty/; Facebook's S-1, *supra* note 2.

4. *See Facebook's S-1*, *supra* note 2.

5. *See* Moore, *supra* note 3.

6. *See* Josh Constine, *If Investors Want More Voting Rights, They Should Have Invested Facebook*, TECH. CRUNCH (Feb. 14, 2012), http://techcrunch.com/2012/02/14/facebook-voting-rights/.

7. *The Tragedy of the Dual Class Commons*, INSTITUTIONAL SHAREHOLDER SERVICES, Feb. 13, 2012, at 3 [hereinafter Tragedy of the Dual Class Commons], http://online.wsj.com/public/ resources/documents/facebook0214.pdf.

8. *See id.*

action problem borne out by shareholder passivity.[9] One commentator notes that "[t]his passive behavior is thought to manifest itself when dispersed shareholders in large corporations realize that the costs associated with agent monitoring are solely incurred, while the returns are shared pro rata."[10]

B. A Brief History of Dual Class Stock Structure

Shares of common stock have been historically understood to represent a bundle of rights, including the right to vote on corporate decisions. The one-share, one-vote rule emerged in the 1800s as legislatures, suspicious of corporations, shifted the legal system away from imposing a maximum number of votes for any individual shareholder.[11] By the mid-1900s, most U.S. corporations migrated to the one-share, one-vote rule.[12] Because corporations were not required to adhere to the statutory standard, they started using nonvoting common stock to retain control after raising money in the public market.[13] It soon became clear, around 1918, that a growing number of corporations started using two classes of stock—one class that obtained full voting rights, and another class that obtained no voting rights but gained the benefit of a potentially greater dividend payout.[14]

Commonly known as Class A and Class B shares, the former are composed of preexisting common stock, while the latter include a proportionally larger amount of votes per share (usually 10). Class B shares are typically not transferrable, but can be converted to Class A shares to be sold. The use of the separate classes declined during the Great Depression, but rebounded during the 1980s as hostile takeovers also became more prevalent.[15]

When corporations started lobbying the NYSE and Amex to liberalize rules on shareholder voting rights, the SEC tried to promulgate a one-share, one-vote standard in the form of the

9. Douglas C. Ashton, *Revisiting Dual-Class Stock*, 68 ST. JOHN'S L. REV. 863, 906 (1994).

10. *Id.* at 907.

11. Stephen Bainbridge, *The Scope of the SEC's Authority over Shareholder Voting Rights* 4 (May 7, 2007), *available at* http://www.sec.gov/comments/4–537/4537–17.pdf.

12. *See id.* at 5.

13. *See id.* at 6.

14. *See id.*

15. *See id.* at 7.

failed Rule 19c-4.[16] Rule 19c-4 attempted to bar companies listed on national securities exchanges from using super-voting classes of stock.[17] The D.C. Circuit, deciding not to venture into a realm already governed by state corporate law and stock exchanges, struck down the rule in Business Roundtable v. SEC.[18]

C. THE ARGUMENT FOR DUAL CLASS STOCK STRUCTURE

Shareholder rights activists and advocates argue that dual class structures pose many potential harms to effective corporate governance. For one thing, as the ISS made clear while lambasting Facebook's corporate governance choice,[19] dual class structures may weaken incentives for shareholder control.[20] This means that the more separation of control there is between the investor and her shares, the less motivated she is to manage the rights that are attached to the equity. On the other side of the same problem is entrenchment risk.[21] The more separated the non-controlling shareholder is from her interests, the higher the probability that her interests will not be protected. Finally, scholars have pointed out that dual class structures pose a higher risk that controlling shareholders will be further incentivized to extract other internal private benefits of control.[22] The idea here is that controlling shareholders enjoy benefits from their controlling position, while minority shareholders receive a disproportionate share of those benefits.

These views have their vociferous advocates, but a survey of the academic literature and studies across the board show that the presumed negative effect of dual class stock structures is far from certain.[23] First and foremost, corporate law scholars generally do

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16. Stephen Bainbridge, *The Scope of the SEC's Authority over Shareholder Voting Rights* 8-9 (May 7, 2007), *available at* http://www.sec.gov/comments/4–537/4537–17.pdf.

17. *Id.* at 7-9.

18. *See id.* at 9.

19. *See Tragedy of the Dual Class Commons*, *supra* note 7, at 1.

20. Karl Hofstetter, *One Size Does Not Fit All: Corporate Governance for "Controlled Companies"*, 31 N.C. J. INT'L L. & COM. REG. 597, 649 (2006).

21. *See id.*

22. *See id.*

23. *See generally* Ashton, s*u*pra note 9 (analyzing policy positions of the SEC, NYSE, and NASD with respect with dual class common stock); Jeffrey N. Gordon*, Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1, 76 (1988) (arguing that the New York Stock Exchange should forbid recapitalizations with dual class common stock); *see also* Stephen M. Bainbridge, *The Short Life and Resurrection of Sec Rule 19c-4*, 69 WASH. U. L.Q. 565, 579 (1991).

not consider dual class structures associated with IPOs to be disenfranchising.[24] With the proper disclosure, shareholders are on notice that the founding entrepreneurs exchange a penalty in the form of a lower price per share for access to equity markets without the dilution of control.[25] Potential shareholders can then decide for themselves whether or not to purchase the shares. Because a company seeking to register its securities on the market discloses this information up front, there is minimal risk of investor coercion. In Facebook's case, the media makes this information highly public—and thus widely disclosed—in every instance it makes Facebook's dual class structure the source of the IPO's controversy.

The illusion of shareholder disenfranchisement aside, sound economic justifications exist for implementing a dual class stock structure. In the face of hostile takeovers, for example, a dual class stock structure "can protect outside shareholders from coercive takeover tactics. . . ."[26] For example, collective action problems prevent the many shareholders from acting in concert, dampening their negotiating power. A dual class structure steps in by forcing bidders to deal with a single controlling group, which has the effect of increasing the power of all shareholders.[27] Another significant reason founders choose the dual class structure to begin with is to lower the risk of takeovers. A dual class structure reduces the likelihood that shareholders will flip their shares over to a purchaser who then attains control over the company and removes the incumbent.[28] Without the dual class structure, managers who foresee—mistakenly or accurately—a takeover and potential removal may have less incentive to invest time and money in the company, thereby leaving open the possibility of a lowering of the company's value.

Current regulations provide enough protections for investors of public companies.[29] The media and the ISS worry that the Facebook IPO's dual class structure will disenfranchise future non-controlling shareholders. However, they need not fret. Even without economic justifications and theoretical studies, a look at

24. *See* Ashton, *supra* note 9, at 876.
25. *See id.* at 884.
26. *See id.* at 923.
27. *See id.*
28. *See id.*
29. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78j (2006).

the experience of a similarly positioned company, Google,[30] offers proof that a dual class stock structure does not necessarily wield such destructive power. Facebook will likely follow a similar path to overwhelming financial and social success, dual class structure notwithstanding.

30. *See Dual-Class Share Structures - The Cost of Control*, THE ECONOMIST, Jul. 23, 2011, at 65, *available at* http://www.economist.com/node/18988938.