Snap's IPO builds an 'impregnable fortress' where only the founders have power

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The founders of Snap Inc. want to take the company public. But that doesn't mean they want to run a public company.

Public companies, after all, have to deal with shareholders who don't like the way the company is being run. They have to ask shareholders whether they are paying executives too much. They have to seriously consider takeover offers. They have to, in other words, cede at least some control and influence to investors.

Unless they don't.

When the company behind messaging app Snapchat holds its much-anticipated initial public stock offering in the coming weeks, it will offer new shareholders exclusively nonvoting shares, something no company has tried before in a public debut.

The novel move has an array of implications for the Los Angeles company and would-be investors, affecting the types of documents Snap will have to file with regulators and limiting input from shareholders. But most importantly, it will ensure founders Evan Spiegel and Bobby Murphy can retain power in perpetuity.

"It's all about control," said Kai Liekefett, a partner at law firm Vinson & Elkins who works with companies under pressure from investors. "There's no other reason. There's no tax reason, no business reason."

So tight will be the pair's grip on the company that they will be able to maintain control even if they no longer work for Snap, and even if they own a tiny percentage of the company's total shares. They'll also be able to decide who can acquire shares that have even token voting power.

Following the IPO, Murphy and Spiegel will each own about 18 percent of Snap shares, yet each will control 44 percent of the company's votes. And they could ultimately own much smaller stakes - perhaps less than 3 percent apiece - while still holding the vast majority of voting power.

Even in the tech realm, where company founders have grown accustomed to outsized control, Snap is an outlier, giving its founders the kind of permanent influence that in other cases has been granted only to more proven leaders.

"You can create an impregnable fortress by doing an IPO where the controlling stockholders keep absolute or near-absolute voting control, which is what this kind of share arrangement is," said Stuart Shapiro, a New York attorney who specializes in corporate mergers and acquisitions. "It's a magic bullet."

A Snap spokeswoman declined to comment, noting that the firm is in a quiet period ahead of the IPO. In the company's public filings, it says it wants to keep Spiegel and Murphy in control so that they can innovate, take risks and prioritize "long-term goals rather than short-term results."

That's essentially the same reasoning offered by other tech companies that, over the last decade and a half, have gone public with corporate structures that give founders more control than other shareholders.

Indeed, while the terms of Snap's IPO are groundbreaking, they're also predictable - a logical if brazen evolution in a years-long trend. When Google went public in 2004, the shares it offered to new investors came with a single vote while the shares held by the company's founders, executives and early investors were worth 10 votes apiece.

Workday, Groupon, LinkedIn and Facebook all went public with two classes of stock, allowing founders and early investors to keep voting control.

The difference between those offerings and Snap's, then, is one of degree. Instead of giving ordinary shareholders single-vote shares while keeping 10-vote shares for themselves, as other companies did, Snap plans to give new shareholders no votes at all.

Google and Facebook later issued nonvoting stock with the aim of cementing their founders' control, a controversial step probably made easier by those companies' perennial success. Snap is doing the same, but without the track record.

Some investors probably will have no problem with this arrangement and will be eager to buy shares of a hot company that's going public amid an otherwise slow IPO market. Others may refrain from investing at all, believing that ownership should come with the right to help decide how a company is run.

The California Public Employees' Retirement System, the nation's largest public pension fund, recommends companies give equal voting rights to all shareholders. So does the Investor Stewardship Group, a new coalition that includes investment giants Vanguard, BlackRock and the California State Teachers' Retirement System, another huge pension fund.

Aeisha Mastagni, a CalSTRS investment officer, said structures that give founders extra power are especially concerning when, as with Snap, those powers could continue for decades. Spiegel, 26, and Murphy, 28, don't lose their voting control unless they sell the vast majority of their holdings or die.

"Trying to protect the founders' vision is one thing," Mastagni said. "But if they're no longer even working for the firm, it's just them wanting to entrench themselves and maintain control in perpetuity. It's very alarming."

There's another consequence of nonvoting shares: They remove some of the ways investors try to keep companies honest.

Voting shareholders can withhold votes for board candidates or vote against company proposals, a way of publicly protesting a firm's actions or governance.

"Even a little vote allows them to send the board a message," said Sean Quinn, head of U.S. research for Institutional Shareholder Services, which advises institutional investors. "It's at least an opportunity to appeal to the company's social conscience or shame the company insiders, for all the good that will do. It puts the company in the position of having to defend its decisions."

Voting shareholders can also submit proposals that are included on a company's annual ballot. Last year, for instance, Boston firm Northstar Asset Management asked its fellow Facebook shareholders to vote for a change that would give all shareholders equal rights and dilute Zuckerberg's influence.

Julie Goodridge, Northstar's chief executive, knew the proposal would not win a majority - Zuckerberg, after all, represents a majority by himself. But her aim wasn't to win; it was to make a point and to publicly voice displeasure with the company's structure. With Snap, she wouldn't be able to do even that much.

Because Snap plans to issue only nonvoting shares in its IPO, investors won't be able to submit those types of shareholder proposals, according to the company's filings.

"It's disgusting to me," Goodridge said of the Snap's structure. "It's a way of saying, 'We don't care what anybody else thinks.'"

There's also a worry among investors that Snap's concentrated voting power could prevent the company from accepting a lucrative buyout offer.

Imagine Snap's public offering values the company at $25 billion. Now imagine Google immediately offers to buy Snap for $50 billion. Investors might salivate at doubling their money overnight, but the company's board - members of which will be chosen and elected by Spiegel and Murphy - could reject the offer. Even if the board considered such a deal, Spiegel and Murphy could vote it down.

As the company notes in its filings, Spiegel and Murphy are "entitled to vote their shares ... in their own interests, which may not always be in the interests of our stockholders generally."