Silicon Valley Is Moving Backward on Shareholder Rights

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It's springtime in America and that means it's proxy season, when most publicly traded companies hold annual meetings, and shareholders elect corporate directors. So it seems a good time to review the state of corporate governance: It's slipping.

Mark Zuckerberg, the Facebook Inc. founder and chairman, last month agreed to pay $1 billion for the photo-sharing service Instagram without consulting his board. Groupon Inc. in March had to correct its very first quarterly report as a public company and also reveal a "material weakness" in its internal controls, meaning it lacked checks and balances even after accounting missteps last year.

LinkedIn Corp., Zynga Inc. and Groupon went public late last year with dual-class shares, which grant their founders and directors super-voting rights to trump ordinary shareholders' one vote per share. If a corporate raider tries to oust the management, the dual-class shares will protect them -- even if they are performing badly.

And then there's Google Inc., which already has two share classes. It announced last month that it would issue a third class with no voting rights whatsoever.

Category Apart

It's no accident that all these examples come out of the technology industry. For better or worse, many Silicon Valley executives hold themselves out as a special class. But when it comes to corporate governance -- the rules that hold management accountable to those who provide capital -- the high-tech industry is truly a category apart.

The founders of Facebook, Google, Zynga, LinkedIn and Groupon need to rethink their approach. They may be visionaries, and shareholders certainly should want them to stay on after an IPO. But not all founders make great managers, especially in times of rapid growth, and none are immune to entrenched-management disease, which can strike executives protected from the disciplinary threat of removal. The symptoms: a slowing of innovation, a decline in sales and profits, and an increase in compensation even as nimbler competitors take market share.

Take Facebook. (FB) The social network's first-quarter profit declined 12 percent and expenses almost doubled from the previous quarter. This could be an early warning that spending is out of control and management isn't on top of it.

Anti-Takeover Devices

Yet Zuckerberg’s Class B shares give him almost complete control, fortified by an impressive array of anti- takeover devices. Unhappy shareholders, for example, can take action only at shareholder meetings, and only Zuckerberg can call such meetings.

Facebook’s mid-May IPO is expected to value the company as high as $96 billion, or more than 25 times annual sales and four times Google’s valuation in 2004 when it went public. At that lofty price, shouldn’t Facebook shareholders have stronger rights to protect their investment?

Corporate governance is the only way that shareholders can hold managers responsible. Governance was once dismissed as the playground of liberal activists hoping to turn corporations into social-welfare programs. Over the past decade, though, a large volume of academic research has shown that strong governance rules (read: shareholder rights) can improve a company’s value.

Harvard law professor Lucian Bebchuk and two co- authors have created an entrenchment index, or e-index, to evaluate a company’s governance. It includes staggered boards, in which only a certain number of a company’s directors face election each year, an arrangement that acts as a powerful defense against removal of an ineffective board through a proxy fight. The index also includes poison pills, which ward off hostile takeovers, and golden parachutes, which richly reward top executives if there is a change of control at the company.

There has been progress on some fronts. On May 1, Groupon plugged a hole on its board by adding two public- company financial accountants. And last month more than half of Citigroup’s shareholders revolted against the pay plan for Chief Executive Officer Vikram Pandit. His 2011 compensation, at $15 million, was among the highest for large-bank executives, and yet Citigroup’s stock performance has been one of the poorest. The vote is nonbinding, however, and Citigroup can override it.

Numerous companies have recently agreed to consider ending staggered boards, also known as classified boards. Studies by Bebchuk, a leader in efforts to end the practice, show that such boards depress a company’s value. But Silicon Valley’s dual-class model probably has more entrenchment power than staggered boards ever did.

When a company goes public, it enters into a compact with shareholders. If it has no intention of keeping its part of the bargain, it should stay private.