Trends in Structuring Corporate Governance and Liquidity Rights for the Sponsor-backed IPO Candidate

This Article explores current trends in structuring corporate governance and liquidity rights for private equity sponsor-backed initial public offerings.

This Article was first published by Practical Law Company on its PLCCorporate & Securities web service at *http://uscorporate.practicallaw.com/4-502-9398*

Warren de Wied, Wilson Sonsini Goodrich & Rosati, P.C. and John Monsky, Oak Hill Capital Partners

Rising stock prices and reduced volatility sparked a rebound in the initial public offering (IPO) market in the second half of 2009 and early 2010. Having shut down completely in early August 2008, the IPO market re-opened cautiously in the spring of 2009, gaining momentum over the remainder of the year. By year end, 48 offerings by US registrants had closed, with an average of eight deals per month from September to December of 2009. In the first quarter of 2010, 18 IPOs of US registrants closed and many more deals entered registration. With volatility returning to the market in the second quarter, the pace of new issues slowed, but issuers remain keen to access the market when conditions permit.

Private equity sponsor-controlled companies accounted for almost 40% of US company IPOs in 2009 and a comparable percentage in 2010. With M&A activity still relatively subdued, the public market offers a critical path to liquidity for the sponsor, as well as a source of capital to highly leveraged portfolio companies that need to repair overstressed balance sheets. In addition, the expectation of tax legislation targeting "carried interest" has brought increased urgency to private equity sponsors' quest for liquidity.

The IPO may be an important step on the road to liquidity for the sponsor, but the road may be long and there may be bumps along the way. While a significant portion of IPOs of sponsor-controlled companies have included a substantial secondary offering, the sponsor generally retains a large equity stake, is subject to a customary six-month lock-up with the underwriters and must deal with continuing business and market uncertainty. A post-IPO governance structure should give the sponsor appropriate ongoing governance rights, as well as the ability to capitalize on opportunities to maximize the value of its investment. However, undue emphasis on liquidity, rather than governance, may leave a sponsor inadequately protected if it ends up having to hold its investment longer than anticipated. On the other hand, the sponsor should ensure it has sufficient rights to trigger an exit, if one is available.

When sponsors acquire companies, they put in place detailed stockholders agreements and governance provisions giving the sponsor broad control over management and operations of the company, corporate transactions, transfers of equity interests and other liquidity events. Similarly, when funds make a PIPE investment, they negotiate detailed governance agreements with the public company target. But the same issues frequently seem to get less attention at the IPO stage and our survey of more than 70 significant IPOs of (non-venture) sponsor-backed companies from 2007 through the second quarter of 2010 reveals significant variation in the scope of post-IPO protections.

This Article highlights the key issues that impact the sponsor's governance planning at this critical stage in the investment cycle and the different approaches that may be taken to address the issues. Our survey examined how the sponsors dealt with key governance and liquidity issues. There is not a one-size-fits-all governance prescription for a sponsor-backed public company, any more than for a widely held public company. We have tried to identify the governance issues we think a sponsor should focus on in tailoring post-IPO governance rights. With leading sponsors focused on accessing the IPO market for multiple portfolio

Practical Law Company provides practical know-how for transactional lawyers. To find out more about PLC and register for a free trial, please visit www.practicallaw.com or call (646) 562-3405.
Copyright © 2010 Practical Law Publishing Limited and Practical Law Company, Inc. All Rights Reserved. Use of PLC websites and services is subject to the Terms of Use (us.practicallaw.com/2-383-6690) and Privacy Policy (us.practicallaw.com/8-383-6692).

companies, and with sponsors in many cases likely to maintain significant ownership stakes for a meaningful time period, we expect to see increased attention to these issues as more deals come to market.

SPONSOR PERSPECTIVE

Many factors influence sponsor thinking about governance and liquidity, including:

- How long the sponsor expects to continue to hold its investment post-IPO.
- How much of the company the sponsor owns.
- Whether there is a single dominant sponsor or the investment is held by a sponsor group in a club deal.
- The company's short- and long-term business and growth prospects.
- The nature and risks of the company's business.
- The likelihood of a post-IPO M&A exit.
- The preferences of senior management.
- The sponsor's own predispositions.
- The views of potential purchasers in the IPO and the aftermarket.
- The expected share size of the public float and the applicable listing rules of the exchange (such as the New York Stock Exchange or NASDAQ Stock Market) on which the company's shares will trade.

However, the sponsor's number one concern in the IPO process is getting to market successfully. The success of the offering is primarily driven by market factors, the company's business, financial performance and condition, its future prospects and management team. This may explain why sponsors do not have an especially uniform approach to governance planning in the IPO context; it does not seem so important at the time.

KEY ISSUES IN GOVERNANCE STRUCTURING

Capital Stock Structure

A relatively straightforward way to preserve sponsor control post-IPO is to go public with dual classes of common stock. In this case, the sponsor would retain a class of common stock with higher voting rights and the company would issue lower voting common stock to the public. However, sponsors often do not favor this approach because of the possible impact on the offering price in the IPO. Less than 15% of the IPOs in our survey involved companies with a dual-class common stock structure.

Although there is little specific evidence of a direct negative impact, most underwriters advise against a dual-class structure. Typically sponsors feel they can accomplish their objectives without complicating the capital structure and possibly risking an adverse impact on pricing. Although a dual-class structure would address some of a sponsor's governance concerns, many of the issues discussed below apply to both dual-class and single-class common stock structures.

Board of Directors

Before an IPO, the sponsor usually has broad control over board composition (subject to agreements with senior management that may allocate one or more board seats to key executives). When the portfolio company goes public, the sponsor must be comfortable with the board following the IPO. The key considerations are set out below.

Board Size

Sponsors generally prefer a relatively lean board structure. In our survey, the most common post-IPO board size was seven directors (about 30% of our sample). About two-thirds of the companies in our survey had a board size ranging from six to eight directors.

Nomination Rights

The sponsor should ensure that it will have the ability to nominate directors to the board after the IPO. However, in more than 50% of the IPOs we surveyed, the sponsor received no contractual protections to safeguard its nomination rights post-IPO. In about 60% of the situations in which the sponsor had no contractual protection, the portfolio company adopted a classified board structure (creating some assurance of continuity for a period after the IPO) and more than half were situations in which sponsors retained a dominant equity stake post-IPO and arguably did not feel the need for contractual rights (see below, *Annual versus Classified Boards*).

However, in our view, the better practice (reflected in the other 40% of the deals we surveyed) is to obtain contractual rights to nominate directors post-IPO, with voting agreements among significant pre-IPO stockholders

Practical Law Company provides practical know-how for transactional lawyers. To find out more about PLC and register for a free trial, please visit www.practicallaw.com or call (646) 562-3405.
Copyright © 2010 Practical Law Publishing Limited and Practical Law Company, Inc. All Rights Reserved. Use of PLC websites and services is subject to the Terms of Use (us.practicallaw.com/2-383-6690) and Privacy Policy (us.practicallaw.com/8-383-6692).

to vote for the sponsor's nominees. It is also advantageous to the sponsor to fix by contract the composition of the nominating committee so that, to the extent permitted under applicable listing rules, the sponsor can control or be represented on the nominating committee post-IPO.

Typically, the number of directors that the sponsor has the right to nominate contractually reflects the expected post-IPO ownership of the fund. As the sponsor's ownership percentage declines, the number of directors that it has the right to nominate also typically declines with all nomination rights dropping away at a certain point (known as scale-down provisions). In cases in which the sponsor (individually or with other club members) had the right to nominate a majority of the directors, this right generally required ownership of 20% to 40% or more of the shares. Between 10% and 20% ownership, the sponsor may retain the right to nominate two directors; with between 5% and 10%, the sponsor may be entitled to one nominee (although we found examples in which the sponsor retained the right to nominate one director at 2% or even for so long as it owned any shares). In club deals, the sponsor should ensure that the sale of shares by one sponsor does not inappropriately affect the board nominating rights of a non-selling sponsor. Otherwise, a sale of equity by one sponsor may drastically shift the balance of power on the board at a time when other members of the club maintain a large percentage of their pre-IPO holdings.

Independent Directors and Conflicts of Interest

Many sponsor-backed companies qualify for the "controlled company" (a company of which more than 50% of the voting power for the election of directors is held by a single person, entity or group) exception under applicable listing rules when they go public. Therefore, these companies are not required to have a majority of independent directors at the time of the IPO (about 50% of the companies in our survey that were eligible to use the exception did so). However, these companies are still required to have at least three independent directors to satisfy SEC requirements relating to audit committees (see *Practice Note, Corporate Governance Standards: Board of Directors (http://us.practicallaw.com/0-381-5330)*).

However, sponsors and their counsel must think beyond these SEC and listing rules in choosing independent directors. Conflicts of interest between the sponsor and the company and future corporate transactions may give rise to the need for directors who qualify as independent under the more exacting standards applied by state corporate law. In response to potential conflicts of interest between the sponsor and the company, sponsors and their counsel should ensure that they include an express waiver by the company of any obligation of the sponsor and its board representatives to refrain from competing with the company or to present corporate opportunities to the company in the corporate charter (in some states, the corporation law statute specifically permits a company to renounce a corporate opportunity, such as *Delaware General Corporation Law (DGCL) §122(17)*).

For more information on the type of transactions requiring approval by an independent board and the applicable state law standards, see *Practice Notes, Making Good Use of Special Committees (http://us.practicallaw.com/3-502-5942)* and *Going Private Transactions: Overview (http://us.practicallaw.com/8-502-2842)*.

Replacement of Directors

The sponsor must take into account that the board's composition, and the company's potential needs in terms of director qualifications, can change over time and the sponsor should have the ability to remove, replace or add directors. Accordingly, it may be appropriate to include in the charter and by-laws the right of stockholders to act by written consent or to call special meetings so that there is a mechanism available to the sponsor to make changes to the board other than through the annual meeting process, if necessary.

Annual versus Classified Boards

The classified board remains the most significant structural defense against an unsolicited bid or activist effort to stimulate third party offers for the company. Despite opposition from activists and proxy advisory firms, the majority of newly public companies (including sponsor-backed companies) still adopt a classified board structure. In our survey, about two-thirds of the issuers adopted a classified board structure at the time of the IPO.

As noted above, a sponsor-backed company's adoption of a classified board may reflect a focus on board continuity rather than structural or other contractual defensive protections (see above, *Nomination Rights*). However, depending on the sponsor's objectives, its voting power and other rights, a classified board could advance or impede realization of those objectives. So the choice should be made after careful consideration of the potential impact on the sponsor.

Practical Law Company provides practical know-how for transactional lawyers. To find out more about PLC and register for a free trial, please visit www.practicallaw.com or call (646) 562-3405.
Copyright © 2010 Practical Law Publishing Limited and Practical Law Company, Inc. All Rights Reserved. Use of PLC websites and services is subject to the Terms of Use (us.practicallaw.com/2-383-6690) and Privacy Policy (us.practicallaw.com/8-383-6692).

Veto Rights

At the time of its initial investment, including a PIPE investment in a public company, a sponsor or sponsor group focuses intently on securing appropriate veto rights over material corporate transactions. In IPOs of sponsor-backed companies, it is common practice to give up these rights and to rely on board participation and stockholder voting rights rather than explicit contractual controls. In the distinct minority of IPOs in our survey in which some veto rights were preserved, the rights typically were narrow. Examples included those relating to:

- Changes in control.
- Major acquisitions.
- Incurrence of significant debt.
- Major equity issuances.
- Termination or appointment of a CEO.
- Compensation matters.

With the market turbulence of the last two years still fresh, we expect sponsors to be mindful of the risks of having to hold their investments longer than planned and the need to ensure that they retain prudent controls post-IPO. Therefore, we may see greater continuity of sponsor veto rights over material transactions as additional portfolio companies come to market. When determining whether or not it is necessary to negotiate veto rights, sponsors should consider the current economic and market conditions, exit strategy and a realistic timeline for holding the investment.

Management Services Agreements

Many sponsors enter into management services agreements with their portfolio companies at the time of their initial investment (for an example of a customary management services agreement in an LBO, see *Standard Document, Management Services Agreement (http://us.practicallaw.com/1-387-5031)*). These agreements may provide for transaction fees as well as annual management fees to the sponsor for providing advisory services to the company. These agreements are ordinarily terminated when the company goes public or on a change of control, in some cases for no additional fee and in others for a lump sum payment (in some cases, the lump sum payment is based on the net present value of the remaining payments under the agreement, which can be substantial if the agreement has a long remaining term).

SPONSOR LIQUIDITY

Liquidity is fundamental to any sponsor. Ideally, all sponsors want to maintain post-IPO the conditions that can ensure a successful exit, including:

- The unfettered right to cause a sale of the company.
- Ability to exert maximum leverage over potential buyers.

However, sponsors sometimes fail to focus on key provisions that can help achieve their post-IPO liquidity goals. Certain features that could be very helpful in achieving those goals were not especially common in the deals we reviewed. Important rights that sponsors and their counsel should consider when negotiating the company's post-IPO governing documents are set out below.

Registration Rights

Almost universally, sponsors negotiate registration rights after the company goes public, granting the sponsor demand and piggyback registration rights. There may be a pre-existing agreement that requires little, if any, modification, or the parties may enter into a new agreement establishing registration rights and allocating relative priorities among investors to participate in a later offering (see *Practice Note, What are Registration Rights Agreements? (http://us.practicallaw.com/3-386-4395)* and *Standard Document, Registration Rights Agreement (Section 4(2) Private Placement Form) (http://us.practicallaw.com/8-500-6936)*).

Demand registration rights permit the holder of the issuer's securities to require ("demand") that the issuer register all or a portion of its securities with the SEC. There are generally two types of demand rights:

- **Long-form registration.** A demand for a long-form registration requires the company to register securities on a Form S-1 (for a discussion of filing registration statements on Form S-1, see *Practice Note, Registration Statement: Form S-1 (http://us.practicallaw.com/0-381-0950)*). However, registrations on Form S-1 tend to be time-consuming and expensive.
- **Short-form registration.** A demand for a short-form registration requires the company to register securities on a Form S-3 (for a discussion of filing registration statements on Form S-3, see *Practice Note, Registration Statement: Form S-3 (http://us.practicallaw.com/9-381-2600)*). Registrations on

Copyright © 2010 Practical Law Publishing Limited and Practical Law Company, Inc. All Rights Reserved. Use of PLC websites and services is subject to the Terms of Use (us.practicallaw.com/2-383-6690) and Privacy Policy (us.practicallaw.com/8-383-6692).

Form S-3 are not as time-consuming and expensive as those on Form S-1 because the company is allowed to incorporate by reference certain information from its other securities filings with the SEC. However, this type of registration right is only available if the company meets certain criteria (see *Practice Note, Registration Statement: Form S-3: Eligibility Requirements for Form S-3 (http://us.practicallaw.com/9-381-2600)*).

Practice regarding the number of demand rights varies. About half the agreements we reviewed provided for an unlimited number of demand registrations. Of those agreements that limited the number of demands, a limit of two to four demands (other than short-form registration demands) was common. On the other hand, it has become common practice in registration rights agreements to provide broader demand rights for short-form registrations. In about two-thirds of the deals which provided for registration rights, there was no limitation on the number of short-form registration demands.

Although the sponsor may be able to negotiate unlimited demand rights, that is not always the case. When providing for liquidity through registration rights, sponsors and their counsel must consider:

- How often can they demand registration?
- Do they have this right for both long-form and short-form registrations?
- Are there minimum share requirements for a stockholder to exercise its demand rights? Most registration rights agreements also require the registration of:
  - a minimum number of shares;
  - a minimum percentage of the shares held by the triggering stockholder(s); and/or
  - shares having minimum expected offering proceeds.

Sponsors can typically negotiate unlimited piggyback registration rights. Piggyback registration rights permit a holder to include shares in a registration being effected by the issuer either for its own account or for the benefit of other selling stockholders subject to certain exclusions (such as the inability to piggyback onto a registration of employee stock options on Form S-8). If a holder only has these rights and not demand rights, the holder cannot trigger the registration process.

Registration rights agreements also typically contain covenants by the issuer to maintain Rule 144 eligibility, so that the sponsor can effect sales under Rule 144, subject to the applicable limitations of the rule, rather than having to register the shares.

For more information on post-IPO registrations, see *Practice Note, Follow-on and Secondary Registered Offerings: Overview (http://us.practicallaw.com/5-381-0957)*.

Opting Out of State Takeover Statutes

State takeover statutes may adversely impact a sponsor's liquidity following an IPO. For example, Section 203 of the DGCL imposes a three-year moratorium on business combinations with any person who becomes the beneficial owner of more than 15% of the common stock, subject to certain exceptions, unless the transaction in which the person crossed the beneficial ownership threshold was pre-approved by the board of directors.

The practical effect of Section 203 of the DGCL is to give the board of directors a say in any proposed sale of shares to a person who would become a more than 15% beneficial owner, because a buyer will rarely proceed without a waiver. If the board uses this leverage to negotiate aggressively on behalf of public stockholders, it may impact deal terms or even thwart the transaction. If the sponsor is otherwise in control of the company, it may desire to receive a control premium not shared by other stockholders. The ability to deny a waiver can give the board of directors significant leverage over the controlling stockholder and make it difficult to obtain a control premium.

The decision by a board to grant a waiver of Section 203 may be subject to onerous “entire fairness” review (see *In re Digex, Inc. S’holders Litig., 789 A. 2d 1176 (Del. Ch. 2000)* and *Practice Note, Fiduciary Duties of the Board of Directors (http://us.practicallaw.com/6-382-1267)*). Accordingly, the sponsor's theoretical ability to control the board and, by doing so, obtain a waiver for the transaction, should not be viewed as adequate protection for the sponsor. Given the potential impact of Delaware’s takeover statute and similar statutes, most sponsor companies might be expected to opt out of the takeover statute at the time of the IPO. Yet, in our survey, only 40% of the companies opted out. It may be that, in many cases, the sponsor is not planning to exit in a private block sale or to effect a unilateral sale of control and is concerned about reputational effects of doing so. But sponsors may want or need flexibility to transact

Practical Law Company provides practical know-how for transactional lawyers. To find out more about PLC and register for a free trial, please visit www.practicallaw.com or call (646) 562-3405.
Copyright © 2010 Practical Law Publishing Limited and Practical Law Company, Inc. All Rights Reserved. Use of PLC websites and services is subject to the Terms of Use (us.practicallaw.com/2-383-6690) and Privacy Policy (us.practicallaw.com/8-383-6692).

without board involvement and we think it more likely that in some cases the benefit to the sponsor of opting out has been overlooked (see *Standard Clause, Certificate of Incorporation: Opt Out Provision of Section 203 of the DGCL (http://us.practicallaw.com/5-382-9589)*).

Other Takeover Defenses

Typically sponsors are not concerned with takeover defenses. In most cases their goal is to find an exit, not to hold for an extended period while the company executes its long-range plan. However, the company's management may have a different time horizon and may have strong views about implementing structural protections, such as a classified board and limitations on stockholder action by written consent and calling of special meetings. Sponsors tend to be sympathetic to management's views on these issues and not to stand in the way of the company implementing these measures either at the time of the IPO or under a "springing" mechanism embedded in the company's charter that causes these defenses to become applicable when the sponsor sells down.

As we noted, a majority of companies in our survey had a classified board, whether or not specifically intended as a defensive measure. A sponsor-controlled company also typically restricts stockholder action by written consent and rights to call special meetings (other than meetings called by the sponsor) so long as the sponsor is in control. Only a couple of the issuers in our survey adopted a rights plan (also known as a poison pill) at the time of going public. We do not expect that practice to change given current institutional investor sentiment about rights plans and underwriter concern that implementing a rights plan at the time of an IPO can have a depressive impact on the stock price.

State takeover statutes, especially freeze-out statutes like Section 203 of the DGCL, can have some of the deterrent effect of a rights plan, but only a minority of companies opted out of these statutes. However, sponsors should consider how other takeover defenses may impact their ability to obtain liquidity or negotiate a control premium.

Assignment Provisions

The ability to engage in a block sale or sale of control may be of lesser value if the sponsor cannot assign its governance and registration rights to potential purchasers. Our survey shows that registration rights are often assignable in connection with a large block transfer. Perhaps surprisingly, rights to board seats and other governance rights, such as veto rights, may not be assignable or the rights may be significantly scaled back when transferred. This may be a fundamental issue for management or other pre-existing investors, who do not want a new partner or new dominant investor imposed on them unilaterally. However, it is in the sponsor's interests to build in a right of assignment if possible.

Information Rights

The mere fact that a sponsor has structured its liquidity rights to preserve unilateral control over a sale of its equity interest with all attendant contractual rights does not necessarily mean that the transaction is practicable without the target company's involvement. An often overlooked issue is the sponsor's potential need to make confidential information of the target available to a prospective purchaser. Unless the sponsor has a pre-existing contractual right to disclose the target's confidential information to third parties for due diligence purposes, it would generally need the target's consent to do so. In our review, we found numerous examples in which this right was not provided. However, management may be reluctant to disclose company confidential information, especially due to competitive or proprietary concerns, and may be resistant to any blanket grant of authority to the sponsor to furnish company information for due diligence purposes, even if conditioned on execution of a customary confidentiality agreement (for an example of a customary confidentiality agreement in an M&A transaction, see *Standard Document, Confidentiality Agreement: Mergers and Acquisitions (www.practicallaw.com/6-381-3253)*).

Consent to Change in Control

A corollary to the sponsor’s right to transfer its stake or control of the company is the ability to block a change in control that the sponsor believes does not represent full value for stockholders. A contractual veto over a sale of the company was rare in the deals we surveyed, although there are a handful of examples in which the sponsor had a veto right (generally attached to an ownership of one-third or more of the outstanding shares). However, while the sponsor has control of the company, a contractual veto right is not necessary. If the sponsor maintains a sizeable minority stake, the company and any prospective buyer will likely be reluctant to enter into a deal the sponsor opposes.

Minimum Holding Period; Restrictions on Transfer

In some cases, the IPO is primarily for corporate purposes and the sponsor's timeline for exit remains long term. While tag-along and drag-along rights tend to be

Practical Law Company provides practical know-how for transactional lawyers. To find out more about PLC and register for a free trial, please visit www.practicallaw.com or call (646) 562-3405.
Copyright © 2010 Practical Law Publishing Limited and Practical Law Company, Inc. All Rights Reserved. Use of PLC websites and services is subject to the Terms of Use (us.practicallaw.com/2-383-6690) and Privacy Policy (us.practicallaw.com/8-383-6692).

eliminated on an IPO, this is not necessarily the case for club deals in which the pre-IPO investors expect to stay in the company for an extended period (for a more complete explanation of the type of transfer rights negotiated by a sponsor at the initial investment, see *Practice Notes, Stockholder Protections (http://us.practicallaw.com/6-382-7132)* and *Stockholders Agreement Commentary (http://us.practicallaw.com/7-381-0517)*). In these circumstances, the club will want to ensure that its members remain aligned regarding the opportunity and timetable for exit. The sponsors may be subject to a minimum holding period post-IPO or requirements for mutual consent by sponsors for any sponsor to sell shares. In addition, the tag and drag-along rights which are typical when the company is privately held may remain in place (see *Standard Clauses, Stockholders Agreement: Tag-along Rights (http://us.practicallaw.com/8-383-5254)* and *Stockholders Agreement: Drag-along Rights (http://us.practicallaw.com/6-383-5245)*). However, more than 90% of the deals we surveyed had no lock-ups or transfer restrictions beyond the standard 180-day lock-up required by the underwriters in the IPO. In the small number of deals that imposed a longer holding period requirement, the period ranged from one to two years post-IPO.

Warren de Wied is a Member of Wilson Sonsini Goodrich & Rosati, P.C. whose practice focuses on Mergers and Acquisitions, Private Equity and Corporate Governance. John Monsky is a Partner and the General Counsel of Oak Hill Capital Partners, a leading private equity firm.

Practical Law Company provides practical know-how for transactional lawyers. To find out more about PLC and register for a free trial, please visit www.practicallaw.com or call (646) 562-3405.
Copyright © 2010 Practical Law Publishing Limited and Practical Law Company, Inc. All Rights Reserved. Use of PLC websites and services is subject to the Terms of Use (us.practicallaw.com/2-383-6690) and Privacy Policy (us.practicallaw.com/8-383-6692).