

## **IPOs Again Considered an Exit Strategy for Private Equity Funds: But Sellers Beware**

Although private equity firms primarily have been sitting on the sidelines and evaluating their exit options for the last 24 months, they continue to monitor the IPO market as a potential exit opportunity. According to data reported by Thompson Reuters, more than 20 venture-backed IPOs were completed in the first six months of 2010, but only three of those offerings priced above their filing range. The number of IPOs completed so far in 2010 is higher than last year, but during this first six month period, more IPOs were abandoned (71) than completed (68). Accordingly, an IPO may not be *the best* exit strategy for every portfolio company, but the public markets do present *an exit* and as firms are eager to liquidate their portfolios, they continue to compare an IPO to other exit options. Now more than ever there are obstacles to be considered and overcome, including:

- Emerging governance trends and an environment for stronger outside shareholders
- Compensation of the CEO, named executives and rank and file employees
- Private equity-backed directors
- Are any of the portfolio company's directors truly independent?
- What happens to board observation rights?

### ***Emerging Governance Trends and Stronger Outside Shareholders***

Of course, a newly public company will be required to comply with all of the SEC's current rules and regulations. Perhaps more importantly, as the board and management prepare for being a public company, they will want to follow the SEC's rule-making process stemming from the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), many of whose measures are aimed at strengthening the power of outside shareholders and increasing their participation in corporate governance. The new corporate governance rules will create significant new obligations aimed at a company's disclosure and transparency. A private equity fund considering an IPO for one or more portfolio companies will want to retain its own counsel to evaluate these new laws from the shareholder's (not just the public company's) perspective.

Congress did not establish a definitive deadline for the promulgation of many of the new rules and the SEC's public comment process will take a very different form this time. The SEC has determined to seek input from interested members of the public much earlier in the rule-making process. The public will be able to comment on the new laws *before* the agency even proposes new rules and amendments. Additionally, the SEC has promised to provide greater public disclosure and transparency regarding meetings with SEC staff and expects to hold a number of public hearings. Any private equity firm that anticipates significant IPO activity from its portfolio likely will want its own counsel to be active in the SEC comment process. In any case, management and the board should be certain to stay abreast of new developments and proposed rules as they become available, and management will want to take them into account as they plan for the IPO and develop and implement new policies and procedures for a newly public company.

### ***Compensation of the CEO, Named Executives and the Rank and File Employees***

Several areas slated for new rule-making by the SEC deserve particular attention. Under the "say-on-pay" provisions, the newly public company will be required to hold two separate shareholder votes at its first annual or other shareholder meeting held more than six months after enactment. The first vote is a non-binding shareholder vote to approve the compensation of named executive officers as reported in the proxy statement. The second is a non-binding shareholder vote to determine the frequency of future say-on-pay votes (*i.e.*, every year, two years or three years?). Shareholders also must be provided an opportunity to revisit the frequency of the say-on-pay votes at least once every six years.

New developments for disclosure of CEO compensation also should be followed closely. The Dodd-Frank Act requires the SEC to revise current rules to require disclosure of the median of the annual total compensation of **all** employees of the company, other than the CEO; the annual total compensation of the CEO; and the ratio of these two amounts. The SEC's current calculation requirements for named executive officer compensation has proven to be very difficult and subject to varying interpretations. Attempting to calculate these amounts for all employees will present a significant challenge, especially for a newly public company.

### ***Private Equity-Backed Directors?***

The Dodd-Frank Act gives the SEC express authority to issue "proxy access" rules that may provide procedures to allow large shareholders to include nominees to the board of directors in a public company's proxy statement. Significantly, the Act leaves it to the SEC to make the important decision regarding the number of shares or the percentage of ownership that will entitle a shareholder to proxy access for this purpose. The private equity investor will be interested in the language of this draft rule as the firm may want to structure its post-IPO shareholdings to continue to have access to one or more additional board seats.

### ***Are Any of the Portfolio Company's Directors Truly Independent?***

Another issue for the private equity firm to consider as it prepares for an IPO is whether any of the current directors will meet the independence standards of the particular exchange on which the company intends to list. In the aftermath of corporate scandals and conflicts of interests, regulators are giving relationships between and among management, directors and the company additional scrutiny. The boards of private equity-backed companies typically include the company's founder, one or two members of the company's senior management team and several representatives from the numerous private equity and venture firms that have financed the company through a number of rounds of capital-raising. Sometimes, the board also includes a major customer or other business partner. Clearly, none of these directors would be "independent" under the guidelines established by NYSE or Nasdaq for listed companies. But whether a particular director's relationships and business associations create an independence issue is not always clear.

In reaction to disclosure by Black & Decker Corp., the NYSE provided insight regarding how business, and possibly other, relationships between and among directors and even senior management (rather than the company) may impair a director's "independence" under NYSE

rules. Earlier this year, in connection with its proposed merger with Stanley Works, Black & Decker disclosed the existence of a "private business relationship" between an "independent" director and the Black & Decker CEO and chairman. This business relationship was reportedly discussed with counsel, who apparently confirmed that in their view, the relationship did not impede the director's independence under the NYSE standards. When questioned, the company advised the NYSE that it believed that "[p]ersonal business relationships between individuals (as opposed to relationships with the company) generally are not relevant to the independence tests [for directors] under [NYSE] rules because they do not create a material relationship between a director and the company." The NYSE disagreed and asserted "that, in interpreting its rules, the NYSE believes relationships between a director and a member of senior management that are material to either party should be considered by a board of directors in its evaluation of director independence." The NYSE's response should be remembered by a board when it is making independence determinations. The board must take all relevant facts and circumstances into account. As stated in the Commentary of the NYSE Listed Company Manual, "[w]hen assessing the materiality of a director's relationship with the listed company, the board should consider the issue not merely from the standpoint of the director, but also from that of persons or organizations with which the director has an affiliation. Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others...." In the Black & Decker case, one of the directors and the CEO/chairman both were significant investors in a luxury recreational development in Utah. The director independence rules continue to evolve with new interpretation and guidance forthcoming.

The Dodd-Frank Act promises to bring additional commentary on this topic as it instructs the SEC to issue new rules prohibiting the listing of stock on a national securities exchange unless the compensation committee of the issuer is "independent" under *revised standards* to be developed by the exchanges. The forthcoming revised rules will mandate additional consideration of relevant factors in determining independence, including the source of compensation of a committee member (such as consulting, advisory or other compensatory fees), and whether the committee member is affiliated with the issuer or any of its subsidiaries or affiliates. It is likely that the SEC will take the opportunity to provide additional commentary on "private business" relationships (*i.e.*, those unrelated to the company) between and among directors as well.

### ***What Happens to Board Observation Rights?***

Due to the independence requirement and conflicts of interest issues, many private equity firms opt to have their representatives serve as "observers" rather than directors of their portfolio companies. The observer role allows the private equity firm to participate in board meetings and board-level discussions, avoids loyalty issues and leaves room on the board for other directors who may meet the independence test.

Of course, because an observer is not a director, he or she has none of the responsibilities or liabilities of a director. Added benefits of being an observer rather than a director are: the observer can act in the self-interest of the private equity firm without regard to the interests or concerns of any other constituency; and so long as the observation rights agreement so allows, while the company is private, an observer may share confidential information of the corporation

with the firm or company with which he or she is affiliated. The law is unclear regarding whether a director of a private company may share such information, regardless of what the agreement with the corporation may provide. The private equity firm will need to discuss with legal counsel and the company whether and how observation rights will continue once the company is public. It is much less common for outsiders to have full observation rights for a public company board, unless the company is a "controlled company," and, of course, any observer may not disclose material nonpublic information of a public company, excepted in very limited circumstances.

On the other hand, because an observer is not a director, he or she is not covered by director indemnification provisions or D&O insurance (although parallel indemnification rights may be included in the observation rights agreement); may be restricted from certain portions of a board meeting or materials if exposure could adversely affect the attorney-client privilege between the corporation and its counsel; and cannot, of course, vote on matters that come before the board. The ramifications of these observer limitations change once the company becomes public.

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