

Recent Trends in IPOs of Private Equity Sponsor-Backed US Companies

Over the last two years, the IPO market provided liquidity for many private equity firms. Private equity sponsor-backed IPOs during this period reveal a number of trends in how these newly public companies are approaching corporate governance and defensive measures.

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During the 24-month period ending June 30, 2016, the initial public offering (IPO) market provided liquidity for many private equity (PE) firms, notwithstanding the decrease in IPO activity in 2015 and the first half of 2016, as compared to 2014.

A survey by Kirkland & Ellis LLP of PE sponsor-backed IPOs during this 24-month period reveals a number of trends in corporate governance and defensive measures adopted by these newly public companies. The survey reviewed 38 IPOs that generated \$100 million or more in gross proceeds (excluding limited partnerships, limited liability companies, blank check companies, and foreign issuers) (see *Box, Private Equity Sponsor-Backed IPOs*).

The classification of companies as “PE sponsor-backed” involved some measure of subjectivity. Generally, the companies classified as PE sponsor-backed were acquired in leveraged buyouts and the PE sponsor (or a small group of PE sponsors) owned substantially all of the equity prior to the IPO. In some cases, however, company founders or a non-PE co-investor owned a substantial equity stake in addition to the PE sponsor’s equity stake. In those cases, where the founders or co-investor acted together with the PE sponsor through contractual shareholder agreements, the company was generally classified as PE sponsor-backed.

This article discusses the following trends:

- The recent increase in PE sponsor-backed IPOs after a six-month slowdown in the IPO market.
- A majority of the companies surveyed elected to be treated as controlled companies.
- Most PE sponsors sought to maintain their representation on the board following the IPO by entering into nominating agreements.
- PE sponsors have been taking advantage of the convenience of being a controlling stockholder by relaxing the defensive measures of their companies, making it easier for stockholders to take action.
- Public companies controlled by PE sponsors have frequently opted out of Section 203 of the Delaware General Corporation Law (DGCL), Delaware’s anti-takeover statute.
- PE sponsor-backed companies generally took advantage of the flexibility permitted by stock exchange rules concerning governance structure and board independence.
- At the time of their IPO, a majority of the companies surveyed had portfolio company monitoring agreements in place, virtually all of which were terminated in connection with the IPO.
- Of the companies surveyed, 16% utilized dual class stock to facilitate what is often referred to as an “Up-C” structure.
- More than half of the companies surveyed qualified as emerging growth companies (EGCs) and, of these companies, over half elected to present only two years of audited financial statements.

INCREASE IN PE SPONSOR-BACKED IPOs

Beginning in late spring of 2016, the US IPO market showed signs of resurgence after a six-month period in which no PE

sponsor-backed IPOs of domestic companies with proceeds over \$100 million were completed. Six PE sponsor-backed IPOs of domestic companies closed in the first half of 2016, with all of these offerings occurring after late April 2016. In comparison, 11 PE sponsor-backed IPOs were completed in the first half of 2015 and 13 were completed in the second half of 2014.



Search [Key Corporate Governance and Exit Considerations for the Sponsor-Backed IPO Candidate](#) for more on key issues to consider when putting a post-IPO corporate governance structure in place for a PE sponsor.

CONTROLLED COMPANY STATUS

The corporate governance profile of PE sponsor-backed public companies differs in many respects from those of public companies generally and from venture-backed public companies. PE sponsors generally continue to own a significant amount of stock post-IPO, often a controlling stake. The PE sponsor’s controlling interest, both before and after the IPO, allows the PE sponsor to adopt:

- Board structures and nominating policies that ensure a large degree of control throughout the PE sponsor’s investment.
- Charter and by-law provisions tailored to a controlled company, such as provisions permitting action by written consent and allowing stockholders to call special meetings.

Of the companies surveyed, 95% remained controlled companies under applicable New York Stock Exchange (NYSE) or NASDAQ Stock Market standards post-IPO, meaning that more than 50% of the voting interests of these companies continued to be held by the PE sponsor or a group of PE sponsors.

DIRECTOR NOMINATION RIGHTS

PE sponsors generally seek to maintain representation on the board following the IPO until they have sold down their stake in the company. Due to the significant economic stake maintained by these PE sponsors, it is not surprising that approximately 68% of the companies surveyed entered into nominating agreements with the PE sponsor in connection with the IPO. These agreements give the PE sponsor the right to nominate a specified number or percentage of directors to stand for election following the IPO. Further, 62% of these nominating agreements did not require the PE sponsor’s nominees to resign from the board once the PE sponsor’s ownership level in the company declined below the threshold required for the directors’ nomination.

None of the companies surveyed provided a PE sponsor with the right to appoint directors to the board (which can generally only be accomplished by issuing the PE sponsor a different class of stock than that held by the public). PE sponsors are often comfortable relying on nomination rights (rather than the direct right to appoint directors) to ensure their continued representation on the board because plurality voting ensures their nominees are elected. In cases where directors are elected by plurality vote rather than majority vote, the directors receiving the most votes are elected (even if less than a majority of shares are voted “for” election). With plurality voting, absent a proxy contest by a third party, the candidates nominated by the company will be elected. In 97% of the companies surveyed,

the company's charter or by-law provisions provided for plurality voting.

Of the 26 companies surveyed with nominating agreements, 11 (42%) of the agreements gave the PE sponsor the right to nominate a number of directors that was generally proportional to the PE sponsor's percentage of ownership. Eight (31%) of the nominating agreements provided for nomination rights based on the PE sponsor being able to maintain a percentage of its pre-IPO ownership (rather than a percentage of outstanding stock). This is a PE sponsor-friendly term because nomination rights are not impacted by subsequent dilution of the PE sponsor's holdings due to stock issuances by the company. Seven (27%) of the nominating agreements provided for nominating rights based on other formulations.

In some cases, the use of a staggered board can further protect a PE sponsor's right to continued board representation. With a staggered board, one-third of the directors stand for election each year and directors generally serve three-year terms. Ninety-five percent of the companies surveyed adopted a staggered board.

Nominating agreements often do not require that a PE sponsor's representatives resign from the board in the event that the PE sponsor's ownership declines. As a result, a change in ownership only impacts the number of directors that the PE sponsor is entitled to nominate at the next annual meeting. If, for example, a PE sponsor's representative is placed in the class of directors that is not up for election until the third annual meeting post-IPO, the PE sponsor is ensured representation for three years regardless of whether its ownership level decreases. Of the companies surveyed, 62% did not require director resignation if the PE sponsor's ownership declines, while 38% did require it.

In some cases, PE sponsors have sought to further control portfolio companies following an IPO by maintaining a contractual right to veto specified corporate transactions, such as changes in board size, changes in control, and charter amendments. Unlike board representation, contractual veto rights allow a PE sponsor to exercise control in its capacity as a stockholder rather than as a director. In six of the IPOs surveyed, PE sponsors also received contractual veto rights (see *Figure A*).

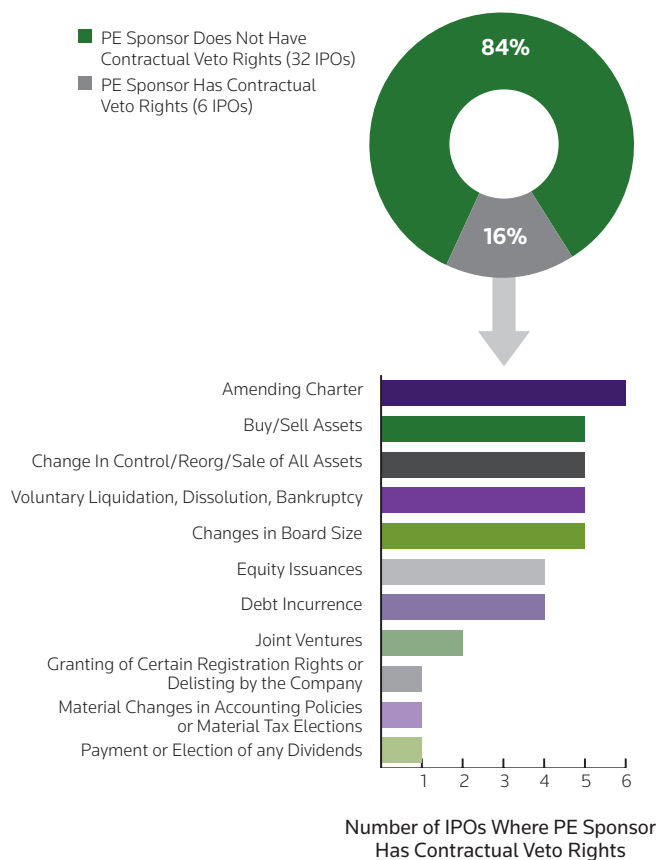
DEFENSIVE MEASURES

PE sponsors generally seek to take advantage of the convenience of being a controlling stockholder for as long as they own 50% of the voting stock by relaxing defensive measures, which makes it easier for stockholders to take action. For example, as discussed below, controlled companies have often permitted:

- Stockholders to take action by written consent.
- Stockholders to call special meetings.
- The amendment of the charter or by-laws without supermajority stockholder approval.

These provisions would be highly unusual in non-controlled companies. As a result, the charter and by-laws often provide that these stockholder rights are eliminated once the PE sponsor (or a group of PE sponsors) ceases to own 50%, or some lower percentage, of the common stock.

FIGURE A: CONTRACTUAL VETO RIGHTS



Search [Stockholder Protections](#) for information on the contractual protections that stockholders in companies with few stockholders typically seek to protect their investment.

ACTION BY WRITTEN CONSENT

Ninety-five percent of the companies surveyed permitted stockholders to take action by written consent (see *Figure B*). Of the 36 companies that permitted action to be taken by written consent:

- 28 (78%) provided that these rights would fall away once the PE sponsor ceased to own a specified percentage of the outstanding stock (fall away percentage).
- 5 (14%) provided for action by written consent subject either to a fall away percentage or to both the action and the taking of the action by written consent being approved by the board.
- 2 (6%) provided that both the action and the taking of the action by written consent must be approved by the board.
- 1 (3%) provided that action could only be taken by unanimous consent.

Figure C indicates the PE sponsor ownership percentage below which the right to take action by written consent falls away, including with respect to the five companies that provided that the action by written consent could alternatively be approved by the board.

RIGHT TO CALL SPECIAL MEETINGS

Seventy-nine percent of the companies surveyed permitted stockholders to call special meetings of stockholders. Of the 30 companies that permitted stockholders to call special meetings:

- 28 provided that this right would fall away once the PE sponsor ceased to own a specified percentage (in some cases with the right to call a special meeting limited solely to the PE sponsor so long as the PE sponsor maintained the specified percentage).
- One provided that a special meeting could only be called by stockholders upon the request of holders of a majority of the votes to be cast at the meeting.
- One provided that the right terminated once no class B common stock remained outstanding (see below *Dual Class Stock and Up-C Structure*).

Figure D indicates the PE sponsor ownership percentage below which the right to call special meetings falls away.

CHARTER AND BY-LAWS AMENDMENT

Only 29% of the companies surveyed required a supermajority vote of stockholders to amend the charter and by-laws at the time of the IPO. All but one of the companies that permitted an amendment of the charter and by-laws with a simple majority vote provided that these documents could only be amended with a supermajority vote once the PE sponsor ceased to own a specified percentage of the outstanding common stock. In the one case in which the right to amend the charter and by-laws with a simple majority vote was not tied to the PE sponsor

maintaining a specified percentage of the outstanding common stock, the by-laws provided that the board had the exclusive right to amend the by-laws.

Figure E specifies the PE sponsor's ownership threshold below which a supermajority vote was required to amend some or all of the provisions of the company's charter and by-laws.

SECTION 203 OF THE DGCL

Public companies controlled by PE sponsors generally opt out of Section 203 of the DGCL, Delaware's anti-takeover statute. Of the companies surveyed, 24 (63%) opted out of Section 203, while 14 (37%) opted in, and of those 14 companies, eight elected not to opt in until a future date when certain conditions were satisfied. If a public company does not opt out, Section 203 provides that any person that acquires 15% or more of a public company's stock without board approval becomes an "interested person" and prohibits transactions between the company and any interested person for a period of three years, subject to limited exceptions.

By opting out, a PE sponsor retains the ability to transfer 15% or more of the company's stock to a third party without the transferee becoming an interested person under Section 203. If a company has opted in to Section 203, the PE sponsor would need board approval in order to exempt the transaction from Section 203, which would trigger the directors' fiduciary duties to all stockholders.

Because Section 203 provides a strong defensive measure, it can be desirable for the company to be subject to Section 203 after



PRIVATE EQUITY SPONSOR-BACKED IPOs (June 30, 2014–June 30, 2016)

The findings in this article are based on Kirkland & Ellis LLP's survey of the following PE sponsor-backed IPOs, which generated \$100 million or more in gross proceeds (excluding limited partnerships, limited liability companies, blank check companies, and foreign issuers) during the 24-month period ending June 30, 2016:

American Renal Associates Holdings, Inc.
Ollie's Bargain Outlet Holdings, Inc.
Amplify Snack Brands, Inc.
Party City Holdco Inc.
Atkore International Group Inc.
Performance Food Group Co.
Blue Buffalo Pet Products, Inc.
Planet Fitness, Inc.
Bojangles', Inc.
PRA Health Sciences, Inc.
Catalent, Inc.
Press Ganey Holdings, Inc.

Civitas Solutions, Inc.
Ryerson Holding Corp.
Cotiviti Holdings, Inc.
Shake Shack Inc.
CPI Card Group Inc.
SiteOne Landscape Supply, Inc.
El Pollo Loco Holdings, Inc.
Smart & Final Stores, Inc.
Evolent Health, Inc.
STORE Capital Corp.
First Data Corporation
Summit Materials, Inc.
Fairmount Santrol Holdings Inc.

Surgery Partners, Inc.
GMS Inc.
TransUnion
GoDaddy Inc.
Univar Inc.
INC Research Holdings, Inc.
US Foods Holding Corp.
Metaldyne Performance Group Inc.
Vivint Solar, Inc.
Milacron Holdings Corp.
VWR Corp.
Neff Corp.
Wingstop Inc.

Note: Data for each IPO was obtained from the relevant final prospectus and other filings made with the Securities and Exchange Commission.

FIGURE B: CIRCUMSTANCES UNDER WHICH COMPANIES PERMIT ACTION TO BE TAKEN BY WRITTEN CONSENT

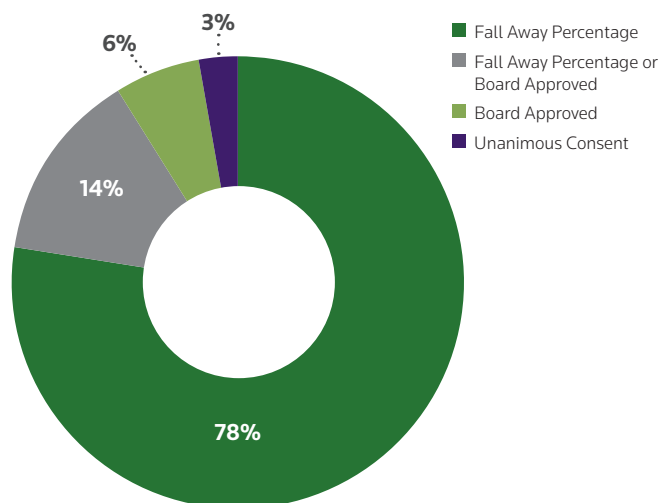


FIGURE C: PERCENTAGE OF PE SPONSOR OWNERSHIP BELOW WHICH RIGHT TO ACTION BY WRITTEN CONSENT FALLS AWAY

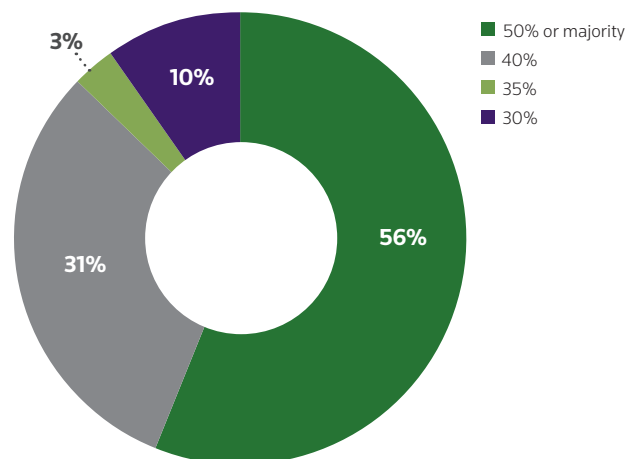


FIGURE D: PERCENTAGE OF PE SPONSOR OWNERSHIP BELOW WHICH THE RIGHT TO CALL SPECIAL MEETINGS FALLS AWAY

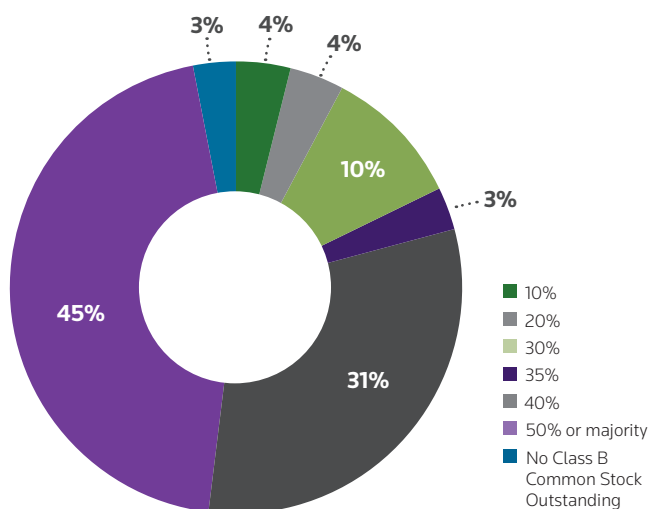
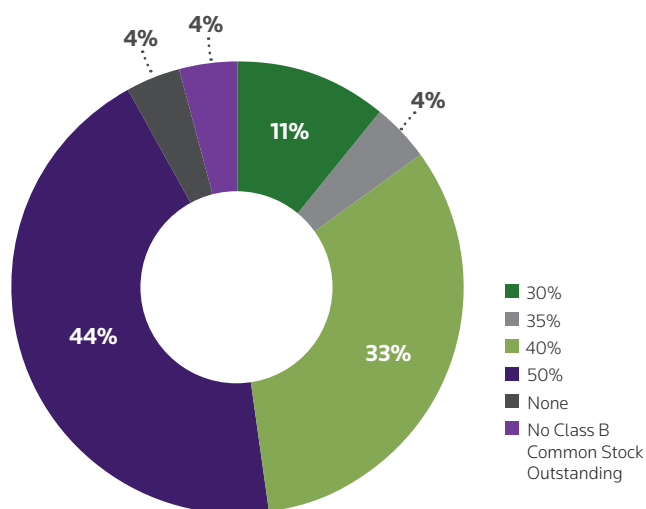


FIGURE E: PERCENTAGE OF PE SPONSOR OWNERSHIP BELOW WHICH SUPERMAJORITY VOTE IS REQUIRED FOR AMENDMENTS



the PE sponsor ceases to control the company. This is generally accomplished in one of two ways. Some companies opt out of Section 203, but include in their charter a modified version of Section 203 that excludes from the definition of interested person the PE sponsor, its affiliates, and any person or group that acquires 15% or more of the company's common stock as a result of a transfer from the PE sponsor.

As noted above, some companies include in their charter a provision that states that the company will opt in to Section 203, but not until a future date when certain conditions are met. Generally, these "springing Section 203" provisions provide that the company will become subject to Section 203 when the PE

sponsor owns less than a specified percentage of the company's common stock. This percentage has varied from as high as 50% to as low as 5%. Of the companies surveyed, eight (21%) included a springing Section 203 provision in their charter.

BOARD INDEPENDENCE

Controlled companies are exempt from some of the governance requirements imposed by the NYSE and NASDAQ. Specifically, controlled companies are not required to have:

- A majority of independent directors (as defined under stock exchange rules).

FIGURE F: NUMBER OF INDEPENDENT DIRECTORS ON COMPENSATION COMMITTEE AT IPO

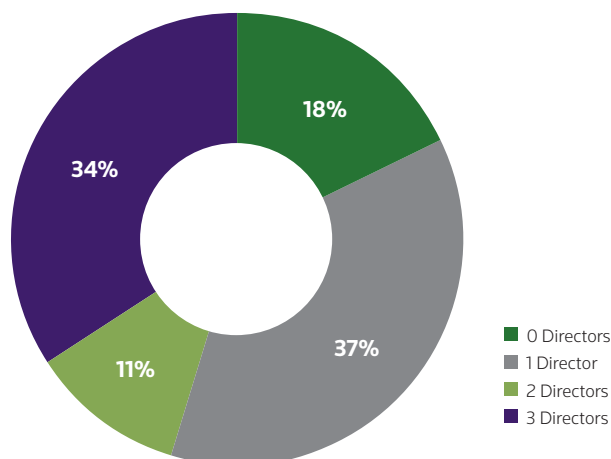
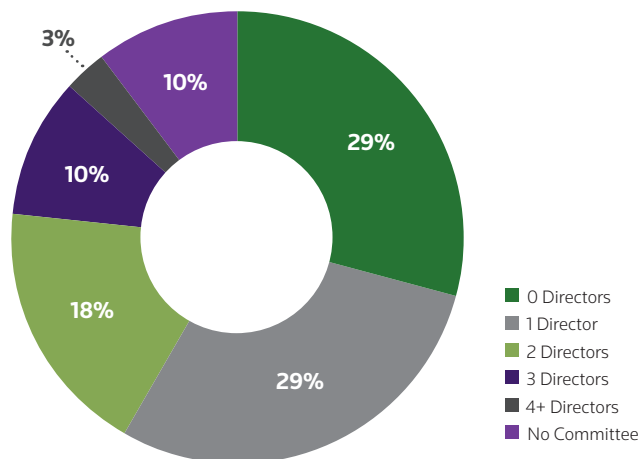


FIGURE G: NUMBER OF INDEPENDENT DIRECTORS ON NOMINATING COMMITTEE AT IPO



- Any independent directors on their compensation or nominating committees.

In addition, all newly public companies are entitled in any event to utilize the phase-in rules of the NYSE and NASDAQ concerning director independence. For companies that do not qualify as controlled companies, the phase-in rules require that they have at least one independent director at the time of the IPO, two independent directors within 90 days of the IPO, and fully independent committees within one year of the IPO.

Generally, the companies surveyed took advantage of the flexibility provided by the exemptions for controlled companies and/or the phase-in rules. Sixty-eight percent of the companies surveyed did not have a majority independent board at the time of their IPO.

Of the companies surveyed:

- 45% had compensation committees comprised of two or more independent directors (see *Figure F*).
- 18% had compensation committees with no independent directors.
- 41% had nominating committees comprised of two or more independent directors (see *Figure G*).
- 39% had nominating committees with no independent directors or had no nominating committee.

In contrast, 71% of the companies surveyed had audit committees comprised of two or more independent directors at the time of the IPO.



Search [Sample Risk Factors: Private-Equity Portfolio Company Status Associated Risks](#) for sample language describing the risks arising from taking advantage of the controlled company exemption from corporate governance requirements.

PORTFOLIO COMPANY MONITORING AGREEMENTS

Before an IPO, PE sponsors often enter into monitoring agreements with their portfolio companies. These agreements frequently provide for an annual fee to be paid by the portfolio company to the PE sponsor for services rendered to the portfolio company, as well as transaction-related fees for services rendered in connection with acquisitions and financings. Of the companies surveyed, 27 companies (71%) had monitoring agreements in place at the time of the IPO.

Of these monitoring agreements, all but one terminated in connection with the IPO. Of the companies that terminated a monitoring agreement, 65% paid a termination fee to the PE sponsor, with fees ranging from \$1 million to \$78 million. The average size of the termination fee was approximately \$19 million and the median was approximately \$12.8 million. The one monitoring agreement that was not terminated was amended and restated in connection with the IPO and provided for termination no later than the second anniversary of the IPO.

Although not all related agreements were filed (perhaps because they were terminated), in several cases the monitoring agreements provided for a termination fee tied to the remaining term of the agreement or to a set number of years of additional payments (for example, ten years). In some cases, these payments were discounted to present value. In other cases, it appears that the amount of the payment was negotiated between the company and the PE sponsor.

Termination fees and accelerated payments under monitoring agreements with portfolio companies have recently come under increased scrutiny from the Securities and Exchange Commission (SEC). An SEC enforcement case from October 2015 required a PE sponsor to disgorge accelerated monitoring fees to the funds and pay a significant fine. Many PE sponsors are reviewing their practices regarding termination fees and

accelerated payments in light of this increased regulatory focus. Although some PE sponsors have received termination fees or accelerated payments in IPOs completed after October 2015, the relatively small number of PE sponsors completing IPOs of portfolio companies in this period makes it difficult to draw any conclusions on the impact of this enforcement case on market practice.



Search [Private Equity Strategies for Exiting a Leveraged Buyout](#) for information on the main exit strategies for PE sponsors making control investments in portfolio companies through leveraged buyouts.

DUAL CLASS STOCK AND UP-C STRUCTURE

Of the companies surveyed, eight (21%) had two classes of common stock at the time of their IPO, while 30 (79%) had just one class of stock. Of the eight companies with dual class stock, 75% utilized their dual class stock to facilitate an Up-C structure.

An Up-C structure allows certain pre-IPO investors to continue to own their economic interests in a pass-through entity partially owned by the public company and partially by the pre-IPO investors (rather than converting the partnership to a corporation at the time of the IPO). This structure is designed to preserve more favorable flow-through tax treatment for pre-IPO investors.

With an Up-C structure, a new company is taken public by selling stock to the public. The newly public company uses the

proceeds of the offering to purchase partnership interests in the existing partnership. The public purchases class A common stock in the IPO company and the pre-IPO investors receive class B common stock of the IPO company. The limited partnership interests, together with the related shares of class B common stock, can be exchanged for class A common stock on a one-for-one basis, which is generally only done when the pre-IPO investor wishes to sell its interest. The class B common stock has voting rights but no economic rights because the pre-IPO investors continue to directly own limited partnership interests in the partnership representing their economic interests.

FINANCIAL STATEMENT PRESENTATION OF EGCs

Of the 38 companies surveyed, 21 (55%) qualified as EGCs. EGCs are permitted to include two rather than three years of audited financial statements in their IPO registration statements and may present as few as two years of selected financial data (as compared to the five years required for non-EGCs under Item 301 of Regulation S-K). Fifty-two percent of EGCs elected to present only two years of audited financial statements and 71% presented less than five years of selected financial data.

The author would like to thank her colleagues John Gunderson, Alex Schwartz, and Aya O'Connor for their assistance with the survey.

