CORPORATE GOVERNANCE PRACTICES IN US INITIAL PUBLIC OFFERINGS

Corporate governance is in a state of unprecedented ferment. In response to pressures from shareholders and advisory groups, the governance practices of large companies have been steadily evolving over the past several years. However, a recent study by Davis Polk & Wardwell LLP found that these pressures have had only a limited effect on companies at the initial public offering (IPO) stage. Richard Truesdell, Jr. and Ning Chiu review the results.

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SCOPE OF SURVEY

The survey examined the corporate governance practices for the 50 largest IPOs by US companies in 2007 and 2008, based on deal size of the IPO and excluding limited partnerships and blank check companies.

Two versions of the survey were conducted: one included "controlled companies" and one excluded "controlled companies".

A controlled company, under NYSE and NASDAQ rules, is a company where a majority of its voting power for electing directors is held by an individual, group or other entity. Controlled companies are exempt from NYSE and NASDAQ requirements for a board consisting of at least a majority of independent directors, an independent compensation committee and an independent nominating and corporate governance committee.

For the survey **including** controlled companies:

- The deal size of the offerings surveyed ranged from $136.5 million to $17.8 billion.
- The companies spanned 36 industries.

For the survey **excluding** controlled companies:

- The deal size of the offerings surveyed ranged from $107.9 million to $17.8 billion.
- The companies spanned 42 industries.

RESULTS OF SURVEY

After Worldcom and Enron, institutional investors, advisory groups and regulators have been assaulting the corporate governance status quo on multiple fronts. While the issue *du jour* has shifted over time from majority voting, to separation of chairman and CEO positions, to proxy access, the consistent themes have been on increasing accountability and oversight and empowering shareholders. Large companies in particular have been the focus of these campaigns and, as a result their governance practices, have been evolving more rapidly than mid-cap and smaller companies in response to these pressures. For many reasons, large companies are also more cognizant and sensitive about being consistent with the practices of their peers, so they tend to change and follow governance developments even when they are not the direct target of activists.

To determine what impact this was having on IPO stage companies, we examined the corporate governance practices of the US companies that conducted the 50 largest IPOs in 2007 and 2008. Interestingly, we found only a limited effect on companies at the IPO stage, and that IPO managements and sponsors generally seek to keep the center of gravity very much at the board rather than at the shareholder level when they first go public.

Our examination focused in particular on the following areas of corporate governance:

- Board independence.
- Classified board structures.
- Majority voting.
- Separation of CEO and chairman positions.
- Anti-takeover charter provisions.

BOARD INDEPENDENCE

Only slightly more than half of the board members of IPO stage companies were independent, compared to 78% for the S&P 1500 and 82% for the S&P 500 (according to RiskMetrics Group and the 2009 Spencer Stuart Board Index, a recent study that examines the state of corporate governance among the S&P 500). Subject to an exception for controlled companies, the NYSE and NASDAQ listing standards require that the board of directors of an IPO company consist of a majority of independent directors within one year from the date of listing. Because a majority of independent directors is required within a year anyway, it is not surprising that IPO stage companies get them on board as soon as possible to obtain any associated marketing benefit. Larger companies aim to go beyond the regulatory standards and have more than a majority of independent directors on their boards, and in some cases, having only one executive, their CEO, present on the board. 50% of the S&P 500 had only one insider on their boards in 2009.

CLASSIFIED BOARD STRUCTURES

A classified board makes it more difficult for shareholders to replace a director that they are unhappy with because only one tranche (typically one-third) of the directors comes up for re-election each year. It also acts as an important anti-takeover device but the threat of potential takeovers may be less important to large-cap companies. 64% of the IPO companies examined (74% excluding controlled companies) had classified board structures compared to only 36% (according to RiskMetrics Group) of large-cap companies. These figures also reflect the fact that:

- Annual elections for all directors have been a hallmark of the activists' battle cry for increased director accountability for some time.
- Institutional investors strongly support these efforts.

A little more than ten years ago, 62% of the S&P 500 companies had classified boards, according to the Spencer Stuart Board Index.

MAJORITY VOTING

Majority voting is viewed by its proponents as empowering shareholders. Under plurality voting, which is the default standard under most state laws, the director is re-elected in an uncontested election if he or she receives at least one vote in favor (assuming a quorum is present), even if a majority of the shareholders disapprove of his or her performance and withhold their votes. By contrast, under majority voting, a director is elected if he or she receives more "for" than "against" votes cast. Approximately 2/3 of the S&P 500 have adopted some form of majority voting, either through bylaw amendments or director resignation policies. IPO companies tend to continue to take advantage of state law, as 88% maintain a plurality standard.

SEPARATION OF CEO AND CHAIRMAN POSITIONS

40% of the IPO stage companies examined had separate CEO and chairman positions compared to 46% (according to RiskMetrics Group) of the S&P 1500. There was a much more striking difference, however, in the independence of the separate chairman. Only 8% of the IPO stage companies examined had an independent chairman compared to 48% (according to RiskMetrics Group) of the S&P 1500. Otherwise, it is likely that the chairman position may be filled by another executive, or possibly, a former CEO. Only 14% of the IPO companies had a lead director, a position that is designed to respond to calls for independent director oversight for companies without independent chairs.

ANTI-TAKEOVER CHARTER PROVISIONS

While only 6% of the IPO stage companies examined had a rights plan in place, most of them had the usual set of anti-takeover provisions in their charter:

- 86% authorized blank check preferred stock.
- 66% required supermajority votes for amending charters and by-laws.
- 68% prohibited shareholders from acting by written consent.

PRACTICE NOTES | DOCUMENTS | CLAUSES | CHECKLISTS | ARTICLES

The following related Practice Notes can be found on practicallaw.com

>> Simply search the title OR resource number

Corporate Governance Standards: Overview or 7-381-0956

Corporate Governance Standards: Board of Directors or 0-381-5330

Corporate Governance Practices: Commentary or 0-383-5234

IMPLICATIONS

Our survey confirms our anecdotal experience in executing IPOs: that corporate governance matters are of secondary importance to IPO investors. Part of the explanation may be that when investors make an investment decision, they focus on issues that have the most direct correlation with value and not on secondary matters such as governance policies and practices. Conversely, when investors are considering whether to vote for or against a governance proposal, the issue, which has been separated from any investment decision, becomes primary. It may also be that investors of well-seasoned companies are looking for a variety of ways to unlock value or hold directors accountable for missteps, including seeking governance practices that allow them to affect board composition. Accordingly, once a company is already public, it is very difficult if not impossible to move "backwards" on any of these governance issues.

The IPO stage is a unique opportunity for companies, affording them considerable discretion in designing governance practices that best fit the company's current situation. Considering the results of the survey, there is no reason to think that these corporate governance matters have any material impact on the success of the IPO or the willingness of investors to participate.