DAVIS POLK & WARDWELL

Private Equity Newsletter

Post-IPO Board Independence Requirements for Portfolio Companies

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NYSE and Nasdaq rules generally require that by the first anniversary[1] of an IPO a majority of the board of directors of a listed US company be "independent" and that the board have wholly independent audit, compensation and nominating/governance committees. While compliance with these rules is generally not unduly burdensome, it is helpful to keep them in mind when structuring portfolio company governance arrangements.

There are limited exceptions to these independence rules. For example, where 50% of a listed issuer's voting power is held by an individual, group or another company, the issuer can elect to be treated as a "controlled company" and not be subject to the general board and committee independence requirements, although a controlled company remains subject to the audit committee independence requirements described below. Similar exceptions exist for foreign private issuers and a variety of other categories of issuers.

Independence Generally

In order for a director to be considered independent, the board must affirmatively determine that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the listed company). This standard is not subject to precise definition and requires a broad assessment of all relevant facts and circumstances. Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others. The stock exchanges do not generally provide concrete guidance as to independence in any particular situation.

Importantly, the amount or relative size of a sponsor's equity investment in a portfolio company does not, by itself, create a general independence issue. However, it can raise significant issues under the heightened audit committee independence standards discussed below. In addition, where a private equity sponsor owns in excess of 50% of the voting power of a portfolio company but does not utilize the controlled company exception, the portfolio company board often does not take the position that directors who are employed by affiliates of the sponsor are independent.

In addition to this general standard, each of the stock exchanges provides a series of bright-line factors that preclude independence. For example, the NYSE rule provides that a director is not independent if:

- *Employment*. The director is, or has been within the last three years, an employee of the listed company, or an immediate family member is, or has been within the last three years, an executive officer of the listed company.

- *Compensation*. The director or an immediate family member has received, during any 12-month period within the last 3 years, more than $100,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service).

- *Relationship with Auditor*. (A) The director or an immediate family member is a current partner of a firm that is the company's internal or external auditor; (B) the director is a current employee of such a firm; (C) the director has an immediate family member who is a current employee of such a firm and who participates in the firm's audit, assurance or tax compliance (but not tax planning) practice; or (D) the director or an immediate family member was within the last three years (but is no longer) a partner or employee of such a firm and personally worked on the listed company's audit within that time.

- *Compensation Committee Interlocks*. The director or an immediate family member is, or has been within the last three years, employed as an executive officer of another company where any of the listed company's present executive officers at the same time serves or served on that company's compensation committee.

- *Commercial Relationships*. The director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the listed company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues.

While similar, the Nasdaq rules[2] vary in a number of respects and it is important to be mindful of the differences in particular circumstances.

We have generally found that most private equity sponsors have little difficulty in identifying board members who meet these criteria, including in many cases individuals who are employed by an affiliate of the sponsor. Since these standards look back over a three-year period, independence issues should be considered at the time the sponsor acquires the portfolio company. Where the issues are identified in a timely manner it is often possible to accomplish the business objectives in a manner that minimizes future independence issues. For example:

- The compensation of individuals serving on a portfolio company board should be documented as director compensation, not as consulting or other services. To do otherwise might put the board in the unfortunate position of trying to conclude that an agreement styled as a consulting agreement is really a director compensation agreement.

- Management or other deal fees paid to a private equity sponsor can raise issues for the independence of representatives of the sponsor on the portfolio company board. If an employee of a financial sponsor serves on the board of a portfolio company, the portfolio company's payment of deal or management fees to the entity that employs the individual in excess of the greater of $1 million or 2% of the employing entity's revenues would cause the individual to not be independent under the NYSE rule (the Nasdaq rule is slightly different). These thresholds can pose practical independence issues where the particular sponsor entity involved has relatively modest amounts of regular revenue.

Audit Committee Independence

In addition to the general independence standards described above, both the NYSE and Nasdaq incorporate the heightened independence standards for audit committee members provided for in Rule 10A-3 under the Securities Exchange Act of 1934. This rule generally requires that (i) at least one member of the audit committee must meet a heightened independence test at the *effectiveness* of the IPO registration statement, (ii) a majority must be independent within 90 days of effectiveness, and (iii) all must be independent by the first anniversary of effectiveness, subject to exceptions for certain types of foreign private issuers and a variety of other categories of issuers. In addition to the general independence standards set forth above, in order to be independent a member of the audit committee may not, other than in his or her capacity as a director:

- accept directly or indirectly[3] any consulting, advisory, or other compensatory fee[4] from the issuer or any of its subsidiaries; or

- be an "affiliated person" of the issuer or any of its subsidiaries.

Affiliated persons are those that are directly or indirectly under common control. The rule provides a safe harbor that a person will not be deemed to control another where the first person (1) does not beneficially own, directly or indirectly, more than 10% of any class of voting equity securities of the specified person and (2) is not an executive officer of the specified person.

It is often the case that a private equity sponsor will hold in excess of 10% of a portfolio company following the initial public offering and in such circumstances careful attention must be given as to whether or not an audit committee member who is an officer or employee of an affiliate of the sponsor will be independent for purposes of the rule. While the rule expressly provides that exceeding the 10% beneficial ownership threshold does not create a presumption of control, the general principles that apply to determinations of affiliate status under the federal securities laws may make it difficult to be able to conclude otherwise where substantial sponsor ownership and control exists. Over the last few years sponsors and companies have generally become more conservative in making this determination, particularly given the scrutiny sometimes applied in hindsight to the conduct of audit committee members following financial irregularities or accounting restatements.

Importantly, the heightened audit committee independence rule only tests current relationships. As it does not "look back" to historical relationships in the same manner as the general independence standards, it allows potential audit committee independence issues to be dealt with at the time of the IPO or potentially during the one-year phase in period.

Disclosure Considerations

Both stock exchange and SEC rules require disclosure of the identity of the independent directors and the basis for a board determination that a relationship is not material. Many companies have adopted categorical standards to assist in making determinations of independence. Once these standards are disclosed, the stock exchange rules do not require specific disclosure of immaterial relationships that fall within the categorical standards. As a result, many companies adopted categorical standards that minimized disclosure about independence determinations. The stock exchanges and the SEC are generally of the view, however, that overbroad categorical standards are inappropriate, including categorical standards that essentially mimic the enumerated bright-line tests for independence.

Recently, the SEC has encouraged companies to provide additional disclosure regarding independence determinations beyond merely referring to a company's categorical standards. In particular, the SEC believes that the obligation to describe for each director *by specific category or type* any transactions, relationships or arrangements that were considered in making independence determinations requires at least some director-specific disclosure. Although this is a developing area, given that most portfolio companies carefully vet their disclosure at the time of an IPO we do not expect any incremental disclosure to be unduly burdensome to the typical sponsor or portfolio company.

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[1] A company listing in connection with its IPO is generally permitted to achieve compliance over time as follows: one independent member of each of the audit, compensation and nominating/governance committees at the time of listing, a majority of independent members on each such committee within 90 days of listing and fully independent committees and majority board independence within one year. Companies emerging from bankruptcy, companies that cease to be controlled companies and companies transferring a listing from another market all have similar phase-in periods.

[2] Current Nasdaq rules contain a general standard for qualification as an "independent director," and then specify a list of directors who, because of their particular relationship to the company, cannot be considered independent. Under the general standard, an "independent director" is any director other than:

- an executive officer or employee of the company or
- any other individual having a relationship which, in the opinion of the board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

In addition, the following directors cannot be considered independent:

(A) A director who is, or at any time during the past three years was, employed by the company or by any parent or subsidiary of the company.

(B) A director who accepted or who has a family member (*i.e.*, spouse, parent, child, sibling, whether by blood, marriage or adoption, or anyone else residing in the director's home) who accepted any compensation from the company in excess of $100,000 during any period of 12 consecutive months within the 3 years preceding the determination of independence, other than the following:

(i) compensation for board or board committee service;

(ii) compensation paid to a family member who is an employee (other than an executive officer) of the company; or

(iii) benefits under a tax-qualified retirement plan, or non-discretionary compensation.

(C) A director who is a family member of an individual who is, or at any time during the past three years was, employed by the company as an executive officer.

(D) A director who is, or has a family member who is, a partner in, or a controlling shareholder or an executive officer of, any organization to which the company made, or from which the company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year, or $200,000, whichever is more, other than the following:

(i) payments arising solely from investments in the company's securities; or

(ii) payments under non-discretionary charitable contribution matching programs.

(E) A director of the company who is, or has a family member who is, employed as an executive officer of another entity where at any time during the past three years any of the executive officers of the company served on the compensation committee of such other entity.

(F) A director who is, or has a family member who is, a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditor who worked on the company's audit at any time during any of the past three years.

[3] "*Indirect*" acceptance by a member of an audit committee of any consulting, advisory or other compensatory fee includes acceptance of such a fee:

- by a spouse, a minor child or stepchild or a child or stepchild sharing a home with the member, or
- by an entity
  - -- in which such member is a partner, member, an officer such as a managing director occupying a comparable position or executive officer, or occupies a similar position (except limited partners, non-managing members and those occupying similar position who, in each case, have no active rule in providing services to the entity); and
  - -- which provides accounting, consulting, legal, investment banking or financial advisory services to the issuer or any subsidiary of the issuer.

[4] Compensatory fees do not include the receipt of fixed amounts of compensation under a retirement plan, including deferred compensation, for prior service with the issuer so long as such compensation is not contingent in any way on continued service.