Private Equity Newsletter

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Post-IPO Charter Provisions for Portfolio Companies

2005 was a blockbuster year for the IPO exit: In 2005, U.S. private equity funds priced more IPOs of their portfolio companies on U.S. exchanges than in 2003 and 2004 combined.[1] According to one industry publication,[2] the average portfolio company taken public in 2005 was, at year-end, trading more than 23% higher than its IPO price. In preparation for an initial public offering, a financial sponsor should review the portfolio company's "legal make-up" (governance, defensive provisions, capital structure, etc.) and consider modifications as appropriate for the company's new life as a public company.

Much of this review may involve streamlining the charter to remove provisions that were particular to the company when it was privately held (*e.g.*, references to an existing shareholders agreement and class voting rights). Indeed, IPO underwriters will generally express a strong preference for a "plain vanilla" charter to facilitate the marketing of the IPO. However, because of unique considerations arising from the fact that the financial sponsor will generally continue to own a significant shareholding for some period of time after the IPO, the financial sponsor may prefer a governance structure and constituent documents that look very different than those appropriate for a widely held public company. The private equity fund must balance a desire for near-term flexibility (which would lead it to include few, if any, defensive provisions) while at the same time considering the preferences of management as to how best to protect the portfolio company once the fund ceases to hold a controlling stake.

This newsletter summarizes provisions of a portfolio company's charter that are particularly important to consider in this context. We assume for present purposes that the portfolio company is a Delaware corporation. If the portfolio company is incorporated in a state other than Delaware, the fund should consider whether the corporation law of the portfolio company's state of incorporation imposes restrictions that may make it advisable to redomicile in Delaware.

Classified Board

In anticipation of a private equity fund selling down its ownership position, it could be advantageous for defensive reasons to have a classified board of directors. In general, in the absence of a classified board, stockholders have the power to remove any or all directors, with or without cause. However, where the board is classified in accordance with the Delaware General Corporation Law (DGCL), the certificate of incorporation may provide that directors may only be removed for cause. In addition to serving as a defensive provision, a classified board (on which the term of each class of director expires on a staggered basis) might serve to extend the period of time during which the private equity fund maintains board representation.

Poison Pill

Although not technically a provision that would be included in a company's certificate of incorporation, and notwithstanding the trend to the contrary, some non-buyout-backed IPO candidates adopt poison pills typically out of concern prior to an IPO. In contrast, perhaps as a result of the balancing process discussed above, buyout-backed IPO candidates rarely decide to implement a poison pill at the time of the IPO, that institutional investors may not support adoption of a poison pill once the company is public. If the portfolio company charter provides for blank-check preferred stock (which it should in any event), the company can always adopt a pill in the future in response to a specific takeover bid.

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[1] *Source: Thomson Financial.*
[2] *Source: Buyouts (Thomson).*

Section 203 Opt-Out

Section 203 of the DGCL prohibits a corporation that has voting stock traded on a national security exchange or listed on The NASDAQ Stock Market from engaging in certain business combinations with an interested stockholder (defined as the owner of 15% or more of the corporation's voting stock), or an interested stockholder's affiliates or associates, for a three-year period unless, among other exceptions, approval of the board of directors (and, in some cases, the disinterested stockholders) is received. A private equity fund should consider including a charter provision pursuant to which it elects not to be governed by Section 203,[3] thus providing greater flexibility for the fund to facilitate an exit through a sale of its remaining interest to a third party without the approval of the company's board of directors.[4]

Action by Written Consent

For both defensive and logistical reasons, most non-buyout-backed public companies do not permit stockholders to take action by written consent in lieu of a special meeting. A public company backed by a financial sponsor, however, should consider permitting stockholder action by written consent at a special meeting to maximize flexibility, particularly in the event where the fund's share ownership would permit it to control any vote otherwise to be taken at a meeting itself.

Certain Supermajority Provisions

Supermajority voting provisions are generally not included in a public company's certificate of incorporation. However, under certain circumstances and depending upon the financial sponsor's ownership percentage post-IPO (and the timing of the sponsor's exit plan), the sponsor may wish to consider increasing the percentage threshold required for stockholders to approve (or cause to be taken) certain actions by the corporation to ensure that the sponsor has an effective veto over these actions. These actions include removal of directors, amendment of charter or bylaws and calling a special meeting of stockholders. Of course, the inclusion of a supermajority provision works both ways and may give a third party with a significant shareholding the ability to block an action that the company and the controlling shareholder wish to take.

Actions Taken by Board; Blank Check Preferred

The DGCL permits certain corporate actions (*e.g.,* amendment of bylaws) to be approved by the board of directors (as an alternative to the stockholders) if so provided in the charter or bylaws. Pursuant to the DGCL, certain other actions (*e.g.,* filling vacancies on the board) may be taken by the board of directors unless otherwise stated in the charter. To maximize flexibility and enable the company and its controlling stockholders to act more quickly, a fund-backed company should consider giving the board the ability to take these actions without requiring an additional stockholder vote.

Similarly, including a charter provision for blank check preferred stock will permit the board to authorize and issue preferred stock without prior stockholder approval and should be included in the post-IPO charter.

Hart-Scott Rodino Savings Clause

When a private equity fund owns warrants or non-voting convertible securities, it should review whether the exercise or conversion of those securities into common stock (which often occurs automatically upon the IPO) will be considered an acquisition of voting securities that would require HSR reporting. Specifically, if a fund will hold, upon exercise or conversion, voting securities of the issuer that would be valued (based on the IPO price in the case of common stock) at more that $56.7 million and the HSR Act's other thresh-

[3] *The opt-out provision should be included in the charter at the time of the IPO. While it is technically possible to amend the charter to add an opt-out provision once the company is public, it is infrequently done and subject to a 12-month waiting period before the opt-out is effective.*

[4] *A subsequent business combination between the portfolio company and the fund itself should generally be exempt from DGCL Section 203.*

Hart-Scott Rodino Savings Clause *(cont.)*

olds are met, the fund is often surprised to discover that it must comply with the provisions of the HSR Act (namely, filing requirements and the need to wait until expiration or termination of the waiting period) prior to exercise or conversion of the securities. HSR Act compliance could, obviously, affect the timing of a sale of the underlying securities and prevent the stockholder from taking advantage of a market timing opportunity. To address this issue, consideration should be given to including a charter provision to the effect that the shares received upon exercise or conversion will have no right to vote until the filing and waiting period requirements of the HSR Act have been satisfied.

Renouncement of Business Opportunities

Section 122(17) of the DGCL permits a corporation to renounce in its certificate of incorporation or by action of its board of directors, any interest or expectancy of the corporation in specified business opportunities or specified classes or categories of business opportunities that are presented to the corporation or one or more of its officers, directors or stockholders. Directors nominated by private equity funds are often employees of the fund sponsor and, in any event, typically have other responsibilities that may make them aware of a variety of business opportunities. Accordingly, it is generally advisable for a private equity fund to ensure that the portfolio company's charter includes a provision that specifically renounces business opportunities that may be available to its directors.

Please call your Davis Polk contact if you have any questions regarding this newsletter. For a list of Davis Polk's primary private equity lawyers, please click here.

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