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Commentary | Judgment call

Private equity–controlled companies can create transparent corporate governance regimes aligned with the interests of the board. Here's how *by Adam Weinstein*

THE PE WAY

FOR A CORPORATION AND ITS stockholders, the primary benefits of a strong and independent board structure are clear: value creation, effective management and compliance with fiduciary duties. Less obvious is the high cost of implementing and maintaining this board structure.

If stock ownership is dispersed among public stockholders, and a company lacks real control stockholders, the interests of executives and stockholders are not necessarily aligned. It is often cost-prohibitive for an individual stockholder to supervise executive management, resulting in significant agency costs to sustain this governance structure. In contrast, private equity–owned companies often enjoy markedly lower governance costs and, in turn, greater value creation.

PE-controlled companies can create transparent corporate governance regimes aligned to the interests of the board. Here is how it's done.

Board size and composition. A lean board may facilitate communication among directors, but this facility needs to be balanced against the need for the right mix of individuals. Boards should have private equity sponsor–appointed representatives who are experienced in equity and debt markets and can help position the company for a valuable exit. These representatives should remember that they represent all stockholders, not just PE sponsors.

To effectively supervise management, the board should also have experienced, industry-knowledgeable individuals who can critique management's strategic plan and its implementation. Finally, to ensure proper information flow in the exercise of directors' duty of care and to ensure proper control of the board by the PE sponsor, the CEO should be a director but not chairman.

Committees. Board committees are instrumental in allocating responsibility among directors based on expertise, with the audit, compensation and ethics/compliance committees being the most important. The audit committee should consist of representatives of the PE sponsor as well as financial experts and should ensure proper communication with financial staff and auditors, as well as with the compensation and other committees. The audit committee should also manage risks consistent with the company's strategic plan and ensure proper resolution of conflicts.

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The compensation committee should set compensation in a manner that aligns the interests of management with those of the PE sponsor, including meaningful equity incentives and real invested capital by the management team. The ethics/compliance committee should ensure that appropriate ethics, compliance and other policies are in place. If the committees are not controlled by PE sponsor appointees, they should serve as advisory committees that make recommendations to the board.

Corporate policies. To define the relationship with the management

team, PE-controlled companies should have a set of corporate policies setting forth a clear blueprint of actions requiring board, committee and/or stockholder approval, including limits on capital expenditures, acquisitions, divestitures, debt incurrence, change of business lines, geographic expansion and management compensation/benefits plans.

Exit and liquidity. PE sponsors should have agreements in place that define the rights of the sponsor and other stockholders to initiate and participate in public offerings, restrict transfers by minority holders, drag along minority holders in a sale transaction and allow management/minority holders to participate in a sale.

Board meetings/conduct. Board and committee meetings should be carefully planned with clear agendas and advance distribution of board packages containing detailed information. Some meetings should be held without a management representative present.

PE sponsor consulting agreement. PE sponsors should have a consulting agreement in place defining the fees and expenses that the PE sponsor's management affiliate will receive. Because PE sponsors are often named in litigation against the portfolio company, the agreement should contain an indemnification provision that survives the sale by the PE sponsor of its equity interests.

PE sponsors make significant control investments to cost effectively participate in the supervision of the executive management team by pooling money from limited partners. With a mix of PE professionals, industry experts and operating partners who are loyal to the PE sponsor, the interests of directors and stockholders can be aligned. ■

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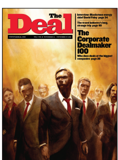

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