ALTERNATIVE MODELS OF GOVERNANCE
Among public companies, governance features are imposed by regulators, listing exchanges, and capital-market pressure.

However, other organizational structures exist:

- Family-controlled businesses
- Venture-backed companies
- Private equity-owned companies
- Nonprofit organizations

The governance features of these firms will reflect the issues they face regarding purpose, ownership, and control.
1. FAMILY-CONTROLLED CORPORATIONS

• Family-controlled businesses are those in which a founder or founding-family member maintains a presence as shareholder, director, or manager.

  (+) Large ownership position aligns interests with minority investors.
  (+) Long-term orientation (see the company as their “legacy”).
  (+) Vigilant oversight of management, strategy, risk, and compensation.

  (-) Might exert disproportionate control relative to ownership stake.
  (-) Might extract private benefits at the cost of minority shareholders.
  (-) Might be excessively risk-averse.

Percentage of large corporations that are family-controlled:
• Emerging markets: 60%
• Europe: 40%
• United States: 30%

Family-controlled corporations tend to:

- Exhibit superior long-term performance, especially when the founder serves as CEO.
- Maintain better employee relations, stronger culture.
- Be less prepared for CEO succession, make worse selection choices.
- Demonstrate higher earnings quality.
- Exhibit less transparency, engage in higher levels of insider trading.

Anderson and Reed (2003); Mueller and Philippon (2011); Pérez-González (2006); Ali, Chen, and Radhakrishnan (2007); Anderson, Duru, and Reeb (2009)
2. VENTURE-BACKED COMPANIES

- Venture capital (VC) firms:
  - Provide initial and early-stage capital to small, high-growth companies.
  - Focus on rapidly changing industries where potential returns and risk are high.
  - Reduce risk by investing in a diversified portfolio (a few highly successful investments offset a large number of losses).

- Venture capital funds:
  - Structured as a limited partnership.
  - Capital is committed for 10-years.
  - Capital is returned to investors when companies are sold or go public (IPO).
  - VC firm receives percent of the profits ("carried interest").
## 2. VENTURE-BACKED COMPANIES

### VENTURE CAPITAL SUMMARY STATISTICS

<table>
<thead>
<tr>
<th></th>
<th>1993</th>
<th>2003</th>
<th>2013</th>
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<tbody>
<tr>
<td>NUMBER OF VC FIRMS</td>
<td>370</td>
<td>951</td>
<td>874</td>
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<tr>
<td>NUMBER OF VC FIRMS RAISING $ THIS YEAR</td>
<td>93</td>
<td>160</td>
<td>187</td>
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<tr>
<td>VC CAPITAL RAISED THIS YEAR ($ BN)</td>
<td>4.5</td>
<td>9.1</td>
<td>16.8</td>
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<tr>
<td>VC CAPITAL UNDER MANAGEMENT ($ BN)</td>
<td>29.3</td>
<td>263.9</td>
<td>192.9</td>
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<tr>
<td>AVERAGE VC FUND SIZE TO DATE ($ M)</td>
<td>40.2</td>
<td>94.4</td>
<td>110.3</td>
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<tr>
<td>VC INVESTMENTS BY STAGE</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SEED</td>
<td>17.2%</td>
<td>1.9%</td>
<td>3.3%</td>
</tr>
<tr>
<td>EARLY STAGE</td>
<td>15.7%</td>
<td>18.3%</td>
<td>33.5%</td>
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<tr>
<td>EXPANSION</td>
<td>51.0%</td>
<td>49.7%</td>
<td>33.2%</td>
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<tr>
<td>LATER STAGE</td>
<td>16.1%</td>
<td>30.1%</td>
<td>30.0%</td>
</tr>
<tr>
<td>PERCENTAGE OF IPOs VC-BACKED</td>
<td>N/A</td>
<td>37.1%</td>
<td>47.9%</td>
</tr>
</tbody>
</table>
2. VENTURE-BACKED COMPANIES

• **Board of directors**
  – Tightly controlled: 4 directors, 2 of whom are members of VC firm.
  – Low independence (56% of directors); CEO rarely serves as chairman (15%).
  – No formal audit, comp, or governance committees until run-up to IPO.

• **Executive compensation**
  – Heavily weighted toward equity-based awards.
  – Prior to IPO, CEO holds 15% of equity, top five managers 26%, total directors and officers 63%.

• **Antitakeover protections**
  – Remain tightly controlled following IPO.
  – 77% staggered board, 15% dual-class shares, 69% restrict shareholder rights.

Wongsunwai (2007); Daines and Klausner (2001); Proskauer (2015)
2. VENTURE-BACKED COMPANIES

Venture-capitalists tend to positively impact the firms they invest in:

- Contribute to the “professionalization” of start-ups by replacing founder with outside CEO, introducing stock options, and influencing HR policies.
- Encourage innovation, investment in research, and deal activity.
- Demonstrate higher earnings quality.
- Positive effects are most pronounced among companies backed by “high-quality” VC firms.

Hellman and Puri (2002); Celikyurt, Sevilir, and Shivdasani (2014); Hochberg (2012); Klausner (2013); Wongsunwai (2007); Krishnan, Ivanov, Masulis, and Singh (2011)
3. PRIVATE EQUITY-OWNED COMPANIES

- Private equity firms are privately held investment firms that invest in businesses for the benefit of retail and institutional investors.

- Tend to target mature companies that generate substantial free cash flow to support a leveraged capital structure.

- Following acquisition, the target undergoes a complete change in management, board, strategy, and capital structure.

- If successful, the private equity firm sells the company back to the public or to a strategic or financial buyer.

- The private equity firm earns a carried interest and returns the remaining proceeds to investors.
# 3. Private Equity-Owned Companies

## Private Equity Summary Statistics

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Combined Enterprise Value</td>
<td>$257 BN</td>
<td>$149 BN</td>
<td>$554 BN</td>
<td>$1,055 BN</td>
<td>$1,563 BN</td>
<td>$3,616 BN</td>
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<tr>
<td>Number of Transactions</td>
<td>642</td>
<td>1,123</td>
<td>4,348</td>
<td>5,673</td>
<td>5,188</td>
<td>17,171</td>
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<tr>
<td>LBOs by Type</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Public to Private</td>
<td>49%</td>
<td>9%</td>
<td>15%</td>
<td>18%</td>
<td>34%</td>
<td>27%</td>
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<tr>
<td>Independent Private</td>
<td>31%</td>
<td>54%</td>
<td>44%</td>
<td>19%</td>
<td>14%</td>
<td>23%</td>
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<tr>
<td>Divisional</td>
<td>17%</td>
<td>31%</td>
<td>27%</td>
<td>41%</td>
<td>25%</td>
<td>30%</td>
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<tr>
<td>Secondary</td>
<td>2%</td>
<td>6%</td>
<td>13%</td>
<td>20%</td>
<td>26%</td>
<td>20%</td>
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<tr>
<td>Distressed</td>
<td>0%</td>
<td>1%</td>
<td>1%</td>
<td>2%</td>
<td>1%</td>
<td>1%</td>
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<tr>
<td>Type of Exit</td>
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<tr>
<td>Bankruptcy</td>
<td>6%</td>
<td>5%</td>
<td>8%</td>
<td>4%</td>
<td>3%</td>
<td>6%</td>
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<tr>
<td>IPO</td>
<td>25%</td>
<td>23%</td>
<td>11%</td>
<td>10%</td>
<td>1%</td>
<td>14%</td>
</tr>
<tr>
<td>Sold to Strategic Buyer</td>
<td>35%</td>
<td>38%</td>
<td>40%</td>
<td>38%</td>
<td>34%</td>
<td>38%</td>
</tr>
<tr>
<td>Sold to Financial Buyer</td>
<td>13%</td>
<td>17%</td>
<td>23%</td>
<td>31%</td>
<td>17%</td>
<td>24%</td>
</tr>
<tr>
<td>Sold to LBO-Backed Firm</td>
<td>3%</td>
<td>3%</td>
<td>5%</td>
<td>7%</td>
<td>19%</td>
<td>5%</td>
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<tr>
<td>Sold to Management</td>
<td>1%</td>
<td>1%</td>
<td>2%</td>
<td>1%</td>
<td>1%</td>
<td>1%</td>
</tr>
<tr>
<td>Other or Unknown</td>
<td>18%</td>
<td>12%</td>
<td>11%</td>
<td>8%</td>
<td>24%</td>
<td>11%</td>
</tr>
</tbody>
</table>

Kaplan and Strömberg (2008)
3. PRIVATE EQUITY-OWNED COMPANIES

• **Board of directors**
  – Small: 5 to 7 directors, heavily represented by insiders.
  – Closely involved in strategic and operating decisions.
  – Require more time than public boards (54 days v. 19 days, per year).

• **Executive compensation**
  – Lower salary but higher total pay opportunity than public company CEOs.
  – CEO equity stake in company doubles following sale to PE firm.
  – Performance targets shifted from qualitative to profitability measures.
  – Equity awards contain a mix of performance and time-vested awards.

• **Capital structure**
  – Debt-to-equity ratio triples following acquisition (25% to 71%).

Acharya, Kehoe, and Reyner (2008); Leslie and Oyer (2009); Cronqvist and Fahlenbrach (2013); Guo, Hotchkiss, and Song (2011)
Private equity owners have an uncertain impact on the firms they invest in:

- Tend to outperform publicly traded companies.
- Are aggressive in redirecting investment from less productive to more productive activities.
- Still, it is unclear the extent to which returns are driven by operating improvement, rather than increases in leverage and tax reduction.
- Research is mixed on how private and public equity returns compare on a risk-adjusted basis.

Phalippou and Gottschalg (2009); Harris, Jenkinson, and Kaplan (2014); Guo, Hotchkiss, and Song (2011); Acharya, Gottschalg, Hahn, and Kehoe (2013); Davis, Haltiwanger, Handley, Jarmin, Lerner, and Miranda (2014)
4. NONPROFIT ORGANIZATIONS

- Nonprofit organizations operate in a wide range of activities, including:
  - Education
  - Social and legal services
  - Arts and culture
  - Health services
  - Civic, fraternal, and religious organizations.

- Tax-exempt under rule 501(c) of the Internal Revenue Code.

- Have a stakeholder (rather than shareholder) orientation.
4. NONPROFIT ORGANIZATIONS

NONPROFIT SUMMARY STATISTICS

<table>
<thead>
<tr>
<th>Category</th>
<th>U.S. TOTALS 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>REGISTERED NONPROFITS</td>
<td>1.4 M</td>
</tr>
<tr>
<td>PUBLIC CHARITIES, 501(c)(3)</td>
<td>1.0 M</td>
</tr>
<tr>
<td>FINANCIAL INFORMATION</td>
<td></td>
</tr>
<tr>
<td>TOTAL REVENUES</td>
<td>$1.65 T</td>
</tr>
<tr>
<td>TOTAL ASSETS</td>
<td>$2.99 T</td>
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<tr>
<td>BREAKDOWN OF CHARITIES</td>
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<tr>
<td>ARTS, CULTURE, HUMANITIES</td>
<td>9.9%</td>
</tr>
<tr>
<td>EDUCATION</td>
<td>17.1%</td>
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<tr>
<td>ENVIRONMENT, ANIMALS</td>
<td>4.5%</td>
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<td>HEALTH</td>
<td>13.0%</td>
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<tr>
<td>HUMAN SERVICES</td>
<td>35.5%</td>
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<tr>
<td>INTERNATIONAL AFFAIRS</td>
<td>2.1%</td>
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<tr>
<td>PUBLIC, SOCIAL BENEFIT</td>
<td>11.6%</td>
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<tr>
<td>RELIGION-RELATED</td>
<td>6.1%</td>
</tr>
</tbody>
</table>

McKeever and Pettijohn (2014)
4. NONPROFIT ORGANIZATIONS

- **Board of directors**
  - Large: 16 members.
  - CEO rarely serves as chairman.
  - Directors often have significant fundraising obligations.
  - Audit committee not required.

- **Executive compensation**
  - Significantly lower than for-profit companies ($130,000 median).
  - Comprised of salary and cash bonus.

### BOARD ATTRIBUTE | U.S. AVERAGE 2012
---|---
NUMBER OF DIRECTORS | 16
NUMBER OF MEETINGS PER YEAR | 7
NUMBER OF COMMITTEES | 5.5
AUDIT COMMITTEE | 72%
DUAL CHAIR/CEO | 3%
CEO NONVOTING DIRECTOR | 40%
CEO NOT ON BOARD | 46%
DIRECTORS REQUIRED TO DONATE | 75%
DIRECTORS REQUIRED TO FUNDRAISE | 42%
FEMALE DIRECTORS | 45%
ETHNIC MINORITY DIRECTORS | 18%

BoardSource (2012)
Governance quality varies significantly across organizations:

- Many board members do not fully understand their obligations as directors.
- Many do not understand strategy, mission, and performance of the organization.
- Many nonprofits lack formal governance processes (external audit, internal controls, succession planning, board evaluations).

Nonprofits with weak controls are more likely to exhibit agency problems (e.g., understate or shift costs to appear more efficient).

Stanford University, BoardSource, and GuideStar (2015); Krishnan, Yetman, and Yetman (2006); Krishnan and Yetman (2011)


Proskauer LLP. 2015 IPO Study. 2015.


Stanford Graduate School of Business, Rock Center for Corporate Governance at Stanford University, BoardSource, and GuideStar. 2015 Survey on Board of Directors of Nonprofit Organizations. April 2015.
