Going-Private Transactions – An Overview

In recent years an increasing number of small to mid-sized pubic companies have elected to go private for reasons including: (i) eliminating legal, accounting and public relations costs associated with being a public company, (ii) focusing on long term company objectives rather than being dictated by the short term results driven culture fostered by quarter to quarter reporting, (iii) reducing the potential for securities litigation against the company, its directors and officers and well as director and officer liability under SOX, (iv) reducing the disclosure of sensitive business information associated with SEC reporting requirements, and (v) allowing additional corporate governance flexibility.

In going-private transactions, a controlling shareholder typically acquires the shares of minority shareholders in a public company for cash, debt or stock thereby reducing the company's shareholder base sufficiently to permit the company to elect to terminate its status as a public company. Under SEC rules, a company may elect to go private when it is owned, directly or indirectly, by fewer than 300 persons. Going-private transactions take a variety of forms but typically are (i) accomplished by a merger, tender offer or reverse stock split, (ii) spearheaded by the company's senior management, and (iii) financed by third party debt and/or equity financers. The form chosen for the transaction in any particular case depends on need for outside financing, the composition of the shareholder base and the likelihood of a competing bid for the company, among other factors.

Tender Offer

A tender offer is the structure of choice when the proponents of the going-private transactions do not own a controlling interest in the company. In order to take acquire a controlling interest in a company, proponents of going private offer to purchase shares held by certain or all of the shareholders on an individual basis. Under Delaware law a controlling interest is obtained when an acquirer owns at least 90%. As a result, tender offers are commonly conditioned on the acquirer obtaining this threshold ownership mark which allows the acquirer to perform a short form merger or reverse stock split to obtain the remaining outstanding shares. If the board of directors has assisted the acquirer in the course of the tender offer, the company is generally required to form a special committee that advises the shareholders to tender. Acquirers often favor tender offers since independent court appraisal of their share value is not available to shareholders who accept a tender offer.

Merger

State laws generally provide for two types of mergers: long and short form mergers. In long form mergers, an acquirer negotiates and executes a merger agreement with the company's board of directors and, if approved by a vote of the company's shareholders, the company mergers with an entity formed by the acquirer and shares of the company's stock are converted into the rights to assert appraisal rights or receive the merger consideration. A long form merger generally leaves the surviving company with one shareholder, a subsidiary of the acquirer. Short form mergers allow an acquirer who has more than 90% of the company's stock to merge without a vote of shareholders. Minority shareholders receive cash or debt in exchange for their shares subject to appraisal rights under applicable state law.

"Entire Fairness" Standard

Ordinarily the decisions of a company's board of directors are governed by the "business judgment rule" in determining whether it has fulfilled its fiduciary duty to shareholders to act in good faith, informed manner, without self dealing or direct self interest. In interested transactions, such as going private transactions, where directors are also members of the buyout group, Delaware courts have applied a more rigorous "entire fairness" standard. The standard requires the acquirer in a going private transaction to prove the elements of "fair dealing" and "fair price". Fair dealing relates to the process by which the transaction was approved by examining factors such as the timing of the transaction, how it was initiated, structured and negotiated and how director and shareholder approval was obtained. Fair price involves an economic analysis of value received by shareholders.

The burden of proving the entire fairness of a given transaction is normally placed on the acquirer. In order to avoid conflicts of interest and shift the burden of proof to the challenger of a given transaction it is now standard practice for a company's board to appoint a special committee of independent directors to negotiate an arm's length transaction in the best interest of shareholders. For a special committee to operate independently and for the company to obtain the benefit of burden shifting "particular consideration must be given to the evidence of whether the special committee was truly independent, fully informed, and had the freedom to negotiate at arm's length."[1] The role of the special committee is to negotiate the best deal for shareholders, and therefore it should retain its own legal and financial advisers and should not be influenced by the actions of insiders. Although the burden of proof can be shifted by utilizing a special committee, the entire fairness of the private transaction must still be demonstrated.

The appointment of a special committee is standard practice in long form mergers since they require board and shareholder approval. Tender offers do not automatically trigger the entire

[1] Kahn v. Lynch Comm'n Sys., 638 A.2d, 1110, 1120-21 (Del. 1994)

fairness test but Delaware courts have required that offers conducted by controlling shareholders must include certain terms to ensure that they are non-coercive.

SEC Scrutiny

Viewing them as inherently one-sided, the SEC requires extensive disclosure and closely scrutinizes going-private transactions. Schedule 13E-3 requires disclosures and certifications regarding the following items:

- The purpose of the transaction
- Whether alternatives were considered and why they were rejected
- Reasons for the structure of the transaction
- Identity of persons filing, including affiliates engaged in the transaction
- Description of the relationship of the buyers of the company and their roles in the transaction
- All expenses relating to the transaction
- Why the transaction is being undertaken at this time
- Why the company or affiliate taking the company private believes the transaction is fair
- All reports, opinions and appraisals relating to the value of the transaction
- Extensive audited financial information

Keys to a Successful Going Private Transaction include the following:

- Appoint an independent and diligent Special Committee of the Board with broad authorization to negotiate an arm's length transaction that is conducted in a fair and transparent manner
- Retain independent legal counsel and financial advisers to the Special Committee
- Keep detailed minutes of the Board of the Special Committee meeting relating to the transaction, and a detailed record of all negotiation, deliberation and proceedings relating to the consummation of the transaction
- Agree on a price that is "demonstrably fair"