

CONSIDERING A GOING-PRIVATE TRANSACTION: A REVIEW OF THE GOING-PRIVATE PROCESS

Scott D. Levine, CPA, ABV, CFA, ASA; Joseph L. Landen, CPA, CFA; and Jessica Zeldin, Esq.

INTRODUCTION

Publicly traded companies are increasingly less interested in remaining publicly owned. Valuations have declined since the U.S. equity markets peaked in March 2001. In addition, the annual costs and time requirements to comply with greater financial reporting and regulatory requirements for public companies have increased significantly.

As illustrated in Figure 1 below, the Sarbanes-Oxley Act of 2002 increased scrutiny by the investing public, and various regulatory requirements enacted by the Securities and Exchange Commission (SEC) are causing publicly traded companies to evaluate whether they should remain public.

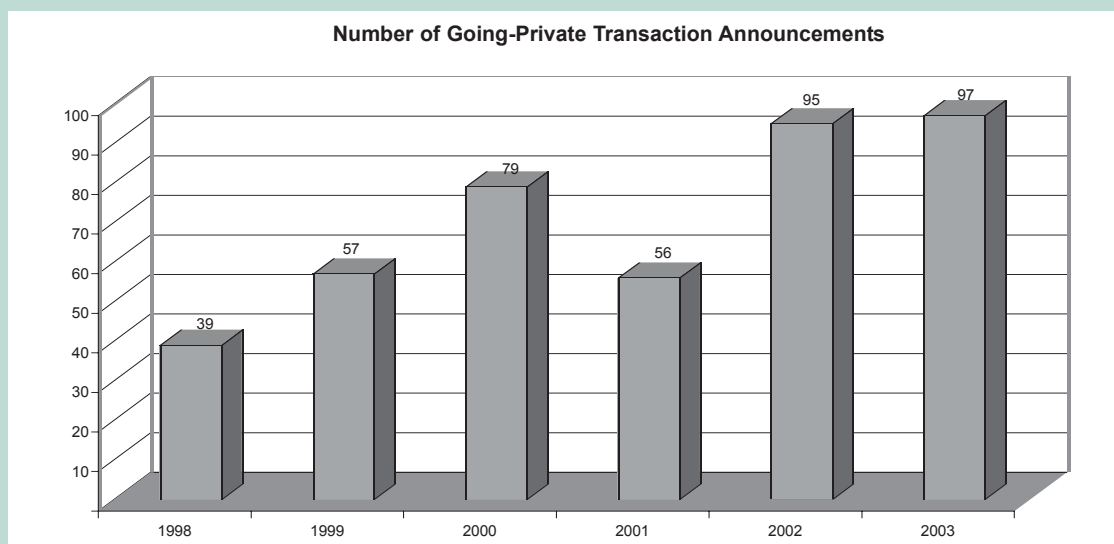
“Going-private transactions can also maximize shareholder value.”

An increasing number of small and mid-sized public companies have recently started to explore strategic ownership alternatives that include a potential sale of the company. An alternative to an outright sale of the company is a going-private transaction. Going-private transactions (1) can eliminate the economic costs required of publicly traded companies and (2) still allow a company to maintain its existing management structure. Going-private transactions can also maximize shareholder value.

Going-private transactions generally involve the acquisition of the equity of a publicly traded company by (1) the majority owners of the company or (2) the company’s management team. Going-private transactions are consummated for a vari-

Figure 1
Observations Concerning Going-Private Transactions and the Current Regulatory Environment

- Since the August 2002 passage of the Sarbanes-Oxley Act: (1) accounting costs for companies with less than \$3.0 billion in annual sales are estimated to have doubled,¹ and (2) the number of public companies that have completed going-private transactions have increased by an estimated 30 percent.²
- According to Securities Data Corporation (SDC), the number of going-private transaction announcements increased from 56 transactions in 2001 to 97 transactions in 2003.



Notes:

1. Based on a study by Grant Thornton LLP.
2. Based on a study by Foley & Lardner LLP.

ety of reasons. Those companies that are particularly good candidates for a going-private transaction include:

1. small capitalization companies, because the costs related to financial reporting and regulatory requirements are disproportionately high, and
2. companies that are not covered by securities analysts, which results in reduced institutional ownership and liquidity.

This article will discuss:

1. the advantages and disadvantages of a going-private transaction;
2. the different types of transaction structures used to complete going-private transactions, including certain legal aspects specific to each of these structures; and
3. the important role that independent financial advisors play in a going-private transaction.

“There are two categories of going-private transactions: (1) true going-private transactions and (2) technical going-private transactions.”

ADVANTAGES AND DISADVANTAGES OF GOING PRIVATE

During the past few years, many management teams, boards of directors, and majority owners of publicly traded companies concluded that the reasons that originally motivated a company to initiate a public offering either (1) no longer exist or (2) have been offset by the increased costs incurred to remain public. Many companies complete initial public offerings (IPOs) (1) to provide greater access to capital and (2) to obtain a higher level of industry prominence, among other reasons. However, after a company reaches a certain level of maturity, it may no longer need the access to capital that the public market provides.

Additionally, visibility in the public market has declined materially for many companies in recent years. This is due to (1) investment banks downsizing their analyst departments and ceasing coverage of many small and mid-sized companies, and (2) institutional investors generally following and investing in larger companies.

Some of the advantages of a going-private transaction include the opportunity to:

1. acquire the company’s equity at attractive prices in a depressed market and maximize shareholder value to existing shareholders;
2. reduce legal, accounting, and public relations costs;
3. eliminate the need to issue financial statements and other company information to the public;

4. manage the company for the long term without the pressure to maximize quarterly profits;
5. prevent the company from being subject to a hostile takeover attempt;
6. avoid exposure to liability under certain federal securities laws by removing conflicts of interest and SEC-mandated fiduciary duties; and
7. reduce the amount of time needed to comply with new reporting and corporate governance responsibilities created by Sarbanes-Oxley.

The potential disadvantages related to a going-private transaction include: (1) reduced access to capital markets, (2) reduced liquidity for the remaining shareholders, (3) a potentially lower level of public visibility, and (4) a potentially lower level of industry prominence.

Other factors that should be considered prior to initiating a going-private transaction include: (1) the cost and difficulty related to financing such a transaction, (2) the limitations imposed by bank covenants, and (3) the legal exposure that may be created by a going-private transaction.

TRANSACTION METHODOLOGIES AND LEGAL STANDARDS

There are two categories of going-private transactions: (1) true going-private transactions and (2) technical going-private transactions. True going-private transactions are designed to eliminate all public shareholder ownership in a company. Technical going-private transactions are designed to terminate a company’s public reporting requirements by reducing the number of shareholders below a certain threshold.

The three most popular going-private transaction structures are:

1. the traditional negotiated merger method,
2. the tender offer and short-form merger method, and
3. the reverse stock split method.

The structure of the going-private transaction typically determines the legal standards to which the buyers and sellers are held.

TRADITIONAL NEGOTIATED MERGER METHOD

The traditional negotiated merger method is a true going-private transaction. This method generally starts with a propos-

al—from an individual or group that is seeking to acquire control of the company—that is submitted to the company’s board of directors. Often this expression of interest is provided by the company’s management or majority shareholder. The buyer typically pays a premium to the company’s publicly traded stock price to entice public shareholders to sell.

If the offer is accepted, the parties enter into a merger agreement. The target company is required to issue a proxy statement that describes the terms of the transaction to all shareholders. And, shareholder approval is necessary to complete the transaction.¹

Because the same individuals managing or controlling the company—for the benefit of the public shareholders—are also negotiating the purchase of the company, traditional going-private transactions involve an inherent conflict of interest. This conflict of interest may lead to (1) additional public disclosure as well as (2) an increased level of scrutiny by the SEC.²

State law also imposes heightened fiduciary obligations in the context of a negotiated going-private merger with a controlling group. The buyer will likely owe fiduciary obligations to the minority shareholders.³ Many courts, such as those in Delaware, evaluate controlled, going-private mergers under the stringent “entire fairness” test rather than defer to the directors’ business judgment.⁴ If minority shareholders challenge the transaction in a lawsuit, the entire fairness test requires the defendants to prove that the transaction was entirely fair as to both process and price.⁵

According to the Delaware Supreme Court:

The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of the company’s stock.⁶

The test of fairness is not a bifurcated one; rather, all aspects of the issue are examined as a whole.⁷

The burden of proving entire fairness is not insurmountable and can be shifted (1) by use of an independent committee of directors that exercises real arm’s-length bargaining power (a so-called “Special Committee”) or (2) by conditioning the merger on the approval of a fully informed majority of the minority vote.⁸ Because a majority of the minority votes is

uncertain, most going-private mergers rely on a Special Committee to alleviate the potential for liability.

To be effective, a Special Committee must “function in a manner which indicates that the controlling shareholder did not dictate the terms of the transaction and that the committee exercised real bargaining power ‘at arm’s-length.’”⁹ The Special Committee should be empowered to negotiate with the controlling shareholder and must have—and be willing to exercise—the discretion to “say no” and veto the transaction if it is unfair.¹⁰

The Special Committee may also want to explore strategic alternatives and canvas the market for other buyers. If the controlling shareholder has made it clear that it is not willing to sell its shares to such a third-party buyer, the Special Committee’s task becomes not one of maximizing the control premium for the minority shareholders, but one of obtaining the best available terms from the minority’s point of view.¹¹

In fulfilling these obligations, it is important for the Special Committee to engage competent and independent legal and financial advisors.

“The test of fairness is not a bifurcated one; rather, all aspects of the issue are examined as a whole.”

TENDER OFFER AND SHORT-FORM MERGER METHOD

The tender offer and short-form merger method is also a true going-private transaction. This transaction structure consists of two steps.¹² First, an insider group makes a tender offer to all stockholders. A short-form merger is completed, without a shareholder vote, after the insider group acquires 90 percent of the company’s stock.¹³

One advantage of this method is that mergers based on tender offers can close in 20 business days.¹⁴ This is materially less time than the months required for the traditional merger method (due to proxy and shareholder voting requirements). Other advantages of this method are that (1) the transaction need not be entirely fair and (2) there may be no need to negotiate with a Special Committee.¹⁵

Because tender offers involve a voluntary decision by tendering shareholders,¹⁶ state courts generally apply less scrutiny to going-private transactions effectuated by tender offers followed by a short-form merger than by a one-step merger. In Delaware, the entire fairness review does not apply to such transactions so long as the first-step tender offer (1) includes full disclosure and (2) is not coercive.¹⁷

To be noncoercive, a going-private tender offer must:

- be subject to a nonwaivable majority of the minority tender condition,
- include a promise by the controlling shareholder to complete a prompt short-form merger if it obtains 90 percent of the shares at the tender offer price, and

- not involve any retributive threats by the controlling shareholder.¹⁸

Federal law still imposes a duty on the target company to take a position with respect to most tender offers (or to make a statement as to why it cannot take a position).¹⁹ In making this recommendation, at least one Delaware court has imposed upon the independent directors of the target a duty (1) to act in good faith and diligently, and (2) to pursue the best interest of the minority.²⁰ Moreover, a controlling shareholder has been held to owe:

. . . a duty to permit the independent directors on the target board both free rein and adequate time to react to the tender offer, by (at the very least) hiring their own advisors, providing the minority with a recommendation as the advisability of the offer, and disclosing adequate information for the minority to make an informed judgment.²¹

Creating a Special Committee of disinterested and independent directors to evaluate the tender offer is the best way to insure that these duties are fulfilled.

REVERSE STOCK SPLIT

The reverse stock split method is a technical going-private transaction. This structure often requires a company to recapitalize and amend its certificate of incorporation; such changes generally require a stockholder vote for approval.²²

For example, Company ABC issues one new share of company stock for every 25,000 shares of existing company stock. All shareholders who own less than 25,000 shares prior to the recapitalization own a fractional share of company stock post recapitalization. The ownership interests of these fractional shareholders are then redeemed by the company in exchange for cash. The company's registration with the SEC is eliminated once the number of shareholders declines below the SEC threshold of 300 shareholders.²³ However, a shareholder vote is still required, and the risk of litigation from frustrated shareholders still exists.²⁴

Like traditional mergers, going-private transactions utilizing a reverse stock split structure (1) are subject to entire fairness review and (2) often involve the formation of a Special Committee.²⁵

While the structures used to complete a true or technical going-private transaction may differ, a majority of going-private transactions are consummated through the use of leverage—where the assets of the company are pledged as collateral for debt financing. Other forms of financing often used to complete a going-private transaction include (1) new equity,

- (2) the rollover of corporate insiders' stock in the company, or
- (3) the company's own cash—a form of self-financing.

Additionally, some companies establish an employee stock ownership plan (ESOP) to be used as a vehicle to help finance a going-private transaction. Unique financing alternatives available to an ESOP include using:

1. the rollover of retirement plan assets into an ESOP trust for the purchase of the company's stock and
2. the pledge of future company retirement plan contributions to secure debt financing in a leveraged transaction.

THE ROLE OF THE INDEPENDENT FINANCIAL ADVISOR

Regardless of the structure, use of a qualified and independent financial advisor is often critical to the success of a going-private transaction. The primary role of the independent financial advisor in a going-private transaction is to render a fairness opinion on the proposed transaction to the company's board of directors or Special Committee. (The board of directors and the Special Committee are hereinafter collectively referred to as the "Special Committee").

According to *The Handbook of Advanced Business Valuation*, "A fairness opinion is a letter, prepared by a knowledgeable financial advisory firm (generally an investment banking firm or an entity specializing in valuations), that states whether or not the transaction—or the consideration or financial terms of the transaction—are fair. Fairness is assessed from a financial point of view, to one or more parties as of a specific date, based on certain assumptions, limitations, and procedures."²⁶

It is important to note that a fairness opinion letter is a formal document that is included in transaction-related filings with the SEC.

A fairness opinion letter describes the analyses prepared, procedures performed, and opinions reached by the financial advisor. The analysis that is completed in preparing a fairness opinion letter involves extensive due diligence procedures related to the company and the proposed transaction. The due diligence process completed by the independent financial advisor consists of:

1. a review of company historical and prospective financial statements,
2. management interviews and site inspections,
3. a review of relevant economic and industry information,
4. an analysis of the company's historical and prospective financial performance,
5. selection and completion of relevant valuation analyses (i.e., market, income, or asset-based approaches),

6. an analysis of the terms of the transaction including the securities (if any) that are part of the consideration, and
7. the preparation of a fairness opinion letter.

A fairness opinion does not address whether the going-private transaction is fair on a legal basis. Nor does a fairness opinion recommend the going-private transaction from the position of the Company.

To appropriately document the due diligence process, the independent financial advisor typically prepares presentation books. These presentation books contain summaries of the advisor's financial analysis for distribution to the Special Committee. The independent financial advisor then conducts a presentation that explains its fairness opinion to the Special Committee. Based on this presentation, as well as on other things including the advice of its legal advisors, the Special Committee will determine how to proceed with the transaction.

Due to the complexity of completing a going-private transaction, the selection of an appropriate independent financial advisor is extremely important. Unlike attorneys and accountants, financial advisors that provide fairness opinions are not subject to state or federal licensing regulations. Therefore, in selecting an independent financial advisor, the Special Committee should (1) avoid financial advisors that may have a conflict of interest²⁷ and (2) carefully consider the financial advisor's valuation expertise and experience with regard to (a) going-private transactions and (b) the valuation of similar companies.

SUMMARY AND CONCLUSION

A going-private transaction is increasingly viewed as an attractive alternative to remaining public. However, the board of directors should consider both the advantages and disadvantages of a going-private transaction before pursuing this corporate action.

Increased scrutiny by the investing public and by regulatory agencies, higher costs, and lower valuations are some of the disadvantages public companies currently face. If a board of directors decides to pursue a going-private transaction, it is prudent for the board to carefully consider the benefits obtained by forming a Special Committee with the ability to engage independent legal counsel and independent financial advisors.

Notes:

1. Shareholders who oppose the merger may have the right to petition a court to determine the fair value of their shares. See, e.g., 8 Del. C. § 262.
2. Securities and Exchange Commission Rule 13e-3 covers all going-private transactions and subjects a company completing a going-private transaction to specific filing and disclosure requirements that include the filing of Schedule 13e-3.
3. See, e.g., *Kahn v. Lynch Communications Sys., Inc.*, 638 A.2d 1110, 1112 (Del. 1994). Delaware courts have found, in the context of going-private transactions, that a shareholder with less than 50 percent ownership of the outstanding stock is a controlling person, owing a duty of fairness to the public, minority shareholders. See, e.g., *id.* at 1113-14 (holding that shareholder that owned 43.3 percent of outstanding stock, designated 5 of 11 directors on the target corporation's board, opposed alternative transactions, and had a veto on alternative transactions because of a super-majority voting requirement in the company's charter owed fiduciary duties); *In re Cysive, Inc.*, 846 A.2d 531, 551-52 (Del. Ch. 2003) (holding that entire fairness was applicable to a transaction in which the CFO and CEO and family members owned 40 percent of the outstanding stock).
4. *Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997).
5. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).
6. *Id.*
7. *Id.*
8. *Kahn v. Lynch*, 638 A.2d at 1116-17.
9. *Kahn v. Tremont*, 694 A.2d at 429.
10. *Kahn v. Lynch*, 638 A.2d at 1119.
11. See *Mendel v. Carroll*, 651 A.2d 297, 304-06 (Del. Ch. 1994).
12. The controlling group may be able to take the company private solely through use of a short-form merger if it already owns a large amount of the stock—normally 90 percent. See, e.g., 8 Del. C. § 253. In Delaware, short-form mergers will not be subject to the entire fairness rule (discussed herein) absent "fraud, gross overreaching, or other such wrongful conduct" or inadequate disclosure. *In re Unocal Exploration Corp. S'holders Litig.*, 793 A.2d 329, 338 (Del. Ch. 2000), *aff'd sub nom.*, *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242 (Del. 2001). Accordingly, shareholders who are unhappy with the short-form merger price have no remedy other than their statutory right to appraisal. *Id.*
13. See, e.g., 8 Del. C. § 253.
14. 17 C.F.R. § 240.14a-3.
15. Only shareholders who refuse to tender into the merger and who are cashed-out in the second-step, short-form merger will generally have appraisal rights. See, e.g., 8 Del. C. § 262.

"Due to the complexity of completing a going-private transaction, the selection of an appropriate independent financial advisor is extremely important."

16. See, e.g., *Solomon v. Pathe Communications Corp.*, 672 A.2d 35, 89 (1996).
17. *In re Aquila Inc.*, 2002 WL 27815 (Del. Ch. Jan. 3, 2002) (establishing rules for first-step tender offer); *In re Siliconix Inc. S'holders Litig.*, 2001 WL 716787 (Del. Ch. July 19, 2001) (same); *Unocal Exploration*, 793 A.2d at 338 and n.26 (establishing rules for second-step, short-form merger). Of course, even if a court does not probe into price, minority shareholders will. The case of Siliconix—the subject of one of the principle legal decisions—is illustrative. Even though the Court did not enjoin the tender offer based on the alleged unfair price, minority shareholders rejected the offer.
18. *In re Pure Resources S'holders Litig.*, 808 A.2d 421, 445 (Del. Ch. 2002); see also *In re Next Level Communications, Inc. S'holders Litig.*, 834 A.2d 828, 846 (Del. Ch. 2003). In *Pure Resources*, the Court of Chancery found that the majority of the minority condition was defective because the definition of "minority" included stockholders who were affiliated with the controlling shareholder by virtue of employment, severance, and put agreements. *Id.* at 446.
19. 17 C.F.R. § 240.14e-2.
20. *In re Pure Resources*, 808 A.2d at 445. That court, however, found that the independent directors had no obligation to block the transaction through, for example, the use of a poison pill. *Id.* at 446.
21. *Id.* at 445.
22. See, e.g., 8 Del. C. § 242.
23. Michael T. Burr. "Going Private Trend Falls Short of Expectations: 'Entire Fairness' Doctrine Creates Legal Buzz Saw for Acquirers." *Corporate Legal Times*, August 2002, p. 16.
24. *Id.*
25. See, e.g., *Applebaum v. Avaya*, 812 A.2d 880 (Del., 2002).
26. Robert F. Reilly and Robert P. Schweih. *The Handbook of Advanced Business Valuation* (New York, NY: McGraw-Hill, 1999), p. 310.
27. In order to prevent the appearance of a conflict of interest, the Special Committee's selection of a financial advisor should not be a firm providing investment banking services to the company, a bank that provides commercial lending or trustee services to the company, or a firm that derives income from any other services to the company (other than income from appraisal services).

Scott Levine is a principal in our Washington, D.C., office. Scott can be reached at (703) 235-4607 or sdlevine@willamette.com.

Joe Landen is a senior associate in our Washington, D.C., office. Joe can be reached at (703) 235-4602 or jllanden@willamette.com.

Jessica Zeldin is counsel to Rosenthal, Monhait, Gross & Goddess, P.A., a Wilmington, Delaware-based law firm. She can be reached at jzeldin@rmgglaw.com.

The opinions expressed in this article are those of the authors only and do not necessarily represent the views of Rosenthal, Monhait, Gross & Goddess, P.A. or its clients.

We are pleased to announce that
Kenneth J. Pantoga
has joined our San Francisco office as a
principal and director of valuation services

Ken will be responsible for all business enterprise valuation, security analysis, and intangible asset/intellectual property valuation and transfer price analyses.

In particular, Ken specializes in financial valuation services related to financial accounting, corporate strategic planning, gift and estate tax, domestic and international income tax, ESOPs, solvency and insolvency issues, and shareholder disputes and other litigation matters.

Before joining the firm, Ken was a director of valuation and financial advisory services for the Huron Consulting Group. Before that, he was a senior manager in the Arthur Andersen valuation services group.

Ken holds a BS degree in history from the University of Wisconsin at Madison and an MBA degree in finance from the University of Texas at Austin. Ken is also a CFA (chartered financial analyst).

We are pleased to announce that
H. Carter Maser
has joined our San Francisco office as a
principal and
director of restructuring

Carter specializes in litigation support, expert testimony, and dispute resolution services; financial advisory/capital market transaction and financing opinion services; and troubled company valuation, restructuring, and reorganization services.

Before joining the firm, Carter was a senior manager with the Deloitte & Touche financial advisory and restructuring services practice. Before that, he was a manager in the Arthur Andersen corporate finance: restructuring and turnaround services group.

Carter holds a BA degree in political science from the University of California at Berkeley and an MBA degree in finance from Cornell University.