

Going Private: What Companies Need to Know

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Overview

- What is Going Private?
- Going Private versus Going Dark.
- What is the process for Going Private?
- Is there potential liability for Going Private?
- What are the benefits of Going Private?
- What are the downsides of Going Private?

What is Going Private?

- Any of the below transactions or series of transactions which produce the effect of either:
 - causing a class of securities to be held by less than 300 record holders (or 500 if < \$10M in assets) and therefore eligible for termination of registration and suspension of reporting obligations*; or
 - delisting any class of securities from an exchange or NASDAQ**
- **Transactions**
 - Purchase of an equity security by an issuer or its affiliate
 - Tender offer by an issuer or its affiliate
 - Proxy solicitation covering a merger, consolidation or recapitalization
 - Sale of substantially all assets to an affiliate
 - Reverse stock split involving purchase of fractional interests

*Issuer subject to Section 12(g) or Section 15(d) of the Act

** Issuer subject to Section 12(b) of the Act

Going Dark vs. Going Private

Going Private – the issuer, an affiliate or a private equity firm acquires all of the outstanding stock

- Going Private usually involves the cash-out of all or almost all of a company's public shares
- Can take many forms (e.g. merger, tender offer or reverse split)
- Usually undertaken by controlling stockholders or third party acquirers
- Issuer delists shares from exchange or NASDAQ*
- Issuer deregisters its shares with the SEC
- Minority shareholders are cashed out

*If on the OTCBB no need to delist

Going Dark vs. Going Private

Going Dark

- Issuer does not acquire all of the outstanding stock
- Does not involve the cash out of all or almost all of a Company's shares
 - Issuer with less than 300 record holders (or less than 500 if assets are < \$10 million) voluntarily ceases to be a reporting company; or
 - Issuer delists shares from exchange (not applicable to OTCBB companies)
 - Issuer deregisters its shares with the SEC

Going Dark vs. Going Private

Going Dark transactions usually entail:

- Potential fiduciary concerns
- Trading continues, typically with a drop in share price and volume
- Litigation risks (less significant than risks involved in going private)
- Shareholder base typically does not change
- If number of shareholders returns to 300/500, the SEC reporting requirements are reinstated, regardless of whether US or foreign
- Reduced level of ongoing stockholder disclosure

Why Go Private?

- Expenses can total nearly \$2 million even for relatively small companies
 - Preparing and filing periodic reports and other SEC documents
 - Investor relations requirements – press release issuances, research analyst discussions, shareholder discussions and investor conferences
 - Legal and accounting costs
 - SOX 404 compliance
 - Current market and regulatory environment – diminished benefits to remaining public
- Reduced benefit of being public for smaller companies
 - Limited research coverage
 - Lower trading volume/liquidation
 - Limited access to capital markets
- Minimize management diversion
- Focus on long-term goals & objectives
- Decrease liability
- Reduce or eliminate the obligation to disclose competitive business information (“materiality” effect upon smaller companies)

First Steps in Going Private

- Engage in cost-benefit analysis of remaining public versus going private
- Review record stockholder list to determine number and nature of holders
- Review relevant documents to ascertain any restrictions from going private – contracts, financing documents, credit agreements, stock option plans, certificate of incorporation, bylaws
- Determine structure (e.g. tender offer, merger, reverse stock split)
- Determine timing of Going Dark/Going Private
 - Consider two step process of first going dark and then going private

Going Private Transaction Structure

- Tender Offer
 - Acquirer (may be company, management, or third party) sends a written offer document that sets forth the terms of the offer containing SEC disclosures and a letter of transmittal to the shareholders
 - If the acquirer obtains 90% of the company's stock, can perform a short form merger whereby the remaining 10% shares are converted into a right to assert appraisal rights or right to receive merger consideration
 - Why a tender offer?
 - Faster – No proxy statement and shareholders who accept the tender have no right to seek independent court appraisal of the value of their shares
- Long Form Merger
 - Acquirer negotiates and executes a merger agreement with the company's board of directors (i.e. Special Committee)
 - Upon board approval, shareholders vote on the transaction
 - Why a long form merger?
- Reverse Stock Split
- Factors To Consider:
 - Need for outside financing
 - Composition of the stockholder base
 - Likelihood of a competing bid
 - Timing of transaction

Mechanics of Going Dark

- To deregister, a Company must file a Form 15 disclosing the number of its holders of record
- To delist from an exchange, a Company must file a Form 25
- Reporting obligations can never be terminated – only suspended
- Thus, if the number of stockholders of a company subsequently increases to more than 300/500, a company's SEC reporting obligations will be reinstated be it foreign or domestic

Sample Timeline

Going Dark

- Day 1: Issue press release and file issue press release and file report with the SEC announcing intention to delist from exchange and go dark
- Day 10: File a report with the SEC*
- Day 20: Delisting is effective. File a report with the SEC **
- Day 21: Stock begins (or continues) trading on the Pink Sheets

*Form 25 required by Section 12b

** if the company was subject to Section 12(g) prior to its listing on an exchange

Sample Timeline (cont'd)

- Day 100: Form 25 becomes effective*
(now deregistered from the SEC. No further SEC reporting obligations)
- Day 110: Form 15 becomes effective**
(now deregistered from the SEC. No further SEC reporting obligations)

*deregistered under Section 12(b); no further SEC obligations under Section 12(b)

** deregistration under Section 12(g); suspension of reporting obligations under Section 15(d) (if applicable)

Sample Timeline - Going Private*

Tender Offer/Short Form Merger

- Day 1: Form Special Committee and hire separate special committee counsel
- Day 1-10: Special Committee and buyers negotiate terms of the tender offer and merger agreement.
- Day 12-19: Company and buyers collaborate to draft Offer to Purchase.
- Day 20: Special Committee and board of directors approves merger agreement. Company and buyers issue press release announcing agreement on terms of a business combination and expected tender offer.
- Day 20: “Date of Commencement” of tender offer. Placement of newspaper advertisement summarizing Offer to Purchase. Company and buyers cooperate regarding distribution of tender offer documents to stockholders.
- Day 20-50: Tender offer open. If the tender offer is amended with respect to the offering price, number of shares sought or dealer’s soliciting fee, the offer must be extended for at least 10 days from the date of such amendment.
- Day 50: Closing of tender offer. At the close of the tender offer, the controlling shareholders need to pay the cash consideration to the minority shareholders. Therefore, simultaneously with the tender offer, the controlling shareholders should close the financing necessary to fund for the tender offer. Delivery of funds for shares tendered to depository.
- Day 52: Consummate short form merger

*Does not include timing of Schedule 13E-3 filing and SEC review

Traps for the Unwary

- A company's reporting obligations may not be suspended during any fiscal year in which the SEC has declared effective a company's:
 - registration statement or
 - post-effective amendment to registration statement
- SEC has granted no-action relief for companies that have withdrawn all of their effective registration statements requiring updates (e.g., Form S-3s) before filing their Form 10-K
- If the Form 10-K has been filed, the company will be required to make all mandated filings for that fiscal year, including the Form 10-K due after the close of the fiscal year unless it obtains no-action relief from the SEC.

Traps for the Unwary

- When it files a Form 15, a company must have a good faith belief that it has less than 300/500 stockholders of record.
- The number of holders of record can change between the time the company decides to go dark and the filing of Form 15 for various reasons:
 - broker distributions or “kick-outs” to beneficial owners
 - ordinary trading or
 - intentional actions of stockholders
- SEC reporting obligations are reinstated if the number of record holders subsequently increases to more than 300/500.
- A company should make sure that it is not in danger of going back over 300/500 holders before filing the Form 15.

Traps for the Unwary

- Public announcement may put company in play
- Mergers may have appraisal rights
- Consider who will be required to file the going private filing with the SEC (schedule 13E-3) and when discussions amongst a “group” triggers the filing requirement

Going Private Filing/Schedule 13E-3*

A Going Private Schedule 13E-3 is required to be filed with the SEC by certain going private participants

- Each issuer and affiliate engaged, directly or indirectly in a going private transaction is required to file a Schedule 13E-3 with the SEC and furnish the required disclosures to the stockholders
- A going private transaction is “any transaction or a series of transactions...” (Rule 13E-3(a)(3))
- Intent to go private, even without success triggers Rule 13E-3
- Look for first step in furtherance of going private; filing obligation triggered at the first step; open market purchases may be first step
- Affiliate defined – person who controls, is controlled by, or is under common control with the issuer (e.g. members of senior management, board members, significant stockholders)
- Must include fairness determination

*In addition to proxy statement/information statement required in merger structure requiring stockholder approval

Going Private Filing (Continued)

Who is “engaged” in going private transaction

- Target company in an exchange offer is engaged if it recommends the offer
- An issuer who solicits proxies for approval of the transaction
- Acquisition vehicle

When is management “engaged”

- Look for benefits not received by other shareholders
- Ongoing equity participation
- Increase in compensation
- Alterations in existing executive agreements favorable to management
- Representation on board of the acquiring company

Becoming an affiliate by teaming up with management

- If management partners with formerly unaffiliated entities to take a company private, can become affiliates for purposes of Rule 13e-3
- Will the entity hold equity of company after the transaction
- Timing – was there an affiliation with management before terms of transaction were negotiated (vs. auction process where bids made when no affiliation existed)

Going Private Disclosure Requirements

- More onerous than customary disclosure requirements for a proxy, including disclosure with respect to purpose of the transaction, post-transaction plans for the issuer and the bidders view as to the fairness of the transaction to the public shareholders.
- Key disclosure provisions address fairness of the proposed transaction
- Required exhibits include filing of financial advisor presentations (e.g. board books) that are materially related to the transaction prepared for the issuer (even by the bidder). This extends to oral reports and reports and opinions that address matters in addition to the fairness of the transaction.
- Issuer and filer may be liable for material omissions

Going Private Disclosure Requirements

Past Contacts, Transactions, Negotiations and Agreements

- Events leading up to the decision to go private – any contacts, negotiations or interactions with parties involved during the past 2 years
- Who initiated idea to go private
- Reasons for timing to go private
- Board deliberations
- How principle terms of merger were negotiated

Going Private Disclosure Requirements

Purposes, Alternatives, Reasons and Effects of Transactions

- State purpose of transaction; discuss alternatives and why such alternatives were rejected
- Alternatives should include why not remain public, as well as alternate means of going private
- State reasons for the structure and why the transaction is being undertaken at this time
- Include clear description of the effects of the transaction on the issuer, the affiliates and unaffiliated security holders, including benefits and detriments that are quantified to the extent practicable

Going Private Disclosure Requirements

Fairness of the Transaction

- Fairness of the transaction to unaffiliated security holders
- Each filing person must make determination
- Must address substantive fairness and procedural fairness (i.e. approved by a majority of independent, non-interested directors)
- Factors in determining fairness:
 - Current market prices;
 - Historical market prices;
 - Book value;
 - Going concern value;
 - Liquidation value;
 - Purchase prices paid in previous purchases;
 - Any report, opinion, or appraisal
- Identify firm offers

Going Private Disclosure Requirements

Fairness Opinion

- State whether or not a report, opinion or appraisal was received that is materially related to the transaction
- Must be summarized whether oral or written (both preliminary and final); includes drafts, talking papers, spread sheets, summaries, outlines, board books, etc.
- Projections given to fairness advisor and used to formulate opinion must be disclosed
- Must describe in detail the methodology and evaluations obtained

Going Private: Potential Liability

- Concern: Stockholders may bring suit against the board of directors for breach of fiduciary duty
 - Consider Company's shareholder base and its impact upon likelihood of litigation.
Large and fragmented?
Dominated by institutional holders?

Going Private: Potential Liability

- Breach of Fiduciary Duty
 - Majority Shareholder Liability
 - Only applicable when the shareholder owns a majority interest in the company or exercises control over its business affairs (*Kahn v. Lynch*)
 - If transaction is through a tender offer, only must provide full and fair disclosure (*Siliconix*)
 - If transaction is through a short form merger, as long as all material information about the merger has been disclosed, absent fraud or illegality, the only rights an objecting shareholder has are appraisal rights
 - Board of Director Liability
 - Duty of Loyalty
 - *Revlon* duties where there is a change of control
 - Duty of Care
- Breach of Disclosure Obligations
 - Failure to disclose “material facts”
 - False or misleading information in the Proxy Statement, Schedule TO, or other disclosure documents

Going Private Transaction Structure and Method of Review

- Negotiated Tender Offer
 - The Supreme Court in Delaware has held that a negotiated tender offer (aka negotiated two-step freeze-out) is subject to the **Entire Fairness Standard**. See *Kahn v. Lynch Commc'n Sys., Inc.*; accord *In re Revlon, inc. S'holders Litig.*; *In re Emerging Commc'ns S'holders Litig.*; *In re Unocal Exploration Corp.*
- Unilateral Tender Offer
 - The Supreme Court in Delaware has yet to rule on the method of review that should be utilized when reviewing a unilateral tender offer. The trial courts have utilized three separate approaches:
 - *Cox Communications/ CNX Gas*
 - A unilateral tender offer is subject to the **Business Judgment Rule** if the “tender offer is both (i) recommended by a duly empowered special committee of independent directors and (ii) conditioned on the affirmative tender of a majority of the minority shares. Otherwise, it will be subject to the Entire Fairness Standard.
 - *Pure Resources*
 - A unilateral tender offer “**will not be reviewed substantively**” if: (i) it is subject to a non-waivable majority of the minority tender condition; (ii) the controlling stockholder promises to consummate a prompt short-form merger at the same price if it obtains 90% of the shares; (iii) the controlling stockholder has made no retributive threats; and (iv) the independent directors on the target board have free rein and adequate time to react to the tender offer. Otherwise, it will be subject to the Entire Fairness Standard.
 - *Siliconix*
 - A unilateral tender offer will not be reviewed under the Entire Fairness Standard unless the offer is **structurally coercive**
- Long Form Merger
 - The Supreme Court in Delaware has held that a long form merger (aka single-step freeze-out) is subject to the **Entire Fairness Standard**. See *Emerald Partners v. Berlin*; *Rosenblatt v. Getty Oil Co.*; *Weinberger v. UOP, Inc.*

Going Private: Method of Review Defined

- Entire Fairness Test
 - Fair Dealing
 - When was the transaction timed?
 - How was the transaction initiated, structured, negotiated, and disclosed to the directors?
 - How were approvals from the directors and stockholders obtained?
 - Fair Price
 - What financial and economic considerations (assets, market value, future prospects, etc.) were utilized in determining the price?
- Business Judgment Rule
 - Corporate directors have not breached their fiduciary duty to shareholders as long as they acted on an informed basis, in good faith, and in the honest belief that their actions are in the company's best interests.
 - Shields corporate directors from liability for unprofitable or harmful corporate transactions if the decisions approving such transaction were made in good faith, with due care, and within the directors' authority.
 - Plaintiff has the burden of proof.

Going Private: Minimizing Potential Liability for Entire Fairness Standard

- How to Shift the Burden to the Plaintiff Shareholder
 - Special Committee of Independent Directors or an Informed, non waivable majority-of-the-minority vote (*Kahn v. Lynch*)
 - That said, if the acquirer dictates the terms of the merger or the special committee does not have real bargaining power, the burden will not be shifted to the plaintiff (see *Kahn v. Lynch*; *Rosenblatt v. Getty Oil Co.*)
- Additional Measures to Minimize Liability
 - Expert valuation or fairness opinion
 - Prompt, thorough and accurate public disclosure
 - All negotiations and evaluations done by truly independent directors, a special committee, or a special independent representative of the minority shareholders
 - If independent directors or special committee, make sure that they have:
 - Broad authorization from the Board of Directors to negotiate in an arm's length transaction
 - Access to independent counsel and financial advisors
 - Complete and accurate documentation of all committee meetings, negotiations, deliberations and proceedings relating to the transaction
 - Window shopping the proposal
 - Majority of the minority voting standards
 - Consider whether there exists any potential conflicts of interests of directors or stockholders (e.g. avoiding Section 13/16 reports)
 - Avoid purchases of company shares by affiliates in the open market after the deregistration

Benefits of Going Private

1. Significantly lower operating costs
2. No SOX 404 compliance
3. Management can focus more on the business
4. Reduces potential liability for officers and directors
5. D & O insurance costs will likely decrease

Benefits of Going Private (cont'd)

- Eliminates disclosure requirements
- More confidentiality regarding business activities
- Simplified corporate governance
- Greater freedom to explore extraordinary corporate transactions

Downsides of Going Private

1. Litigation risk
2. Reinstatement of SEC reporting obligations if more than 300/500 holders
3. Lack of public exposure
4. Shares are less useful for acquisitions and employee compensation
5. Can result in conflicted transactions
6. Stockholders may think the company is in play or hiding something

Final Thoughts

- Principal decision: does remaining a public company outweigh the benefits of going private?
- Some companies are too small to benefit from being a public company
- Going private may significantly reduce the value and attractiveness of employee stock option or other stock compensation plans

Final Thoughts

- Factors to consider before Going Private:
 - Stock price
 - Public float
 - Company performance
 - Compliance costs (including SOX 404)
 - Accounting requirements
 - Currency for acquisitions and employees
 - Creditor and customer requirements
 - Relationship with stockholders
 - Prestige
 - Risk of litigation
 - SEC review process

Contact Information

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