A BRIEF ROADMAP TO GOING PRIVATE

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I. INTRODUCTION

In the midst of increasing regulatory burdens and a shaken economy that is slow to recover, more and more U.S. companies are choosing to forego their public status through "going private" transactions. "Through the end of August, sixty public companies had already [gone] private in 2003, . . . up from forty-nine during the same period in 2002 and thirty-two in 2001."[1] The number of companies going private in the sixteen-month period following the passage of the Sarbanes-Oxley Act numbered 120, 30% more than in the sixteen-month period prior to its July 30, 2002 enactment.[2] Experts expect that with the sluggish economic recovery and increased regulatory compliance costs, the going private trend will continue to pick up speed.[3]

The purpose of this paper is to offer the reader a basic roadmap to going private, introducing and bridging the major considerations involved in the typical going private transaction. Part Two provides an overview of going private, beginning by defining "going private" and highlighting the major reasons companies go private, including the effective closure of capital markets, avoidance of regulatory expenses, long-term value maximization, and decreasing agency costs.

[1] Britt Erica Tunick, *Adrift in a Rocky Market, Small Caps Mull Going Private*, INVESTOR REL. BUS., Oct. 13, 2003.

[2] Robert Weisman, *More Firms Finding Advantages in Going Private*, BOSTON GLOBE, Jan. 4, 2004, at D2.

[3] *See* Tunick, *supra* note 1.

It continues by pointing out current sources of these reasons, such as market downturns and the passage of the Sarbanes-Oxley Act, which combine to make an environment highly favorable to going private transactions. The section then presents barriers that may prevent a company considering going private from making the move and introduces the key players in a going private transaction. Part Two closes by analyzing the popular means by which to finance a going private transaction and the current climate in which such financing may be procured.

Part Three presents the legal considerations that come into play when a company chooses to go private, including federal disclosure rules and state compliance laws. These considerations may affect both the choice of whether to take a company private and the optimal transaction structure chosen once such a decision has been made. The section begins by examining Rule 13e-3, the federal disclosure standard that governs going private transactions, describing its mechanics and disclosure requirements. Relevant state law issues are then introduced, with particular attention being given to legally enforceable standards of review, including the well-known "entire-fairness" test.

Finally, Part Four details the possible means of structuring the going private transaction, which include the long-form merger, the tender offer, the reverse stock split, and the asset sale and dissolution. Advantages and disadvantages of each structure are compared, and reflect timing, financing, tax, and legal considerations, including recent Delaware case law that makes the tender offer the transaction of choice for controlling shareholders taking a company private.

II. AN OVERVIEW OF GOING PRIVATE

A. Going Private—Defined

As used in this paper, the term "going private" refers to any transaction that falls within the ambit of Rule 13e-3, promulgated under the Securities Exchange Act of 1934, "in which certain of the existing stockholders or affiliates of a public target become stockholders of the entity surviving the acquisition of the target and the target is no longer subject to Section 12(g) or Section 15(d) of the Exchange Act."[4] This includes both "true" going private transactions and "technical" going private transactions, as distinguished by Borden.[5] A "true" going private transaction is one "by which an individual or a group of individuals controlling a public corporation by virtue of an impregnable stock position . . . undertakes a corporate transaction in order to acquire . . . the entire equity interest in the corporation."[6] In "technical" going private transactions, such as management buyouts ("MBOs") and leveraged buyouts ("LBOs"), the acquirer does not hold a controlling stock position, but is an "affiliate" within Rule 13e-3.[7] Not included in this definition of going private are LBOs or other takeover mechanisms in which neither substantial stockholders nor management are aligned with the acquiring group or delistings by companies that already have fewer than 300 shareholders.[8]

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[4] STANLEY FOSTER REED & ALEXANDRA REED LAJOUX, THE ART OF M&A 658-59 (2d ed. 1995).

[5] ARTHUR M. BORDEN & JOEL A. YUNIS, GOING PRIVATE §§ 1.02, 1.05 (2003).

[6] *Id.* at § 1.02.

[7] *Id.* at § 1.05.

[8] For public companies that already have fewer than 300 record holders (or 500 if certain asset tests are met) and no liquid market for their shares, privatization can be achieved by voluntary deregistration with the SEC by filing Form 15. Deregistration is not effective for ninety days, but financial reporting may be stopped immediately. However, companies must continue to comply with all other SEC regulations until the deregistration is effective.

B. Reasons Companies Go Private

1. Effective Closure of Public Capital Markets

One of the chief motivations of a company going public is to access investment capital in public capital markets.[9] While markets remain strong and stock valuations high, both companies and shareholders benefit from the relatively easy access to capital and the added prestige of keeping the company public.[10] However, when markets tighten and valuations plummet, public capital markets may effectively close to companies, especially those of smaller size, thereby eliminating one of the main benefits of maintaining public status.[11] Therefore, companies that are confident in their business model and profitability, but plagued by limited analyst coverage, negligible trading volume, and flat stock prices, may find that the arguments for staying public are no longer compelling.[12]

2. Avoidance of Regulatory, Compliance, and Insurance Expenses

Another reason companies may choose to go private is to avoid the regulatory, compliance, and insurance expenses tied to public status. Such expenses include the traditional costs of executive time, legal expenses, accounting costs, filing fees associated with SEC filing requirements, and D&O insurance premiums, as well as new costs associated

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[9] Alan J. Bernstein, *"Going Private" After The Sarbanes Oxley Act of 2002*, Carter Ledyard & Milburn LLP Client Advisory, January 2003, *at* http://www.clm.com/pubs/pub-1144369_1.html.

[10] Kimble Charles Cannon, *Augmenting the Duties of Directors to Protect Minority Shareholders in the Context of Going-Private Transactions: The Case for Obligating Directors to Express a Valuation Opinion in Unilateral Tender Offers after Siliconix, Aquila and Pure Resources*, 2003 COLUM. BUS. L. REV. 191, 198 (2003).

[11] Bernstein, *supra* note 9.

[12] *See* Dennis J. White & Patricia A. Johansen, *The Tide's Turning for Going Private*, BUYOUTS, May 26, 2003.

with the recently enacted Sarbanes-Oxley Act. Key highlights of the Sarbanes-Oxley Act that have raised compliance expenses include the requirement of an entirely independent audit committee and the prohibition of accounting firms providing most non-audit services for public companies they audit.[13] The Act also provides for the criminal liability of CEOs and CFOs for reports submitted to the Securities and Exchange Commission, which has had a costly effect on the rates of D&O insurance premiums.

3. Long-Term Value Maximization

Management might also like to see its company go private so as to enable focus on long-term growth and value maximization. Often managers are forced to forego such long-term growth strategies because of the pressure to meet analysts' forecasts for short-term earnings.[14] After going private, managers are given more freedom "to make hard strategic decisions, such as selling a failing division at a loss, that would be punished on the public markets."[15] Therefore, in order to increase its control and abandon public scrutiny, management of companies with a long-term focus may support a move to go private.[16]

4. Reducing Agency Costs

Firms may also go private as a way of reducing agency costs that result from the divergent interests of management and shareholders. Michael Jensen theorizes that managers have an incentive to maximize their compensation, job security, power, and prestige by growing and diversifying the companies they control even beyond their optimal size.[17]

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[13] *See* Meg Richards, *Too Soon to Tell if Sarbanes-Oxley is Working*, DESERET NEWS, Jul. 27, 2003.

[14] *See* Cannon, *supra* note 10, at 207.

[15] *The Case for Going Private*, ECONOMIST, Jan. 25, 2003.

[16] *Id.*

[17] *See generally* Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986).

Managers retain "free cash flow" ("cash flow in excess of that required to fund all projects that have positive net present values") and use it to fund negative net present value projects for the sole purpose of growth rather than distributing the excess cash to shareholders through dividends.[18] Jensen also suggests that increasing the firm's debt ratio combats this agency cost by bonding management's promise to pay out future cash flows.[19] In addition, the tendency of managers to distribute cash inefficiently is minimized when management controls a large portion of firm equity.[20] Therefore, firms with low positive net present value growth prospects and large free cash flows are good potential going private candidates, as there is value to be captured by both the increase in leverage and the allotment of equity interests among managers which, as explained later in this paper, are inherent in most going private transactions.[21]

C. Current Sources of Reasons to Go Private

1. The Downturn of Public Capital Markets

Market downturns over the past three years have effectively closed public capital markets to many companies, especially small and mid-caps. Despite recent signs of

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[18] *Id.* at 323.

[19] *See id.* at 324-26.

[20] *See generally* Wi Saeng Kim & Eric H. Sorensen, *Evidence on the Impact of the Agency Cost of Debt on Corporate Debt Policy*, 21 J. FIN. & QUANT. ANAL. 131 (1986).

[21] Empirical studies support such a proposition. *See, e.g.*, Kenneth Lehn & Annette Poulsen, *Free Cash Flow and Stockholder Gains in Going Private Transactions*, 44 J. FIN. 771 (1989) (likelihood of going private directly related to free cash flow, and premiums paid to shareholders in private transactions are positively and significantly related to undistributed cash flow); Spuma M. Rao et al., *Going Private: A Financial Profile*, 8 J. FIN. & STRAT. DEC. 53 (1995) (major source of gain in going private transactions is mitigation of agency problems of free cash flow and amount of free cash flow major determinant of firm's decision to go private).

economic upturn, the market continues to experience decreased trading volume, diminished investor confidence, and arguably deflated stock prices. In addition, many companies have been hurt by regulatory efforts to separate stock research from investment banking, which has led Wall Street to cut analyst coverage of small-cap stocks.[22] Thousands of companies with a market capitalization of less than $300 million now have fewer than two analysts following their stock.[23] Consequently, "it is almost impossible for [these] firms to issue fresh equity or for investors to sell large blocks of shares in them without accepting a big discount to the quoted price."[24] Indeed, the market is ripe for these "orphans" to reconsider whether public status is worth its costs.[25]

2. The Passage of the Sarbanes-Oxley Act

The recent passage of the Sarbanes-Oxley Act has led to dramatic increases in regulatory and compliance costs. For example, the Act's requirement of independent directors to supervise auditing may be costly in terms of relinquished control, as well as salary and required D&O insurance coverage. Further, prices for auditing are also likely to increase with the prohibition on bundled services because, "whereas once profitable non-audit services . . . supplement[ed] competitive auditing fees, now auditors will need to make a profit from audit services alone."[26]

While it is too soon to definitively gauge the increase in compliance costs attributable to Sarbanes-Oxley, estimates

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[22] *See* Jeremy Kahn, *The Burden of Being Public*, FORTUNE, May 26, 2003, at 35.

[23] *Id.*

[24] *A (Going) Private Matter*, ECONOMIST, Mar. 22, 2003, *available at* 2003 WL 6245423.

[25] David A. Stockton et al., *Going Private: The Best Option?*, NAT'L L.J., June 23, 2003, at 19. (defining "orphans" as "companies with small or dramatically fluctuating market capitalizations that effectively are ignored by the investment banking and institutional investor community").

[26] Cannon, *supra* note 10, at 208-09.

range from a conservative $1 million to $3 million per year.[27] One recent survey indicated that the average annual cost of being a midsized public company has almost doubled since the passage of the Sarbanes-Oxley Act, from $1.3 million to almost $2.5 million.[28] Perhaps most importantly to note, though, is that these compliance costs have little or no correlation to a company's size.[29] Thus, since there is a base fixed cost to comply, smaller or midsized companies may be disproportionately burdened.[30] Especially for these companies, though compliance costs alone may not be enough to warrant a going private transaction, the marginal increase just may be the "straw that breaks the camel's back" for those already considering the move.[31]

3. Increasing D&O Insurance Premiums

The cost of D&O insurance is expected to increase substantially in the wake of Sarbanes-Oxley, primarily due to the fact that executives are now personally liable for the accounting practices of their companies.[32] Financially strong companies will likely face increases of 25% to 40% in premiums, while premiums for weaker companies could

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[27] *See A (Going) Private Matter*, *supra* note 24.

[28] Tamara Loomis, *Costs of Compliance Soar After Sarbanes-Oxley*, N.Y. L.J., May 5, 2003, *available at* http://www.law.com/jsp/article.jsp?id=1051121827546 (citing a study conducted by the law firm of Foley & Lardner).

[29] *See* Stockton, *supra* note 25.

[30] In fact, larger companies are generally better equipped to deal with increased regulation and compliance costs if they have already devoted substantial company resources in addressing the fixed costs of compliance (i.e., establishing a compliance department). The smaller companies that outsource all of their legal and accounting work are the ones that will bear the brunt of rising prices for these services.

[31] Judy Radler Cohen, *Sarbanes-Oxley: One Year Later*, MERGERS & ACQUISITIONS REPORT, July 28, 2003, *available at* http://www.mareport.com/mar/news_updates.cfm?articleId=2540&categoryId=1; Marshall McKnight, *Fleeing Enron-Inspired Rules by Going Private*, NJBIZ, June 9, 2003, at 89.

[32] *See* Bernstein, *supra* note 9.

increase by as much as 400%.[33] Because of possible litigation from the going private transaction, continued exposure to business risks, and recent court rulings that directors of private companies have the same fiduciary obligations as do directors of public companies, firms should maintain D&O insurance for at least a few years even after going private.[34] However, the benefit of going private is clear, as the premiums for a company could fall by as much as 90% after the going private transaction is complete.[35] Therefore, especially in the wake of the Enron scandal and Parmalat's troubles, the Sarbanes-Oxley Act's provision for potential criminal liability may certainly be a credible reason not to be public.[36]

D. Hurdles to Going Private

With so many reasons for a struggling public company to consider going private, it must be noted that there exist major hurdles to such a move and that not every struggling company is a good going private candidate. First, and most simply, there is the possibility that the company's depressed or volatile stock price accurately reflects its "poor financial performance or other operating deficiency, such as a faulty business model, ineffective management, overleverage or an unreliable cash flow stream."[37] If this is the case, going

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[33] Michael J. Levitin & Steven S. Snider, *Going Private*, *available at* http://articles.corporate.findlaw.com/articles/file/00144/008504 (citing a report by Willis Group Holdings, Ltd.).

[34] *See* Michael Ha, *Going Private? Keep D&O Cover, Experts Say*, NAT'L UNDERWRITER (Prop. & Casualty-Risk & Benefits Mgmt. Ed.), Sept. 8, 2003; *See* Pereira v. Cogan, 294 B.R. 449 (S.D.N.Y. 2003). In *Pereira*, the court applied Delaware law and held the directors of Trace International Holdings, a private company, to the same criteria for fiduciary responsibility normally given to directors and officers at public companies.

[35] *See id.*

[36] *See* McKnight, *supra* note 31 (quoting Christopher Petersen of the Strategic Research Institute: "CEOs are saying, 'Wait a second. I don't want to go to jail if something goes wrong'").

[37] Stockton, *supra* note 25.

private is obviously not the solution to the company's problems, and, in any event, may be impossible to accomplish because the poorly performing firm would be unable to procure the necessary financing to complete the transaction.

Another barrier to going private is the high cost of the transaction. Financing can be expensive and hard to arrange, and bank covenants can be almost as restricting to management as the scrutiny from the public market.[38] Additionally, because many going private transactions are subject to the entire fairness standard of review, they tend to attract stockholder litigation and require costly safeguards, such as the appointment of a committee of independent directors to negotiate the transaction, so as to avoid the harshness of the fairness inquiry.[39] The addition of the committee brings with it the cost of independent legal and financial advisors to guide the committee through negotiations and offer opinions of fairness.[40] Further, compliance with SEC going private rules is both expensive and time consuming. In total, the costs of investment banking, legal, and accounting fees in going private deals typically reach above seven figures,[41] and the transaction may take up to a year to complete.[42]

A further deterrent to going private is the possibility of a third party takeover. By announcing a going private transaction, the company may be put "'into play' attracting unsolicited third party bids. In such situations, the board has no choice but to maximize stockholder value and explore all opportunities."[43] Thus, the costs and risks involved in going private transactions present major hurdles that may

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[38] *See* Michael T. Burr, *Going-Private Trend Falls Short of Expectations*, CORP. LEGAL TIMES, Aug. 3, 2003, at 16.

[39] *See* White & Johansen, *supra* note 12.

[40] *See* Stockton, *supra* note 25.

[41] *See id.*

[42] *See* Lisa Fickenscher, *Tech Firms Abandon Wall St.: High Costs, Hassles Lead Public Companies to Go Private*, CRAIN'S N.Y. BUS., Feb. 10, 2003, at 1.

[43] White & Johansen, *supra* note 12.

be preventative for some companies considering making the move.

E. The Going Private Candidate

With the above benefits and hurdles of going private in mind, one might begin to form a picture of a likely going private candidate. The firm may be smaller in size with compliance, public disclosure, and D&O insurance costs disproportionate to earnings. It may also have a lot of free cash flow and a low debt to equity ratio. It is likely being penalized by the market with limited access to capital or a deflated or volatile stock price.[44] In addition, for ease of procuring financing and structuring the transaction, the firm will probably have stable cash flows and concentrated ownership.[45]

F. Key Players in the Going Private Transaction

The key players in a going private transaction include management, the controlling shareholder, the special committee, financial advisors, lawyers, and capital providers. Management, if not initially part of the acquiring group, is almost always invited to participate because capital providers desire continuity of management so as to assure the stable cash flows needed to discharge acquisition debt.[46] Management also has valuable knowledge of corporate operations that due diligence may not uncover, and, unless the acquisition group plans to dismantle the company immediately upon purchase, will probably be invited to stay

[44] *See A (Going) Private Matter*, *supra* note 24 (prime candidates are being severely penalized by the market, in terms both of their high public equity costs and of their valuation).

[45] *See* Burr, *supra* note 38; Stockton, *supra* note 25 ("Realistic going-private candidates must be fundamentally healthy businesses that can project consistent cash flow, as the commercial banks, private equity funds and other institutional investors that typically finance such transactions must be convinced that they have a reasonable chance for a fair return.").

[46] *See* BORDEN & YUNIS, *supra* note 5, § 3.02.

after the transaction in order to maintain consistent operations.

The controlling shareholder will many times represent or be included in the acquisition group. In the event there is a controlling shareholder that is not part of the group, however, it is crucial that the acquirer get a pledge of support from the controlling shareholder before launching the acquisition.[47] Indeed, the transaction may be difficult or, in the case of a majority shareholder, impossible to complete without its approval.[48]

Depending on the type of transaction chosen to take the company private, there may be a need for the company's board to appoint a special committee of outside directors. In Delaware, a long-form merger or asset sale and dissolution must satisfy the entire fairness test, which is more stringent than the normal business judgment rule.[49] This elevated standard, in combination with the inherently conflicted nature of the typical going private transaction, invites litigation arising from going private transactions. As explained below, a tender offer by a controlling shareholder followed by a short-form merger can avoid the entire fairness standard, but still runs the risk of being deemed "coercive." "Because of these factors, and to make the transaction as arm's length as possible," the company's board should appoint a committee of outside directors to review and negotiate the proposal and to make formal recommendations.[50] The committee should hire its own

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[47] Yet care should be taken so as not to create an absolute lock up without an effective fiduciary out clause. *See* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003) (holding that when target corporation's board combines stockholder voting agreements and the authority of directors to insert a Del. Code Ann. tit. 8, § 251(c) provision in a merger agreement to create an absolute lock up, in the absence of an effective fiduciary out clause in a merger agreement, the target's board must contract for an effective fiduciary out clause to exercise its continuing fiduciary responsibilities to minority stockholders).

[48] *See* Cannon, *supra* note 10, at 215.

[49] *See* Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997).

[50] MEREDITH M. BROWN ET AL., TAKEOVERS: A STRATEGIC GUIDE TO MERGERS AND ACQUISITIONS 467 (2001).

independent financial and legal advisors, at the expense of the company.[51]

The role of the financial advisor is to help the committee evaluate the proposed transaction and assist in the negotiating process. Before offering its opinion as to fairness, the financial advisor should conduct a due diligence review and investigate the valuations of comparable companies and transactions.[52] The financial advisor then provides the committee with a report regarding the fairness of the price, which is presented to shareholders in the public filings required by the SEC.[53] In a going private transaction, the financial advisor is commonly paid when it is ready to deliver its opinion, as opposed to at the closing of the transaction, as is done in most acquisitions by unaffiliated third parties.[54] This is done to avoid any possible economic incentive to offer a favorable opinion solely to expedite closing.[55]

Lawyers are also crucial to the going private transaction. For large transactions, there are generally three sets of counsel involved, one for the proponent, one for the company, and one for the committee of independent directors (if the transaction is such that a committee is needed).[56] Other variations include one counsel that represents both the company and the proponent and another that represents the committee, or one counsel that represents the committee and the company and another that represents the proponent, or, for small transactions, one counsel that represents all parties.[57]

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[51] *See id.*

[52] *See id.* at 472.

[53] *See* Jonathan Bell, *Going Private: How VCs Can Get in the Game*, VENTURE CAP. J., Oct. 1, 2002, *available at* 2002 WL 2289861.

[54] *See* BROWN ET AL., *supra* note 50, at 471.

[55] *See id.*

[56] *See* BORDEN & YUNIS, *supra* note 5, § 9.01.

[57] *See id.* As mentioned before, it is preferable that the committee of independent directors have its own counsel so as to facilitate arm's length negotiations.

Outside capital providers are also necessary in many going private transactions. Almost all going private transactions involve some form of leveraged buyout and, depending on the resources of the company, the group taking the company private may need to seek funding from sources beyond banks.[58] Such sources of outside equity capital may include buyout funds, venture capitalists, private equity firms, and strategic investors.[59] Depending on the needs of the group, the role of these outside investors can range from mere capital provider to active participant in the planning, financing, and executing of the going private transaction.[60]

G. Financing the Going Private Transaction

Going private transactions can be funded in a variety of ways, but, as previously noted, are usually highly leveraged. Because of its many advantages, debt is the largest and most preferred method of financing, though equity investment also plays a role in the typical going private transaction. Depending on the company's resources, more specialized forms of financing may also be available, such as the use of an employee stock ownership plan.

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[58] *See* Bell, *supra* note 53.

[59] *See* Cannon, *supra* note 10, at 215.

[60] *See id.*

> Indeed, nonmanagement equity investors may bring many benefits to the deal. [T]hey provide management expertise, usually in the form of seats on the board and key contacts in the business community. In sound operations, equity investors tend to leave things alone and to avoid upsetting the continuity of profitable operations. In poorly performing operations, equity investors typically have the resources to bring in new talent and spearhead new strategies.

MICHEL ALLEN, THE COMPLETE GUIDE TO A SUCCESSFUL LEVERAGED BUYOUT 192 (1988).

1. The LBO

The leveraged buyout ("LBO") is a typical way to structure the financing of a going private transaction. In an LBO, a group of outside equity investors aligns with the company's management and finance the acquisition of the company's publicly-held shares on the credit of the company's assets.[61] When the management of the company initiates the transaction, the buyout is referred to as a management buyout ("MBO"). Normally, the acquiring group creates a new shell company with the sole purpose of raising the necessary funds and acquiring the target company by using any of the usual methods for going private, such as a merger or tender offer.[62]

2. Debt Financing

Debt has many advantages that make it the preferred form of financing a going private transaction. Debt has a distinct tax advantage over equity in that interest payments are generally deductible, whereas payments made on equity (i.e., dividends) are not.[63] It also has no upside and thus maximizes the payout to the small group of equity investors facilitating the transaction while, at the same time, transferring some risk to creditors. Debt need only be repaid in the amount of principal plus interest payments, while equity investors share a claim to the remaining profits captured after the company has gone private.

Banks provide leverage for the transaction in three basic forms: revolving debt, term debt, and mezzanine debt. The revolving facility is a loan that is drawn upon by the company for its daily operations.[64] Rather than having set dates for payments, the loan goes up in months with a

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[61] *See* Bernstein, *supra* note 9.

[62] *See id.*

[63] *See* 26 U.S.C. § 163(a) (2000). Of course, with recent changes in dividend taxation, the relative advantage of debt over equity has, in general, decreased.

[64] *See* RICK RICKERTSEN, BUYOUT 167 (2001).

negative cash flow and down during times of positive cash flow, much like a checking account, throughout the term of the loan.[65] The revolving credit usually has the best interest rate, as it is most senior and secured by the most liquid assets in the firm, and has a term of one to three years, which is normally renewed so long as the company is in good financial condition.[66]

Term debt, on the other hand, is due to be paid down at specific times over the term of the loan.[67] The term is usually five to seven years, longer than that of the revolving debt, and the loan is normally secured by less liquid assets, like real estate and equipment.[68] Term debt is second in seniority and has a longer term, so its interest rates are higher than those of revolving debt. Combined, revolving debt and term debt provide between 40% and 70% of the purchase price in an LBO.[69]

Mezzanine debt[70] is paid off over a period of time like term debt, but usually has a longer term and requires a much higher yield because of its risky liquidation position.[71] Mezzanine debt often includes an equity feature, such as detachable warrants or a right to convert into common stock, provided to compensate the lender for the increased leverage risk or to motivate the lender to reduce the interest rate.[72] Mezzanine debt has the advantage of filling in for equity investment when not enough can be raised for the buyout or when the acquirer's preferences demand it. Its drawbacks are the time and effort it takes to pitch potential mezzanine investors and the greater financial risks created by the high mezzanine coupon.[73]

[65] *See id.*

[66] *See id.*

[67] *See id.*

[68] *See id.*

[69] *See* BORDEN & YUNIS, *supra* note 5, § 3.02.

[70] Mezzanine debt is so named because of its placement in the capital structure below senior debt, but above preferred equity.

[71] *See* RICKERTSEN, *supra* note 64, at 168.

[72] *See* BORDEN & YUNIS, *supra* note 5, § 6.02

[73] *See* RICKERTSEN, *supra* note 64, at 168.

3. Equity Financing

The common equity holders in a going private transaction are usually management as or with the acquisition group. "[M]ost LBO sponsors require members of the group to make what for them is a substantial investment in the new enterprise, even though it may be a minor part of the entire LBO capitalization, as a means of committing management to the enterprise."[74] In such situations, the percentage of management equity following the transaction generally ranges from 4% to 20%.[75] In addition, as previously mentioned, outside equity capital is also needed in most going private transactions and can come from a variety of sources, like "buyout funds, venture capitalists, private equity firms and strategic investors."[76]

4. ESOP Financing

Another notable means of financing a going private transaction is through the use of the company's employee stock ownership plan ("ESOP").[77] In this situation, a company uses its existing ESOP or forms a new plan in order to finance the purchase of the company using the ESOP's pre-tax cash flow.[78] The ESOP borrows the money necessary for the transaction, with the loan guaranteed by the company, and then uses the proceeds to buy the company's stock.[79] The purchased stock is pledged to the lender, and the company uses the proceeds of the sale to pay down some

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[74] BORDEN & YUNIS, *supra* note 5, § 3.02.

[75] *See id.*

[76] Cannon, *supra* note 10, at 215.

[77] An ESOP is a defined contribution benefit plan through which employees acquire an equity interest in their employer. The employing company sets up a trust on behalf of its employees and contributes either company stock or tax-deductible payments with which the trust purchases company stock and distributes it to individual employee accounts. The trust may also borrow money to purchase stock, with the employing company repaying the loan.

[78] *See* Bernstein, *supra* note 9.

[79] *See id.*

of the LBO debt.[80] Thus, in effect, the company is amortizing the buyout debt using pre-tax dollars. The ESOP can also be used in a going private tender offer, whereby the ESOP uses the loan proceeds to purchase stock directly from the public.[81] It should be noted, however, that the use of ESOPs in going private transactions presents substantial issues, including:

> the price and other terms at which the ESOP purchases its shares in relation to the price and other terms at which other investors (including management and lenders) purchase equity and/or debt securities, and the degree to which borrowing by the ESOP may be limited by covered compensation restrictions under the tax laws.[82]

Consequently, great care must be taken in structuring and implementing a leveraged ESOP transaction.

5. Current Financing Climate

The economic climate for raising financing for going private transactions is good. First, relatively low interest rates may permit going private transactions to be financed with borrowed funds on attractive terms.[83] The "flight to quality" in debt markets has begun to slow, and debt funds are readily available for going private transactions, although banks are still fairly selective.[84] Mezzanine financing is also increasingly accessible, evidenced by Goldman Sachs's recent announcement of a $2.7 billion mezzanine fund, the largest ever of its kind.[85]

Second, large pools of capital are currently available for going private transactions. With the scarcity of recent mergers and acquisitions activity, many equity funds have been left with excess cash and are therefore highly motivated

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[80] *See id.*

[81] *See id.*

[82] BORDEN & YUNIS, *supra* note 5, § 3.02.

[83] *See* Levitin & Snider, *supra* note 33.

[84] Burr, *supra* note 38.

[85] *See* Henny Sender, *Deals & Dealmakers: Goldman Raises Big Mezzanine Fund*, WALL ST. J., Sept. 9, 2003, at C5.

to close deals.[86] It is estimated that there is currently about $150 billion in private equity available to be invested in deals.[87] Further, venture capital has finally begun to make a rebound, as overall venture investing, which hit a five-year low of $4 billion in the first quarter of 2003, rose slightly to $4.3 billion during the second quarter, representing the first increase since the Internet stock bubble burst.[88] It therefore appears that there are plenty of financing opportunities available in the current market for companies ready to embark on a going private transaction.

III. LEGAL CONSIDERATIONS OF THE GOING PRIVATE TRANSACTION

Going private transactions are regulated by both federal and state law. Applicable federal law focuses on disclosure and filing requirements, and is outlined by Rule 13e-3. State laws focus on the substance of the transaction, including fiduciary duties of the persons involved and the standard by which the transaction will be reviewed, and the legality of the different means by which a going private transaction may be structured.

A. Federal Law—An Introduction to Rule 13e-3

Going private transactions involve an inherent conflict of interest since either management, a controlling shareholder, or both, stand on each side of the transaction. In 1979, the Securities and Exchange Commission promulgated Rule 13e-3, which attempts to provide additional disclosure (through the mandatory filing of Schedule 13E-3) to the public stockholders of a company going private in order to demonstrate the transaction's fairness.[89] The purpose of

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[86] *See* Stockton, *supra* note 25.

[87] *See* Sender, *supra* note 85.

[88] *See* Ann Grimes, *Venture Capitalists: A Bit More Willing*, WALL ST. J., July 29, 2003, at C1.

[89] *See* REED & LAJOUX, *supra* note 4, at 659.

Rule 13e-3, therefore, is to protect unaffiliated shareholders from unfair going private transactions.[90]

> Rule 13e-3 applies to certain transactions initiated by an issuer or between an issuer and one or more of its affiliates[91] that have a reasonable likelihood or purpose of causing one or more of the following effects:
>
> (A) Causing any class of equity securities of the issuer which is subject to section 12(g) or section 15(d) of the Act to be held of record by less than 300 persons;
>
> or
>
> (B) Causing any class of equity securities of the issuer which is either listed on a national securities

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[90] As the Commission explained in 1981:

> The nature of and methods utilized in effecting going private transactions present an opportunity for overreaching of unaffiliated security holders by an issuer or its affiliates. This is due, in part, to the lack of arm's-length bargaining and the inability of unaffiliated security holders to influence corporate decisions to enter into such transactions. Additionally, such transactions have a coercive effect in that security holders confronted by a going private transaction are faced with the prospects of an illiquid market, termination of the protections under the federal securities laws and further efforts by the proponent to eliminate their equity interest. Because of the potential for harm to security holders, particularly small investors, and the need for full and timely disclosure, the Commission continues to believe that Rule 13e-3 is necessary and appropriate for the public interest and the protection of investors.

Interpretative Release Relating to Going Private Transaction Under Rule 13e-3, Exchange Act Release No. 34-17719, 46 Fed. Reg. 22571 (April 20, 1981).

[91] An affiliate is defined as "a person that directly or indirectly through one or more intermediaries controls, is controlled by, or is under common control with such issuer." 17 C.F.R. § 240.13e-3(a)(1) (2003).

> exchange or authorized to be quoted in an inter-dealer quotation system of a registered national securities association to be neither listed on any national securities exchange nor authorized to be quoted on an inter-dealer quotation system of any registered national securities association.[92]

The transactions to which the rule applies include the purchase of any equity security by its issuer or by an affiliate of the issuer; a tender offer for an equity security by its issuer or by an affiliate of the issuer; a proxy or consent solicitation or distribution of information subject to Regulations 14A or 14C with respect to a merger, consolidation, reclassification, recapitalization, reorganization or similar transaction of an issuer or between an issuer (or its subsidiaries) and its affiliate; a sale of substantially all the assets of an issuer to its affiliate or group of affiliates; and a reverse stock split involving the purchase of fractional interests.[93]

Some transactions are explicitly exempted from the rule, including clean-up transactions following a tender offer by an unaffiliated third party; certain mergers in which shareholders receive common stock or other equity securities that are registered under the Exchange Act if such securities have "substantially the same rights as the equity security which is the subject of the Rule 13e-3 transaction including, but not limited to, voting, dividends, redemption and liquidation rights,"[94] transactions by a holding company registered under the Public Utility Holding Company Act of 1935; redemptions or purchases pursuant to the terms of the securities; solicitations with respect a bankruptcy reorganization if made after order approving such plan; and any tender offer or business combination made in compliance with § 230.802, § 240.13e-4(h)(8), or § 240.14d-1(c).[95]

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[92] 17 C.F.R. § 240.13e-3(a)(3)(ii) (2003).

[93] *See* 17 C.F.R. §§ 240.13e-3(a)(3)(i)(A)-(C) (2003).

[94] 17 C.F.R. §240.13e-3(g)(2)(i) (2003).

[95] 17 C.F.R. § 240.13e-3(g) (2003). For a detailed explanation of these exceptions, see BORDEN & YUNIS, *supra* note 5, § 10.04. *See also*

Many transactions that fall under Rule 13e-3 are also subject to the disclosure requirements of other provisions.[96] Rule 13e-3 does not preempt the requirements of these provisions, but supplements them.[97] It requires many of the same disclosures as these other rules, but also includes additional disclosures specific to the inherently conflicted nature of going private transactions that relate to the fairness of the transaction and the special benefits, if any, that the affiliate will receive. To streamline the disclosure process for transactions that may involve requirements from more than one rule, the SEC adopted Regulation M-A, under which a company may file one set of disclosures for all transactions that may be needed to fully take a company private.[98] Accordingly, Schedule 13E-3, the filing of which is mandated for a Rule 13e-3 going private transaction,[99] derives all of its disclosure requirements from items included in Regulation M-A.[100] The discussion of disclosures in this paper is limited to those mandated by Schedule 13E-3.

B. The Mechanics of Schedule 13E-3

Rule 13e-3 mandates that a company going private file a Schedule 13E-3 with the SEC and distribute certain information to its stockholders.[101] Technically, if both the issuer and an affiliate are involved in the transaction, both are subject to the filing requirement; they may, however, file the schedule jointly.[102] The filing must be done

THEODORE W. GRIPPO & MATTHEW I. HAFTER, CORPORATE STOCK REPURCHASES AND GOING PRIVATE (Bureau of Nat'l Affairs, Corp. Practice Series, No. 7-3d).

[96] For example, a tender offer requires the filing of Schedule 14D-1 or Schedule TO, and a merger or reverse stock split may require proxies and the distribution of an information statement under Regulations 14A or 14C.

[97] *See* 17 C.F.R. § 240.13e-100, General Instruction H (2003).

[98] *See* 17 C.F.R. § 229.1000 (2003).

[99] *See* 17 C.F.R. § 240.13e-3(d)(1) (2003).

[100] *See* GRIPPO & HAFTER, *supra* note 95, at A-37.

[101] *See* 17 C.F.R. § 240.13e-3(d)-(e) (2003).

[102] *See supra*, note 90.

electronically, through the SEC's Electronic Data Gathering Analysis and Retrieval system ("EDGAR").[103] The required timing of the filing depends on the type of transaction being performed. If the transaction includes the solicitation of proxies or an information statement under Regulation 14A or 14C, the schedule must be filed at the same time as the preliminary or definitive proxy or statement.[104] If the transaction involves the filing of a registration statement under the Securities Act of 1933, the schedule must be filed with the statement.[105] If the transaction involves a tender offer, the schedule must be filed "as soon as practicable" on the date the offer is "first published, sent or given to security holders."[106] For all other cases, the schedule must be filed at least thirty days before the purchase of any securities subject to the going private transaction.[107] It should be noted that if the going private transaction involves a series of transactions, Schedule 13E-3 should be filed with the first of such transactions.[108]

C. Items Required by Schedule 13E-3

Schedule 13E-3 requires that sixteen "items" be supplied. Items one through six require detailed information on the terms of the transaction, the subject company, the filing party, the past contacts or negotiations between the subject company and the affiliate, and any accompanying plans that would result in an extraordinary transaction.[109] Items seven

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[103] *See* 17 C.F.R. § 232.10(a) (2003).

[104] *See* 17 C.F.R. § 240.13e-100, General Instruction D (2003).

[105] *See id.*

[106] 17 C.F.R. § 240.13e-100, General Instruction D (2003). Note that "a combined statement on Schedules 13E-3 and TO may be filed with the Commission under cover of Schedule TO." 17 C.F.R. § 240.14d-100 General Instruction J (2003).

[107] *See* 17 C.F.R. § 240.13e-100, General Instruction D (2003).

[108] *See id.*

[109] *See* 17 C.F.R. § 240.13e-100, Items 1-6 (2003); 17 C.F.R. § 229.1001 (2003); 17 C.F.R. § 229.1002 (2003); 17 C.F.R. §§ 229.1003(a)-(c) (2003); 17 C.F.R. §§ 229.1004(a), (c)-(f) (2003); 17 C.F.R. §§ 229.1005(a), (c)-(e) (2003); 17 C.F.R. §§ 229.1006(b), (c)(1)-(8) (2003).

through nine, probably the most important parts of Schedule 13E-3, require the discussion of the purposes of the transaction and the reasons for foregoing any alternatives, information and opinions regarding the fairness of the transaction, and all expert opinions, reports, and appraisals materially related to the transaction.[110] Items ten through twelve require the disclosure of how the transaction is to be financed, the filing parties' interest in securities of the subject corporation, and whether any affiliate of the issuer intends to tender or vote shares pursuant to the transaction or encourage others to do so.[111] Items thirteen through fifteen require the filing of financial statements, the identification of persons or assets used to complete the transaction, and the disclosure of any other material information needed to make the schedule complete.[112] Item sixteen requires numerous documents relating to the transaction to be provided as exhibits.[113]

A more complete list of these items, including the main information that must be submitted under each, is included as Appendix One.

D. State Law

In addition to the federal disclosure issues described above, when structuring a going private transaction the practitioner should be mindful of state standards that reach such transactions. Most states do not have explicit rules regulating going private transactions, but rather legally enforceable standards of fiduciary duty and judicial review aimed at protecting shareholders from unfair corporate

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[110] *See* 17 C.F.R. § 240.13e-100, Items 7-9 (2003); 17 C.F.R. §§ 229.1013-15 (2003).

[111] *See* 17 C.F.R. § 240.13e-100, Items 10-12 (2003); 17 C.F.R. § 229.1007-08 (2003); 17 C.F.R. § 229.1012(d), (e) (2003).

[112] *See* 17 C.F.R. § 240.13e-100, Items 13-15 (2003); 17 C.F.R. § 229.1010(a)-(b) (2003); 17 C.F.R. § 229.1009 (2003); 17 C.F.R. § 229.1011(b) (2003).

[113] *See* 17 C.F.R. § 240.13e-100, Item 16 (2003); 17 C.F.R. § 229.1016(a)-(d), (f), (g) (2003).

dealing, applicable in all corporate transactions.[114] State law is also important as it dictates the acceptable terms of possible transactions structures that will be described later in the paper, such as mergers, reverse stock splits, and asset sales.[115]

E. Legally Enforceable Standards of Review

The most critical legal concern for a going private transaction is whether the transaction will survive the scrutiny of state standards of review. Delaware has three relevant standards of review: the business judgment rule, the entire fairness standard, and an enhanced scrutiny standard of review. For the most part, Delaware courts review the decisions made by boards under the deference of the business judgment rule, which presumes "that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[116] However, when conflicts of interest exist or fiduciaries are shown to have breached the duties of care or loyalty, Delaware courts may review transactions under the more stringent entire fairness standard, which requires a showing of both fair price and fair dealing.[117] An enhanced scrutiny standard of review is invoked in cases dealing with the Unocal or Revlon duties, which are discussed later.

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[114] Some states, though, including California and Wisconsin, have promulgated rules aimed at regulating going private transactions and, to some degree, mandating fairness in them. *See* WIS. ADMIN. CODE § 6.05 (2002); CAL. CORP. CODE § 1101 (2002).

[115] For example, many states, including Delaware, allow cash as permissible consideration for shares exchanged in a long-form or short-form merger. *See, e.g.*, 8 DEL. CODE ANN. § 251(b), § 253(a) (2002). In a minority of states, however, cash is impermissible as consideration in a long-form merger, but allowed in a short-form merger. *See, e.g.*, ILL. COMP. STAT. ANN. Ch. 32 §§ 11.05(c), 11.30(a)(2) (2002). To the extent relevant and discussed in this paper, such state laws will reflect Delaware law.

[116] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

[117] *See* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

Because of their inherently conflicted nature, going private transactions are most often subject to the entire fairness standard of review. Generally, the entire fairness standard applies whenever a controlling person proposes a going private transaction. The standard certainly governs in the case of a going private transaction involving a majority shareholder,[118] but is also applicable when there is a minority controlling shareholder,[119] in an MBO,[120] and when management is invited to align with an outside acquirer.[121] The entire fairness standard is not applicable, however, in a non-coercive going private tender offer by a controlling shareholder.[122] Also, in the case of any transaction subject to entire fairness, approval by a properly functioning committee of independent directors[123] or by the holders of a majority of the company's publicly held shares[124] shifts the burden of proving unfairness to the plaintiff, producing results similar to the business judgment rule.[125]

Beyond the fairness of the transaction, however, going private transactions may create other legal issues as well, especially in the context of technical going private transactions (like MBOs), where focus is shifted to the

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[118] *See id.*

[119] *See* Kahn v. Lynch Communication Sys., Inc., 1993 WL 290193 (Del. Ch. July 9, 1993).

[120] *See* In re Shoe-Town Inc. Stockholders Litig., 1990 WL 13475 (Del. Ch. Feb. 12, 1990).

[121] *See* Mills Acquisition Co. v. MacMillan, 559 A.2d 1261 (Del. 1989).

[122] *See, e.g.*, Next Level Communications, Inc. v. Motorola, Inc., 834 A.2d 828 (Del. Ch. 2003).

[123] *See* Kahn v. Tremont Corp., C.A. No. 12339, 1996 WL 145452 (Del. Ch. Mar. 21, 1996).

[124] *See* Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985). In the case of a merger, therefore, the group may consider making the merger conditional on the approval of a majority of the shareholders (or majority of the minority if the controlling shareholder is part of the group). *Id.*

[125] For a discussion of the laws of various states applied to different going private transactions, which analyzes conditions under which the entire fairness standard may be avoided, see Jason M. Quintana, *Going Private Transactions: Delaware's Race to the Bottom?*, 2004 COLUM. BUS. L. REV. 547.

conduct of the committee of independent directors. In particular, two enhanced-scrutiny rules enforced by Delaware courts, the Unocal[126] and Revlon[127] rules, may be relevant. Technical going private transactions where the acquiring group controls an insignificant share of the target could give rise to a hostile acquisition approach by a third party. In such a situation, the conduct of directors invoking defensive tactics is judged according to the Unocal rule, which requires the reasonable belief in a threat to corporate policy and effectiveness and that defensive measures taken are reasonable in relation to that threat.[128] The Revlon rule requires directors to seek the maximum offering price when the company has been put up "for sale." Though Revlon duties have been held not to apply in going private offers made by controlling shareholders,[129] they may conceivably be invoked in technical going private transactions.[130]

IV. POSSIBLE STRUCTURES FOR GOING PRIVATE TRANSACTIONS

A company can go private in a variety of ways, including a merger, a tender offer, a reverse stock split, and an asset sale and dissolution. Traditionally, the most common going private transaction structure was the long-form cash merger.[131] However, recent court rulings regarding the non-applicability of the entire fairness standard to non-coercive tender offers have made the tender offer alternative much more attractive in the case of a going private transaction

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[126] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

[127] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

[128] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954-56 (Del. 1985).

[129] *See, e.g.*, Bershad v. Curtiss-Wright Corp., 535 A.2d 840 (Del. 1987).

[130] For a complete discussion of the application of the Revlon standard, see BORDEN & YUNIS, *supra* note 5, § 4.12(4).

[131] *See* White & Johansen, *supra* note 12.

involving a controlling shareholder.[132] Reverse stock splits are used much less frequently than mergers or tender offers, and asset sales and dissolutions are even rarer.[133]

A. Mergers

The most familiar buyout structure is the long-form cash merger. Though mergers may be executed in a variety of forms, a common method in the context of going private transactions is for the insider group to form a new company, "Newco," through which it negotiates the merger agreement with the target company and raises the necessary financing. The company sends stockholders a proxy statement to solicit votes on the merger, and, once all conditions to the merger are satisfied, the merger commences. After the merger, the acquiring group's shares become the only outstanding shares of the surviving corporation, and the shares of the unaffiliated stockholders of the target are converted into cash or exchanged for debentures or redeemable preferred stock.[134]

A shortcoming of the long-form merger, from the perspective of the acquisition group, is that it requires board approval, as well as approval from a majority of the stockholders,[135] which makes the process both costly and

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[132] *See, e.g., In re* Siliconix, Inc. S'holders Litig., 2001 WL 716787 (Del. Ch. June 19, 2001) (reaffirming the notion that a majority shareholder tendering for the minority's interest does not owe a duty to offer a fair price and is not subject to entire fairness review assuming that the offer is voluntary and the targeted shareholders receive full disclosure); Glassman v. Unocal Exploration Corp., 777 A.2d 242 (Del. 2001) (holding entire fairness inapplicable to short-form mergers); *In re* Aquila, Inc., S'holders Litig., 805 A.2d 184 (Del Ch. 2002) (holding no duty of entire fairness on a controlling stockholder making a non-coercive tender offer where minority shareholders have adequate information and time to make an informed decision whether to tender).

[133] *See* BORDEN & YUNIS, *supra* note 5, § 3.02.

[134] *See id.*

[135] Delaware law requires that the board of directors adopt a resolution declaring the terms of the merger agreement advisable. *See* 8 Del. Code Ann. § 251(b) (2002). Then, the agreement is submitted to the shareholders for their approval. *See* 8 Del. Code Ann. § 251(c) (2002).

time-consuming. Also, as a general rule, mergers trigger shareholder appraisal rights.[136] In addition, the long-form merger is subject to Delaware's entire fairness standard, which leads to increased litigation following the transaction and effectively requires the establishment of a committee of independent directors. The committee is costly, as it requires its own legal and financial advisors, and is also free of any external pricing discipline, which may result in "hold-up" tactics that cause the acquiring group to pay more than market price.[137] The committee is also under no pressure to act promptly, resulting in an uncertain deal time line.[138]

Nevertheless, there are certainly reasons to favor the long-form merger in going private transactions. Long-form mergers are easier and more tax favorable than are asset sales.[139] Whereas asset sales result in taxable income to both shareholders and the target, mergers may be structured in ways that result in income to only one group or the other, or may be entirely tax free.[140] Mergers are favorable to tender offers in that they avoid the requirement of upfront and unsecured financing, as well as the risk that fewer shares will be tendered than the ninety percent necessary for a short-form merger. Its advantage over the reverse stock split is that it ensures that only the acquiring group (or

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[136] *See* 8 Del. Code Ann. § 262 (2002).

[137] Charles M. Nathan et al., *Current Developments in U.S. Mergers and Acquisitions Law, in* PLI'S SECOND ANNUAL INSTITUTE ON SECURITIES REGULATION IN EUROPE, at 873 (PLI Corp. Law & Practice Course, Handbook Series No. 1347, 2002).

[138] *See id.*

[139] *See* BORDEN & YUNIS, *supra* note 5, § 3.04.

[140] Asset sales and forward cash mergers result in recognition of taxable gain by both the target and its shareholders. Cash tender offers and reverse cash mergers result in taxable gain by shareholders only. To be tax-free, a merger must meet the following requirements: (1) Business purpose for the transaction; (2) Business of Target must be continued or significant portion of Target's assets used by acquiring group; (3) Must be a plan of reorganization; (4) Former shareholders of Target must maintain continuing interest in resulting entity. 26 C.F.R. § 1.368-1(b)-(d) (2003). For a more thorough discussion of tax issues in going private transactions, see BORDEN & YUNIS, *supra* note 5, ch. 6.

others that the group chooses) will have equity in the corporation and that the stock will not be redistributed, possibly resulting in the number of stockholders again exceeding 300.

B. Tender Offers

An alternative method that may be used to take a company private is a two-step transaction of a tender offer followed by a short-form merger. In the first step, the acquisition group sends all of the target's stockholders an "offer to purchase" and a letter of transmittal, which the stockholders use to tender shares. During this stage the group must make extensive disclosures in accordance with the filing of a Schedule TO.[141] Once ninety percent of the company's shares are acquired, the group moves to the second stage, the completion of a short-form merger, in which the remaining public shareholders are cashed out.[142] The short-form merger requires only approval of the company's board of directors, so no stockholder vote is necessary.[143]

The tender offer alternative has many advantages. The first advantage is speed. Shareholders will usually get their money sooner in the context of a tender offer than in a merger, as no SEC review is necessary before beginning a tender offer.[144] The time frame is quicker for the acquiring group, as well, since the short-form merger requires no stockholder approval and can close in as few as twenty

[141] *See* 17 C.F.R. § 240.14d-100 (2003).

[142] *See* 8 Del. Code Ann. § 253 (2002). Typically, the tender offer will be conditioned on the group owning at least ninety percent of the stock by the close of the tender offer.

[143] *See id.*

[144] *See* BROWN ET AL., *supra* note 50, at 473. Merger proxy statements, on the other hand, must be approved by the SEC before delivery to shareholders.

business days.[145] In addition, the shareholders will have no appraisal rights with respect to the shares they tender.[146]

Perhaps the biggest advantage to the tender offer alternative comes into play when a controlling shareholder makes the offer. Recent Delaware decisions have held that so long as the tender offer is non-coercive,[147] the controlling shareholder has no fiduciary duty to offer a fair price, so the transaction is not subject to entire fairness review.[148] In addition, though it appears that boards should take the action of empowering independent directors to bargain and give a recommendation to shareholders,[149] the controlling

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[145] *See* Burr, *supra* note 38.

[146] They will, however, maintain appraisal rights with respect to the second-step merger. *See* 8 Del. Code Ann. § 262 (2002).

[147] An acquisition tender offer by a controlling shareholder is non-coercive only when: "1) it is subject to a non-waivable majority of the minority tender condition; 2) the controlling stockholder promises to consummate a prompt §253 merger at the same price if it obtains more than 90% of the shares; and 3) the controlling stockholder has made no retributive threats" and 4) the independent directors are given "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 to the advisability of the offer, and disclosing adequate information for the minority to make an informed judgment." *In re* Pure Resources S'holders Litig., 808 A.2d 421, 445 (Del. Ch. 2002).

[148] *See, e.g.*, *In re* Siliconix, Inc. S'holders Litig., 2001 WL 716787 (Del. Ch. June 19, 2001) (reaffirming the notion that a majority shareholder tendering for the minority's interest does not owe a duty to offer a fair price and is not subject to entire fairness review assuming that the offer is voluntary and the targeted shareholders receive full disclosure); Glassman v. Unocal Exploration Corp., 777 A.2d 242 (Del. 2001) (holding entire fairness inapplicable to short-form mergers); *In re* Aquila, Inc., S'holders Litig., 805 A.2d 184 (Del Ch. 2002) (holding no duty of entire fairness on a controlling stockholder making a non-coercive tender offer where minority shareholders have adequate information and time to make an informed decision whether to tender).

[149] In this regard, *Pure Resources* modifies *Siliconix* and *Aquila*, which would permit target board passivity. *Pure*'s framework now seems to be the established standard of the Delaware Chancery Court. *See* Next Level Communications, Inc. v. Motorola, Inc., 834 A.2d 828, 845 (Del. Ch. 2003) ("[T]he court will apply the framework of the analysis . . . discussed in the *Pure Resources* case.").

shareholder may go ahead with the transaction despite a negative recommendation if it is confident the requisite shares will nevertheless be tendered. During a long-form merger, on the other hand, bargaining breakdowns lead to the loss of the transaction entirely. Such advantages make the tender offer very attractive to controlling shareholder acquirers.

The tender offer is less attractive, though, when the group taking the company private is not a large controlling shareholder. In that case, it may be harder to be confident that the requisite number of shares will be tendered. Even if the controlling shareholder is the acquirer, great care must be taken that the tender offer cannot be considered coercive. Additionally, the tender offer alternative has the strain of requiring the bulk of financing up front, which can increase financing costs.[150]

C. Reverse Stock Splits

Although the transaction is somewhat rare, companies can also go private through a reverse stock split.[151] This approach can be practical for small companies controlled by a limited number of shareholders. For example, when the acquisition group's holdings are concentrated in blocks of shares, each of which is larger than blocks of unaffiliated parties, the company can issue one new share in exchange for a number of shares greater than the largest unaffiliated block.[152] The unaffiliated stockholders are then forced to take cash rather than fractional shares. As the number of shareholders falls below the SEC threshold of 300, the company is able to deregister and go private.

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[150] *See* Burr, *supra* note 38.

[151] Reverse stock splits are authorized under Delaware state law at 8 Del. Code Ann. § 242(a) (2002).

[152] Thus, in a 1-for-10,000 split, each stockholder who owns more than 10,000 shares would receive one new share for each 10,000 shares owned and cash for the remainder; each stockholder who owns less than 10,000 shares would receive cash only.

The procedure for a reverse stock split can be cumbersome and time-consuming. The reverse stock split is accomplished through an amendment of the company's certificate of incorporation,[153] requiring the company to hold a stockholder meeting and obtain the vote of the majority of shareholders prior to executing the split.[154] Another drawback to the reverse stock split is that it may not accomplish the acquiring group's goal of acquiring all equity of the corporation if there are other large blocks of shareholders. This situation would also create the possibility of such blocks being redistributed so as to result in the number of shareholders again reaching 300.

Nevertheless, as mentioned before, the transaction may be convenient and practical for a very closely held corporation, as not as much detailed work and planning is required for a reverse stock split as is for a merger or tender offer. Additionally, shareholders in reverse stock splits do not have appraisal rights under Delaware law, unless they are expressly conferred in the company's certificate of incorporation.[155]

D. Asset Sales and Dissolutions

A company may also go private through an asset sale followed by a dissolution or a dissolution followed by an asset sale, although these transactions are quite rare. In an asset sale, upon majority vote of the stockholders, the company's assets are sold to a new corporation set up by the acquiring group.[156] The proceeds of the sale are then distributed to the stockholders in a corporate dissolution. In a dissolution, the majority of shareholders approve the dissolution of the company, which is followed by the sale of the of the corporation's assets by the directors, as trustees, to the acquiring group's new corporation.[157] The cash received from

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[153] *See* 8 Del. Code Ann. § 242(a) (2002).

[154] *See* 8 Del. Code Ann. § 242(b) (2002).

[155] *See* 8 Del. Code Ann. § 262(c) (2002).

[156] *See* 8 Del. Code Ann. § 271 (2002).

[157] *See* 8 Del. Code Ann. § 275 (2002).

the sale is then distributed to the former unaffiliated shareholders.

Assets sales and dissolutions have many drawbacks:

> The principal difficulty with both techniques is that they are an unduly cumbersome and indirect way to eliminate minority stockholders, and have certain adverse tax consequences resulting from the repeal of the General Utilities Doctrine. Moreover, the consents required from innumerable contracting parties may provide enough time for opposing stockholders to mount expensive and dilatory legal challenges. Courts often prevent dissolutions when the minority stockholders are unduly oppressed, especially when the purpose of the dissolution, as in the case of a going private transaction, is to "squeeze out" or "freeze out" the minority . . . . In addition, these techniques may expose the proponents to a substantial tax liability, as they may be deemed to receive the same liquidation distribution as other stockholders.[158]

Consequently, these methods are generally the least favored means of structuring the modern going private transaction.

V. CONCLUSION

The time is ripe for going private transactions. A slow economy and mounting regulatory burdens are forcing companies to question whether public status is worth its costs. Capital markets have been effectively closed to many small and mid-caps by economic downturn and limited analyst coverage, and the enactment of the Sarbanes Oxley Act has brought with it highly elevated compliance expenses that often disproportionately burden smaller companies. Many firms seeking to avoid such market punishment and regulatory costs and to capitalize on other benefits of private status, such as focus on long-term value maximization and

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[158] BORDEN & YUNIS, *supra* note 5, § 3.02.

decreased agency costs, are increasingly engaging in going private transactions.

As a company goes private, it is confronted with various decisions, requirements, and obstacles, all of which have been the focus of this paper. The company must take care to follow the guidelines of federal disclosure laws (Rule 13e-3) and state laws of fiduciary duty and fairness, which will generally require the engagement of a properly functioning committee of independent directors, financial advisors, and counsel. It must also face the decision of how to finance the going private transaction, which will likely be highly leveraged and may involve the use of an ESOP. Finally, the acquiring group must determine whether the transaction should be structured as a long-form merger, a tender offer followed by a short-form merger, a reverse stock split, or an asset sale and dissolution. Key considerations when choosing among these transactions are applicable standards of review, the availability of shareholder appraisal rights, the requirement of stockholder approval, and the time and cost of the transaction. Recent court rulings have made the tender offer the transaction of choice for controlling shareholders taking the company private, though other situations may urge the consideration of an alternative structure.

APPENDIX ONE

Following is a summary of the items and information required by Schedule 13E-3:[159]

Item 1. Summary Term Sheet[160]

Must be written in plain English using a bullet format

Must include information sufficient to understand the essential features and significance of proposed transaction

[159] For a more thorough analysis of Schedule 13E-3, see BORDEN & YUNIS, *supra* note 5, § 10.09.

[160] 17 C.F.R. § 229.1001 (2003).

Need not be filed if information has already been included in a prospectus

Item 2. Subject Company Information[161]

Basic information, including corporation's name and address

Information about the securities subject to the transaction, including their trading market, price, and dividends

Details of filing person's purchases of the subject securities during previous two years

Item 3. Identity and Background of Filing Person[162]

Name, address, and business background of filing person

If filing person is a partnership, syndicate, or other group, must provide business and background information of general partners or partnership, each member of syndicate, and each person controlling partner or member

If filing person is a corporation, must provide background information for CEO, directors, controlling persons, and each executive and director of any corporation ultimately in charge of corporation

Item 4. Terms of the Transaction[163]

Material terms of the transaction

Minimum information that must be disclosed for mergers, tender offers, or similar transactions

Whether any term treats holders of subject security differently

Whether dissenting stockholders are entitled to appraisal rights or any other rights

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[161] 17 C.F.R. § 229.1002 (2003).

[162] 17 C.F.R. § 229.1003(a)-(c) (2003).

[163] 17 C.F.R. § 229.1004(a), (c)-(f) (2003).

Whether unaffiliated stockholders have been given access to files or counsel or appraisal services at the expense of filing person

Whether filing person intends that securities be issued in exchange for subject securities be traded on an exchange

Item 5. Past Contacts, Transactions, Negotiations, and Agreements[164]

Disclosure of transactions between the issuer and the affiliate[165] during the two years before the going private transaction

Information regarding contacts or negotiations during two years prior to the going private transaction with respect to a possible merger, consolidation, acquisition, tender offer, election of issuer's directors, or a sale of a significant portion of the issuer's (or one of its subsidiaries') assets

Information on any agreement between the filing person and any other person concerning the subject securities

Item 6. Purpose of the Transaction and Plans or Proposals[166]

Whether securities acquired in going private transaction will be retained, retired, held in treasury, or otherwise disposed of

Any plans, proposals, or negotiations that would result in an extraordinary transaction (before or after the transaction), such as a merger or reorganization; any purchase, sale, or transfer of a material amount of assets; any material change in dividend policy, debt, or capitalization; any change in directors or managers of company; any material change in corporate structure or business; the delisting of corporation's securities; or the

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[164] 17 C.F.R. § 229.1005(a), (c)-(e) (2003).

[165] This includes the affiliate's officers, directors, controlling persons, partners, or members of a group comprising the affiliate or with which the affiliate is affiliated.

[166] 17 C.F.R. § 229.1006(b), (c)(1)-(8) (2003).

corporation not being required to file reports under § 15(d) of the Exchange Act

Item 7. Purposes, Alternatives, Reasons, and Effects[167]

Purpose of going private transaction

Whether corporation considered alternative methods of accomplishing those purposes and why they were rejected

The reasons for the structure of the transaction

The reasons for going private at the time of filing

The effects of going private on the corporation, its affiliates, and unaffiliated stockholders, including tax consequences

A reasonably detailed narratives of pros and cons of transaction, quantified if possible

Item 8. Fairness of the Transaction[168]

Whether filer reasonably believes the transaction is fair or unfair to unaffiliated stockholders

Identity of directors abstaining or dissenting and reason, if known

Analysis of all factors that went into decision and discussion of the basis for concluding the transaction is or is not fair

Normally, factors considered should include current and historical prices, net book value, going concern value, and liquidation value; prices paid by filing party in recent purchases of security; any expert opinions or valuations; terms of other firm offers within two years; procedural safeguards for minority protection[169]

Whether approval of majority of unaffiliated stockholders was required

Item 9. Reports, Opinions, Appraisals, and

[167] 17 C.F.R. § 229.1013 (2003).

[168] 17 C.F.R. § 229.1014 (2003).

[169] *See* 17 C.F.R. 229.1014(f)(2) (2003).

Negotiations[170]

All expert reports, opinions, or appraisals from outside parties that are materially related to the going private transaction

Identity and qualifications of expert

Methods by which expert was selected

Any material relationship during preceding two years between outside party and company or affiliates

Summary of findings and recommendations of expert, methods used to arrive at them, any limitations established by company on scope of investigation, and any instructions received by company or affiliate

Statement that report is available for inspection

Item 10. Source and Amounts of Funds or Other Consideration[171]

Specific sources and total amounts of funds or other consideration to be used in the transaction; if tender offer, amount of funds or other consideration required to purchase maximum amount sought

Material conditions to financing and alternative plans if such financing falls through

Itemized statement of all expenses expected to be incurred in transaction

Summary of loan arrangements if funds are borrowed

Item 11. Interest in Securities of the Subject Company[172]

The number of shares and percentage of company's outstanding shares beneficially owned by each person named in Item 3 and by each associate and majority-owned subsidiary of such persons

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[170] 17 C.F.R. § 229.1015 (2003).

[171] 17 C.F.R. § 229.1007 (2003).

[172] 17 C.F.R. § 229.1008 (2003).

All transactions in the company's securities involving such persons during the 60 days prior to filing

Item 12. The Solicitation of Recommendation[173]

Whether filing person is recommending unaffiliated stockholders vote for or against or sell their shares in connection with the transaction

Reasons for position taken

To the extent known after reasonable inquiry, whether any officer, director, affiliate, or other person named in Item 3 intend to sell or tender shares or, if vote is involved, how shares or proxy held by persons will be voted, and the reasons for the intended actions

Item 13. Financial Statements[174]

Audited financial statements for preceding two years

Unaudited balance sheets, comparative year-to-date income statements, cash flow statements, and comprehensive income included in company's most recent quarterly report

Ratio of earnings to fixed charges for preceding two years

Book value per share as of most recent balance sheet

If material, pro forma information on effect of transaction on these statements

Fair and adequate summary of all information disclosed under this section

Item 14. Persons/Assets, Retained, Employed, Compensated, or Used[175]

Persons to be retained, employed, or compensated to make solicitations or recommendations in connection with transaction and material terms of retainer or employment agreement

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[173] 17 C.F.R. § 229.1012(d), (e) (2003).

[174] 17 C.F.R. § 229.1010(a)-(b) (2003).

[175] 17 C.F.R. § 229.1009 (2003).

Employees or corporate assets of the company used by the filing person in connection with transaction

Item 15. Additional Information[176]

Any additional material information needed to make the required statements not materially misleading (catch-all)

Item 16. Exhibits[177]

Disclosure materials furnished to stockholders, including tender offer materials, solicitation or recommendation, going private disclosure document, or prospectus

Any loan agreement referred to in response to Item 7

Any report, opinion, or appraisal referred to in response to Item 8

Any document setting forth agreement referred to in Item 5

Detailed statement of stockholders' appraisal rights and procedures for exercising them

Written instructions supplied to persons making solicitations or recommendations for the filer relating to the transaction

[176] 17 C.F.R. § 229.1011(b) (2003).

[177] 17 C.F.R. § 229.1016(a)-(d), (f), (g) (2003).