

## Private Equity Newsletter

### Going Private Transactions with Private Equity Funds

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Private equity funds have been looking increasingly to the public markets for investment opportunities. In fact, the number of going private transactions with private equity funds in the first five months of 2010 nearly tripled relative to the same period in 2009. This trend is the result of several factors. The thawing of the debt markets may be the most important factor. In addition, the disclosure obligations and ever-increasing scrutiny of public companies have made members of management and boards more aware of, and discouraged by, the disadvantages of public company status, and thus more willing to take their companies private. Acquirors are also determined to act before the economy and stock market recover any further.

Special legal requirements apply to going private transactions, and these transactions have generally been subject to close scrutiny by both courts and the SEC because they inherently raise conflict of interest issues. To anticipate and try to avoid or at least limit the potential cost, delay and other consequences of legal challenges, private equity funds should be mindful of these legal requirements and consider their implications when formulating the overall transaction strategy – before approaching the target company's board or management, to avoid unintended consequences.

Davis Polk lawyers recently published "[Going Private Transactions: Overview](#)," which describes important strategic considerations and legal requirements for going private transactions, including:

- **The target company board will want to shop the company, either before or after the deal is struck with the private equity fund.** If the board of a public company determines that the company should be sold for cash to a private equity fund buyer, the board will have fiduciary duties to shop the company and consider alternative transactions to maximize value for the stockholders. This process may take place before the deal is signed or after, depending on the circumstances. If not done before, the board will insist on a "go shop" provision to allow it to shop the company for a limited period of time after signing. Even without a "go shop" provision in the acquisition agreement, the private equity fund should understand that a higher offer may be proposed to the target company board after the acquisition agreement is signed, and the board may determine to terminate the agreement with (and pay a break-up fee to) the private equity fund buyer.
- **Most going private transactions are the subject of litigation.** Most going private transactions are challenged in court by class action lawsuits filed on behalf of stockholders, generally based on claims that the target company's board has breached its fiduciary duties and that insufficient disclosure has been provided to stockholders to enable them to make an informed decision as to whether to approve the proposed transaction. The private equity fund may also be named as a defendant.
- **You may have to (and want to) negotiate the terms of the deal with a special committee of the target company's board.** If a significant stockholder, management or one or more directors (or their affiliates) is, or could become, engaged in the transaction with the private equity fund or otherwise treated differently from the public stockholders (other than non material changes to compensation arrangements for management), the target company's board is likely to create a special committee of independent, disinterested directors to negotiate the deal because this will

benefit them in subsequent litigation – either by shifting the burden of proof to the plaintiffs or by allowing a less stringent standard of review by the court. Use of a special committee can also benefit the private equity fund buyer because the cost of litigation generally does not reduce the purchase price that it pays for the target company shares and the litigation may continue post-closing. Of course, even if a formal special committee is not formed, the private equity fund should expect that the key negotiators on behalf of the target company will be independent, disinterested members of the board.

- **You may be prohibited from talking to management about the terms of the deal or their future compensation arrangements until the economic terms of the overall deal for stockholders are set.** To prevent management conflicts of interest from tainting the process, and to avoid arguments that management is engaged in the going private transaction (which may require a more stringent standard of review by the court in stockholder litigation), the target company’s board or special committee is likely to insist that management must not be involved in negotiating deal terms or discussing their future employment arrangements with the private equity fund until agreement has been reached on the economic terms of the deal for the stockholders. Again, this may ultimately benefit the private equity investor by reducing litigation costs.
- **Going private transactions that involve a stockholder “affiliate,” director or senior management will require additional disclosure.** State law fiduciary duties as well as the requirements of federal securities laws (Rule 13e-3) impose additional disclosure obligations on the parties to going private transactions when an “affiliate” (such as a substantial stockholder, director or senior management) is engaged in the transaction. For example, the private equity fund itself may have to disclose why it considers the proposed transaction to be “fair” to the public stockholders and file with the SEC a copy of all reports, opinions and appraisals that it received from outside parties that are “materially related” to the proposed transaction (such as analyses prepared by a financial advisor). Moreover, although proxy statements in the past have often stated that the terms of the economic arrangements with management have not yet been agreed to with the private equity fund, Delaware courts are increasingly requiring more detailed disclosure regarding these arrangements, which may make it more likely that the SEC staff will require the additional disclosures under Rule 13e-3. The private equity fund should also consider whether it is subject to disclosure obligations that apply generally to investments in public companies.<sup>1</sup> The timing and substance of the necessary disclosure should be considered in advance to ensure that appropriate steps are taken (or not taken) to avoid premature disclosure and to ensure that materials are prepared with the understanding that they will later be disclosed publicly.

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<sup>1</sup> For additional information regarding these disclosure obligations, please see our prior Private Equity Newsletter “[What Every Investor Should Know Before Acquiring a Large Stake in a Public Company.](#)”

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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