Going Private Transactions: Overview

An overview of going private transactions, including the key strategic considerations, fiduciary duty issues, procedural safeguards and required disclosures. This Note focuses on Delaware law because the vast majority of public companies are incorporated in Delaware. However, the state laws governing going private transactions may vary if the target company is incorporated in a state other than Delaware, so the parties should review the laws of the relevant state.

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"Going private" is a term used to describe a transaction (or series of transactions) with a controlling stockholder or other affiliated person(s) that reduces the number of stockholders of a public company, allowing the company to terminate its public company status and related reporting obligations under the Securities Exchange Act of 1934 (Exchange Act). The most common types of going private transactions are:

- Acquisitions by a controlling stockholder of a subsidiary with publicly traded shares (these transactions are also commonly referred to as squeeze-out mergers).
- Acquisitions by a significant but non-controlling stockholder.
- Leveraged buyouts by a private equity fund or other third-party acquiror working with management.

WHY DO COMPANIES GO PRIVATE?

There are many reasons why it may make sense for a public company to go private. For example, a going private transaction might:

- Permit a controlling stockholder and its publicly-traded subsidiary to integrate their operations more efficiently and effectively, without concerns for fairness to other stockholders.
- Allow management to focus on long-term objectives rather than short-term profits to appease Wall Street.
- Permit the public stockholders to realize a better price for their shares than they would realize from continuing to hold the shares or selling in the market, perhaps due to low trading volumes, lack of analyst coverage or lack of any other buyer (particularly if there is a controlling stockholder that would be unwilling to sell its shares).
- In the case of a leveraged buyout, allow the acquiror and target to realize the tax benefits of a more leveraged capital structure than would be acceptable for the target as a public company.
- Enable the company to save costs and avoid the disadvantages of complying with the requirements of the Exchange Act and the Sarbanes-Oxley Act, which require, among other things, periodic disclosure of what may be competitive or strategic business information and impose inflexible corporate governance requirements.
- Reduce the distraction (and litigation) that can result from dissatisfied public stockholders.
- Realize the benefits of consolidation for tax and/or accounting purposes.

However, companies that go private may face disadvantages, including loss of visibility and the inability to quickly tap the public markets for debt or equity financing or offer a liquid acquisition currency. For more on the advantages and disadvantages of being a public company, see *Practice Note, Deciding to Go Public (www.practicallaw.com/8-381-1347)*.

PRELIMINARY PLANNING ISSUES

The parties engaged in a going private transaction must comply with both state and federal laws that apply to acquisitions of public companies generally, as well as the additional legal requirements that state courts and the Securities and Exchange Commission (SEC) have

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established for going private transactions. These additional requirements are designed largely to protect the public stockholders and impose requirements on the procedures used for, as well as the substance of, going private transactions. The additional legal requirements mean that parties contemplating a going private transaction must be particularly attentive to strategic considerations. To avoid unintended consequences, an acquiror should carefully consider several key issues **before** approaching the target company's board or management, including:

- The risk (and likelihood) of litigation.
- The structure of the transaction.
- Disclosure obligations.
- Timing considerations.
- Potential for competing offers.

Risk of Litigation

Most going private transactions are challenged in court, generally based on claims of breach of fiduciary duties and disclosure obligations. When the transaction creates actual or potential conflicts of interest, as many do, the reviewing court will often apply an enhanced level of scrutiny, known as "entire fairness" review, to the process used by the parties to determine the terms of the proposed transaction. The use of certain procedures to protect the interests of the minority stockholders can shift the burden of proof or the standard of review applied by the court, depending on the type of transaction, so both the acquiror and the target company's board should understand the proper alternatives available to achieve these benefits.

Structure of the Transaction

As with any acquisition of a public company, a going private transaction is generally accomplished in one of two ways:

- One-step merger.
- Tender offer followed by a back-end merger (known as a two-step merger).

With a going private transaction, additional factors should be considered when deciding on its structure. A going private transaction with a controlling stockholder or affiliate, or with an affiliate of one or more directors or senior executives, that is structured as a one-step merger will likely involve negotiating with a special committee of the target company's board. If the transaction is with a controlling stockholder, it may be possible to structure it as a non-coercive tender offer followed by a short-form merger. Historically, a non-coercive tender offer could provide a means to avoid negotiating the terms of the transaction with a special committee of the target company's board and still have the court apply a less stringent standard of review in any resulting litigation. The benefits of this approach have become more uncertain recently. (see *Procedural Safeguards* and *Tender or Exchange Offer Followed by a Short-form Merger*).

Although it is theoretically possible for an acquiror to make privately negotiated and/or open market purchases of the target's stock to reach the 90% threshold required to execute a short-form merger, the obligation to promptly disclose changes in ownership and the possibility that these purchases may trigger application of the tender offer rules generally makes this approach impracticable.

Disclosure Obligations

Both state law and federal securities laws create disclosure obligations that apply to going private transactions. As with any public deal, 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 that materials are prepared with the understanding that they will later be disclosed publicly. In a going private transaction, the parties need to be particularly aware of the additional disclosure requirements, the timing of this disclosure, the increased scrutiny of this disclosure and the likelihood of litigation relating to the disclosure (see *Disclosure Obligations in a Going Private Transaction*).

Timing Considerations

The power of the target company's board to turn down or delay its response to an offer, to pursue alternative transactions or to publicly recommend against a tender offer, even if the offer is at a substantial premium, creates powerful negotiating leverage for the board. The acquiror should be prepared for a potentially long and complex negotiating process, and should be disciplined in its approach. It is important to recognize that target boards often use delaying tactics to frustrate a bidder into increasing its offer price. The target company's board can and should exercise this power, but understand also that this power is circumscribed by its fiduciary duties and the

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risk of stockholder dissatisfaction with the board's strategy (see *Practice Note, Defending Against Hostile Takeovers (www.practicallaw.com/9-386-7206)*).

In addition, depending on how the transaction is structured, the timing of the transaction may be impacted by SEC review. The SEC often has substantial comments on proxy materials used in connection with one-step mergers, particularly in going private transactions, so the SEC review and proxy revision process can typically take one to two months. Tender offers for cash consideration have a timing advantage over one-step mergers. SEC approval of a Schedule TO (tender offer statement) is not required for the tender offer to begin, although the SEC may have comments and require the Schedule TO to be amended or supplemented after filing (see *Disclosure Obligations in a Going Private Transaction*).

Competing Offers

A potential acquiror should be aware that, until (and sometimes after, if there has been insufficient solicitation in advance) a deal is reached, the target company's board may have fiduciary duties under *Revlon* if the board has determined that a sale for cash is appropriate, and thus may feel obligated to shop the company and evaluate alternative transactions to create a more competitive bidding process and comply with those duties. With a controlling stockholder transaction, however, an alternative sale of the company may not be an option because the controlling stockholder will likely block any of these alternatives.

If the controlling stockholder decides to propose a going private transaction to the target company's board or its stockholders, it will want to make clear to the board that the target company is otherwise not for sale and that the controlling stockholder will block any sale to competing bidders or other alternative transactions that would require its approval. For more information on the board's duties under *Revlon*, see *Practice Note, Fiduciary Duties of the Board of Directors (www.practicallaw.com/6-382-1267)*.

KEY ISSUES FOR A CONTROLLING STOCKHOLDER ACQUIROR

Going private transactions often involve the acquisition of a public company's shares by its controlling stockholder. These transactions raise special issues because:

- They are conflict transactions, which can be subject to the entire fairness level of scrutiny if challenged in court (as they almost always are).
- A controlling stockholder owes fiduciary duties to the other stockholders so the controlling stockholder itself may be subject to liability for breach of those duties.

Under Delaware law, a controlling stockholder is defined as a stockholder who either:

- Owns more than 50% of the voting power of the corporation.
- Exercises control over the business and affairs of the corporation.

Notably, a stockholder can be a "controlling stockholder," with fiduciary duties to other stockholders under Delaware law, even if it owns less than a majority of the public company's shares. However, a stockholder is not considered a controlling stockholder unless it has "such formidable voting and managerial power that [it], as a practical matter, [is] no differently situated than if [it] had majority voting control" (*In re PNB Holding Co. Shareholders Litigation, 2006 WL 2403999 (Del Ch. 2006))*.

Conflicts of Interest

An inherent conflict of interest exists in a going private transaction by a controlling stockholder because the controlling stockholder is seeking to acquire the entire target company to further its own interests while it owes fiduciary duties to the minority stockholders, whose shares would be purchased in the proposed transaction. In addition, the controlling stockholder's ownership interest gives it the power to control the approval of the transaction (and reject any alternative transaction) and to change the composition of the company's board of directors and management if they do not act in accordance with its wishes. In general, Delaware jurisprudence has reflected concerns that the interests of minority stockholders must be protected against self-dealing by the controlling stockholder, and skepticism regarding the motives of directors and management of the target company, who may not be independent of the controlling stockholder and may have interests in the going private transaction that are different from those of the public stockholders.

If a lawsuit challenging a going private transaction by a controlling stockholder is filed, a Delaware court will apply the stringent entire fairness standard of review (unless the transaction is structured in certain ways, as discussed below), as opposed to the deferential business judgment standard that applies to most board actions that do not raise conflict or duty of loyalty issues (see *Practice Note, Fiduciary Duties of the Board of Directors: Business*

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Judgment Rule (www.practicallaw.com/6-382-1267)). An important strategic goal of the parties to a going private transaction with a controlling stockholder, therefore, is to avoid the burden of proving in court that the transaction is fair to the non-controlling stockholders. This goal can be accomplished by either:

- **Using procedural safeguards.** Most commonly, the target company uses a special committee of independent, disinterested members of its board of directors to negotiate the terms of the deal. In Delaware, this has the effect of shifting the burden of proof to the plaintiffs to prove that the transaction is not fair to the non-controlling stockholders. A recent Delaware Chancery Court case suggests that it may also be possible for directors and the controlling stockholder to obtain the benefit of business judgment review by using a special committee and requiring majority-of-the-minority stockholder approval, although this would require overturning Delaware Supreme Court precedent in the context of a going private merger transaction (see *Procedural Safeguards*).
- **Structuring the deal as a non-coercive tender or exchange offer with a second-step short-form merger at the same price.** Historically, this would have removed the transaction from entire fairness review completely, but there is now uncertainty as to whether additional procedural safeguards may be required to achieve this benefit (see *Tender or Exchange Offer Followed by a Short-form Merger*).

In determining whether to follow the negotiated merger or tender offer approach, the controlling stockholder should consider, among other things:

- Whether it would prefer to negotiate the terms of a merger transaction with a special committee of the board (after evaluating who are likely to be the members of the special committee) before announcing the transaction or negotiate the tender offer price with key stockholders of the target company after commencement of a tender offer. The controlling stockholder must recognize in each case that the dynamics of a particular transaction may result in the controlling stockholder having to negotiate with both constituencies.
- The likelihood that the tender offer will succeed in allowing the controlling stockholder to reach the 90% ownership threshold required to effect the second-step short-form merger.
- Whether board approval is required for any aspect of the transaction (such as a poison pill waiver) or to obtain regulatory approvals.
- Litigation risk management strategies.

Procedural Safeguards

The burden of proving the procedural and substantive fairness of a proposed controlling stockholder transaction can be shifted to the stockholder plaintiffs if certain procedural safeguards are used. In *Kahn v. Lynch*, the Delaware Supreme Court held that if a cash-out merger initiated by a controlling stockholder is approved by **either** a special committee of independent, disinterested directors **or** an informed majority-of-the-minority stockholders, the burden of proof on the issue of fairness shifts to the challenging stockholder (*Kahn v. Lynch Communication Systems, Inc., 638 A.2d 1110 (1994)*). Because a fully-informed majority-of-the-minority vote can be unpredictable and difficult to obtain, and because use of a special committee may be more helpful in defending board members in pre-closing litigation (which is most common), most controlling stockholders and public company boards prefer to use a special committee to negotiate the terms of a going private transaction with a controlling stockholder rather than relying on a majority-of-the-minority vote.

In an attempt to provide transaction planners with greater litigation protection, Vice Chancellor Strine proposed a business judgment standard of review if the transaction is negotiated and approved by a special committee of independent, disinterested directors and also approved by a fully informed vote of a majority-of-the-minority stockholders (see *In re Cox Communications, Inc. Shareholders Litigation, 879 A. 2d 604 (Del. Ch. 2005)*). However, until the recent decision of Vice Chancellor Laster in *In re CNX Gas Corporation Shareholders Litigation, C.A. No. 5377-VCL (May 25, 2010)*, the *Cox Communications* approach had not gained much traction (see *Tender or Exchange Offer Followed by a Short-form Merger*).

Special Committees

A well-functioning special committee consisting entirely of independent and disinterested directors to negotiate the controlling stockholder transaction can ensure that the process approximates an arm's length, third party negotiation. In subsequent litigation, the use of a special committee can:

- Shift the burden of proof to the plaintiff stockholder, who would be required to show that the transaction was

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not fair to the minority stockholders.

- Be presented as evidence of the fairness of a transaction.

To try to satisfy potential challenges to a special committee process, the target company's board should, among other things:

- Ensure that each member of the special committee is in fact disinterested and independent.
- Establish a clear mandate for the special committee, including a well-defined scope of authority, power and responsibility. In particular, the special committee should have the authority to say no to the proposed transaction if that is in the best interests of the corporation and its stockholders.

To determine whether a director qualifies as independent and disinterested for purposes of serving as a member of a special committee, Delaware courts apply the test articulated in *Aronson v. Lewis*, which requires that the director must be free of "extraneous considerations or influences" and therefore in a position to consider the proposed transaction based solely on its corporate merits (*Aronson v. Lewis, 473 A.2d 805 (1984)*). Delaware cases explain that a director who is otherwise independent would be disqualified from serving on the special committee only if his or her interest in the transaction is sufficiently material that it would interfere with his or her independent judgment in representing the stockholders generally. For a list of factors that are helpful in demonstrating that a director is qualified to serve on a special committee, see *Box, How to Demonstrate Independence*.

Once it has its mandate, the special committee must remain fully engaged during the transaction process and should, among other things:

- Select qualified, experienced and independent financial and legal advisors ensuring that the:
  - advisors have no material past or present relationships with the controlling stockholder; and
  - committee chair and/or the committee as a whole are engaged in interviewing and selecting the advisors.
- Consider the feasibility and potential benefits of alternative value-enhancing transactions.
- Negotiate vigorously and use the bargaining power available to it in reaching the final terms of the transaction with the controlling stockholder, rather than merely accepting the terms dictated in the proposal.
- Encourage all members of the special committee to be active participants in the process, including attending all or almost all meetings of the special committee and keeping fully informed of all material information about the negotiations and consideration of alternatives.
- Exercise its own judgment in negotiating the principal elements of the transaction and, if applicable, in approving the transaction, rather than merely relying on the judgment of the advisors to the special committee.

HOW TO DEMONSTRATE INDEPENDENCE

Factors that are helpful in demonstrating that a director is qualified to serve on the special committee include:

- The director has no personal or business relationships with the controlling stockholder.
- The director has not entered into any material transactions or other agreements with the controlling stockholder in the past, outside of the agreement to serve as a director of the target company.
- The director will not receive any material benefit from the transaction that is not received by stockholders generally.
- The director will not suffer a material detriment as a result of the transaction that is not suffered by stockholders generally.
- The director does not serve with the controlling stockholder (or a member of its board or management) on the board or management of any other company or organization.
- The director demonstrates independence in his or her actions and deliberations during meetings and negotiations.

Majority-of-the-minority Stockholder Vote

Under *Kahn v. Lynch*, another way to shift to the plaintiff the burden of proving the entire fairness of a controlling stockholder merger transaction is to obtain

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majority-of-the-minority stockholder approval. This requires both of the following:

- The transaction must be approved by a majority of all of the minority shares that are entitled to vote, not merely a majority of the shares that are actually voted.
- The majority-of-the-minority approval requirement must be included in the transaction agreement and non-waivable.

In addition, the vote must be informed. This means that parties relying on this procedural mechanism must ensure not only that the transaction will be sufficiently attractive to secure the approval of a majority-of-the-minority stockholders, but also that stockholders are provided with all relevant information when deciding whether to approve the transaction. Therefore, the parties must consider what information and materials should be included in the proxy statement (for example, financial projections and underlying assumptions) to ensure that appropriate and sufficient information is made available to the voting stockholders and to try to avoid or, at least, limit future plaintiffs' claims of inadequate disclosure.

Tender or Exchange Offer Followed by a Short-form Merger

A controlling stockholder may structure its going private transaction as a tender or exchange offer followed by a short-form merger. Under this approach, the controlling stockholder makes an offer to purchase all shares of the target company held by the public stockholders. The controlling stockholder's goal is to own more than 90% of the outstanding shares of the target company following the tender offer, in which case the short-form merger statute (*Delaware General Corporation Law § 253*) allows the controlling stockholder to merge with the target company and cash out the remaining stockholders without the approval of the target company's board or stockholders.

In response to the tender offer, Section 14(d) and Rules 14d-9 and 14e-2 under the Exchange Act require the board of directors of a company subject to a tender offer to file a solicitation/recommendation statement on Schedule 14D-9 with the SEC within ten business days after commencement of the tender offer, to disclose either that it recommends that stockholders accept or reject the tender offer or that it expresses no opinion.

In the case of a going private transaction with a controlling stockholder, the target company's board should create and authorize a special committee of independent, disinterested directors to at least oversee the filing of the Schedule 14D-9, and depending upon the litigation strategy adopted, to have a greater role in the process as discussed below.

There is uncertainty as to the way Delaware courts will review going private transactions structured as tender or exchange offers followed by short-form mergers. Historically, Delaware courts have not generally applied the entire fairness standard of review to non-coercive tender or exchange offers. As articulated by the Delaware Chancery Court, a tender offer by a controlling stockholder will be considered to be "non-coercive" if each of the following is shown:

- The offer is conditioned to succeed only if a majority of the shares held by minority stockholders are tendered in the offer. Directors, officers and affiliates of the controlling stockholder do not count as minority stockholders for this purpose.
- The controlling stockholder has committed to complete a short-form merger at the same price promptly after the tender offer is completed if it obtains more than 90% of the shares.
- There are no retributive threats by the controlling stockholder to minority stockholders (for example, to halt dividends, to execute a subsequent cash-out merger at a lower price or to delist the company's shares) if they do not tender into the offer.
- The independent directors are given complete discretion and sufficient time to react to the tender offer, by hiring their own advisors, providing a recommendation to the non-controlling stockholders, and disclosing adequate information to allow the non-controlling stockholders an opportunity for informed decision making.

(See *In re Pure Resources Shareholders Litigation, 808 A.2d 421, 446 (Del Ch. 2002).*)

The *Pure Resources* approach has been criticized for creating different legal standards for transactions that generate the same substantive result, but has generally been followed in subsequent Delaware Chancery Court decisions, including most recently in *In re Cox Radio, Inc. Shareholders Litigation, C.A. No. 4461-VCP (May 6, 2010)*. However, most recently in CNX Gas Corporation, Vice Chancellor Laster proposed a unified standard of review for both transaction structures. This unified standard was derived from the approach proposed by Vice Chancellor

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Strine in *Cox Communications* even though that approach had not gained much traction in the intervening five years. Under the *CNX Gas Corporation* unified approach, a going private transaction structured as a one-step merger would be subject to business judgment and not entire fairness review if the transaction is **both**:

- Negotiated and approved by a special committee of independent, disinterested directors.
- Conditioned on an affirmative vote of a majority-of-the-minority stockholders.

Mirroring the above, under the *CNX Gas Corporation* unified approach, a going private transaction that is structured as a non-coercive tender or exchange offer followed by a short-form merger would be subject to business judgment and not entire fairness review if the tender or exchange offer is **both**:

- Negotiated and recommended by a special committee of independent, disinterested directors.
- Conditioned on an affirmative tender of a majority-of the-minority shares.

CNX Gas Corporation modifies Vice Chancellor Strine's approach in *Cox Communications* in two ways:

It requires that the special committee actually negotiate the terms of the tender offer with the acquiror, not simply review and recommend (or take a neutral position on) the tender offer to the minority stockholders. Indeed, the *CNX Gas Corporation* court requires that the special committee of the board be granted authority comparable to what the full board would possess in an arms-length transaction, including authority to consider alternative transactions, establish a poison pill and litigate against the controlling stockholder. In contrast, *Pure Resources* concluded that the special committee did not need to have expanded powers beyond evaluating the offer and making a recommendation to the stockholders.

It imposes the entire fairness standard of review if the special committee does not affirmatively recommend a tender offer, as opposed to *Cox Communications*, which stated that entire fairness review would apply only if the special committee recommended that the minority stockholders not tender their shares, suggesting that entire fairness might not apply if the special committee does not take a position on the tender offer.

CNX Gas Corporation did not explicitly address whether the *Kahn v. Lynch* rule of burden shifting would continue to apply to one-step merger transactions that use either a special committee or a majority-of-the-minority stockholder vote, but not both. However, because *CNX Gas Corporation* follows *Cox Communications*, which expressly proposed that *Kahn v. Lynch* would continue to apply to mergers which did not use both a special committee and a majority-of-the-minority vote, it would appear that the parties to a controlling stockholder acquisition can continue to rely on *Kahn v. Lynch* burden-shifting. Furthermore, *Kahn v. Lynch* is a decision of the Delaware Supreme Court, so it is unaffected by either of these Chancery Court decisions.

As a result, the acquiror must consider another strategic question, whether to negotiate with both a special committee as well as minority stockholders in order to invoke the business judgment rule; or to rely on only one of the two procedural protections and face entire fairness review, but with the burden of disproving entire fairness shifted to the plaintiff stockholders.

The *Pure Resources* standard of review gives the controlling stockholder the option of proposing a going private transaction without first engaging in negotiations with a special committee, or after determining that negotiations with the special committee are not progressing to its satisfaction. However, following *CNX Gas Corporation*, acquirors should anticipate that special committees and plaintiffs will demand that the special committee has greatly expanded powers and negotiating authority.

For more information on the timing and disclosure requirements of a tender offer, see *Practice Note, Tender Offers: Overview (www.practicallaw.com/1-382-7403)*.

KEY ISSUES FOR NON-CONTROLLING STOCKHOLDERS AND MANAGEMENT

A going private transaction may also involve an acquisition of a public company by a non-controlling stockholder or a leveraged buyout of a public company by a private equity fund or other third-party acquiror working with management. These transactions require an understanding of the same strategic considerations discussed above. However, because stockholders who are not controlling stockholders do not owe fiduciary duties to the other stockholders, Delaware courts generally will apply the business judgment rule rather than the entire fairness standard of review to these going private transactions.

Delaware courts have noted, however, that certain types of going private transactions, even if they do not involve

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a controlling stockholder, create inherent conflicts of interest and may trigger an entire fairness standard of review unless procedural safeguards are used to protect the public stockholders (see *Box, Entire Fairness With Non-Controlling Stockholder Transactions*).

Many going private transactions involve participation by members of the company's board and/or senior management, who also owe fiduciary duties to the target stockholders. Because the extent of senior management's involvement in a going private transaction can influence the court's standard of review if the transaction is challenged, consideration should be given to steps that may be taken and procedural protections that may be used to avoid application of the entire fairness standard of review. For example, an acquiror and target company board can reduce management's involvement in the acquisition by ensuring that:

- The terms of the transaction are negotiated only with disinterested members of the target company's board.
- The acquiror refrains from negotiating post-transaction employment arrangements with existing management until the terms of the acquisition are finalized.

Any party considering a going private transaction should keep in mind that, absent a controlling stockholder who can effectively block competing bids, an offer to acquire the target for cash will likely trigger *Revlon* duties for the target board. The board will then be charged with maximizing short-term value for the target's stockholders, which may require shopping the company or conducting an auction. If the target company's board does conduct a sale process, *Revlon* duties will also require that it conduct the sale process so that acquirors working with management and/or directors do not gain any improper advantage in the sale process.

DISCLOSURE OBLIGATIONS IN A GOING PRIVATE TRANSACTION

As mentioned above, both state law and federal securities laws create disclosure obligations that apply to going private transactions. As a matter of state law, the Delaware courts have held that directors and officers of the target company (and the controlling stockholder in the case of a going private transaction with the controlling stockholder) have duties to ensure that all "material facts" that are relevant to the decision by stockholders to approve or reject the proposed transaction must be disclosed to the public stockholders. These requirements have been established by case law, where plaintiffs have challenged the adequacy of the disclosure and the court decisions have generally hinged on whether particular information is "material" to the public stockholders under the specific facts of the case. The requirement for disclosure of all material information is also imposed by federal securities laws, and the SEC has established specific rules that highlight particular information that must be included in the public disclosure for a going private transaction.

A going private transaction requires the same SEC filings as any other public company acquisition, but with the incremental disclosures required by Rule 13e-3 of the Exchange Act. The basic disclosure documents required by the SEC rules depend in part on the structure of the acquisition. For a transaction structured as a one-step merger, the target company must solicit approval of its stockholders by using a proxy statement that complies with Regulation 14A and Schedule 14A under the Exchange Act (or, if proxies are not solicited, the equivalent disclosures in an information statement that complies with Regulation 14C and Schedule 14C under the Exchange Act). For more information on the securities laws and disclosure obligations applicable to proxy statements, see *Practice Note, Proxy Statements: Public Mergers (www.practicallaw.com/6-383-4972)*.

For a transaction structured as a two-step merger, the acquiror must file a tender offer statement on Schedule TO. A Schedule TO requires the acquiror to provide certain disclosure required by Regulation M-A under the Exchange Act. In addition, the target company must file a Schedule 14D-9 within ten business days after the commencement of the tender offer to disclose either that it recommends that stockholders accept or reject the tender offer or that it expresses no opinion. For more information on the securities laws applicable to tender offers, see *Practice Note, Tender Offers: Overview (www.practicallaw.com/1-382-7403)*. If securities are being offered as all or part of the consideration, those securities must be offered pursuant to a registration statement on Form S-4 (see *Practice Note, Registration Statement: Form S-4 and Business Combinations (www.practicallaw.com/5-384-6225)*).

In addition, the acquiror (and/or other parties) may have disclosure obligations under Section 13(d) of the Exchange Act (see *Box, Section 13(d) Disclosure Obligations*). An acquiror who holds 10% or more of the target company's equity before a going private transaction should also be mindful of the short-swing profit rules under Section 16(b) of the Exchange Act if it has sold any of the target company's

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ENTIRE FAIRNESS WITH NON-CONTROLLING STOCKHOLDER TRANSACTIONS

There are two notable Delaware decisions that provide guidance on circumstances when the court will apply the entire fairness standard of review despite the absence of a controlling stockholder on both sides of the transaction:

- A Delaware court held that a going private transaction created a conflict that was significant enough to warrant entire fairness review, despite the absence of a controlling stockholder, because the directors would realize benefits from the proposed going private transaction that were not offered to other stockholders (see *In re PNB Holding Co. Stockholders Litigation (2006 WL 2403999 (2006)*). The court noted, though, that approval of this type of transaction by an informed, non-coerced majority of the disinterested stockholders may have the effect of invoking the business judgment rule in lieu of the entire fairness standard of review.
- Another court held that the entire fairness standard of review should be applied when the controlling stockholder holds a separate class of shares and separately negotiates the terms on which he would sell his shares to a third-party acquiror, so the minority stockholders were effectively in competition with the controlling stockholder to receive a portion of the total purchase price (see *In re John Q. Hammons Hotels Inc. Stockholder Litigation (2009 WL 3165613 (2009)*). The court in Hammons indicated that the use of sufficient procedural protections for the minority stockholders could have resulted in application of the business judgment standard of review instead of entire fairness and explained that adequate protections would have existed had the transaction been both:
  - recommended to the minority stockholders by a disinterested and independent special committee; **and**
  - approved by stockholders in a non-waivable vote of the majority of all the minority stockholders.

shares in the six months prior to the going private transaction (see *Practice Note, Section 16 Reporting: Why, How and When to Do It (www.practicallaw.com/2-386-1726)*).

Finally, as discussed in detail below, the target company and each affiliate engaged in the going private transaction may be required to adhere to the additional disclosure obligations and waiting period requirements imposed by Rule 13e-3.

Types of Transactions Subject to Rule 13e-3

Rule 13e-3 under the Exchange Act imposes disclosure requirements that apply to going private transactions meeting certain criteria. Accordingly, parties engaging in these types of going private transactions must comply with both the generally applicable requirements for public company acquisitions (such as the proxy and tender offer rules) as well as the enhanced disclosure requirements under Rule 13e-3. In general, a transaction is subject to Rule 13e-3 if it satisfies a three-part test that analyzes its type, participants and effects. Specifically, a transaction will be subject to Rule 13e-3 if it has all of the following characteristics:

- **Type of transaction.** It is one of the following types of transactions:
  - purchase of any equity security by the target or an affiliate of the target;
  - tender offer for any equity security by the target or an affiliate of the target; or
  - proxy or consent solicitation or distribution of an information statement by the target or an affiliate of the target in connection with a merger or similar corporate reorganization, an asset sale or a reverse stock split involving a repurchase of fractional interests.
- **Participants.** It is "engaged in" by the target or an "affiliate" of the target.
- **Purpose.** It has a "reasonable likelihood or a purpose" of causing any class of public equity securities of the target company to be either eligible for termination from registration or reporting obligations under the Exchange Act or removed from listing on a national securities exchange.

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SECTION 13(D) DISCLOSURE OBLIGATIONS

The parties to a going private transaction must consider the need and timing for compliance with any filing requirements imposed by Section 13(d) of the Exchange Act.

If a controlling stockholder (or other beneficial owner of more than 5% of a class of equity securities) proposes a going private transaction and has previously filed a Schedule 13D without disclosing its intent to participate in a going private transaction, it must amend its Schedule 13D filing to indicate that change in intent. The SEC has indicated that this amendment must be filed promptly after the filer forms its intent to enter into the transaction, not merely on execution of formal documents or commencement of a tender offer. Consequently the acquiring stockholder must carefully consider the timing for its filing an amendment to its Schedule 13D, which may be before (but no later than) engaging in substantive discussions about a potential going private transaction with the target company's board of directors.

If the stockholder that proposes a going private transaction has filed a Schedule 13G (other than pursuant to Rule 13d-1(d), for which a Schedule 13G filing is permitted even if the securities are held with the purpose or effect of changing or influencing control of the target company), it must file a Schedule 13D within ten days after it forms the intent to change or influence control of the target company. This Schedule 13D filing or amendment must disclose the acquiror's intentions, so it should carefully consider what actions can and should be taken before approaching the target company board without triggering these disclosure obligations.

Even parties who are not Schedule 13D filers may become subject to Section 13(d). For example:

- A person who owns less than 5% that engages in discussions with a 5% beneficial owner about a potential going private transaction may trigger a separate Schedule 13D filing obligation if a "group" as defined in Rule 13d-5(b)(1) is formed during the process.
- A potential acquiror that enters into a voting agreement with a stockholder or stockholders owning (in the aggregate) at least 5% of the target's outstanding stock is required to file a Schedule 13D if the voting agreement gives the potential acquiror the power to vote, or to direct the voting of, the shares, which causes the potential acquiror to become the beneficial owner of the shares under Rule 13d-3.

For more information on the Section 13(d), see *Practice Note, Section 13(d) Beneficial Ownership Reporting (www.practicallaw.com/3-501-2261)*.

Rule 13e-3 also applies to a "series" of any the transactions listed above that, taken together, satisfy the other elements of the Rule 13e-3 test. For example:

- A non-affiliate conducting a going private transaction through open market purchases must satisfy Rule 13e-3 disclosure obligations before making the initial purchase, because it will eventually become an affiliate even though the initial purchase taken alone would not fall within Rule 13e-3.
- If the target company sells certain assets and then uses the proceeds of the asset sale to repurchase its shares and that repurchase results in a going private transaction, then this series of transactions may require compliance with Rule 13e-3 before the initial asset sale.

However, Rule 13e-3 does not apply to transactions that fall under one of the exceptions listed in Rule 13e-3(g). The most significant exceptions are set out below:

- **Second step clean-up transactions.** Rule 13e-3(g)(1) excepts second-step clean-up transactions (such as short-form mergers) that occur within one year after expiration of a tender offer (even though the acquiror became an affiliate of the target company upon completion of the tender offer), if certain conditions are satisfied. The SEC views these transactions as a single, integrated transaction by a non-affiliate to acquire the entire class of equity securities

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of the target on the same per share basis as the tender offer. To fall within this exception, the acquiror must offer consideration "at least equal to the highest consideration offered during such tender offer" (see *Rule 14-10, Exchange Act*). The acquiror must also disclose its intent to complete a back-end merger in an offer to purchase (the primary disclosure document) disseminated to the stockholders and the merger must occur as described.

- **Equivalent equity securities.** Rule 13e-3(g)(2) excepts transactions in which stockholders are offered or receive common stock or another equity security if the following conditions are met:
  - The new security is registered under Section 12 of the Exchange Act or reports are required to be filed under Section 15(d) of the Exchange Act.
  - The new security has substantially the same rights as the old security, including voting, dividends, redemption and liquidation rights.
  - If the old security was either listed on a national securities exchange or authorized for trading on an inter-dealer quotation system, the new security must be as well.

  If the transaction meets the criteria of one of the types of deals subject to Rule 13e-3, for the Rule 13e-3(g)(2) exception to apply, the new security must be issued by the acquiror and not a third party. The Rule 13e-3(g)(2) exception is available even in a cash election merger, where stockholders may opt to receive either cash or a new equity security, if the cash and equity security are of substantially equal value.

When is a Transaction "Engaged In" by the Target Company or its Affiliate?

Rule 13e-3 applies to a transaction of a type described above if it is "engaged in" by the target company or an affiliate of the target. The target company or affiliate need not be the purchasing entity in a going private transaction to be considered to be "engaged" in the transaction. It may be considered to be "engaged" in a wide variety of circumstances, including transactions in which:

- The target company recommends that its stockholders accept a tender offer by its affiliate, even if the target company has not signed a business combination agreement with the affiliate.
- Senior management (who are generally considered to be "affiliates") will receive material benefits from the transaction that will not be received by the public stockholders.

When is a Person an "Affiliate" of the Target Company?

Difficult interpretive issues can arise in determining whether a person is an "affiliate" of the target company. Rule 13e-3(a)(1) defines an "affiliate" of an issuer as "a person that directly or indirectly through one or more intermediaries controls, is controlled by or is under common control with such issuer." Rule 12b-2 under the Exchange Act defines "control" to mean the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract or otherwise.

Under case law and SEC interpretations of these terms, a stockholder may be an "affiliate" for purposes of Rule 13e-3 even if it does not meet the test for a "controlling stockholder" under Delaware law (see *Key Issues for a Controlling Stockholder Acquiror* for more information on how Delaware law defines a "controlling stockholder"). "Control" may be found with ownership of substantially less than 50% of the target company. Practitioners generally consider that ownership above 10% or having a right to appoint a director to a company's board requires special scrutiny of the facts and circumstances of the relationship to determine whether or not a person is an affiliate.

The question of control and affiliation depends not only on the size of a stockholder's equity ownership, but also on other factors. In particular, the analysis should consider the stockholder's ability to influence the target. Factors that have been considered by courts and the SEC in determining whether a person is in control of a company have included:

- Whether the company and the person have common board members, officers or stockholders.
- Representation on board committees (especially compensation committees) that have significant influence over the decisions of management or the company.
- Contractual relationships with the company.
- Existence of one or more other large stockholders (effectively reducing the person's ability to control the company). However, the mere presence of another large

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stockholder will not preclude a stockholder owning a lesser amount of securities from being considered an "affiliate" (see *SEC Compliance & Disclosure Interpretations, Going Private Transactions, Exchange Act Rule 13e-3, and Schedule 13E-3, Question 102.01 (2009)*).

- Nature of past, current or future relationships with the company.

In determining whether affiliation exists, the SEC focuses on the power to exercise control and not merely whether that power has in fact been exercised. The SEC has explained that "affiliation cannot be eliminated by attempting to conduct negotiations in an arm's length manner" (see *Technology for Communications Int'l, Inc. SEC No-Action Letter (1988)*). That is, if a control person is "engaged" in the going private transaction, Rule 13e-3 will apply despite procedural safeguards designed to prevent the party from exercising control, such as use of a special committee.

Members of the senior management team of a company (such as the CEO and CFO) are considered to be affiliates of that company. Accordingly, an acquisition of a public company by a private equity fund or other third party may be deemed a going private transaction subject to Rule 13e-3 in situations where the target company's senior management is "engaged in" the transaction (other than on behalf of the target company). Factors that tend to support a finding that senior management is "engaged in" a transaction or affiliated with the acquiror include:

- Senior management's role with the target company, the acquiror and its affiliates following the transaction.

- Material increases in compensation or other favorable changes in employment agreements with senior management. The SEC has stated that it "would not view a person as an affiliate of the purchaser solely because such person enters into or agrees to enter into a reasonable and customary employment agreement or is elected or there is an agreement to elect such person as an executive director or officer of the purchaser" (see *SEC Release No. 34-16075 (1979)*). By implication, employment arrangements outside of what is usual and customary for the company may trigger a conclusion that management is "engaged" in the transaction. The parties must therefore consider the timing of entering into employment arrangements with management because they may cause a proposed transaction to become subject to Rule 13e-3.

- Whether senior management will own a material amount of the surviving company's equity securities. Even if there is no formal agreement between a private equity buyer and the senior management of the target company in place, the SEC has stated that management may be deemed to be engaged "[w]here there exists a general understanding that a target's senior management will receive equity in a surviving entity" (see *SEC Compliance & Disclosure Interpretations, Going Private Transactions, Exchange Act Rule 13e-3, and Schedule 13E-3, Question 201.06 (2009)*).

- Representation of senior management on the acquiror's or target company's board after the transaction.

- Involvement of senior management in the negotiation and process of the transaction. For example, if it is management who initially approaches a buy-out sponsor, a strong argument may exist that management was "engaged in" the transaction.

Implications of Triggering Rule 13e-3

If a going private transaction is subject to Rule 13e-3, the target company and each affiliate engaged in the going private transaction must file a Schedule 13E-3 with the SEC and otherwise comply with Rule 13e-3. The target and each affiliate must also file amendments to the Schedule 13E-3 to report any material changes to the Schedule 13E-3 as well as a final amendment reporting the final results of the transaction. The SEC will look through any acquisition vehicles (merger subsidiaries or others) to determine whether the intermediate or ultimate parent should be an additional filing person under Rule 13e-3. If so, both the acquisition vehicle and the person or entity that formed it will be considered filing persons.

Disclosure and Documentation Required Under Rule 13e-3

Schedule 13E-3 shares many of the same disclosure requirements as Schedule 14A (which must be filed with the Schedule 13E-3 for going private transactions structured as one-step mergers) and Schedule TO (for going private transactions structured as tender offers). In most cases, the disclosure required by Rule 13e-3 will be provided in the proxy statement (included in the Schedule 14A) or offer to purchase (included in the Schedule TO), as applicable, and the Schedule 13E-3 (filed simultaneously) will simply incorporate this information by reference.

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In transactions where both the target company and its affiliate(s) are engaged in the Rule 13e-3 transaction, a joint filing is allowed. However, the SEC requires that any joint filing include individual statements concerning the purpose and fairness of the transaction and certain other disclosure items from (and specific to) each of the filing persons (see *below*).

The key additional disclosures required by Schedule 13E-3 appear in Items 7, 8 and 9 of Schedule 13E-3. These items require disclosure of the information required by Items 1013, 1014 and 1015 of Regulation M-A, and must appear prominently in a "Special Factors" section at the front of the proxy statement or offer to purchase. Each "Special Factors" disclosure item is described below.

Purposes of the Transaction. The target company and each affiliate engaged in the going private transaction must disclose its purposes for the transaction. This disclosure should include:

- A description of any alternatives considered and why they were rejected.
- An explanation of the reasons for the structure of the transaction and for undertaking the transaction.
- Disclosure of the effects of the transaction on the target company, its affiliates and unaffiliated stockholders, including the tax consequences of the transaction. A description of the effects of the transaction should include a reasonably detailed discussion of both the benefits and detriments of the proposed transaction to the target, its affiliates and unaffiliated stockholders. It should also quantify the effects to the extent possible. The affiliate's disclosure should include the effect of the transaction on the affiliate's interest in the target's net book value and net earnings, in both dollar amounts and percentages.

Fairness of the Transaction. Each filing person must provide information regarding the substantive and procedural fairness of the transaction. This disclosure should include:

- Whether each filing person believes that the transaction is fair to unaffiliated stockholders.
- A discussion of the material factors upon which that belief is based and the weight assigned to each factor.
- Whether the transaction requires the approval of at least a majority of unaffiliated stockholders and whether a majority of the non-employee directors approved the transaction.
- Whether any directors dissented or abstained from voting on the transaction, and if so, why.
- Whether a majority of the non-employee directors retained an unaffiliated representative to negotiate the terms of the transaction on behalf of the unaffiliated stockholders.

Reports, Opinions, Appraisals and Negotiations. The disclosure must also include a description of all reports (including any oral reports), opinions and appraisals from outside parties that are "materially related" to the transaction, including any reports, opinions or appraisals related to the price or fairness of the transaction (for example, the financial advisor's fairness opinion). A copy of each report, opinion or appraisal must be filed with the SEC as an exhibit to the Schedule 13E-3. For each document, the following information must be disclosed:

- The identity of the outside party, including whether any material relationship exists between the outside party and the target company or its affiliates.
- Whether the outside party or the target company (or its affiliate) determined the price.
- A summary of the document, including the procedures followed, findings and recommendations, the basis for and methods of arriving at the findings and recommendations, instructions received from the target or affiliate, and any limitation on the scope of the analysis imposed by the target company or its affiliates.

The SEC has indicated that this disclosure requirement covers **any** appraisals or reports related to valuation, whether written or oral, and whether or not prepared in connection with the proposed transaction. Given the breadth of this disclosure requirement, the target company, its affiliates and their advisors should be aware that documents such as presentations, board books and other similar materials, whether preliminary or final, may need to be disclosed and filed with the SEC.

Financial projections, while not specifically required by Schedule 13E-3, are generally requested by the SEC staff in its review and comment process, and may be required to be disclosed and filed with the Schedule 13E-3, especially if they have been provided to the acquiror or its advisors. The safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995

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(PLSRA) does not apply to statements made in connection with going private transactions (see *Disclosing Nonpublic Information: Disclosures of Forward-Looking Information (www.practicallaw.com/2-382-5502)*). Therefore, the parties to a going private transaction should not refer to the PSLRA in the Schedule 13E-3 or other disclosures made in connection with a Rule 13e-3 transaction, including any press releases, the offer to purchase, and proxy materials.

Timing for Filing and Waiting Period Requirements

The required timing for filing the Schedule 13E-3 with the SEC depends on the structure of the transaction. For one-step mergers, the Schedule 13E-3 must be filed at the same time as the preliminary or definitive proxy statement or information statement For tender offers, the Schedule 13E-3 must be filed as soon as practicable on the date the tender offer materials are first published, sent or given to stockholders. In either case, if the transaction involves a registration of securities (if stock is being offered as consideration), the Schedule 13E-3 must be filed at the same time as the registration statement covering the offer of those securities. In addition, the Schedule 13E-3 generally must be amended to refer to additional disclosure each time the proxy statement or offer to purchase is amended. For Rule 13e-3 transactions that do not involve any of the filings described above (such as issuer repurchases), the Schedule 13E-3 must be filed at least 30 days before any purchase of securities of the class of securities subject to the Rule 13e-3 transaction.

There is effectively a waiting period of at least 20 days for any Rule 13e-3 transaction because, under Rule 13e-3(f), the information required in the Schedule 13E-3 must be provided to stockholders no later than 20 days before any one of the following:

- Any purchase of equity securities in the Rule 13e-3 transaction.
- Any vote, consent or authorization concerning the Rule 13e-3 transaction.
- The date of the meeting held to consider the Rule 13e-3 transaction.
- The date of any corporate action taken concerning any Rule 13e-3 transaction that involves an information statement.

If the Rule 13e-3 transaction involves a series of transactions, the Schedule 13E-3 must be filed within the time frames described above for the first transaction, and then amended promptly for each subsequent transaction. Therefore, if a target or affiliate of the target proposes to purchase securities in the market as a first step in a series of transactions that will collectively constitute a Rule 13e-3 transaction, the target (and/or its affiliate) must file a Schedule 13E-3 at least 20 days before commencing the purchase program.

The timing of the transaction will also depend on SEC review and comment on the public filings made in connection with the transaction. The SEC often reviews going private transactions and usually has substantial comments on proxy materials used in connection with one-step mergers. The SEC review and proxy revision process can typically take one to two months. Tender offers for cash consideration have a timing advantage over a regular merger transaction because SEC approval of a Schedule TO is not required for the tender offer to begin (although the SEC may have comments or require the Schedule TO to be amended or supplemented after the filing). For more information on the timing of one-step mergers and tender offers, see *Public Merger Timeline (www.practicallaw.com/9-383-1095)* and *Tender Offer Timeline (www.practicallaw.com/2-383-1032)*). For more information on the SEC review process, see *Practice Note, Registration Process: SEC Review (www.practicallaw.com/5-380-8011)*.

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