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Going Private Transactions

A serious alternative for small and midsized public companies

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Even before the passage of the Sarbanes-Oxley Act (Sarbanes-Oxley) in July 2002 made life a lot more complicated for public companies, the idea of taking a public company private had significant allure to certain shareholders of small to medium-sized public companies. The increased cost of Sarbanes-Oxley compliance (time and resources) and the increased potential for civil and criminal liability have acted as the proverbial "straw that broke the camel's back." Companies that were previously only curious about the process or those that toyed with the notion of going private have now developed the final impetus to seriously consider a going private transaction as a viable shareholder alternative.

Sarbanes-Oxley and related SEC regulations have produced a myriad of new requirements resulting in even more unanswered questions. When these are added to the increased costs, management time and disclosure obligations as well as the additional exposure to criminal and civil liability, and the corporate governance reform at the NYSE and NASDAQ, executives of small and midsized publicly traded companies are increasingly turning toward exploring the ultimate exit from public life: the going private transaction.

While these new rules and disclosures apply to all public companies, both large and small-cap, the additional high fixed legal, accounting and other costs to ensure compliance mean that greater and greater dollar amounts and people resources will be needed just to remain in place. Inevitably, this burden will fall disproportionately on small and midsized companies. Recent reports indicate that the annual costs for being public have nearly doubled for midsized public companies since Sarbanes-Oxley became law.

Whether Sarbanes-Oxley, the other recent rules and regulations and the attendant costs and liabilities have finally tipped the scale is debatable, but there are sure signs that going private transactions are finally gaining momentum. Accordingly, smaller and midsized public companies that have been unsuccessful in attaining the benefits of public ownership may owe it to themselves and their shareholders to consider this alternative when assessing potential appropriate measures to maximize shareholder value and liquidity.

Why Go Private?

A "going private transaction" is one in which the company reduces the number of its shareholders to fewer than 300 and is, therefore, no longer required to file reports with the SEC. In the typical going private transaction, a controlling shareholder or a management-led team acquires all of the outstanding public shares.

The principal factors cited by small and midsized companies include:

1) Increased costs. While public companies have always incurred legal, accounting and other costs to support such status, Sarbanes-Oxley and the related SEC regulations may have pushed these companies to the breaking point. Aside from the certain increases in legal and accounting fees to comply with the new rules, there are many additional associated costs. For example, companies whose boards and audit committees are not comprised of the requisite number of outside directors meeting the enhanced independence requirements must now expend resources locating such persons, including a "financial expert." In addition, by all accounts, the cost of directors' and officers' insurance has tripled or even quadrupled over the last year.

2) Increased liability. CEOs and principal financial officers now have to regularly certify as to various financial, procedural and other factors relative to the company. Not only do their certifications expose those individuals to significant civil penalties, but create an

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additional risk of criminal liability, potentially resulting in prison time.

3) Increased disclosure burdens. The passage of Sarbanes-Oxley has also led to the introduction of many new disclosure requirements. At the top of this list are the requirements for establishing and maintaining an internal control infrastructure over financial reporting and including management internal control reports in 10-Ks, as well as providing the aforementioned officer certifications in periodic reports, heightening the risk of exposure to civil and criminal liability.

4) Little benefit to remaining public. While the past several months have seen some dramatic upward price movement in the markets, many smaller and midsized companies have not benefited sufficiently. Low valuations of company stock, resulting from the relatively depressed stock market of the past few years (until recently) and low trading volumes have meant little or no analyst coverage for most companies with market capitalizations below $300 million, regardless of company performance or prospects, and therefore little or no interest from institutional investors. As a result, many such companies cannot access the capital markets for financing, or use their stock as currency to make growth acquisitions or provide viable management incentives in the form of stock options.

5) Liquidity. Given the low valuations and trading volumes, going private transactions can offer public shareholders the opportunity not otherwise available in the market to sell their shares (without regard to driving down stock prices) at premiums over recent market prices — although not necessarily over the price originally paid for the stock.

Advantages and Disadvantages

There are many advantages to converting to a private company, among them:

- Reducing legal, accounting and other costs and eliminating reporting obligations under the Securities Exchange Act of 1934, as amended (Exchange Act);
- Eliminating certain potential personal liabilities resulting from the imposition of new rules and a difficult regulatory climate;
- Restoring management focus to long-term business goals instead of quarterly financial targets and daily stock performance;
- Freedom from burdensome new corporate governance rules, such as the requirement for a majority of independent board members and the prohibition on personal loans to directors and executive offers; and
- Eliminating the competitive disadvantages that may have resulted from required disclosure of sensitive business information.

Of course, there are also downsides to going private, including:

- The loss of prestige that attaches to being public;
- The loss of the potential to eventually reap the benefits of public ownership (i.e., access to the capital markets and use of stock for acquisitions and management retention) should the markets, analyst coverage or institutional interest for a company improve; and
- The time and cost necessary to complete a going private transaction.

Accomplishing a Going Private Transaction

1) Choosing a transaction structure. There are four basic routes that companies with more than 300 shareholders take to go private: (a) a cash-out merger in which the public company is merged with an entity controlled by a buyout group and the public shareholders receive cash for their shares; (b) a tender offer by a buyout group, typically followed by a short-form cash-out merger; (c) an issuer self-tender offer in which the issuer repurchases its shares; and (d) a reverse stock split in which the public company solicits shareholder approval to amend its charter to provide for the combination of a large number of outstanding shares into one share, and then cashes out the small holders that are left with only fractional shares. The first two structures are the most common.

Once the transaction is consummated and the company shareholders are fewer than 300, the company can proceed to delist its shares from the applicable exchange or NASDAQ and deregister its shares under the Exchange Act.

In deciding on a structure, a company needs to evaluate several factors, including the make-up of its shareholder base, the percentage of stock held by insiders, the existence and commitment of a buyout/management group and various tax ramifications. It must also consider the likelihood of competing bids for the company, the need for outside financing vs. available cash in the company and, possibly, the applicable standard of review under state law.

2) SEC filings. All of the above require SEC filings to disclose information regarding the transaction to the public shareholders. If the structure involves a merger (other than a short-form merger) or a reverse stock split, the company will be required to file a proxy statement soliciting shareholder approval for the merger or the charter amendment, as the case may be. If the structure involves a tender offer, the buyout group or the issuer will be required to file a tender-offer statement. A special committee appointed by the board to evaluate the fairness of the tender offer will be required to file a statement advising whether it recommends the transaction to the public shareholders. In all events, if management, directors or controlling shareholders involved in the going private transaction are going to continue to retain an interest in the company once it goes private, Rule 13e-3 of the Exchange Act, requiring additional disclosures, will likely be triggered. This additional information can be included in the proxy statement or tender-offer statement. The key provisions of Rule 13e-3 address the fairness of the proposed going private transaction.

3) The participants. The participants in a going private transaction will largely be dictated by the structure used. In the typical going private transaction in which management or other affiliate is part of the buyout group, the board of directors appoints a special committee with the authority to engage counsel as well as a financial advisor to render an opinion as to the fairness of the consideration from a financial point of view to the public shareholders unaffiliated with the company or the buyout group.

Accordingly, at some point in the transaction's evolution, there are likely to be multiple counsel and financial advisors on behalf of the company as well as the special committee and the buyout group.

4) State law considerations. A company engaging in a going private transaction must also comply with applicable state statutes, such as merger (including short-form) statutes, appraisal rights for minority shareholders in merger transactions and the technical requirements of state antitakeover laws, such as Section 203 of the Delaware General Corporation Law.

Conclusion

What public company has not been exasperated by recent events, changes in the law and an increasingly aggressive and skeptical shareholder base. The original allure to a company's founder, majority shareholder or group of executives with significant equity positions, of access to capital markets and limited, predictable regulatory oversight has changed.

A relatively friendly or, at worst, neutral regulatory environment has turned into a feeding frenzy of scrutiny by state and federal regulators (including prosecutors) as well as shareholders emboldened by an increasingly aggressive plaintiff's bar. CEOs, CFOs and other executives and board members, now face increased personal liability, including the possibility of prison time.

For many small and midsized public companies, the benefits of being public are beginning to be outweighed by the burdens, costs and liabilities. Going private is frequently the answer for transferring value to the shareholders and moving to a way of corporate life removed from most of the recent headaches and heartaches that accompany being public. ■