Public company acquisitions and going private transactions

BY GERALD T. NOWAK

Being a public company ain't what it used to be. Between the additional regulatory burdens and liability exposure, real or perceived, imposed on U.S. public companies under Sarbanes-Oxley and the, shall we say, less than robust capital markets in the United States, public companies are increasingly deciding that the costs of being public outweigh the benefits. At the same time, private equity and strategic investors are finding that the reduced equity valuations extant in the public markets make some, though clearly not all, public companies a compelling value. These two dynamics combined are resulting in people taking a hard look at various forms of "going private" transactions. "Going private" in its broadest sense may be, for this recessionary period, what "going public" was for the preceding boom – the emblematic transaction that captures the essence of the market's current mood.

"Going private" is both a descriptive term used to describe any transaction that results in the target company ceasing to be publicly held, and a technical term used in the United States to describe a subset of those transactions, towit, any transaction *involving an affiliate of the company* that results in the company ceasing to be an SEC reporting company or, if it is an exchange-listed company, ceasing to be so listed. In deference to my colleagues at bar, I will use "going private" in its technical sense, and use the term "public company acquisition" to describe the broader category.

Public company acquisitions are fundamentally different animals from private company acquisitions. When acquiring a private company, much of the negotiations centre around indemnification issues, i.e., who will indemnify whom, for what, how long, under what circumstances and in what amount. In a public company acquisition, however, there (typically) is no indemnity because there (typically) is no one who can indemnify. One can't expect to go back to "the public" to satisfy an indemnity obligation. (One could theoretically get an indemnity from a large stockholder, or place funds into escrow, but this is rare.) What buyers and sellers care about in a public company acquisition is the certainty of closing. The buyer would like the company to be irrevocably obligated to complete the transaction, but wants the option to walk away if the company exhibits any material flaws before closing. The seller would like the ability to accept a better offer if one comes along, but wants certainty of closure if one does not. Thus, the negotiations in a public company acquisition surround conditions to closing and "deal protection" measures, like break-up fees and no-shop provisions. A public company acquisition can be structured as a merger, subject to a stockholder vote, or a tender offer. The principal advantage of a merger is greater certainty of execution; the principal advantage of a tender offer is speed.

Under the U.S. federal securities laws, a public company acquisition becomes a "going private" transaction when an affiliate of the company becomes sufficiently interested in the transaction as to trigger the SEC's "going private" rules. Those rules require expanded disclosure regarding such a transaction, including the purposes of, reasons for and alternatives to the transaction, whether the related party believes the transaction is fair to the unaffiliated stockholders and how it reached that conclusion, whether the company or the related party has received any reports or appraisals regarding the transaction, a statement of plans or proposals regarding the company's structure or business, including asset sales, post-transaction and, if material, pro forma information for the company going forward. The SEC reviews all going private transactions.

The definition of "affiliate" for purposes of the going private rules is subject to the typical "controls, is controlled by, or is under common control with" test generally applicable under U.S. federal securities law. The SEC has consistently taken the position that members of senior management are affiliates for this purpose. Whether an affiliate of the company has a sufficient interest in a transaction to make it a technical "going private" transaction is a matter of facts and circumstances. Factors typically examined surround the nature of the relationship after the transaction, i.e., whether an officer, for example, would hold a material amount of the company's securities, be on the board of directors or otherwise be in a position to direct the management and policies of the company going forward.

A going private transaction will also likely trigger heightened duties under Delaware corporate law, typically leading the board to form an "independent" special committee of the board, with separate advisors, to consider the transaction.

The concern raised by a going private transaction, under both SEC rules and Delaware law, is that management, with all of its inside information and insight into the company, will attempt to buy the company from the public at a bargain price. The SEC, in its typical fashion, addresses this issue by requiring additional disclosure. Delaware law addresses the issue in its typical fashion, by imposing stricter scrutiny on the board's discharge of its fiduciary obligations.

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In each case, companies looking to effect a going private transaction should not be deterred from doing so by the legal regime surrounding these types of transactions. At the end of the day, such a transaction may be the right thing for the enterprise, a fair deal for the public and a compelling value for the new owners. The legal regime does no more than ask the sponsor to make its case publicly and ask the directors to consider the matter fairly and thoroughly.

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