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Going Private: Legal and Strategic Considerations

Structuring Transactions to Withstand Court and SEC Scrutiny

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:
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Introduction - What is a Going Private Transaction?

What is a Going Private Transaction?

- A transaction or series of transactions:
  - with a controlling stockholder, management, or other persons affiliated with a public company
  - that reduces the number of stockholders, allowing the company to terminate its public company status and related reporting obligations under the ’34 Act

Most common types of going private transactions:

- Acquisition by controlling stockholder (sometimes referred to as a squeeze-out merger)
- Acquisition by a significant but non-controlling stockholder
- Leveraged buyouts by a private equity fund or other third-party acquirer working with management

Introduction - Current Trends

Going private transactions are becoming more common after a slow year in 2009

- Factors:
  - Increased availability of debt financing (for both financial and strategic buyers)
  - Cash positions on many corporate balance sheets
  - Private equity commitments must be invested before commitment periods expire
  - Growing disclosure obligations and enhanced scrutiny and regulation of public companies
- Significant concerns remain that transactions won’t close
  - Continued focus on reverse break-up fees to compensate target company if acquiror fails to close
    - Amount and circumstances when reverse break-up fee is payable
  - Focus on rights to specific performance to force sources of committed debt and equity financing to fund their commitments

Introduction – Focus of this Webcast

Legal and strategic considerations for going private transactions based on:

- Reasons for going private
- Structure of going private transactions
- Risk of litigation
- Delaware law developments
- Disclosure obligations under state law
- Disclosure obligations under SEC Rule 13e-3
- Section 13(d) disclosure obligations

Reasons for Going Private

"Going private" allows the company to avoid the disadvantages of being a public company, while permitting the controlling stockholder to retain, or new owners to acquire, control

Reasons for going private may include:

- Belief that the company's stock is undervalued
- Allow the company to focus on long-term objectives rather than short-term profits
- Permit a more leveraged capital structure than what would be tolerable for a public company
- Save costs and burden of compliance with the Exchange Act and the Sarbanes-Oxley Act
- Reduce distraction of public stockholders and analysts
- Lessen risk of stockholder litigation

Structure of Going Private Transactions

Most common structures:

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

May be advantages to pursue a tender offer/two-step merger:

- Timing advantage - less time for SEC review (and competing bidders)
- May benefit from lesser standard of review, but Delaware law in flux

Risk of Litigation

Most going private transactions are challenged in court

- Typical claims:
  - Breach of fiduciary duties
  - Failure to comply with disclosure obligations
- Potential for conflicts of interest may lead court to apply "entire fairness" standard of review
  - Controlling stockholder conflicts
  - Management conflicts
- Use of proper procedures is critical
  - If entire fairness review, proper procedures may shift burden to plaintiff
  - Proper procedures may allow for business judgment review rather than entire fairness

Recent Developments in Delaware Law on Squeeze-Out Transactions

Delaware case law before recent decision in *CNX* :

- According to Delaware Supreme Court *(Kahn v. Lynch*)*:* one-step merger with controlling stockholder reviewed for entire fairness, but burden shifted to plaintiffs to prove "not fair" *if* transaction approved by ***either:***
  - Special committee of independent, disinterested directors ***or***
  - Majority of the minority stockholders
- According to Chancery Courts (e.g., *Pure Resources*): two-step merger with controlling stockholder subject to more deferential business judgment review ***if*** transaction "non-coercive":
  - Same consideration in both steps;
  - Non-waivable majority of the minority tender condition;
  - Promise to consummate short-form merger if controller obtains 90% stock ownership in tender offer; and
  - Special committee of independent, disinterested directors provided sufficient time and information to make a recommendation to minority.

Recent Developments in Delaware Law on Squeeze-Out Transactions *(cont.)*

Chancery Court decision in *CNX* shifted this landscape:

Facts in *CNX*:

- 80% stockholder launched a two-step tender offer to acquire the minority interest of CNX Gas.
- Controlling stockholder followed *Pure Resources* model:
  - No negotiations with special committee (tender offer price was result of bargaining with significant minority stockholder, which also owned stock in controller)
  - Special committee formed after launch of tender offer – did not express opinion on whether stockholders should tender; noted concerns about the process resulting in the offer price

***CNX* Holding:**

- Satisfying *Pure Resources* test is not sufficient to attain business judgment review
- Business judgment review is available only if transaction is ***both***:
  - Approved by special committee vested with full power of board to respond to offer, ***and***
  - Approved by a majority of the minority stockholders

Recent Developments in Delaware Law on Squeeze-Out Transactions *(cont.)*

Implications of *CNX* for Two-Step Tender Offers:

- Business judgment review appropriate only when transaction approximates true arms-length process
  - Must balance following *CNX* structure with disadvantages of powerful special committee
- *CNX* raises the bar for potential damages claims if the controlling stockholder commences a two-step tender offer without complying with *CNX* requirements
  - Transaction would be reviewed for entire fairness
  - Settlement value for claims challenging a non-*CNX*-compliant transaction has increased

Recent Developments in Delaware Law on Squeeze-Out Transactions *(cont.)*

Other Implications for Two-Step Tender Offers:

- *Special Committee Authority:* To obtain business judgment review, CNX suggests special committee should have full power of board, including power to:
  - Explore alternative transactions (or decide not to)
  - Adopt poison pill
  - Negotiate terms of the transaction
- *Calculating Majority-of-the-Minority Stockholder Approval.* True majority of unaffiliated stockholders is required.
  - *CNX* suggests a "hedged stockholder" (a minority stockholder who owned a similar economic interest in both the controlling stockholder and the target company) should have been excluded from calculation
  - Directors, officers and employees should likely be excluded
  - "Denominator" should include all (and only) minority shares

Recent Developments in Delaware Law on Squeeze-Out Transactions *(cont.)*

- Expect judicial skepticism of directors who do not stand up to controlling stockholders:
  - *Landry's:* Court of Chancery highly critical of
    - target board's failure to adopt a poison pill to prevent the CEO from creeping to a control position through open market purchases, and
    - board's decision to waive payment of reverse break fee when CEO terminated merger agreement
  - *Loral:* Court of Chancery found breach of fiduciary duty when company issued additional equity to 35% stockholder in a PIPE transaction
    - No pressing need for equity
    - Directors did not explore other alternatives for raising equity

Recent Developments in Delaware Law on Squeeze-Out Transactions *(cont.)*

Impact of *CNX* on One-Step Mergers with Controlling Stockholders:

- Vice Chancellor Laster (like Vice Chancellor Strine in *Cox Communications*) advocates "unified approach"
  - Business judgment review should apply to one-step squeeze-out mergers (like two-step transactions) if ***both***:
    - Negotiated and approved by a special committee of independent, disinterested directors, ***and***
    - Conditioned on affirmative vote of a majority-of-the-minority stockholders.
- Supreme Court precedent (*Kahn v.* Lynch) still stands:
  - Entire fairness review applies, but burden shifted to plaintiffs to prove "not fair" if transaction approved by ***either***:
    - Special committee of independent, disinterested directors ***or***
    - Majority-of-the-minority stockholders

Recent Developments in Delaware Law on Management/Private Equity Buyouts

In general, entire fairness standard does not apply if controlling stockholder is not involved in going private transaction

- Involves sale of the company so *Revlon* applies: directors responsible for obtaining the highest value reasonably attainable for the shareholders
  - If a target is thoroughly shopped pre-signing, it is more reasonable for the target to enter into "tighter" deal protection to encourage the buyer to put its last nickel on the table
  - If there are reasons not to conduct broad pre-signing auction:
    - may be possible to rely on a post-signing market check to satisfy *Revlon*
    - looser deal protection: "go shop" period; weak "window shops"; smaller termination fees.

Recent Developments in Delaware Law on Management/Private Equity Buyouts *(cont.)*

Involvement/participation by management may create conflicts of interests, giving rise to risk deal will be enjoined or potential post-deal lawsuit for damages against directors

- Delaware's Court of Chancery has summarized two of these concerns:
  - "Steering," i.e., concern that if management leads the sale process, it will be skewed in favor of private equity buyers or other buyers predisposed to team with management
  - "Skimming," i.e., concern that management will bargain for its own consideration (in terms of equity, future compensation or otherwise), which may reduce consideration offered to non-management stockholders

Disclosure Obligations – Delaware Law

Delaware litigation/case law is playing significant role in establishing disclosure requirements

- When stockholders are asked to vote on a merger or decide whether to exercise appraisal rights, "all material facts" must be disclosed to stockholders
  - Financial projections may be material (and thus required to be disclosed), particularly if used by the target company's financial advisor to conduct a DCF analysis
    - *Netsmart*: disclosure should contain (i) analyses the bankers used, (ii) the "key inputs" into those analyses and (iii) "range of ultimate values" that were the output of those analyses.
  - Other cases: undisclosed projections would not alter the "total mix" of available information or were not sufficiently reliable to disclose. *See Checkfree, 3Com* (Chancellor Chandler), *Globis* (Vice Chancellor Parsons), *Margolis* (Vice Chancellor Noble).
- Controlling stockholder effecting second-step merger cannot necessarily rely on information previously disclosed in the market to satisfy its disclosure obligations
  - *Motorola:* Court of Chancery held that notice of appraisal sent to minority stockholders must include summary financial information and explain how to obtain additional information
  - If disclosure obligations are not satisfied, court may order quasi-appraisal as a remedy.

Going Private Transactions under Rule 13e-3

Rule 13e-3 three-pronged test:

- Transaction is a merger, tender offer, purchase of stock, sale of all or substantially all assets, reverse stock split, etc.;
- Issuer or an "affiliate" of the issuer is "engaged in" the transaction; and
- Reasonable likelihood or purpose of causing:
  - any registered class of equity securities to be eligible for termination of registration;
  - any registered class of equity securities to be eligible for termination or suspension of reporting obligations; or
  - any listed class of equity securities to cease to be listed.

Interesting (Often Challenging) Issues Under Rule 13e-3

What is an "affiliate" of the issuer?

- Same as "affiliates" under other provisions of '33 Act or '34 Act: person "that controls, is controlled by or is under common control with" the issuer (directly or indirectly).
- No bright line test establishing ownership percentage that triggers affiliation.

When is senior management (who are affiliates) "engaged" in the transaction?

- Involvement in negotiation process
- Post-closing stock ownership and role with target company, acquiror and its affiliates
- Material increases in compensation/other employment arrangements
- Receipt of other benefits not received by other stockholders
- SEC C&DI: no formal arrangement between acquiror and management is required; a "general understanding" suffices to find engagement.

Interesting (Often Challenging) Issues Under Rule 13e-3 *(cont.)*

To avoid triggering Rule 13e-3, board should instruct management and acquiror not to engage in any discussions of post-closing employment agreements or other management arrangements

- Any discussions between the acquiror and management should be supervised to ensure compliance

May not be possible to avoid triggering Rule 13e-3 if acquiror requires management participation

- Rollover of equity, employment agreements or other assurances that management will continue in their roles post-closing may be critical to the acquiror's interest in proceeding with the transaction

Implications of Triggering Rule 13e-3

Rule 13e-3 is a disclosure rule

- Must file Schedule 13E-3 and include additional disclosure in proxy statement
- Disclosure must be made by *each filing person* (target company and each affiliate engaged in the transaction, which may include the acquiror)
- Timing implications – closer scrutiny by SEC to ensure compliance with Rule 13e-3's disclosure requirements.

Key incremental information requirements

- Purposes for proposed transaction
- Substantive and procedural fairness to unaffiliated stockholders
- All "reports, opinions and appraisals" received from any outside party that are "materially related" to the transaction
    - Must be summarized and attached as exhibits

Section 13(d) Disclosure Obligations

Filing obligations include:

- Must file Schedule 13D within 10 days after acquire "beneficial ownership" of >5%
- Must amend Schedule 13G within 10 days after form intent to change or influence control
- Must "promptly" amend Schedule 13D if material change

Formation of "group" may trigger filing obligation

Item 4 of Schedule 13D requires disclosure of "plans or proposals" relating to securities

- *Tracinda cease-and-desist proceedings:* failure to disclose plan to sell additional shares
- *NAACO Industries*: misleading Schedule 13D disclosure may support common law fraud claims
- SEC C&DI: "A plan or proposal . . . is not deemed to exist only upon execution of a formal agreement or commencement of a tender offer, solicitation or similar transaction. Generic disclosure reserving the right to engage in any of the kinds of transactions enumerated in Item 4(a) – (j) must be amended when the security holder has formulated a specific intention with respect to a disclosable matter." (citing *Tracinda*)