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Finance and Transactions Group

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The Going Private Solution

Introduction

Today's changing public markets have caused small to middle-market public companies to re-think the benefits of staying public. These same market characteristics have also spawned a great deal of interest in the private-equity and leveraged buyout markets for companies that present bargain opportunities for these financiers.

The deluge of "dot com" companies into the public marketplace is one of many factors that has helped create a phenomenon known in the industry as "market orphans." Many small to middle-market public companies that lack investor appeal (notwithstanding strong financial performance) are finding themselves significantly undervalued. Often times the stock prices of these companies are trading at prices far below their IPO price. An even more alarming fact facing these companies is that they are often trading at cash flow multiples well below sale multiples for comparable privately held companies. Some common characteristics shared by these companies are: an out-of-favor industry group; an undervalued stock price; limited analyst coverage; low trading volume; erratic earnings; out-of-the-money options; a substantial amount of cash; an inability to complete strategic acquisitions due to their depressed stock price or dilution concerns; and an experienced management team restrained by market forces out of their control.[1] For the board of directors and management of these "market orphans", their status as public companies in today's market likely has less appeal than it did when they were first going public or during periods when small cap (non-technology) stocks were in favor. When a company reaches this crossroads, a "going private" transaction is both an attractive and viable strategic choice.

The going private trend is occurring across industries, from automotive companies[2] to furniture makers[3] to home products distributors[4] to textile products makers[5]. According to a recent article published in *The Wall Street Journal*, in 1999 there were 38 leveraged buyouts of small to mid-cap companies that took the form of going private transactions.[6] So far in 2000 there have been 8 such transactions which represents twice the number of transactions from the same period last year.[7] This trend presents a unique opportunity that market orphans should consider and that the private-equity and leveraged buyout community should continue to seriously explore.

What is a going private transaction?

A going private transaction can have a variety of structures but is typically (i) effectuated by a voluntary or involuntary exchange offer, tender offer or merger, (ii) spearheaded or organized by a company's controlling stockholders or management and (iii) financed by sophisticated third party financiers. The express purpose of a going private transaction is to enable the company or the control group to acquire all or substantially all of the publicly-held shares of stock of the company in order to "take the company private." By going private, the company eliminates public ownership of its stock, delists from the public exchange on which its stock is traded and eliminates the need to comply with federal disclosure and proxy requirements. Thus, the proponents of the going private transaction return the company to its pre-IPO "closely held" status. The most common methods of structuring a going private transaction include a merger, a reverse stock split or a tender offer.

In a typical going private merger, a closely held corporation (typically with a controlling interest in the public company), and the public company which it controls, enter into a transaction whereby the public company is merged into the closely held corporation (or its acquisition vehicle). The minority shareholders of the public company (the outsiders) usually receive cash or debt securities for their equity, while the controlling shareholder is left as the sole shareholder of the merged entity. Subsequently, since the controlling interest in the public company is now held by the private corporate shareholder, the required statutory shareholder approval for the "going private" step (*i.e.*, formally de-listing and complying with SEC going private disclosure requirements) is virtually guaranteed.[8]

Alternatively, the control group may induce the company to proceed with a reverse stock split in order to take the company private. This is accomplished by the company exchanging one share of stock for a predetermined block of a specified number of shares (*e.g.*, 1-20, 1-100, 1-1000), which proportionally reduces the number of outstanding shares and increases the value of each share. Smaller shareholders who were issued fractional shares or scrip in the reverse stock split are then cashed out or redeemed out for a fair price. The end result of a reverse stock split is the elimination of the outsider group. This leaves the control group as owners of a closely held public company which they will then take private.

A tender offer is the going private structure of choice when the proponents of the transaction do not own a controlling interest in the company. In order to take the company private under these circumstances, the shareholder/management group must acquire a controlling interest in the company through a tender or "self tender" offer for the shares of the outsiders. The group initiating the tender (either a shareholder making a tender offer or the company's management group initiating a self tender) offers to purchase shares of the company held by certain or all of the shareholders on an individual basis. Typically, a tender offer rarely results in the shareholder or management group acquiring 100% ownership of the company. Thus, tender offers are frequently followed by a reverse stock split or merger (as discussed above).

Advantages of Going Private

There may be many advantages to certain public companies and their control group in taking such companies private. Once private, a company's management can focus more on long-term growth, marketing and research and development goals. Often times a company's management may sacrifice long-term planning in order to focus on short term "quarter-to-quarter" goals which it feels are necessary to achieve in order to appease stockholders, analysts and Wall Street, and meet per share earnings expectations. In addition, a company's low share price provides management with a growth and risk incentive to increase its ownership stake (*e.g.*, a "good use" or good investment of company funds).

Moreover, the time, effort and expense that management previously allocated to complying with federal disclosure and proxy requirements can by redirected. The control group (who were likely the driving force behind a company's IPO) may find the prospect of again controlling a privately held company very appealing in today's market.

Going private also reduces or eliminates certain risks inherent in public company operation: hostile takeover threats; shareholder lawsuits; and public disclosure of competitive information such as technology, research and development plans and growth and acquisition strategies. In addition, the control group has the flexibility, based upon full disclosure and a carefully structured transaction, to capitalize on a restructuring opportunity when the market price for the shares is depressed as compared to the value of the company's assets.

Risks

In general, going private transactions differ from the basic types of fundamental corporate change trans-actions *(i.e.*, mergers, stock sales and asset sales) primarily because they treat one group of shareholders (the control group) differently from other shareholders of the same class (the outsider group). By their nature, going private transactions exclude some shareholders from continuing to hold equity in the company. Thus, the outside investors' expectations of participating in the future profits of the company are often frustrated by such investors' inability to maintain an ownership interest in the entity. For this reason, the typical test of corporate action – whether the action is in the best interests of all shareholders – is not readily applicable. As a result, going private transactions must be structured to prevent the inherent danger that the control group will, whether intentionally or not, treat itself more favorably than the outsider group.

Other risks of going private include the loss of public company prestige and advantages (*e.g.*, secondary resale market, credit/financing flexibility, public market basis for valuation of share price and attractive public company option plans). A going private transaction may also trigger an unwanted response from the market (*e.g.*, hostile takeover bids, an auction process, etc.). There is also the risk of minority shareholder suits seeking to enjoin the transaction and the attendant judicial scrutiny of the transaction which could severely delay the entire process. Another risk is that the control group may be accused of acting on insider information because of the inherent conflict of interest that these transactions raise.

In order to lessen the inherent risks to the control group and the company of a going private transaction, it is prudent for the control group to structure the transaction with three key strategic principles in mind: fairness, business purpose and disclosure. These strategic principles are discussed below.

Strategic Principles

Objective Fairness. The most important requirement in any going private transaction is the fairness of the transaction to the outsider group. Delaware courts require "entire fairness" in going private transactions, which is a premise that suggests that every aspect of the transaction should be objectively fair to the outsider group. Unfortunately, since the entire fairness principle emerged in the late 1970's, neither the courts nor the SEC has established a uniformly accepted method of actually measuring fairness.

Nevertheless, the marketplace is available to assist a company in determining whether the price offered to the outsider group is fair. For example, if the control group makes a public tender offer for shares of the company, fully discloses material information and a significant number of outside shareholders (including some sophisticated investors) accept the offer, one might reasonably conclude the offering price is fair. Continuing this logic, if the price is fair for the tender offer, it should also be fair for the second step going private transaction (*i.e.*, second step merger, cash out or redemption). In general, courts and commentators have approved as presumptively fair the going private step of the transaction, as long as the price previously accepted by a large majority of shareholders in the tender offer is the same price offered to the outsider group in the second stage. However, where the outsiders are a small group of generally unsophisticated investors, their acceptance of the tender offer price does not necessarily constitute a reliable litmus test of fairness. In such a case, the board of directors must act cautiously when establishing a price. This caution can be exercised in the form of a pointed question: Whether a fully-informed, sophisticated investor would accept the offering price?

By offering a premium on the price, the company increases its chances for a successful going private transaction. It is more likely that a well-informed investor will respond favorably to a tender offer where the price offered is higher than the pre-transaction market price for the shares, *i.e.*, a premium. A premium may be viewed as fair by both shareholder groups, but it may also be necessary because it helps balance the benefits the control group expects to realize after the outsider group's interests are eliminated. A premium also compensates the outsider group to some extent in recognition of the costs they may incur as a result of the transaction (*e.g.*, unanticipated capital gains taxes or a capital loss, and brokerage expenses incurred in reinvesting the cash received). Thus, the Company's directors should take affirmative steps to determine whether post-transaction benefits to the outsider group are adequate compared to the benefits received by the control group, since a court may inevitably be asked to decide whether any expected premium was adequately shared with the outsider group.

Appropriate steps that the board of directors should take when setting a price in a going private transaction include creating an independent committee of disinterested directors to consider and negotiate the transaction and the price with the control group or management (assisted by sophisticated legal and financial advisors), and obtaining a "fairness opinion" from a nationally recognized investment banking firm.

Business Purpose. The inherent inequality in going private transactions increases the risk that the outside stockholders will be abused by the control group. As a result, another established principal is that a valid business purpose should be the impetus behind any going private transaction. Absent such a purpose, regardless of whether the transaction is fair, it is still subject to attack by the outsider group. Particularly in circumstances where a going private transaction is proposed that does not involve a merger with another pre-existing entity, the business purpose of the company is opened up to closer scrutiny. If a company lacks a business purpose for the transaction, it subjects itself to the risk that the transaction might be delayed or defeated by a lawsuit brought by an outsider claiming that, among other things, the board of directors breached its fiduciary duty in approving the deal.

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Another business purpose that is not used very frequently by management is the desire to reduce the costs incurred in reporting to, and servicing the needs of, small shareholders by having to prepare and distribute periodic reports, meeting notices, proxy solicitations, dividend distributions and stock transfer information. More often, this business purpose is one of many reasons supporting management's decision to go private. A more difficult issue arises when management's purposes for going private are both to reduce reporting costs as well as eliminate the burdens of complying with the disclosure requirements of the Securities Exchange Act of 1934 (the "Exchange Act"). Going private may not only reduce the corporate reporting burden but may also benefit certain large stockholders by eliminating their obligation to disclose their ownership of blocks of shares in excess of 5% and the burdens and potential liabilities of officers, directors and 10% shareholders under the Exchange Act. This second part of the business purpose may not be well-received by the courts or the SEC. Therefore, when considering whether the business purpose test is met, the control group must determine whether a going private transaction not only serves an appropriate business objective but is also the way to achieve its objective in a manner that is least offensive to the interests of the outsider group.

Disclosure. The requirements of SEC Rule 13e-3 apply in most instances where a publicly-held corporation takes itself private. Rule 13e-3 applies in situations where, as a result of the proposed transaction, (a) the number of shareholders of record of any class of equity securities falls below 300, (b) the company would be required to de-list from any of the national securities exchanges, or (c) the company would become ineligible for quotation on an inter-dealer quotation system of a registered national securities association (*e.g.*, NASDAQ). It is notable that a "reasonable likelihood or purpose of producing" any of these results is the threshold test for whether the rule applies.

In tandem with the rule, the SEC adopted Schedule 13E-3 as a disclosure form for transactions satisfying the requirements of the rule. The disclosures required on Schedule 13E-3 are extensive and should be carefully reviewed as a guideline for appropriate disclosure by control groups and management considering a going private transaction, even if the transaction falls outside the scope of Rule 13e-3. It is important to note that all such disclosures should be carefully tailored to meet the needs of the particular situation.

Conclusion

Control groups and management considering a going private transaction should educate themselves about the availability of going private as a strategic option in corporate restructuring. Likewise, these groups should understand the benefits and risks associated with the transaction. In doing so, advice on transaction structure and planning assistance should be sought from sophisticated and knowledgeable legal and financial advisors. Armed with full information and a cohesive transaction team, the risks can be anticipated and dealt with efficiently, and the desired results can be achieved.

[1] Venture Capital Journal November 1, 1999.

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[2] Hayes Lemmerz International, Inc. announced a going private transaction on January 11, 2000.

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[3] WinsLoew Furniture, Inc. went private in August 1999.

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[4] Cameron Ashley Building Products Inc. is currently being courted by three bidders after announcing plans to go private.

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[5] The CEO of WestPoint Stevens, Inc. recently announced his offer to take the company private.

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[6] *Wall Street Journal (Midwest Edition)*, February 21, 2000, "Buyout Binge Trickles Down to Small

fiduciaries.

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Companies".

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[7] *Id.*

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[8] The corporate laws of most states require majority shareholder and board of director approval of mergers and most states, like Delaware, permit short-form mergers. In a short form merger, typically where the company is merged with a corporate shareholder owning a 90% interest, shareholder approval is not required.

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