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April 2, 2020

Going Private Transactions

The stock market downturn in the midst of the Coronavirus pandemic has generated increased interest in taking public companies private. Many boards of directors may not be receptive to these transactions in the near term, anticipating that their companies should recover when the crisis passes, and recognizing that the financing market creates risk and uncertainty. But going private may be an attractive option for some, and companies can expect to receive overtures from major stockholders and financial sponsors, despite potential financing challenges. Hence, a reminder of the legal fundamentals of these transactions seems timely.

Overview

The terms "take private" and "going private" transaction (for convenience, in this memorandum, we use the term "going private") are both used to describe an acquisition of a public company by a controlling stockholder or other affiliate, or a transaction by a financial or other buyer that raises the specter of potential conflicts of interest on the part of members of senior management or the board of the target. The general framework under federal and state law that applies to any acquisition or sale of a public company applies to going private transactions. In addition, these transactions are subject to state law principles governing conflict of interest transactions, and may be subject to Rule 13e-3 under the Exchange Act.

Going private transactions frequently result in litigation, and the parties should be sensitive to the potential for litigation and consider what procedural safeguards may be appropriate to address these risks. In Delaware, a substantial body of case law provides a roadmap to navigate these issues. While certain Delaware legal doctrines, such as "Revlon" duties and "entire fairness," do not apply in some states, in our experience, deal practice in going private situations does not differ meaningfully where the target is not incorporated in Delaware.

In addition, if Rule 13e-3 applies, the transaction is subject to heightened disclosure requirements and certain waiting period requirements under federal law. The Rule 13e-3 requirements are separate from, and have no impact on, the substantive law of the state of incorporation that governs the transaction. The heightened disclosure requirements under Rule 13e-3 increase the potential for litigation, and some disclosures mandated by Rule 13e-3 may draw additional scrutiny in litigation, but the fact that a proposed transaction may be subject to Rule 13e-3 should not alter the parties' substantive focus. As in any M&A transaction, the parties should focus on issues of deal process, strategy and tactics to optimize their outcome.

Process, Strategy and Tactics

By their nature, going private transactions tend more often to be initiated by an inbound inquiry. In cases where the initiating party is a financial sponsor or other non-controlling party, the acquirer will hope to gain an advantage over other potential suitors by building a rapport with key insiders, getting a head start on diligence, and potentially submitting a preemptive offer and/or persuading the target to forego an auction or pre-signing market check. Sometimes, the acquirer will seek to get the target comfortable with foregoing a pre-signing market check by offering the target the right to conduct a post-signing "go shop" process. In deals with a "go shop," there is typically a reduced or two-tier breakup fee that serves as a lesser deterrent to competing offers and provides a lesser reward for the initial merger partner if its bid is ultimately topped by a competing bidder.

Of course, not every acquirer wants to bid against itself, or meet the target's threshold for a preemptive offer and, in any case, the target may insist on a pre-signing market check. However, a financial sponsor or other non-controlling party should consider whether it makes sense to do as much work as possible up front on the basis of public information, to shorten the potential transaction timeline and maximize its opportunity to get to a deal before a competitive process develops. It should also be mindful that, once the board or a special committee becomes actively involved, it likely will establish rules of engagement that preclude discussions with management regarding their post-closing role and compensation until the broader transaction terms are finalized and generally limit the opportunity for potential acquirers to align with key insiders. A potential acquirer that is a member of management or the board, or that engages in preliminary discussions with these persons, should consider that these persons have a duty of candor. Caution should be taken to refrain from communications that may result in the acquirer's interest being disclosed to the board before the acquirer is ready for that step. An insider pursuing a going private transaction (and any potential acquirer engaged in discussions with an insider) should also bear in mind that generally the insider does not have the right to share the target's confidential information with potential equity partners or debt financing sources without the target board's consent.

For a non-controlling acquirer, these issues of process, strategy and tactics require balancing the desire to "get a jump" on other suitors against the possibility that the acquirer's actions create animosity within the target's board that negates any first mover advantage. There is no prohibition on a founder or insider, in its capacity as a stockholder, aligning itself with a preferred acquisition partner, but the board or a special committee may insist that the founder or insider not lock itself into an alliance with a single bidder and remain neutral in the process. In addition, where an insider does align with a particular bidder, that insider will be precluded from participating in the board's oversight of the transaction process. Moreover, the course of dealing between the acquirer, insiders and the target must be accurately disclosed in the proxy or tender offer statement for the transaction, and those disclosures, and any omissions in those disclosures, may have reputational consequences for the acquirer and/or increase litigation risk.

As in any M&A process, the target's board will be focused on issues of value and deal certainty. But, if the board is prepared to engage, it will also be focused on running the right process, including establishing an appropriate process to address conflicts of interest, seeking to minimize disruption to the business and, usually, to avoid the risk of leaks or public disclosure and, if the transaction is a "Revlon" transaction, ensuring that the process is reasonably designed to maximize value.

Disclosure Considerations at the Initiation Stage

As a general matter, the target has no obligation to disclose the receipt of a going private proposal. On the other hand, a potential acquirer may have disclosure obligations under Regulation 13D. The 13D rules apply to any more than 5% "beneficial owner" (persons who have or share voting or dispositive power over the relevant securities) or group of stockholders that collectively "beneficially own" more than 5% of a class of registered equity securities of the target. The SEC takes the position that a 13D amendment must be filed promptly after the filer forms a "plan" to engage in a transaction or makes a proposal for a potential transaction, not when a merger agreement is signed or a tender offer is commenced, and that generic disclosures reserving the right to engage in transactions do not satisfy the filer's obligation to disclose an actual plan or proposal. A person who previously filed a Schedule 13G is generally required to file a Schedule 13D within ten days after it forms the intent to change or influence control of the target, although this requirement does not apply to persons who filed a 13G pursuant to Rule 13d-1(d) (which applies to persons who held their securities before the target became a reporting company).

In the current market environment, there is a temptation for interested parties to go into the market and acquire a "toehold" position in the target. Any such acquisition is, of course, subject to the Hart-Scott-Rodino Act (requiring clearance for acquisitions of voting securities by any person not solely for investment in excess of approximately $94 million), the 13D rules and the federal securities laws generally. An interested party considering acquiring a toehold should carefully consider the rules related to disclosure of any 13D group (which do not apply to a party who does not own stock), if the acquirer plans to engage in discussions with key equity holders.

Rule 13e-3 transactions are subject to additional disclosure obligations (including, importantly, the requirement for the parties to the transaction to file with the SEC all reports, opinions and appraisals from outside parties materially related to the transaction). Participants in a potential Rule 13e-3 transaction should be mindful of these requirements and ensure that appropriate steps are taken in connection with materials (including valuation materials) presented by outside parties (e.g., financial advisors) that may later be required to be disclosed.

Legal Standards under Delaware Law

Revlon. A potential acquirer should be aware that the target's board may have fiduciary duties under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* (506 A.2d 173 (Del. 1986) if the transaction constitutes a "sale of the company." In that circumstance, the board may feel obligated to shop the company and evaluate alternative transactions in order to create a competitive process and comply with those duties. With a controlling stockholder transaction, however, *Revlon* generally does not apply. If a controlling stockholder proposes a going private transaction to the target's board or stockholders, it should generally make it clear at the time of its proposal that it is solely a buyer and not a seller, and will not support an alternative transaction.

Safeguards to Avoid Entire Fairness in a Controller Transaction. A controlling stockholder owes fiduciary duties to other stockholders under Delaware law, although this does not mean the controlling stockholder is precluded from exercising its fundamental rights as a stockholder, such as the right to vote its shares against alternatives. Moreover, the Delaware courts will apply the "entire fairness" standard to a going private merger transaction with a controlling stockholder, unless certain procedural safeguards are met. In *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635 (Del. 2014), the Delaware Supreme Court affirmed that the business judgment rule would apply in circumstances where the controlling stockholder conditioned a going private proposal *from the outset* on both approval by an independent special committee empowered to negotiate and to say "no" to the deal and approval by a majority of the unaffiliated minority stockholders. The "from the outset" requirement means that the procedural protections must be offered before substantive economic negotiations have begun – when it is still possible to replicate an arm's-length transaction.

Assuming the target is not "for sale" and the transaction satisfies the two requirements listed above, the transaction will be reviewed under the business judgment rule, so long as (1) the special committee is independent and disinterested, (2) it meets its duty of care in negotiating price, (3) the vote of the minority is informed (through a disclosure document that includes comprehensive disclosures reflecting the discussions and negotiations between the parties, financial projections and other material information) and (4) the vote of the minority is not coerced.

It should be noted that the issue of who is a "controlling stockholder" is frequently a focus in going private-related litigation. Generally speaking, in Delaware, a controlling stockholder is one who either owns more than 50% of the voting power of the corporation or exercises actual control over the business and affairs of the corporation or over the decision with respect to the transaction at issue.

Tender Offers by Controlling Stockholders. Since the early 2000s, Delaware courts generally have not applied the entire fairness standard to non-coercive tender or exchange offers (i.e., unilateral offers to the public stockholders that are not made pursuant to a merger agreement with the target) by a controlling stockholder. The Delaware Chancery Court, in *In re Pure Resources Inc. Shareholders Litigation*, 808 A.2d 421 (Del. Ch. 2002), established a test to determine whether a tender offer is "non-coercive" and therefore not subject to an entire fairness analysis. The *Pure Resources* test required a majority of the minority investment (tender) decision, but it did not require approval of a special committee with power to say "no." Instead, independent directors must have the opportunity to evaluate the offer with their own advisors, and adequate time to respond, provide a recommendation and disclose relevant information to stockholders.

More recently, in *In Re CNX Gas Corp. Shareholders Litigation*, 4 A.3d 397 (Del Ch. 2010), the Delaware Court of Chancery sought to unify the approaches taken in controller transactions, whether structured as a one-step merger or as a tender offer and short-form merger. The *CNX* court held that a going private transaction structured as a non-coercive tender or exchange offer followed by a short-form merger is subject to the presumptions of the business judgment rule if the offer is both (1) negotiated and recommended by a special committee of independent, disinterested directors; and (2) conditioned on the tender of a majority of the minority shares. The *CNX* test essentially mirrors the test for one-step mergers with a controlling stockholder laid out in *MFW*.

Burden Shifting in an Entire Fairness Transaction. Some transactions with a controlling stockholder will not meet the *MFW* requirements. If the controlling stockholder stands on both sides of the transaction and the transaction did not employ from the outset both of the procedural protections required by *MFW*, the defendants must show that the transaction is entirely fair to the stockholders in both price and process. However, a controlling stockholder can shift the burden with respect to proving entire fairness to the plaintiff with either approval by a properly functioning independent committee or approval by a majority of the unaffiliated minority stockholders.

Legal Standards in Going Private Transactions with a Financial Buyer. General fiduciary duties, rather than entire fairness, will apply to a going private transaction by an unaffiliated financial sponsor or other non-controlling party. However, many going private transactions involve participation by members of the board or senior management. Because the involvement of conflicted parties in the transaction may influence the standard of review if the transaction is challenged, consideration should be given to procedural protections that may avoid application of the entire fairness standard.

For example, in some circumstances, the target's board may choose to reduce management's involvement in the acquisition process by ensuring that the terms of the transaction are negotiated only with disinterested directors and/or prohibit the acquirer from negotiating equity rollovers and post-transaction employment arrangements with existing management until the material terms of the acquisition are substantially finalized.

An acquisition of a Delaware target company by a non-controlling party will be subject to *Revlon* duties. The board has an obligation to maximize value for stockholders, which may require shopping the company, conducting an auction or preserving the opportunity to engage in a meaningful post-signing market check. However, after *Corwin v. KKR Financial Holdings*, 125 A.3d 304 (Del. 2015) and its progeny, even egregious deficiencies in a sale process not involving a controlling stockholder can be cured through a fully informed stockholder vote. A non-controlling party may therefore have somewhat greater tolerance for process deficiencies, if they work to the acquirer's benefit in the process, but it must ensure that there is comprehensive disclosure in the merger proxy or tender offer documents regarding those deficiencies.

Special Committees

For the reasons discussed above, in the context of a potential going private transaction with a controlling stockholder, the target will almost always form a special committee. A committee is not necessarily required in a transaction with a non-controlling party where a majority of the board is independent and disinterested, and any interested directors and management are excluded from the board's deliberations and appropriately walled off from information. Nonetheless, the target board may choose to form a special committee in that context.

Once a special committee is formed, the committee (rather than the full board) will oversee the process, with the assistance of the committee's advisors, and potential acquirers will have more limited influence over process and more limited ability to engage with management. A potential acquirer that has initiated discussions with the target ahead of other potential suitors may prefer to advance its proposal as far as possible before a special committee is formed.

A special committee should consist solely of independent and disinterested directors, with its own independent legal and financial advisors. Although the target's board will typically make the initial designation of the directors to serve on the committee, upon its engagement, independent counsel to the committee should interview the proposed members to ensure that each member of the committee is, in fact, disinterested and independent. For this purpose, the test of independence is not the test under the listing rules applicable to the target. It is a much more exhaustive inquiry. Factors that may negate independence and disinterestedness include both business and personal relationships with potential counterparties and their principals and, of course, any potential interest in the transaction that differs from stockholders generally. Importantly, technical independence is not sufficient: members of a special committee must demonstrate independence in their actions and deliberations.

The special committee should have a charter or be formed pursuant to board resolutions that define the scope of authority, power and responsibilities of the committee, including the authority to explore alternative transactions and to negotiate the transaction and, in the case of a proposed transaction with a controlling stockholder, to say "no" if that is in the best interests of the target and its stockholders.

Proxy/Offering Document Disclosures

As a matter of state law, the directors and officers of the target (and the controlling stockholder in a going private transaction with the controlling stockholder) have duties to ensure that all material facts relevant to the stockholders' decision to approve or reject the transaction are disclosed. Greater scrutiny has been applied to the adequacy of disclosure in recent Delaware cases.

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, if applicable. While there are distinctions between the disclosures required in a proxy statement versus a tender offer statement, the practical differences are not material.

If the transaction is a Rule 13e-3 transaction, the target and each affiliate "engaged" in the going private transaction must comply with the additional disclosure obligations and waiting period requirements imposed by Rule 13e-3.

Rule 13e-3

Two-Part Test. A "Rule 13e-3" transaction is any transaction or series of transactions which meets the following two-part test.

First, the transaction must involve (1) a purchase of any equity security by the target or an affiliate of the target; (2) a tender offer by the target or an affiliate of the target; or (3) a solicitation subject to the federal proxy rules of any proxy or consent, or the distribution of an information statement in lieu of a proxy statement, in connection with a merger transaction involving the target or between a target and its affiliate, a sale of substantially all the assets of a target to its affiliate; or a reverse stock split involving the purchase of fractional interests.

Second, the transaction must have either a reasonable likelihood or a purpose of causing any class of equity securities of the target to become eligible for termination of registration, or to be delisted from the national securities exchange on which it is listed or no longer quoted on the inter-dealer quotation system on which it is quoted.

Certain transactions are exempt from the disclosure requirements of Rule 13e-3, most notably transactions within one year of the termination of a tender offer in which the acquirer was the bidder and became an affiliate of the target as a result of the tender offer, so long as the consideration offered to unaffiliated security holders in the Rule 13e-3 transaction is at least equal to the highest consideration offered during the tender offer, and transactions in which security holders are offered or receive common stock or certain other qualifying equity securities.

Meaning of "Affiliate" and "Engaged In". The vexing question in going private transactions is who constitutes an "affiliate" who is "engaged in" the Rule 13e-3 transaction. Under SEC interpretations and case law, a stockholder who is not a controlling stockholder may be an "affiliate" for purposes of Rule 13e-3. Ownership above 10% or having a right to appoint a director to a company's board may confer affiliate status. Members of senior management are considered to be affiliates. Therefore, an acquisition by a financial sponsor or other third party may be deemed a going private transaction subject to Rule 13e-3 where the target's senior management is "engaged in" the transaction.

Factors relevant to determining whether senior management is "engaged in" a Rule 13e-3 transaction include: the role of senior management in negotiations and the deal process for the acquirer; senior management's role with the target or with the acquirer and its affiliates following the transaction; material increases in compensation or other favorable changes to terms of employment following the transaction; and the scope of any management equity rollover, whether or not formally documented at the time the parties entered into the transaction.

Rule 13e-3 Requirements. For all the attention given to Rule 13e-3 transactions, the only substantive consequences are that the transaction must meet certain filing and minimum waiting period requirements. The disclosure requirements largely mirror those of the proxy and tender offer rules, except for a few additional items. The disclosures required by Rule 13e-3 will generally be provided in the proxy statement or offer to purchase/Schedule 14D-9 for the transaction, as the case may be. The target and any affiliates engaged in the transaction must file a Schedule 13E-3 that will incorporate this information by reference. As a matter of policy, the SEC generally reviews all Rule 13e-3 transactions.

The principal areas where additional disclosures are required are:

Fairness of the Transaction. Each filing person must provide information regarding the substantive and procedural fairness of the transaction, including: whether the filing person believes the transaction is fair to unaffiliated stockholders and a discussion of the material factors upon which the belief is based; 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; and 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 include a description of all reports (including 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. A copy of each report, opinion or appraisal must be filed with the SEC as an exhibit to the Schedule 13E-3.

The SEC takes an expansive view of what reports are covered. The target, its affiliates and their advisors should be aware that documents such as banker board books and other similar materials from outside parties, including preliminary materials, shared with the target or its affiliates, including any acquirer who is an affiliate, may need to be disclosed and filed with the SEC.

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This Briefing is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this Briefing, please call your regular Fried Frank contact or an attorney listed below:

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