Going private

Gregory Puff and Andrew Abernethy of Akin Gump in Hong Kong give practical guidelines for companies operating in China who want to go private

Several companies listed in the US with operations in China and Hong Kong have recently consummated so-called going private transactions, including China Security & Surveillance and Shanda Interactive Entertainment. Many similar transactions are being contemplated, and are expected to be announced in the next several months.

Going private transactions can be complicated and often involve a greater degree of legal scrutiny and risk as compared to conventional M&A transactions. Consequently, it is important that the parties carefully structure the transaction, implement the proper procedural safeguards and take appropriate steps to minimise the legal risk for all involved parties.

What is a going private transaction?

Under US securities laws, a going private transaction is a transaction or series of transactions involving a listed company and an affiliate pursuant to which the affiliate acquires equity securities of the listed company and the acquisition has a reasonable likelihood or a purpose of, directly or indirectly:

- causing any class of equity securities of the listed company which is subject to the US Securities Exchange Act of 1934 to become eligible for termination of registration or causing the reporting obligations with respect to such class to become eligible for termination; or
- causing any class of equity securities of the listed company which is either listed on a national securities exchange or authorised to be quoted on an inter-dealer quotation system of a registered national securities association to be neither so listed or authorised to be quoted.

Recent experience with going private transactions in China have typically involved a listed company and a controlling stockholder, and recent transactions have all been effected by way of merger. The result of these going private transactions has been the controlling stockholder acquiring all of the shares of the listed company that it did not already own, with the public stockholders receiving cash in exchange for their shares.

Why go private?

Companies and controlling stockholders elect to engage in going private transactions for a variety of reasons.

There may, for example, be financial considerations. As described in greater detail below, both the buyer and the target company board need to state in the 13E-3 filing (which is a required filing under US securities laws in connection with a going private transaction) with the Securities and Exchange Commission why it believes the terms of the transaction, including the per share price, are fair to the public stockholders. However, a going private transaction may allow the purchaser to obtain value by purchasing the target at a price which is attractive to the purchaser due to a perceived weakness in the public equity markets; in other words a company trading below its perceived value to a purchaser. Also, a going private transaction may allow public stockholders to receive value and liquidity not otherwise available to them in the public market.

> “Going private can free up management time”

Strategic concerns could also be a factor. US public companies are required to disclose extensive information about their business and strategy in public filings. In addition, due to the nature of the equity markets, listed companies are often reluctant to implement business strategies that may have long term benefits but could result in an inability to achieve near term quarterly or annual earnings targets. Once a company has gone private, it is not required to make the same level of disclosure and may have more flexibility to implement a corporate restructuring or long term business strategy.

Going private can free up management time. Managers of public companies often spend a great deal of time on investor relations and compliance and reporting activities. Going private can free up this time for management to focus on business operations and company strategy.

Finally, there can be cost savings with going private. Companies incur substantial out of pocket costs as a result of being a public company and listed on a US exchange. These costs include the preparation and filing of disclosure documents with the Securities and Exchange Commission, holding annual meetings involving public stockholders, compensating independent directors, exchange listing fees and costs incurred in connection with compliance with the Sarbanes-Oxley Act. Although the costs involved with a going private transaction are significant, they are one-time in nature and could be offset by a reduction in ongoing costs.

Legal considerations

Under most US state law, including Delaware (which is the applicable state law for a majority of public companies incorporated in the US), the actions of directors of target companies in going private transactions are subject to enhanced scrutiny. Going private transactions contain an inherent conflict of interest, with a controlling stockholder potentially on both sides of the transaction: as an acquirer of the target company's securities and, through its appointees on the board, as the company approving the acquisition. These transactions thus have the potential to involve self-dealing by controlling stockholders at the expense of the other stockholders.

Going private transactions structured as one step mergers have historically been reviewed under the entire fairness standard. To meet the entire fairness standard under Delaware law, the board of directors has the burden of proving that both the terms of the transaction and the process used in approving the transaction were fair to the public stockholders. In *Weinberger v UOP,* 457 A. 2d, 701 (Del. 1983), the Delaware Supreme Court described the entire fairness in the following manner:

The concept of fairness has two basic concepts, fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock. However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.

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The Delaware Supreme Court has provided guidance as to how a board of directors can shift the burden of proving entire fairness to the plaintiffs in merger transactions with controlling stockholders. In *Kahn v Lynch Communication Systems, Inc.*, 638 A. 2d, 1110 (Del. 1994), the court held that the burden would shift in an entire fairness review if the transaction was either negotiated and recommended by an active and informed special committee, or subject to a majority of the minority stockholder vote condition. Shifting the burden of proof to the plaintiffs increases the chances that the board of directors will prevail in litigation (which is very common in connection with going private transactions) and generally lowers the settlement value of a case.

Under certain circumstances Delaware courts have applied the more lenient business judgement rule, rather than the entire fairness standard, to going private transactions. Historically, Delaware courts have applied the business judgement rule to two-step tender offer transactions involving controlling stockholders where: (i) the tender offer is subject to a majority of the minority condition; (ii) the controlling stockholder has committed to effect a short form merger at the tender offer price if more than 90% of the shares are acquired in the tender offer; and (iii) the offer does not involve retributive threats from the controlling stockholder (see *In re Pure Resources Shareholders Litigation*, 808 A.2d 421 (Del. Ch. 2002)).

The justification for the use of the different legal standard is that Delaware courts have viewed tender offer transactions as less prone to self dealing than merger transactions. The disparate treatment of these structures has provided an incentive for boards and controlling stockholders to structure going private transactions using a tender offer as they are potentially able to obtain the benefits of having the transaction evaluated under the business judgment rule while also not using a special committee to negotiate the terms of the transaction. A recent Delaware Chancery Court decision, however, applied a different set of criteria as to when the business judgement rule would apply to a going private transaction structured as a two-step tender offer and advocated a "unified standard" of review for going private transactions.

In re CNX Gas Corporation Stockholders Litigation, C.A. No. 5377-VCL (Del. Ch. May 25 2011) involved a going private transaction between CNX Gas Corporation

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(CNX) and CONSOL Energy (CONSOL), which before the transaction owned approximately 83% of the outstanding common stock of CNX. The transaction was structured as a two-step tender offer, with the per-share cash consideration being the same in each step and consummation of the tender offer was conditioned upon a majority of the minority requirement.

Before the launch of the tender offer, CONSOL negotiated with T Rowe Price, which was the largest minority stockholder of CNX, owning approximately 6% of the outstanding common stock of CNX. T Rowe Price was also a significant stockholder of CONSOL. At the conclusion of these negotiations, CONSOL and T Rowe Price reached an agreement that required T Rowe Price to tender all of its shares into the proposed tender offer.

After the public announcement of the agreement with T Rowe Price, the CNX board of directors formed a special committee of one director (who was the sole independent director on the CNX board) to evaluate the tender offer. While the special committee was authorised to hire independent financial and legal advisers and to make a recommendation to stockholders, the special committee was not authorised to negotiate the terms of the transaction, consider alternatives, implement a rights plan or commence litigation against CONSOL. Ultimately, the special committee elected to remain neutral with respect to the tender offer.

In *CNX*, the Delaware Chancery Court imposed additional requirements for going private transactions structured as two-step tenders offers to be afforded review under the business judgement rule and proposed what it called a unified standard for evaluating going private transactions whether structured as mergers or tender offers. The court ruled that the business judgement rule would only apply to a going private tender offer if the transaction was both negotiated and recommended by a special committee consisting of independent directors, and subject to a non-waivable majority of the minority condition.

The court in *CNX* found that the transaction did not meet the unified standard, as the tender offer was not recommended to stockholders by the special committee and as a result applied the entire fairness standard to the transaction. Additionally, although not necessary to the ruling, the court questioned the scope of the mandate of the special committee and the majority of the minority condition, as the shares owned by T Rowe Price that were contractually required to be tendered were counted toward meeting the condition.

The *CNX* decision is a significant departure from prior Delaware rulings with respect to tender offers as it requires special committee approval for application of the business judgement rule. In addition, the *CNX* decision suggests that a going private transaction structured as a merger may qualify for business judgement rule review, rather than entire fairness, if it meets the unified standard, which is contrary to prior Delaware opinions, including the *Kahn v Lynch Communications Systems, Inc* case described above. It should be noted, however, that *CNX* did not involve a one-step merger so application of the unified standard to going private merger transactions is not clear. A future decision by the Delaware Supreme Court will be required to clarify the future application of the various standards to going private transactions.

Another recent Delaware case involving a transaction with a controlling stockholder is *In re Southern Peru Copper Corp. Stockholder Derivative Litigation*, C.A. No. 966-CS (Del. Ch. October 14 2011), where the Delaware Chancery Court awarded $1.2 billion (plus interest) in damages after ruling that the transaction was not fair to public stockholders. The transaction involved the acquisition of Minera Mexico by Southern Peru, which was a New York Stock Exchange-listed company. Both companies were majority owned by Grupo Mexico, which held approximately 54% of the capital stock and 63% of the voting power of Southern Peru and approximately 99% of the outstanding stock of Minera Mexico. Grupo Mexico proposed a transaction pursuant to which Southern Peru would acquire Grupo Mexico's interest in Minera Mexico in consideration for 72.3 million shares of Southern Peru stock, valued at approximately $3.1 billion based upon Southern Peru's then trading price.

Upon receipt of the offer, the Southern Peru board of directors formed a special committee of independent directors to evaluate the proposal. The special committee was not authorised to negotiate the transaction or to explore alternatives. The financial advisers to the special committee initially conducted a valuation analysis which found that the value of Minera Mexico was approximately $1.4 billion less than the value proposed by Grupo Mexico. Two weeks later, the financial adviser changed its valuation methodology and performed a relative valuation of the two companies.

This approach narrowed the gap between the valuation and the Grupo Mexico offer, but notably resulted in a valuation of Southern Peru approximately $1 billion below its market capitalisation at the time. The special committee ultimately agreed to and approved deal terms that were close in value to the initial Grupo Mexico offer, received a fairness opinion from its financial adviser and the merger was approved by more than 90% of the Southern Peru stockholders.

Notwithstanding the procedural elements described above, the Delaware Chancery Court found the process by which the merger was negotiated and approved was not fair, and the price was not fair. In the decision, the court focused on the "controlled mindset" of the special committee, its narrow mandate only to evaluate the transaction and found that the special committee did not exercise the bargaining power of a true arm's-length third party. Additionally, the court found that valuation methodology used by the special committee and its financial adviser was results-oriented and used to rationalise acceptance of Grupo Mexico's offer rather than to negotiate and potentially reject the transaction.

The court was also critical of the special committee's decision not to update the fairness analysis and re-evaluate its recommendation before the closing of the merger. The merger agreement provided for a fixed exchange ratio and in the time between signing and the stockholder vote the Southern Peru stock price had increased substantially and Minera Mexico's performance had been below its projections.

Guidelines for a going private transaction

The following are suggestions for current best practices that could be used to help minimise legal risk to directors evaluating a going private offer.

About the author

Andrew Abernethy's practice focuses on mergers and acquisitions and investment funds. His experience includes advising international clients on M&A matters, particularly cross-border transactions, investment funds formation and a range of equity and convertible securities offerings.

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The board of directors should form a special committee consisting exclusively of independent and disinterested directors. Members of the special committee can be paid a fee for their service, but should not have an interest in the transaction beyond those of the public stockholders. Many of the going private transactions in China involve companies incorporated in the Cayman Islands. While Cayman Islands law is not as developed as Delaware law, it has been common practice to form special committees where the subject company is incorporated in the Cayman Islands.

The special committee should be granted a proper mandate. As noted above, the mandate of the special committee is often critical when courts determine whether a special committee is well functioning and has performed its role. The special committee should have the authority to: retain independent legal and financial advisers at the expense of the company; negotiate the terms of the transaction; reject any proposed transaction; explore and consider alternatives; and use defensive measures including the adoption of a poison pill.

The special committee should be afforded sufficient time to carry out its mandate. If the controlling stockholder establishes unreasonable deadlines that do not permit the special committee to properly evaluate the proposed transaction or alternatives, the benefits of using a special committee will not be obtained.

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Assuming that the special committee approves the transaction, the committee should vote on the transaction and make a recommendation to the full board of directors and stockholders.

The special committee should obtain a fairness opinion from its financial adviser that the consideration is fair from a financial point of view to the public stockholders. A fairness opinion is not technically required but is customary practice, for both companies incorporated in the US as well as the Cayman Islands, and directors will be taking additional legal risk if they don't receive an opinion.

Parties should strongly consider conditioning approval of the transaction on the tender/vote of a majority of the minority stockholders. As described above, this requirement may be necessary for any going private transaction to be evaluated under the business judgement rule under Delaware law. While potentially providing significant legal advantages, this condition can also introduce substantial deal execution risk and provide hedge funds or other investors with an ability to block a transaction. As a result the parties should carefully weigh the benefits and drawbacks of this condition on a case-by-case basis, including making such condition non-waivable.

This article is only intended as a general discussion of the issues described herein. It should not be regarded as legal advice and no legal or business decision should be made based upon this article.