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# Going Private and Other Change of Control Transactions

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Presentation to

MIT Sloan School of Management

# Going-Private Transactions

- I. General
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- V. Management Issues
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# I. General

- A. The sale of a public company, whether to a strategic acquiror or a private buyer formed by management and private equity sponsors, involves a change of control. As such, the process is highly regulated, complex and relatively lengthy.

“Going-Private” transactions generally are transactions in which a controlling interest of a public company is acquired by a financial buyer and certain members of the company’s management and the company terminates the listing of its stock on its stock exchange and its filing of reports under the securities laws. Following closing, the Company operates as a leveraged, private company.

# General (continued)

## B. Reasons For Going-Private and Other Change of Control Transactions

### 1. Wall Street orphans

- a. Limited analyst coverage
- b. Low market capitalization
- c. Stock trades at low multiples
- d. Erratic earnings histories
- e. Capable management
- f. Unfavorable industry sector

# General (continued)

2. What financial buyers look for
  - a. Enterprise value that reflects single digit EBITDA multiple
  - b. Strong projected cash flows
  - c. Cash on balance sheet
  - d. Adequate debt capacity
  
3. Increased interest by financial buyers
  - a. Availability of capital
  - b. Low interest rates
  - c. Availability of recapitalization accounting

## General (continued)

4. Objectives of strategic acquirers
  - a. Market expansion
  - b. Operational synergies/integration
  - c. Accretion to EPS
  
5. Participants in change of control transactions
  - a. Target Board-independent committee
  - b. Management
  - c. Equity sponsors
  - d. Senior lenders
  - e. Mezzanine lenders

# General (continued)

6. Target Company Advantages
  - a. Ability to focus on long-term growth rather than Wall Street's quarterly expectations
  - b. Eliminate costs associated with investor relations and SEC compliance
  - c. Focus on core business and divest non-core business
  - d. Provide incentive to management

## II. Transaction Structures

### A. Typical MBO/LBO Structure

Acquisition of all of the outstanding stock of target for cash (generally through reverse triangular merger), excluding management roll-over shares

### B. Typical Strategic Acquisition Structure

Acquisition of all of the stock and options of target for cash and/or stock of acquiror (through tender offer followed by merger, or merger)

- management receives employment agreements
- buyer stock issued to target stockholders must be registered with the SEC



# Transaction Structures

## (continued)

- C. Leveraged Recapitalization Cash Merger
  - Certain Stockholders Not Cashed Out in Merger and Retain their Equity Interest
  - 1. Recapitalization accounting treatment available
  - 2. Need target with significant management ownership or retain “public stub”

# Transaction Structures

## (continued)

3. Financial buyer and rollover stockholders receive equity/public receives cash
4. State law disparate treatment issues – Mass. vs. Delaware
5. Mass. Two-Step merger – convert rollover stockholders' common stock to preferred stock; common stock then converts to cash while preferred stock converts into common stock of surviving corporation

# Transaction Structures

## (continued)

- D. Tender Offer Followed by Back End Merger
  1. Offers speed (one month as opposed to three to four months for merger), thereby increasing certainty that transaction will be consummated
  2. Less intensive SEC scrutiny/review
  3. Recapitalization accounting treatment not available

# Transaction Structures

## (continued)

4. Capital is more costly - need financing commitment letter (1% fee)
5. Two-step transaction raises secured lending issue if <90% tender
6. Recent cases under tender offer regulations requiring that all holders receive the same price call into question ability to grant special benefits to management under a tender offer structure

# Transaction Structures

(continued)

## E. Recapitalization Accounting Treatment Verses FAS 142 Purchase Accounting Treatment

1. Recapitalization accounting treatment generally preferred – results in no change in basis in target's assets going forward
2. Purchase accounting under FAS 142 requires examination of target's assets to determine post-acquisition goodwill, indefinite-lived intangibles and amortizable intangibles

# Transaction Structures

(continued)

## F. Financing for Going Private Transactions

### 1. Equity

- a. Financial buyer contributes equity by funding NEWCO – financial buyer’s NEWCO stock converts into target company stock in merger
- b. Participating members of management “roll over” some or all of their equity in target company
- c. Certain non-management stockholders “roll over” some or all of their equity in target company (may be required to obtain leveraged recapitalization accounting treatment)

# Transaction Structures

## (continued)

2. Senior debt – Generally need term loan financing for deal as well as revolving credit facility to provide for working capital after the transaction
3. High yield debt – Depending on size of transaction, may need additional HYD funding
4. Bridge financing – usually is part of HYD commitment letter as back up in case HYD offering is delayed due to market conditions

# Transaction Structures

## (continued)

5. Arranging financing/commitment letters
  - a. Important for financial buyer to line-up financing sources, particularly in auction context
  - b. Tension between desire of financial buyer to have commitments in place to strengthen bid and incurring cost of obtaining these commitments at an early stage of the deal



## III. Fiduciary Duty Issues

- A. General Fiduciary Duty Considerations
  - 1. Critical process for public company target
  - 2. Application of Revlon duties in cash change of control transaction
  - 3. Exclusivity Arrangements
  - 4. Deal protection mechanisms
    - a. Auctions
    - b. Market Checks
    - c. “Fiduciary Outs”
  - 5. Lockups – Omnicare v. NCS

# Fiduciary Duty Issues

(continued)

- B. Management Conflicts – Management Stands Aligned with Buyer, Except with Respect to Post-Transaction Employment and Corporate Governance
- C. Special Committees – Charged with Obtaining Best Price Reasonably Available for Public Stockholders

## IV. Merger Agreement Issues

### A. Buyer Financing Material Adverse Change Condition – Relationship to Commitment Letter MAC

1. A lender seeks broad MAC tied to the target's performance as well as the markets generally. This market MAC also often includes force majeure language and, in the current economic and political climate, is subject to intensive negotiation
2. Buyer seeks financing condition – thus buyer is not required to complete deal if financing cannot be obtained. Alternatively, Buyer seeks broad MAC in merger agreement which tracks MAC contained in the financing commitment letter

# Merger Agreement Issues

## (continued)

3. Target seeks narrow MAC tied to only its performance between signing and closing
4. In bidding contests, lower priced bids having target friendly MAC provisions may be viewed as more likely to be consummated and thus may be accepted by target even though potential for higher prices exists

## B. Buyer Financial Condition Representation – Financial Statements and Ability to Finance Transaction (Commitment Letters)

# Merger Agreement Issues

## (continued)

1. High yield debt
2. Bridge financing
3. Senior debt
4. Side-by-side equity commitments (from fund partners)
5. To pay merger consideration, refinance indebtedness, transaction costs and provide for working capital
6. Representation as to likelihood of commitment letter conditions being satisfied

# Merger Agreement Issues

## (continued)

### C. Buyer as Signatory

1. Generally – equity funds seek to limit potential exposure
2. Performance (representation/warranty/covenant breach) vs. monetary obligations
3. Limited guarantees

### D. Reimbursement of Expenses for Target if Financing Falls Through

# Merger Agreement Issues

## (continued)

### E. Other Key Issues

1. Collars and walk-aways
2. Treatment of management/employees
3. HSR
4. Employment agreements/option grants for continuing employees
5. Indemnification/escrows (private sellers)

## V. Management Issues

- A. Rollover Agreement – Rollover  
Stockholders Agree to Roll Over Stock
- B. Stockholders Agreement to Govern Post-Transaction Rights
  1. Right of first refusal/tag-along/drag-along/co-sale rights
  2. Corporate governance rights
  3. Put/call rights for management/company upon termination of employment



# Management Issues (continued)

- C. Employment Agreements
- D. Confidentiality and Non-Competition Agreements
- E. Incentives – Options and Restricted Stock
- F. Treatment of Change of Control Agreements
- G. Registration Rights Agreements

## VI. Securities Laws Issues

- A. “Going-Private” Transaction Under Rule 13e-3 – Rule 13e-3 Statement
  - 1. Item 1014 of Regulation M-A – fairness of going-private transaction
    - a. Material factors considered in determining fairness
    - b. Other offers
    - c. Specific financial criteria for determining fairness – Instruction 2 (net book value; going concern value; liquidation value)
  - 2. Item 1005(d) of Regulation M-A – conflicts of interests

# Securities Laws Issues (continued)

3. Financial advisor opinions
  - a. Detailed description of methodologies
  - b. Filing of presentation materials (multiple board presentations problem)
- B. Merger Proxy Statement – Pay Particular Attention to Background and Reasons Sections
- C. Registration Statement on Form S-4 if Public Stub Structure, and in Strategic Acquisitions involving stock consideration
- D. Increased SEC Scrutiny – Legal and Accounting

## VII. Litigation Concerns

### A. What the Client Hears....

“There is always a risk of litigation in complex transactions such as this.”

### B. What the Client Should Know

1. Litigation is likely but not certain
2. Carefully document each step in the decision-making process
3. There is no substitute for “process, process, process...”

## Litigation Concerns (continued)

- C. Special Committee Process – Generally
  1. Be prepared to meet often, by telephone, and maintain a flexible schedule
  2. Counsel should be responsible for drafting minutes of each Special Committee meeting
- D. Document Each Step in the Decision-Making Process
  1. Pay careful attention to Board resolutions establishing the Special Committee and defining the scope of Committee's responsibilities

## Litigation Concerns (continued)

2. Prepare minutes for all Special Committee meetings
3. Remember that all materials prepared for the Special Committee by the investment banker (including slides) may be required to be disclosed to the SEC or plaintiff's attorneys in discovery

## VIII. Tax Issues

- A. Target Company Survives, So Tax Basis and Other Tax Attributes Generally Survive
- B. Generally >50% Change in Ownership Occurs, So Limitations on Use of NOLs and Other Tax Attributes Under Section 382 Apply
- C. Generally No Tax Event For Rollover Stockholders
- D. Public Stockholders Who Receive Cash Realize Gain

## IX. Accounting Matters

### A. “Push Down” of Purchase Accounting

1. Acquirer’s accounting basis (i.e., purchase accounting) is “pushed down” into separate books of an acquired company
  - a. A transaction that results in an entity becoming substantially wholly-owned establishes a new basis of accounting for the assets and liabilities which should be reflected in the acquired company’s separate financial statements
  - b. Primary reason for SEC requiring push down accounting is because the new investor has the ability to determine the form of its ownership in the new entity
  - c. SEC staff has adopted following guidelines for post-transaction ownership by the financial buyer:



# Accounting Matters (continued)

## Ownership Percentage

## General Guidance

≥95%

Push down is generally required

80% to <95%

Push down may be strongly encouraged, but generally not required depending on the facts and circumstances

<80%

Push down is generally not allowed

# Accounting Matters (continued)

2. Impairment testing for goodwill and indefinite-lived intangibles hits future earnings

## B. Recapitalization Accounting

1. No impairment testing required
2. Eliminates drag on earnings and adverse effect on future IPO valuation

# Accounting Matters (continued)

3. Management and non-management participation/recent SEC position
  - a. 80%-95% post-transaction (8%-10% of continuing stockholder equity (i.e., rollover) is typical safe haven)
  - b. Percentages should be based on total voting securities outstanding, not fully-diluted (some exceptions)
  - c. Recent SEC guidance suggests that rollover management investors will be aggregated with new investor group for purposes of determining post-transaction equity ownership by new investor group (mutual promotion of transaction and collaborative subsequent control)

# Accounting Matters (continued)

4. NEWCO may not survive (results in popularity of cash merger structure)

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