While many companies obtained the IPO “brass ring” in the capital markets’ most recent expansion, today many public companies are returning that prize by going private. The following discussion explores (i) the factors many public companies consider for going private, (ii) the predominant going-private transaction structures, and (iii) the fiduciary duties imposed by Delaware courts on boards evaluating such transactions involving controlling shareholders.

Rise in Going-Private Transactions

During the 1990s market bubble, initial public offerings offered relatively young companies the advantages enjoyed by their mature publicly traded brethren: (i) access to the capital markets; (ii) liquidity for existing shareholders; (iii) currency to fund acquisitions and offer incentives to employees; and (iv) prestige and prominence. However, with the downturn of the markets, many public companies find these advantages to be outweighed by the costs and risks of being a public company.

First, decreasing analyst coverage for small- and mid-cap companies and increased research focused on large-cap companies adversely affect both the stock price and trading volume of many public companies. With analyst coverage aimed at the largest public companies, small- and mid-cap public companies are rarely the recipients of in-depth research reports. This lack in research for the investing public often results in wildly fluctuating stock prices and nominal trading volumes for these smaller companies.

Second, additional regulations implemented by Sarbanes-Oxley and various marketplaces impose increasing compliance costs on public companies. These costs include increased internal compliance expenses, higher auditing fees, and escalating investor disclosure and public relations expenses. A recent survey suggests that the cost for midsize companies remaining public has doubled with the passage of Sarbanes-Oxley from $1.3 million to $2.5 million.

Third, directors and officers of many public companies have experienced a significant increase in their personal exposure to liability. On the one hand, the rash of securities litigation lawsuits brought on by the Enron and MCI-WorldCom debacles have placed public companies in the cross-hairs of securities litigation plaintiffs. On the other hand, individual directors and officers face increased criminal liability under Sarbanes-Oxley. Apart from the expense of being directly involved in such scandals, untainted public companies may also experience increased costs. A recent report indicates that
premiums for D&O liability policies have increased 25-40 percent for companies with healthy balance sheets and as much as 300-400 percent for companies in financial trouble.4

Fourth, a marketplace myopia focused on quarterly earnings erodes the ability of many public companies to enact long-term strategies. As the investing public demands quarterly earnings guidance from public companies, management’s efforts are shifted from effecting long-term strategic plans to striving to achieve quarterly performance goals. Private companies can avoid this “relentless focus on quarterly earnings” and are better able to focus on long-term strategies to increase shareholder value.5 In short, these factors have compelled many public companies to reconsider whether the benefits of remaining public outweigh the associated costs.

**Transaction Structures**

While a wide range of mechanisms are available for public companies to go private (i.e., reverse stock splits, asset dispositions, bankruptcy-related acquisitions, etc.), long-form mergers and tender offers remain the predominant structures. Many of these transactions involve a large controlling shareholder or management group holding a large block of the outstanding common stock of the company.6 In a long-form merger, an acquiror will negotiate a merger agreement with an issuer whereby the issuer will be merged into an acquisition subsidiary, with the existing shareholders receiving cash for their shares. This merger will require the requisite shareholder approval in accordance with applicable corporate statutes.

In a tender offer, a controlling stockholder or management group will make a tender offer for the remaining shares of an issuer, with the goal of obtaining 90 percent of the outstanding shares. Once 90 percent of the shares are obtained, the acquiror can effect a short-form merger and cash out the remaining shareholders. While arguably both structures involve a degree of tension between the interests of a controlling shareholder and minority shareholders, Delaware courts apply differing fiduciary standards to boards evaluating such transactions.

**Delaware’s Analysis**

Fiduciary principles have long been established to protect minority shareholders in interested transactions. This protection is embodied in the “entire fairness” standard, a reasonably stringent review. Under a fairly recent line of cases, controlling shareholders can avoid the entire fairness review by structuring their going-private transaction as a tender offer. As described in the Delaware Chancery’s decision *In re Pure Resources, Inc. Shareholders Litigation*, Delaware courts now apply two distinct fiduciary standards to boards evaluating a controlling shareholder’s acquisition of the remaining shares of a company.7 On the one hand, as detailed in *Kahn v. Lynch Communications Systems, Inc.*, Delaware courts apply the “entire fairness” standard to long-form merger transactions involving a controlling shareholder:

“The concept of fairness has two basic aspects: 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 this issue must be examined as a whole since the question is one of entire fairness.”8

Moreover, in *Lynch* “[t]he Court held that the stringent entire fairness form of review governed . . . [even though]: i) the target board was comprised of a majority of independent directors; ii) a special committee of the target’s independent

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6 Alternatively, an unaffiliated company might acquire the public company for either stock or cash with the result that the acquired company is no longer a stand-alone public company. While this straight acquisition by a third party is technically also a going private transaction, this article focuses on the more complex affiliate acquisition.


8 638 A.2d 1110, 1115 (Del. 1994) (citing *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983)).
directors was empowered to negotiate and veto the merger; and iii) the merger was made subject to approval by a majority of the disinterested target stockholders. Even with these additional protective mechanisms, the Kahn Court determined that merger transactions involving a controlling shareholder contain an “inherent coercion” of the interests of minority shareholders, thereby requiring the more stringent “entire fairness” standard.

On the other hand, as demonstrated in Solomon v. Pathe Communications Corp., Delaware courts do not apply the “entire fairness” standard to tender-offer transactions involving a controlling shareholder if the tender offer is not coercive. Specifically, the Solomon Court found that “in the absence of coercion or disclosure violations, the adequacy of price in a voluntary tender offer cannot be an issue.” Recent decisions in In re Aquila and In re Siliconix Inc. Shareholders Litigation have followed this doctrine and found that “unless coercion or disclosure violations can be shown, no defendant has the duty to demonstrate the entire fairness of . . . [a] proposed tender offer.” The tender offers in Siliconix and Aquila contained a majority of the minority tender conditions and agreements to consummate DGCL §253 mergers at the same price as the tender offers. While the Chancery Court in those cases determined that the tender offers were not coercive, they did not specify factors for determining whether a tender offer is coercive.

In Pure Resources, while the Chancery Court “remain[ed] less than satisfied that there is a justifiable basis for the distinction between the Lynch and Solomon lines of cases,” it was unwilling to apply the Lynch “entire fairness” standard to tender offers involving a controlling shareholder. The Court found “the preferable policy is to continue to adhere to the . . . Solomon approach, while giving some greater recognition to the inherent coercion and structural basis concerns that motivate the Lynch line of cases.” In an effort to blend both lines of thought and expand upon the decisions in Siliconix and Aquila, the Court determined that a tender offer by a controlling shareholder would be noncoercive only when “1) it is subject to a nonwaivable majority of the minority tender condition; 2) the controlling stockholder promises to consummate a prompt [DGCL]§253 merger at the same price if it obtains more than 90% of the shares; and 3) the controlling stockholder has made no retributive threats.” Accordingly, although the distinction between a noncoercive tender offer and a long-form merger appears to rest on form over substance and has been questioned by commentators (e.g., Franklin Balotti), Delaware courts continue to honor the distinction.

Conclusion

As seen by the Delaware Chancery’s decision in Next Level Communications, Inc. v. Motorola, Inc., target boards evaluating going-private transactions involving a controlling shareholder should continue to use the framework provided in Pure Resources. Whether a going-private transaction involving a controlling shareholder is structured as a merger or a tender offer, additional protective mechanisms should be employed to insulate target boards from breaching their fiduciary duties. For long-form mergers, “an approval of the transaction by an independent committee of the directors or an informed majority of minority shareholders shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff.” Alternatively, tender offers can avoid a coercive taint by including

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9 Pure Resources, 808 A.2d at 435 (summarizing Lynch, 638 A.2d 1110).
10 672 A.2d 35 (Del. 1996).
11 Solomon, 672 A.2d at 40.
14 808 A.2d at 443.
15 Pure Resources, 808 A.2d at 445.
18 Lynch, 638 A.2d at 710.
(i) a nonwaivable majority of the minority tender requirement, (ii) a back end short-form merger at the same price as the tender offer, and (iii) the absence of any retributive threats. 19 Given the Chancery’s internal struggle with this issue, the Delaware courts appear likely to revisit the matter.

Further Information

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19 See Pure Resources, 808 A.2d at 445.