CHAPTER 1

Introduction: Definitions and Policy Background

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§ 1.01  Subject Matter

The subject of this book is how to go private. Its emphasis is on the legal and practical considerations pertinent to a going private transaction. The policy considerations discussed in this chapter are intended as background for a better understanding of the problems encountered in a going private transaction.

The choice of title should not be understood to imply that going private is simply a matter of technique, and that every enterprise can go private if it follows a few simple guidelines. Although a great many companies have gone private,¹ and many more appear qualified to, and may in the future do so, every going private transaction must

¹ A review of Securities and Exchange Commission records reveals that in the last two years 1,700 Schedule 13E-3s were filed.
reckon with a host of legal, business and other problems among which, on analysis, may lurk an insurmountable obstacle to the successful completion of the program.
§ 1.02 Definition of a “True” Going Private Transaction

A “true” going private transaction, and the one for which the term is used in this text, is one by which an individual or a group of individuals controlling a public corporation by virtue of an impregnable stock position, as in Concord Fabrics,\(^1\) undertakes a corporate transaction in order to acquire, either immediately or on a deferred basis, the entire equity interest in the corporation. Although there is an important distinction from the perspective of liability under the federal securities laws,\(^2\) the situations where a controlling shareholder has a majority interest and one where the controlling shareholder has an impregnable although non-majority interest are essentially the same from the point of view of their other legal constraints, and, accordingly, both are characterized generally for purposes of this discussion as “true” going private transactions. The corporate transaction may take any one of several forms: a merger, a reverse split or other form of charter amendment, a sale of assets, or a dissolution. Although the consideration is usually cash, a debenture or redeemable preferred stock may be involved. In a typical going private transaction, the founder of a company that had previously gone public elects to reverse his steps and restore the corporation to the status of sole ownership.

In this text, the term “issuer” denotes the corporation that is the subject of a going private transaction, and the terms “proponent” and “proponents” refer to the individual or group of individuals controlling the issuer who seek to take it private. “Unaffiliated shareholders” are the equity-holders of the issuer other than the proponents; they may be a minority or majority, but they do not have control.

Before proceeding further, it is important that a true going private transaction be distinguished from other varieties of transactions that are here termed “squeeze-outs,” “second or third step takeouts,” and “technical going private” transactions.

This volume takes a broad approach in its discussion of the law governing going private transactions, and its review of applicable state and federal law, tax aspects, and disclosure requirements, which apply to all forms of going private transactions. Accordingly, the examples of going private proxy statements include, *inter alia*, proxy statements for various forms of management buy-outs and other

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leveraged buy-outs. On the other hand, in the discussions of how to structure and manage a going private transaction, the focus is on the true going private transaction, on the theory that it is in this area that the reader may make the best use of some guidance.
§ 1.03 Squeeze-Outs

A squeeze-out, as the term is used here, is a corporate transaction identical in form to a going private transaction, except that it occurs in the context of a "close," as opposed to a "public," corporation. For purposes of this discussion, the important distinction between a close and a public corporation is not in the number of unaffiliated shareholders (i.e., shareholders of the issuer who are not proponents), but in the nature of the interest of the shareholders at the time they first became such. A public corporation, as that term is used in this text, is one in which a significant percentage if not virtually all unaffiliated shareholders made their investment with the expectation of immediate liquidity in a public market, while a close corporation is one in which the investment was not made with that expectation. A squeeze-out is a corporate transaction initiated by proponents for the purpose of acquiring, either immediately or on a deferred basis, the entire equity interest in such a close corporation.
§ 1.04 Second and Third Step Take-Outs

Second and third step take-out transactions are identical in form to true going private transactions. They differ, however, in that they involve in essence a controlling corporation, as opposed to a controlling individual or group of individuals. This corporation is usually, but not necessarily, itself an operating corporation and not merely a holding company. A second or third step take-out is a transaction in which a controlling parent corporation uses a form of corporate transaction to eliminate the minority interest in a publicly held subsidiary.

Normally, second and third step take-outs occur in the context of an overall plan by one publicly held corporation to acquire another publicly held corporation. A second step take-out occurs when the acquiring corporation makes a single initial purchase of shares of a public corporation by means, for example, of a tender offer or block purchase, and then effects a take-out transaction by means of, for example, a merger. A third step take-out is involved when the process includes an additional step; for example, when the acquiring corporation first purchases the interest of a dominant shareholder in a public corporation, then makes a tender offer, and thereafter effects the take-out transaction.

As suggested above, both second and third step take-outs are usually the culmination of a single plan, effected over a relatively short span of time, by which one corporation acquires another public corporation. For purposes of this discussion, however, the terms second or third step take-outs are also used to include transactions by which a parent corporation, which has owned its interest in another corporation for a considerable period of time, elects to effect a take-out of the minority interest in a publicly held subsidiary.

For ease of discussion, unless otherwise indicated, both second and third step take-outs will be referred to generically as "second step take-outs."

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1 It is interesting to note that: "[T]he refusal to commit to a second step merger for the same consideration offered in the tender offer is not coercive." Block and Hoff, "Review of Tender Offers By Controlling Shareholders," New York Law Journal, at 13 (June 27, 2002).

§ 1.05 Technical Going Private Transactions

A technical going private transaction is a transaction that is technically within the ambit of Rule 13e-3,¹ promulgated under the Securities Exchange Act of 1934 (the “Exchange Act”), but is neither a true going private nor a second step take-out, in that the entity that is making the buy is not in any real sense controlled by persons who control the target entity. As will be explained in more detail,² this occurs because the Rule applies if persons who are “affiliates” (as that term is defined under the Exchange Act) of the target company are also affiliates of the acquiring company, even though it would be stretching matters considerably to say that such persons had a controlling voice in the acquiring entity. All management buy-outs (“MBOs”) and many leveraged buy-outs (“LBOs”)³ are technical going private transactions under this definition. A leveraged buy-out is any transaction in which the assets of the firm are used to finance the acquisition. A management buy-out is one in which the management of a public company, itself not owning a substantial equity interest, nevertheless acquires the company using the acquired assets as the borrowing base. Leveraged buy-outs are not going private transactions unless the management has an interest in the buy side of the transaction, even if it is not a controlling interest, so long as the interest suffices to cause the filing of a Schedule 13E-3.⁴ From the point of view of this definition, both MBOs and LBOs in which a Schedule 13E-3 is filed are technical going private transactions, although obviously there is more of a conflict in the MBO situation where the management is quite clearly opposed to the corporation than the LBO where an outside sponsor is negotiating with the corporation, although the management group has a position alongside the outside sponsor in the transaction.

(Text continued on page 1-7)

¹ See Chapter 10 infra.
² See Chapter 10 infra.
⁴ See Chapter 10 infra.
§ 1.06 Definition of Neutralized Voting

The term “neutralized voting” is used throughout this text. It means any technique by which the proponents of a going private transaction sterilize their own voting power and delegate to a majority or super-majority in interest of unaffiliated shareholders, voting at a shareholder meeting called for that purpose, the authority to approve or to reject the proposed transaction.¹

¹ Various techniques of neutralized voting are discussed in § 8.05 infra. Judicial responses to neutralized voting are examined in § 4.06[5] infra.
§ 1.07 The Policy Background

It is obvious that the four categories of transactions that have been identified—true going private transactions, squeeze-outs, second step take-outs, and technical going private transactions—present significant distinctions from a policy perspective, and one would think that the courts would have focused on and explored those distinctions. The fact is to the contrary. The courts have substantially ignored public policy distinctions among the four categories of transactions, and have blithely cited cases involving one category of transaction as precedent in another, without pausing to consider the significant policy distinctions among them. One has to look, therefore, to the commentators for policy evaluations. Indeed, this task has been their principal critical assignment. While the commentators have recognized that there are significant policy distinctions among the four categories of transactions, and have explored them rather thoroughly, they have differed widely as to their evaluations.

Comments have centered on two competing considerations or, as it were, two opposing arguments. On the one hand, there is the contention that the ability of the proponents to influence, if not to control, the timing and the pricing of the transaction creates such a clear and present danger of abuse that the transaction should be either entirely prohibited, or at least subject to more extensive regulation than would otherwise prevail. On the other hand, it is argued that in a free society the ability to buy and sell businesses is a basic value and should not be unduly impinged upon or, as Edward F. Greene has put it, “[i]n a complex industrial society where combinations of businesses are common, flexible means of acquisition and transfer must be available.”

The commentators favor at least some second step take-outs on the ground that they further the interests of a capitalist society. They distinguish cases where an acquiring company uses either a two- or

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1 Exceptions include:
State Courts:

2 Compare, e.g., Brudney and Chirelstein, Cases and Materials on Corporate Finance 649 (2d ed. 1979), with Cary and Eisenberg, Cases and Materials on Corporations 1548 n.4 (5th ed. 1980).

three-step program to effect an acquisition of a previously unrelated company; and, on the other hand, transactions where a public parent moves to eliminate the minority interest in a long-held, publicly owned subsidiary. The first of these two transactions has seemed to the commentators, in general, to be just another form of acquisition transaction, and they have for the most part concluded that no additional strictures should be placed on them. Brudney and Chirelstein, who are among the severest critics of true going private transactions, have taken the position that “mergers representing merely a second step in the take-over of a target firm by a previously unrelated company present the least need for protective regulation and can be dealt with largely through the familiar medium of advance disclosure.”\(^4\) Similarly, Greene calls these transactions “Type I mergers” and concludes that they “should be permitted and minority stockholders should be confined to the existing remedy of appraisal.”\(^5\) The author of this treatise has taken the same view, saying that “sound public policy suggests that the corporation be permitted, as at present, to use the cash take-out to complete its acquisition.”\(^6\)

When it comes to the other variety of second step take-out, i.e., where a public parent moves to eliminate the minority interest in a long-held public subsidiary, the commentators’ position is different. One perspective is that full flexibility in these transactions is not necessary to encourage acquisition programs and, accordingly, that a different result should obtain. This has been this author’s view, particularly by virtue of the concern which goes with the elimination for cash of a minority interest.\(^7\) True, there is an equal conflict of inter-


\(^5\) Greene, N. 3 supra, 28 Stan. L. Rev. at 518.


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“The conflict between responsibility to the trading markets and to the corporate entity and its community of dependent individuals is not a theoretical matter. The viability of the enterprise itself may be at stake in these situations. The mandated disclosure of such straitened circumstances as ‘decreased flow of collections

(Rel. 31)
est where the minority interest in a publicly held subsidiary is eliminated for equity of the parent, but the fact is that these transactions do not meet with the same degree of concern as do cash-out transactions. Accordingly, since there does not seem to be any policy justification for permitting a cash consideration, this author has urged that a cash consideration should not be available where equity can be issued for this same purpose.\textsuperscript{8} Brudney and Chirelstein, on the other hand, take a more favorable view and conclude that “Mergers between affiliated operating companies, though also susceptible to abuse, at the same time promise social benefits in varying degree, and in our opinion are best regulated by rules relating to fairness of price.”\textsuperscript{9} Greene is somewhere in between; he characterizes these as “Type II transactions” and would create a new restraint, in the form of a pre-merger hearing, before permitting them to go forward.\textsuperscript{10}

When it comes to the true going private transaction, the commentators are more divided. Both Brudney and Chirelstein, and Greene, find the opportunity for abuse so great, and presumably the social

\textsuperscript{8} \textit{Id}, 49 N.Y.U.L. Rev. at 1018-1019.


\textsuperscript{10} Greene, N. 3 \textit{supra}, 28 Stan L. Rev. at 510-512.
benefits so questionable, as to justify outright prohibition. According to Brudney and Chirelstein, the only arguments that have been offered in favor of these transactions relate to the saving of “legal and accounting costs of complying with SEC and stock exchange disclosure requirements, as well as the expense of carrying on stockholder relations in one form or another.”\(^\text{11}\) In their view, these savings are “too small” to justify the transaction and indeed, to them, the transaction could not be justified unless it could be shown “that public stock ownership is actually inconsistent with the company’s continued viability, not merely that public ownership entails a cost that can be avoided by eliminating the public’s interest,”\(^\text{12}\) which they contend has never been and never could be demonstrated. They conclude that implementing a fairness standard in the context of these transactions would be of insurmountable difficulty, and accordingly, they would condemn these transactions outright. Greene refers to true going private transactions as Type III transactions and says that they

“. . . should be prohibited. Neither a change in control nor a combination of enterprises with the potential to produce business efficiencies is involved, and corporate flexibility would not seem to require that controlling stockholders be permitted to eject minority stockholders at will while continuing in the business.”\(^\text{13}\)

This author’s view has been different. Although safeguards, which are discussed extensively in this volume, are desirable, it seems that there are considerable social advantages in eliminating from the public rolls a host of companies which probably never should have gone public in the first place and whose continued public existence does not serve any of the original purposes of meeting capital requirements, providing employee incentives, or permitting acquisitions which motivated their going public transaction in the first place.\(^\text{14}\)

\(^{11}\) Brudney and Chirelstein, N. 9 supra, 87 Yale L.J. at 1366.
\(^{12}\) Id., 87 Yale L.J. at 1367.
\(^{13}\) Greene, N. 3 supra, 28 Stan. L. Rev. at 512.
\(^{14}\) Borden, N. 7 supra, 49 N.Y.U.L. Rev. at 1006-1011.

“From the corporate standpoint, the principal reason for going private is the fundamental incompatibility in many enterprises between prudent management and the constraints imposed by public ownership. Prudence requires conservation of resources, resistance to risks, readiness to retrench and conservative accounting resulting in lower income taxes. Being public, on the other hand, for the class of enterprises with which we are concerned, imposes enormous pressures, at least in periods of normal securities markets, to produce increased earnings for each year, and, indeed, for each comparable quarter. These pressures are, in normal markets,
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Perhaps the most convincing evidence of the correctness of this view over the years has been the fact that no persistently pursued going private transaction has been ultimately enjoined, for the simple reason that it has never been really to the interest of any plaintiff to have it enjoined. The ultimate question has always been whether the price has been adequate.

When it comes to close corporations there has again been a schism among commentators. This author’s view has been that in circumstances where one faction dominates the other to the extent that it can force the other faction out, such faction does not need the approval of the other faction to conduct the business and, accordingly, should have no right to squeeze-out the other. After all, one is dealing in a close corporation with investors who likely purchased for investment with a view to long term appreciation and to realization, either in the form of a sale of the business or dividends. That expectation should not be cut short at the will of a majority when there is no public policy whatsoever to be served. Greene refers to these also as a variety of Type III mergers and takes the same view.\textsuperscript{15} Suprisingly, Brudney

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as impossible to resist as they are to satisfy. The unfortunate consequences all too often are free-wheeling accounting, sometimes resulting in the payment of higher income taxes, hasty introduction of new products, ill-conceived entry into new markets, impulsive acquisitions of other businesses, retention of unsatisfactory customers in lieu of reorganizing bad receivables, deterioration of research, products and services, and a host of other imprudent actions, all for the purpose of maximizing short-term profitability and all inconsistent with the basic long-term welfare of the enterprise. As one executive has put it, being public may be a ‘bummer.’

“Moreover, being public involves substantial expenditures for auditing and legal fees, shareholder relations, annual meetings, transfer agents, stock certificates, and the like, aggregating perhaps $75,000 to $200,000 annually for an average public company of Amex size, and considerably more if special problems should arise. An additional and probably more significant cost is the diversion of management time and attention from the business affairs of the enterprise to unproductive concerns such as shareholder relations, auditing and legal matters. . . .

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“A second reason why a corporation might justifiably want to go private resides in the continuous obligation of public corporations to comply with the disclosure requirements of the Exchange Act. This means, in part, the necessity of filing a continuous stream of periodic reports. More importantly, however, both corporate management and prudent counsel must construe their duty to the trading markets, that is, their duty to disclose under Section 10(b) and Rule 10b-5, as superior to their duty to the corporation and its community of associated managers, shareholders, creditors and employees, that is, their duty not to disclose.”

\textsuperscript{15} Greene, N. 3 supra, 28 Stan. L. Rev. at 513.

“Type III freeze-out mergers also occur in the context of a dispute within a close corporation. Again, there is no justification for allowing a freezeout merger to settle differences between the controlling and minority stockholders. Modern
and Chirelstein take a somewhat different view, noting that in these cases, generally “disagreements are of a continuing kind, likely both not be resolved until the business terminates and to plague the parties as they remain unable to disentangle satisfactorily.” They find, therefore, that there is “reason to facilitate or encourage the departure of one group or the other from the enterprise—both in terms of the personal well-being of the participants, and because of the impact of continuing disagreements on their conduct of the enterprise.”

Although the controlling group should not “have an advantage in bargaining over the terms of the break-up,” still, they indicate, “flatly forbidding freezeouts” of this kind would give the minority the power to create a deadlock.

One other note on policy may be in order. Brudney and Chirelstein, and also Greene, reviewed the merits of various categories of transactions without extended consideration of the neutralized voting technique or of the contribution that may be made by the active participation of disinterested directors. The widespread adoption of neutralized voting and the active involvement of independent directors have in fact served to blunt a good deal of the concern which these transactions generated. Certainly, it is difficult from a public policy point of view to urge that a court should overrule the expression of a majority of those interested enough to cast their votes and should substitute its own judgment for the democratically expressed will of the interested parties, especially where disinterested directors employing independent financial advisers have negotiated the price of the transaction.

When all these issues that have been discussed here were first brought to public attention there was no talk of the leveraged buyouts (LBOs) or management buy-outs (MBOs) that today dominate the going-private scene. Unlike true going-private transactions where there is no chance for the minority ever to capture control, a management buy-out raises the alarming spectacle of persons employed

corporate statutes allow stockholders in close corporations to develop their own rules for stockholder participation in management, and to provide for mandatory dissolution or buy-out in certain instances including disagreement, death or termination of employment. The controlling stockholders should not be able to eliminate a dissenting minority stockholder in the absence of bargaining over the terms. If a merger were a permissible way to resolve such disputes, bargaining power would shift dramatically to the controlling stockholders.” (Footnotes omitted.)

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16 Brudney and Chirelstein, N. 9 supra, 87 Yale L.J. at 1356.
17 Id.
18 Id., 87 Yale L.J. at 1356, n.9.
19 See §§ 4.06 and 8.05 infra.
as fiduciaries buying out the interest of those whose assets they were engaged to manage.

Enormous public debate has been engendered by these transactions, which is beyond the scope of this work to evaluate, and which is part of the larger dispute raging about the takeover phenomenon generally, quite apart from its going-private aspects. Many commentators find that MBOs are a violation of a basic tenet that a trustee should not have the option to buy-out those for whom he is beneficiary, while others plead that they impose a competitive constraint on the economy. Certainly, there is a distinction to be drawn between an MBO which is initiated by the management and an MBO undertaken in response to an outside bid and which results in a higher price paid to shareholders than would have been paid if the outside bid had been accepted.

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