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"Turning Off the Lights: 'Going Dark' or 'Going Private'"

Jannat Thompson
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The New Environment

As most public companies are aware, the cost of being a public company has increased substantially since the passage of Sarbanes-Oxley and the resulting rulemaking by the SEC. According to the *Wall Street Journal*, 90 large companies that responded to a recent survey spent an average of \$7.8 million on Sarbanes-Oxley compliance. Audit fees represented about 25% of that amount.[1] Compliance with the new section 404 internal controls reporting rules has hit companies particularly hard, especially small to mid-cap companies, which are finding that their compliance costs represent an ever-increasing percentage of revenues. Although the SEC recently granted smaller companies a reprieve, delaying the date by which they must comply with Section 404,[2] the delay may only serve to spread the economic pain over a longer period of time.

In light of the new regulatory environment, many companies have gone private or gone "dark," or are considering doing so.[3] For example, Meredith Enterprises Inc., a large real estate investment trust, recently filed documents with the SEC to delist its shares from the American Stock Exchange.[4] The increased cost of complying with Section 404 of Sarbanes-Oxley reportedly was a factor in its decision.[5]

The Difference Between Going Dark and Going Private

Going private generally refers to a transaction in which someone (frequently an affiliate, such as controlling stockholder) purchases the outstanding shares of the issuer, either by merger or some form of tender offer. After the shares are purchased, the company delists from a public stock exchange or quotation system and then deregisters the shares, thereby suspending the company's periodic reporting obligations with the SEC.[6] When a company elects to "go dark," it bypasses the first step and voluntarily delists and deregisters the shares without going through the process of cashing out its stockholders. In both instances, the issuer is relieved of its periodic reporting requirements, compliance with Sarbanes-Oxley, and compliance with the rules and regulations of the stock exchange on which the shares were listed. As discussed below, each approach has advantages and disadvantages.

Going dark

Going dark is relatively simple, as there is no actual transaction to complete. Unlike a going-private transaction, a company going dark does not need shareholder approval. In essence, the company is simply choosing to drop out of the regulatory regime, without making any changes to its stockholder base. Going dark is less expensive and time consuming than going private by buying out the company's stockholders, but the option is only available to companies with fewer than 300 stockholders of record, or less than \$10 million in assets at the end of its last three fiscal years and fewer than 500 stockholders of record. Significantly, the number of stockholders is not determined based on individual holders. Rather, shares held in street name for beneficial owners are counted as a single stockholder of record. Accordingly, a company with substantially more than 500 beneficial owners can nonetheless go dark because each beneficial holder is not necessarily counted as a stockholder of record.

The technical aspects of going dark are relatively uncomplicated. The issuer files a form 25[7] with the SEC, which delists the issuer's shares from the relevant stock exchange. The delisting is effective ten days after the filing (unless the SEC postpones the effectiveness) and withdrawal from Section 12(b) reporting (reporting required by virtue of having a class of securities registered under Section 12(b) of the Exchange Act) by the issuer will take effect 90 days later. The requirement to file periodic reports is suspended on filing, although the tender offer and proxy rules will continue to apply to the issuer

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until the deregistration is effective.

Although delisting under the Form 25 will terminate registration under Section 12(b) of the Exchange Act, the company's SEC reporting obligations are not terminated because the shares still will be registered under Section 12(g). To deregister under Section 12(g) and suspend reporting obligations, the issuer must file a Form 15,^[8] certifying that it meets the 300/500 stockholder requirement. Deregistration under Section 12(g) is effective 90 days after filing the Form 15. If the SEC denies termination of registration under Section 12(g), the company will have 60 days to file all periodic reports that it would have been required to file had the Form 15 not been filed.

Although this all appears very simple, it is important to note that, after going dark, an issuer's reporting obligations can be reinstated if the issuer exceeds the 300/500 stockholder limit on the first day of any fiscal year after it files a Form 15. For example, brokers and other institutions holding shares in street name can elect to cease holding the shares in that capacity. In such a case, each beneficial owner will be counted, and the stockholder count may exceed the limits. This risk can be avoided by choosing the more complicated, costly, and time-consuming method of going private.^[9]

Another potential problem is that the loss of liquidity of the company's shares may anger the stockholders. Consequently, an issuer choosing to go dark should consider issuing a press release, allowing its stockholders the opportunity to sell the shares through an exchange prior to delisting.

Finally, as noted below, state securities laws still may require that the company hold stockholder meetings and make certain minimum disclosures. Stockholders wishing to obtain information on a company after it has gone dark still may request the books and records of the company by following applicable state law procedures.

Going Private

Going private generally refers to a transaction in which the stockholders of the company are cashed out—often by a controlling stockholder or group of stockholders, but in some cases by a third party. The goal is to reduce the number of stockholders of record below the 300/500 stockholder level, at which point the company can delist and deregister in the same manner as described above.

A going private transaction can be structured as a merger, an asset sale, a reverse stock-split (useful when a few stockholders hold most of the shares), or a tender offer. The nature of the transaction will depend on a variety of factors that are company-specific and will have to be considered carefully in consultation with the company's legal and tax advisors. Unlike going dark, a company seeking to go private will require the approval, in some form, of its stockholders.

If the company has too large a stockholder base to go dark and, consequently, must use the more complex route of going private, careful consideration must be given to the structure of the transaction. For example, are the majority stockholders driving the transaction or is there an interested third party? Will there be financing involved that will affect the company's leverage and cash flow after the transaction? Does the company's performance and earnings make it a candidate for finding financing from lenders or other sources on attractive terms? How high is the litigation risk? Does management have the time to run the business, comply with regulatory requirements, and work on a going-private transaction?

Going-private transactions tend to be scrutinized closely by the SEC, as they inherently pose the risk of insider self-dealing. Consequently, when a controlling stockholder or group of controlling stockholders is spearheading the transaction, the transaction will be viewed under the "entire fairness" standard, rather than the lesser standard of the business judgment rule. If litigation ensues, which it frequently does in these cases, the board will have to meet this higher standard in defending both its decision to go private and the manner in which the company did so.

The company should take certain procedural steps to meet the standard, including forming a special committee, obtaining an expert valuation, completely and accurately documenting the committee proceedings, and preparing extensive disclosure in the required filings. The special committee should be careful and thorough in its deliberations at all times. Its members must have no relationship with the company that would shed doubt on the committee's independence. The committee

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should have the freedom (and the budget) to retain independent advisors, including outside counsel. Negotiations should be arms-length at all times. In addition, the company should consider obtaining the consent of the "majority of the minority" of the stockholders to ensure that the transaction is not coercive to the minority stockholders. Under Delaware law, such an approval will shift the burden to a plaintiff to prove that the transaction was not fair.

Going private requires complex filings with the SEC under Rule 13e-3 or, if it is an issuer self-tender, Rule 13e-4. If the transaction is an issuer tender offer, the company will be required to file a Schedule 13E-3 or Schedule TO. If the transaction involves a tender offer, or if the consideration is going to consist, in whole or in part, of securities of another issuer, disclosure under Regulation 14D, Regulation 14A, or Regulation 14C also will be required. Preparing the SEC filings and enduring the SEC review process means that a going-private transaction generally will take months to complete.

Why Go Private or Go Dark?

The decision to leave the public company regulatory system will involve numerous factors. In addition to eliminating the time and expense of complying with the ever-burgeoning requirements under the Sarbanes-Oxley regime—in particular the legal and accounting fees that go along with compliance—there are some other positive aspects about departing the system and conducting business out of the public eye. For example:

- Going private can provide liquidity for investors in the absence of a healthy market for the shares and the lack of opportunities to sell in the marketplace.
- Spending less time on compliance and reporting activities leaves management more time and greater freedom to conduct business and build long term value.
- The likelihood of litigation (other than in connection with actually going dark or private) may decrease, given the smaller stockholder base and elimination of certain risks inherent in securities filings.
- D&O insurance costs may be decreased or, possibly, eliminated.
- The need to comply with the proxy rules, periodic reporting requirements, and regulation FD is eliminated, along with the associated legal liability and costs.
- Reporting by insiders under Section 16 and the short swing profit rules is no longer required.
- Personal liability of officers and directors—particularly certifying CEOs and CFOs, who now are subject to criminal prosecution, fines, and imprisonment for false certifications—is eliminated.
- There is no longer a need for extensive disclosure, making it easier to keep matters such as executive compensation or competitive and sensitive business information out of the public realm.
- The company will have greater freedom to explore transactions that might otherwise require a stockholder vote, with the attendant time and cost of complying with the proxy rules.
- Corporate governance requirements are simplified. For example, it would not be necessary to have a fully independent audit committee, or to have one at all.

Potential Disadvantages of Going Dark or Going Private

Whether an issuer goes dark or goes private, it will cease to be subject to a panoply of federal securities regulations and the related public disclosures. As appealing as that may be in today's costly regulatory environment, there are other factors a company should consider before determining if it wants to take either step. For example:

- If the company that goes dark somehow finds itself back over the 300/500 stockholder limit, it will once again be subject to SEC reporting requirements. (This risk generally is eliminated in a going private transaction.)
- Thinly traded or smaller companies may miss the status that being a public company once conferred.
- State securities laws may require ongoing disclosure to the remaining stockholders. In addition, certain corporate formalities, such as annual stockholder meetings, may still be required.

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- Going dark or going private will eliminate the trading market in the company's securities. This creates litigation risk (particularly with respect to going dark, because stockholders are not cashed out) as stockholders who now will be holding illiquid securities may sue the board of directors for breach of fiduciary duty. The price of the stock undoubtedly will fall and, although the shares still may trade on the pink sheets, the volume and activity generally will be significantly less.^[10]
- The securities of an unlisted company will be substantially less attractive as currency in funding acquisitions.
- A company with unlisted stock or stock that only trades on the pink sheets may have difficulty obtaining bank financing. In addition, existing loan documents may require that a company remain public or risk violating a loan covenant.
- The company's stock will be less attractive as a component of incentive programs, such as stock options plans.
- If the company incurred substantial leverage to finance a going-private transaction, it may have difficulty managing its cash flow going forward.
- Going-private transactions carry some risk with respect to execution—for example, if an insufficient number of stockholders tender their shares in an issuer tender offer.
- Filings required in a going private transaction are subject to the anti-fraud rules, thereby increasing exposure for the principals involved.
- Stockholders may think the decision to go dark or go private means that the company has something to hide.
- Going private can take up to six months or more, during which time the focus of management may be diverted from the company's regular SEC compliance obligations and from running the business.
- In a going private transaction, there is a risk that the company would be considered "in play" and therefore, a potential target for acquisition by an unsolicited third party acquiror.

What to Do

The decision to go dark or go private is complex, and it is important to engage proper legal and accounting professionals early on in the process. As outlined above, a number of things need to be considered in making this decision. Primary among them is weighing the benefits of remaining public against the benefits to be obtained by going dark or going private. This analysis will vary by company; each will have different issues to consider. Factors such as stock price, public float, company performance, and the costs of compliance with SEC regulatory regimes will be weighed against the company's need or desire to have publicly traded stock as acquisition currency, lender requirements, and the company's relationship with its stockholders.

Notes

[1] Deborah Solomon, "At What Price?" *Wall Street Journal*, Oct. 17, 2005, at R3.

[2] SEC Release No. 33-8618 (Sept. 22, 2005), *available at* www.sec.gov/rules/final/33-8618.pdf.

[3] See Peter C. Hsu, UCLA School of Law, Law-Econ Research Paper No. 04-16, "Going Private—A response to an Increased Regulatory Burden?" (May 2004), *available at* <http://ssrn.com/abstracts=619501>; Christian Leuz, Alexander Triantis, and Tracy Wang, Working Paper, "Why do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC deregistrations," Nov. 17, 2004, *available at* <http://knowledge.wharton.upenn.edu/papers/1285.pdf>.

[4] See Meredith Enterprises' Form 15, *available at* www.sec.gov/Archives/edgar/data/858346/00009427/form15-110305.htm.

[5] See Solomon, *supra*, note 1.

[6] While SEC rulemaking has made the costs of remaining public rise significantly, it recently streamlined the process for delisting and deregistering shares of a public company issuer. See SEC Release No. 34-52029 (July 14, 2005), *available at* www.sec.gov/rules/final/34-52029.pdf.

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[7] A sample Form 25 is *available at* www.sec.gov/about/forms/form25.pdf.

[8] A sample Form 15 is *available at* www.sec.gov/about/forms/form15.pdf.

[9] Note that a company registered under Section 15(d) of the Securities Act will not be able to suspend reporting during the fiscal year in which a registration statement covering a class of securities is declared effective. No issuer may suspend reporting obligations under Section 15(d) unless the company has filed all of its annual and quarterly reports for the shorter of: (i) its most recent three fiscal years and the portion of the current year proceeding the filing of the Form 15; or (ii) the period since the company became subject to reporting obligations.

[10] See *generally* Leuz et. al., *supra* note 3, at 9.