

# Alert

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## High Cost of Compliance Compels More Public Companies to Go Private

*“Management of a private company can focus on long-term strategic growth rather than the quarter-to-quarter earnings pressure...”*

The passing of Sarbanes-Oxley and related SEC rules has resulted in an enormous financial burden for small to mid-cap public companies. Subsequent costs include higher audit fees, higher director and officer insurance premiums, increased legal fees and escalating fees associated with investor relations and disclosures. The average corporate governance cost for companies with an annual revenue of under \$1 billion is up 130 percent since the enactment of Sarbanes-Oxley in 2002, according to a study done by Foley & Lardner. The study showed that the average cost of being public for these companies was \$2.86 million in 2003, up from \$2.13 million in 2002 and \$1.24 million prior to Sarbanes-Oxley. To avoid the high cost of compliance, many public companies are choosing to go private.

### WHY GO PRIVATE ?

Along with the financial burden, there are other reasons why companies are choosing to go private including the following:

- 1) **Liability exposure.** Directors and officers of public companies are subject to heightened compliance requirements and, subsequently, personal liability exposure, including certification requirements under Sarbanes-Oxley, that mandate more time and dedication.
- 2) **Reduced analyst coverage.** Securities analysts have begun to focus their resources on large, publicly traded companies to limit their liability exposure associated with providing research on a broad range of companies. As a result, a number of small to mid-sized publicly traded companies are losing the benefit of analyst coverage, which causes fluctuating stock prices and nominal trading volumes. Additionally, a company's positive financial performance, because of the lack of coverage, may not be reflected in the company's stock price.
- 3) **Focus on short-term profits.** Management of a private company can focus on long-term strategic growth rather than the quarter-to-quarter earnings pressure associated with periodic filing requirements for public companies.

### STRUCTURING A GOING PRIVATE TRANSACTION

To be considered a private company by the SEC, a public company has to effect a transaction that reduces the number of shareholders to fewer than 300, and is no longer required to file reports with the SEC. A going private transaction can be accomplished through a number of methods, but is generally structured as a cash-out merger, tender offer, reverse stock split, or asset sale.

SEC rules require companies to furnish certain information to shareholders about the transaction. Tender offers are governed by Section 14 of the Securities Exchange Act of 1934. Sec.14 requires the filing of a Tender Offer Statement which must include the target company's

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position on the tender offer (i.e. whether the price and terms are fair to the shareholders). If the going private transaction is initiated by an affiliate (management) of the public company, Rule 13e-3 requires the affiliate to file Schedule 13e-3. The goal of Schedule 13e-3 is to provide enough information to the shareholders to enable them to make an informed decision over whether the board, management and/or the controlling shareholder are performing their fiduciary obligations. The following disclosures are required in Schedule 13e-3:

*“Going private transactions are often surrounded by conflict of interest issues.”*

- a) certain information regarding the parties to the transaction;
- b) the transaction history;
- c) the terms of the transaction;
- d) the post-transaction plans of the parties;
- e) the purpose of the transaction; and
- f) an extensive description of the fairness of the transaction, which includes a description of the reliance on any reports or appraisals obtained in connection with the transaction.

### FIDUCIARY DUTIES

Going private transactions are often surrounded by conflict of interest issues. In typical situations, the board of directors will form a special committee of independent directors to represent the public shareholders due to the conflict of interest of insiders who wish to take the company private. Under Delaware Law, going private transactions are held to an "entire fairness" standard, which refers to both a fair price and fair dealing. Fair price relates to the economic and financial considerations of the transaction. Fair dealing relates to how the transaction was timed, initiated, structured, negotiated, disclosed to directors, and how board approval was obtained. Fiduciary obligations require the board of directors to disclose to the shareholders the process the board took in evaluating the proposed transaction and in establishing the fairness of the price paid in determining whether to approve the transaction.

To fulfill its responsibilities, boards of directors will want to retain a third party to assist it in determining the fairness of the going private transaction. An independent valuation professional can provide a fairness opinion to the board relative to the price being offered to the existing shareholders. In addition, a valuation specialist is often engaged to provide an allocation of purchase cost valuation in support of a going private transaction. Valuation Research Corporation has provided valuation services for numerous going private transactions. For more information regarding our services, contact your Valuation Research representative or Bryan Browning at (414) 221-6249. **VR**

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