THE MANAGEMENT BUYOUT

Considerations and Consequences of a "Going Private" Transaction

By Gregg P. Skall and Ross H. Parr*

The problem

As the public marketplace for broadcasting pure-play stocks reaches maturity, and public investors become sophisticated in broadcast economics, it is becoming increasingly difficult to maintain the type of growth that continues to impress Wall Street analysts. Over the past couple of years, growth in broadcasting stocks has slowed enormously.[1] Some large investor groups are looking to "pare down" their broadcast holdings and several large broadcasters are bolstering their stock price with huge stock buy-back programs.[2] Radio revenue is not growing as fast as the analysts would like[3] and radio groups are running out of strategies to feed Wall Street's expectations of ever-increasing profits. Costs have been cut as much as sanity will allow, maximum economies of scale have been reached and spot inventory has been expanded to the breaking point, particularly for traditional radio groups who are facing competition from satellite radio providers. Clear Channel's "less is more" campaign seems to have hit a resounding note.

As the industry moves toward the second half of 2005, there is an increasing "buzz" that broadcasting companies – and the radio sector in particular – must look for new options. Some believe that the creation of more cohesive station groupings, achieved by selling off clusters of stations that do not fit the basic group strategy, is the answer. Others, however, believe that a better way to enfranchise broadcasters to serve their audience is to "go private."

What does it mean to "go private"?

Generally, a company is said to be "going private" when a buyout group, usually management of a public company or a third-party affiliate, cashes out enough shares to allow the company to deregister its stock with the Securities and Exchange Commission (the "SEC") and delist the stock from the company's stock exchange. For purposes of this article, we will assume generally that a "going private" transaction would take the form of a management buyout, or "MBO," in which corporate management initiates the buyout with financing supplied by an LBO (leveraged buyout) fund or similar investor. Private equity funds that know the broadcasting space are now "chasing" good deals and seeking out retired management for new investments. There is plenty of money available from funds that understand the business and have reasonable expectations.[4] The public market may have been useful for financing the creation of large station groups following the change in ownership limits occasioned by the Telecommunications Act of 1996, but the time may never be better to get out of the public market and replace that capital with funding that will respect the rational, restrained growth that is so important to broadcasting in the current competitive climate.

Some reasons to go private

A private company may be better positioned to operate in an already highly competitive industry faced with new modes of competition and to compete in the face of a steady increase in FCC-authorized stations and a splintering audience base. For many radio and television stations, the challenge is how to keep their market and audience share rather than how to further grow profits. The challenge of meeting well reasoned loan covenants designed to pay back debt with reasonable interest, instead of providing new profit to unrelated investors, should be a welcome respite to broadcasters suffering the criticism of sacrificing audience service to increased dollars.

Importantly, going private also enables a company to shed the ever-growing regulatory burdens of being public. Public status was always a reporting and record keeping burden, but the Sarbanes-Oxley Act of 2002 ("SOX") substantially increased the costs of being public. Today, public company broadcasters are really in the public securities business, serving the shareholder and market professional, and have far less time for broadcasting and serving the audience. SOX requirements have prompted a number of companies in other industries to go private or at least seriously consider the option.[5]

Among the many new requirements under SOX are the following:

- Companies must establish and maintain review procedures for "internal control over financial reporting" – perhaps the most costly aspect of SOX. One recent survey estimated that the annual costs of compliance with this provision alone averaged more than $4 million per company[6];
- The chief executive officer and chief financial officer must certify that the company's periodic reports are not materially misleading and that internal control over financial reporting is adequate (with potential personal liability);
- Company loans to directors or executive officers are prohibited;
- Periodic and beneficial ownership reporting has been accelerated;
- New reporting rules limit disclosure of non-GAAP financial measures and require enhanced disclosure of off-balance sheet arrangements;
- Companies must maintain procedures for audit committee pre-approval of audit and non-audit services, as well as "whistleblower" guidelines; and
- Companies must establish a code of ethics and ensure that the audit committee includes an "audit committee financial expert" (or explain why they have not done so).

Shortly following the adoption of SOX, the New York Stock Exchange, Nasdaq and the American Stock Exchange revised their listing standards to establish numerous corporate governance requirements and restrictions, including rules that make it more difficult for a director to be deemed "independent." The recent corporate scandals that precipitated SOX have also contributed to a significant increase in the cost of acquiring and maintaining director and officer liability insurance – and made it more difficult to find and retain qualified directors to serve on the board (particularly after the recent WorldCom and Enron settlements, in which directors incurred personal liability amounting to millions of dollars).

Besides the enhanced regulatory concerns and expenses facing public companies, many smaller public broadcasters have been unable to

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fully realize the advantages of being a public company. Although some public companies benefit greatly from the increased access to capital, the stock of some broadcasters never sold for much more than the initial offering price and in some cases, less. Even successful offerings do not always attract a large institutional shareholder base and broad analyst coverage. The capital markets are effectively closed for many small companies that are "in the orphanage" – Wall Street slang for companies whose stock is so thinly traded that they are unable to attract the analyst coverage necessary to enable them to raise capital and fuel continued growth.

An overview of the going private process

For some companies, the challenges of broadcasting in the new competitive era that has emerged in the 21st century, coupled with the regulatory burdens and costs flowing from the Sarbanes-Oxley Act of 2002, simply make it impractical for these companies to continue their public existence. By exiting the public securities market, these companies believe that they can recover the value of a business that is undervalued in the public market,[7] reduce (or even eliminate) the quarterly pressure to "meet earnings," operate with more confidentiality and less public scrutiny and perhaps even recognize certain tax benefits that are not typically available to a public company. As noted earlier, a private company may be better able to survive in an already highly competitive industry that is faced with new modes of competition, a steady increase in FCC-authorized stations and a splintering audience base.

The decision to go private, however, cannot – and should not – be made in haste. The board of directors has fiduciary duties of loyalty, care and good faith to both the company and its shareholders, and a decision to go private can backfire if it is not made with appropriate consideration of all relevant factors. Further, simply because a company believes it is too expensive or burdensome to continue as a public company does not mean that it will thrive as a private company. Problems stemming from a company's inefficient operations, inconsistent cash flow, slim margins, or a weak advertiser base will not be miraculously resolved simply because a struggling public company becomes private.[8]

A going private transaction can be accomplished in one of several ways, such as by a tender offer, a cash-out merger (or a combination of the two), or a sale of assets. A true going private transaction is always done for cash. Regardless of the type of going private transaction or the identity of the buyout group, the company must adhere to a number of important detailed substantive, procedural and regulatory requirements.

We mentioned above the importance of working through and resolving the directors' fiduciary duties early on in the process, which requires a focus on both substantive and procedural factors. One of these factors will, in most cases, include the appointment of a special committee of disinterested, independent members of the board of directors to ensure that the going private transaction is fair to the company and the public shareholders and that the buyout group pays a fair price for the company. It is the responsibility of the special committee to ensure that fair dealing and "arms'-length" negotiations occur, even (and especially) if the special committee is dealing with members of management.

Since the special committee (or, in the absence of the special committee, the independent directors) will ultimately be responsible for making a careful and informed decision about whether to engage in a going private transaction, it is important that they fully understand the issues surrounding the valuation of the company and the terms, conditions and pricing structure of the proposed transaction. This cannot be stressed enough, since part of the company's public disclosure requirements will consist of a detailed description of all steps that were taken to ensure that the interests of minority shareholders were protected and that the price paid for the shares was fair. The involvement of the special committee is critical in helping the company establish fairness and the semblance of arms'-length negotiations.

Even if the directors or the special committee determines that an MBO is in the company's best interests, it is important that the management group carefully weigh the pros and cons of the transaction before engaging in a going private transaction. A going private transaction is not a quick process, requires a great deal of intellectual and financial capital and will be heavily scrutinized by both the SEC and the plaintiffs' bar (which will not hesitate to file a lawsuit if it appears that the MBO is not in the best interests of the shareholders or is procedurally deficient). The members of the buyout group should have the same strategic objectives and should be in agreement on the means to achieve them in order to maximize the perceived benefits of exiting the public marketplace. In addition, there are numerous conflicts of interest that arise in an MBO because the interests of the management buyout group and the company are not aligned. The company (specifically, the independent directors or special committee on behalf of the company) must endeavor to get the best price possible for the company's shares, while the management buyout group has an interest in paying as little as possible for those shares to complete the going private transaction. Since the members of management that comprise the buyout group will likely remain employed by the company during the going private transaction, it is important that they (and the board) recognize at the outset the difficulties that such a situation can create. It is therefore critical that the members of management who wish to conduct an MBO request and obtain authority from the independent directors or special committee prior to pursuing the going private transaction.

Next Month: REGULATORY AND OTHER CONSIDERATIONS

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[1] See Radio Business Report Daily Epaper, "Marsh sees still lower radio stocks," Vol. 21, Issue 202 (Oct. 15, 2004) ("'While radio stocks bump around near 52-week lows, we still see downside for the average radio stock from here, especially as we near 2006,' was the dire warning from S.G. Cowen analyst James Marsh in his latest missive to investors.").

[2] See Radio Business Report Daily Epaper, "Entercom wants to buy back more stock," Vol. 22, Issue 55 (Mar. 18, 2005) ("With radio stocks still beaten-up on Wall Street, Entercom is the latest company to say that if investors don't want to pay a good price for its stock, the company will just buy it back.").

[3] See Radio Business Report Daily Epaper, "Wobbly ad revenues worry Westerfield," Vol. 22, Issue 11 (Jan. 17, 2005) ("After hearing 'fresh evidence' of unsteady ad pricing trends from ad buyers, Harris Nesbitt analyst Lee Westerfield has lowered his Q1 and full year 2005 forecast for the broadcast companies that he tracks.").

[4] See Radio Business Report Daily Epaper, "Venture capital money is again chasing radio deals," Vol. 20, Issue 249 (Dec. 23, 2003) ("Interest rates may be at 40 year lows and stock market returns rebounding from negative numbers, but while venture capital companies are actively looking for radio deals, VC investors still expect big returns on their capital.").

[5] See Lee Berton, "U.S. Companies Consider Going Private to Skirt Law," Bloomberg.com (July 20, 2004) ("Small public companies facing the higher costs of complying with the Sarbanes-Oxley law of 2002 are considering going private faster at a time when education is needed, not more regulation, to fight corporate fraud.").

[6] See Press Release, Financial Executives International, "Sarbanes-Oxley Compliance Costs Exceed Estimates" (Mar. 21, 2005) ("Companies' total costs for year one Section 404 [internal control over financial reporting] compliance averaged $4.36 million, up 39 percent from the $3.14 million they expected to pay, based on FEI's earlier July 2004 cost survey.").

[7] See Radio Business Report Daily Epaper, "Cox Enterprises to buy back cable stake for 8.3 billion," Vol. 21, Issue 205 (Oct. 20, 2004) ("Cox Enterprises, Inc. is moving to take Cox Communications private, buying out public shareholders for 8.3 billion dollars.").

[8] See Radio Business Report Daily Epaper, "2004: Tough year for radio stocks," Vol. 22, Issue 2 (Jan. 4, 2005) ("RBR's Radio Index fell 20% for the year and virtually all pure-play radio stocks finished 2004 down from where they began the year."). See also Television Business Report Daily Epaper, "2004: Tough year for TV stocks," Vol. 22, Issue 2 (Jan. 4, 2005) ("[I]nvestors are always trying to look ahead, so most TV stocks fell in 2004 as Wall Street anticipated slower growth in the future. Of the 35 TV stocks in TVBR's daily chart, only 11 were up for the year and not one of them was a pure-play TV group owner.").

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