'Going Dark'

Competing considerations make the decision to exit the SEC reporting system a difficult one for the board.

BY DOUG RAYMOND

TODAY, approximately 9,000 companies file quarterly and annual reports with the SEC. Roughly 40% of these companies report annual revenues of less than $50 million. Dramatically increased compliance responsibilities, a more active enforcement agenda at the SEC and other government agencies, risks of stockholder litigation, and increased risks of personal liability complicate directors' already complex duties. In addition, the costs of being a public company, which already are significant, are continuing to grow, especially for smaller companies.

The burden of these costs may force them to cut back on areas — such as research and development, expansion, and even dividends — that produce direct benefits to their stockholders. Factor in the time and effort that managers must devote to meeting stockholders' short-term expectations, and it is not surprising that many companies are looking for exits from the regulatory burdens imposed by the SEC and the SROs (NYSE, Nasdaq, and now Archipelago).

One exit that many companies are seriously considering is "going dark." A company goes dark by filing a simple form with the SEC. Once a company goes dark, it does not have to file proxy statements or quarterly, annual, or other reports with the SEC. It also does not need to comply with Sarbanes-Oxley and is no longer subject to the rules and regulations of the stock exchange on which its shares formerly were listed. Going dark does not change the identity or number of stockholders, and the company's shares can still be publicly traded on the National Quotation Bureau's "pink sheets." Many companies that have gone dark continue to comply, on a voluntary basis, with many of the rules applicable to public companies.

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The process of going dark is not the same as a going-private transaction, which is a much more complex process in which the company first changes the number of its stockholders through a sale, reverse stock split, tender offer, or similar transaction, and then subsequently delists.

A company may go dark only if it has either: (1) fewer than 300 record stockholders, or (2) fewer than 500 record stockholders and less than $10 million in assets at the end of its last three fiscal years. This count excludes beneficial owners of shares held in street name.

Even though the decision to go dark may save the company a considerable amount of time, money, and management distraction, it can be unpopular with investors. First, investors may believe that the reduced disclosure and resulting loss of transparency that generally follow deregistration will obscure poor performance or encourage questionable transactions by management or controlling stockholders. Second, the company's ability to raise funds is diminished because it is no longer listed on a major exchange. Most important, the company's stockholders lose liquidity for their shares, and the company itself may lose leverage with its lenders and other sources of capital by forgoing ready access to the public markets.

Because of these competing considerations, the decision to go dark can be a difficult one. However, like most business decisions, this one is generally protected, at least in Delaware, by the business judgment rule, which sets up a strong presumption of the validity of board action. However, if challenged, courts may subject the decision to the more stringent "entire fairness" standard of review that applies to transactions in which there is potential for directors' interests to conflict with those of stockholders. Courts may apply this stricter standard if there is evidence that the deregistration was done in contemplation of a later stock purchase or squeeze-out transaction. Also, courts may take away the protection of the business judgment rule if the board's deliberations are seen as perfunctory or as too hasty. If entire fairness applies, the board must be prepared to demonstrate that its decision was fair both from a procedural as well as a substantive perspective.

Directors considering going dark may want to adopt safeguards that they could rely on if asked to demonstrate entire fairness. These may include use of a special committee, with its own advisers, as well as quantitative analyses of the costs and benefits of the going-dark decision. In some situations, a board also may even want to seek an investment bank's opinion as to the fairness of the decision.

In light of the substantial and still increasing costs of being a public company, directors may want or even feel obligated to consider whether the benefits of being a reporting company outweigh the associated costs. If this consideration is reasonably planned and effected, and so long as potential conflicts of interest are adequately addressed, a board may legitimately conclude to drop out of the SEC reporting system and go dark. In many companies, this may be the best decision for all parties. ■

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