

## **Becoming a Publicly Trading Company Via Reverse Mergers and Self-Registrations**

### ***About Reverse Mergers***

A “reverse merger” is a transaction where by a private company becomes a public company by merging with (or otherwise being acquired by, for example via share exchange) a public company. Very often, the public company vehicle is (although it does not have to be) a “shell” company. According to the rules of the U.S. Securities and Exchange Commission (“SEC”), a shell company is a company that has: (a) no or nominal operations; and (b) either: (1) no or nominal assets; (2) assets consisting solely of cash and cash equivalents; or (3) assets consisting of any amount of cash and cash equivalents and nominal other assets. A company can become a shell company through various means, including a sale or liquidation of its business or by agreeing to spin off its current assets and liabilities at the time of the reverse merger.

A reverse merger frequently is accompanied by a concurrent financing into the public company. These transactions are often referred to as APOs, for alternative public offerings.

In a typical reverse merger, upon the public company’s acquisition of the private company, the private company’s shareholders receive a substantial majority of the shares of the public company (normally 90% to 95% or perhaps more) and the control of the board of directors. A key benefit of the reverse merger is that no regulatory (i.e., SEC) review of the transaction is required. The transaction involves the private and public companies exchanging information on each other, negotiating the terms of the acquisition, and signing a merger or share exchange agreement. At the closing, the public shell company issues a substantial majority of its shares and the board control to the shareholders of the private company. In return for the sale of the shell, the private company typically pays the shareholders of the public shell company a sum of money and the shareholders of the public shell retain a negotiated amount of shares of stock in the combined company. The amount of money and percentage of shares retained is a matter of negotiation between the parties. The amounts depend upon: (i) the value of private operating company (ii) type of shell (whether it public reports to the SEC, whether and where its shares trade publicly, whether it has any liabilities or regulatory issues, etc.) and (iii) what the parties want (somewhat more money and less stock, others want less money and more stock).

The goal of the reverse merger is simple – to turn the private company into a public company in a more efficient and cost effective way than a traditional initial public offering (IPO). Another key goal, that is often overlooked, is that once the reverse merger is completed, the conditions should be set for the private company to operate as a public company. In our experience, there are certain key conditions that a private company should be looking for in a public shell vehicle to ensure an optimal outcome for either a reverse merger or an APO. Among these are:

1. The public vehicle should have a meaningful number of shareholders (over 50), each holding at least 100 shares (so called “round lot” shareholders). This allows for at least the beginnings of a shareholder base, which is necessary if the goal is establish a liquid market for the company’s shares (a key reason for going public in the first place). Also, to subsequently be listed on an exchange like Nasdaq, the company will need a minimum of

300 round lot shareholders, and exchange regulators will discount less than round lot shareholders who were shareholders of the shell company for these purposes.

2. The shares of stock that these shareholders hold must be “freely trading.” This is known as the “float” – how many shares are not held by insiders (which is typically a large percentage post-reverse merger due to the reverse merger structure described above). This is also key to helping establish a liquid market.
3. The public vehicle should be an SEC reporting company (meaning subject to the requirements of the Securities Exchange Act of 1934) and should be current with its filing requirements. Non-reporting (or tardy filing) shells are typically more trouble than they are worth given the time and effort it takes to get them into compliance.
4. The public vehicle should be listed for quotation on a trading market such as the OTC Bulletin Board. Ideally, there should be an active market for the public vehicle’s stock (although this is typically not the case for shell companies).
5. The public vehicle should be “clean” – the shell should be owned/managed by reputable people, and there ideally should be no liabilities in the company (including pending litigation) and no other matters which would impair the operation of the private company’s business going forward.

In some cases, the public shell company may have already met these requirements before the acquisition of the private company. If all the requirements are already met, the conditions are more ideal to raise money, either with or after the reverse merger, and the groundwork is set for the former private company to move forward as a public company. In other cases, the public shell company does not meet these requirements before the acquisition. While this could lead to a lower acquisition price for the shell, the old maxim of “you get what you pay for” will still apply – the less ideal the shell is, the harder it will be to raise money and otherwise operate as a public company.

### ***Plan of Action for a Reverse Merger***

1. Identify a suitable shell company. Public shell companies come in all shapes and sizes. As previously stated, some shell companies have met the key criteria stated above; while others have not. Some are quoted or listed on the OTC Bulletin Board (or OTCQB Market) (“OTCBB”) or NASDAQ, while others may be listed on the Pink Sheets (a lesser market). An even more important distinction is whether the shell company is “clean” or not. Although the price may be attractive, troubled shells should be avoided at all cost.
2. Prepare an Audit. If the private company is being acquired by a legal “shell” company, within 4 business days following the transaction, the combined company will be required to file audited financial statement of the private company prepared in accordance with US GAAP standards. **This is a very important lead time item** as it can take a reputable auditor 6-8 weeks or more (depending on the subject company) to complete the audit.
3. Conduct due diligence. Once a suitable shell company is found, due diligence must be conducted. The history of the shell company, its shareholders, and its officers/directors must be documented and reviewed to ensure a smooth transaction and help safeguard against problems post-acquisition.

4. Negotiate an agreement. The private company and the shell company must negotiate and finalize a deal. This is often a more time-consuming process than expected, so budget your time accordingly.
5. Effect the Transaction. All of the transactions associated with a merger or share exchange must be completed by shareholders on both sides of the deal. It may sound obvious, but don't settle for signatures to be delivered later and otherwise missing key elements at the closing table.
6. Post-Acquisition Filing Requirements. Once the acquisition is completed, the former private company principals now find themselves running a public company – this is not easy! The public company obligations start right away – as mentioned above, within four business days, and preferably as early as possible, after the closing of the acquisition, the newly-merged company must file a Current Report on Form 8-K with the SEC, along with audited financials of the private company (note: if the public vehicle is not legally a “shell”, the time requirement is much longer). The 8-K will describe the newly combined company, stock issued, information on the new officers and directors, a full description of the business, and (if applicable) the terms of any financing undertaken. The 8-K must disclose substantially similar type of information that it would be required to provide in registering a class of securities under the Securities Exchange Act of 1934 (see discussion below). Thereafter, the company will need to continue its reporting requirements with the SEC.

### ***Self Registration***

Self Registration is an alternative method to raise funds and become a public company without the services of an investment banking firm. In this method, the private company raises money in a private placement by selling unregistered shares to “accredited investors” and at the same time agreeing to register such shares with the SEC by filing a Registration Statement on Form S-1 (or, for foreign companies, a Form F-1) with the SEC. First, the company raises money through the private placement. Subsequently, a registration statement is prepared, filed with the SEC and ultimately (after the SEC review and comment process described below) declared effective. At this time, the holders of the shares purchased in the private placement may sell the shares publicly. As described further below, prior to going effective, the company must arrange for a listing or quotation of its shares on an exchange like Nasdaq (which is very rare in these situations) or more likely the OTCBB.

The Registration Statement is a comprehensive disclosure document consisting of a narrative description of the company, its business, management, risk factors, a description its securities and audited financial statements for the past 2 years (or inception, whichever is less) and interim quarterly periods. After the Registration Statement is first filed with the SEC, the SEC will generally review the Registration Statement and provide comments within 30 days. The company will then address the SEC's comments to the filing issued by the SEC and amend the filing in response thereto. After the comments are responded to and the SEC has no further comments, the SEC will declare the registration statement effective.

The Registration Statement serves multiple purposes. First, it allows the holders of the company's securities which are registered via the registration statement to sell their shares without further restrictions and second, by filing a Form 8-A (a very short form) at the time the Registration Statement is declared effective, the company makes itself subject to the reporting requirements of the Securities Exchange Act of 1934. This means that, among other things, the company is required the filing of quarterly reports, annual reports, makes the company subject to the SEC's proxy rules, and makes the company's senior management team subject to Section 16 filings whereby they publicly report their ownership in the company.

### ***Plan of Action for a Self-Registration***

Before any stock exchange or quotation service will list or quote the company's common stock for trading, the company must meet the key requirements stated above. As a result, it may be necessary for your company to conduct a private placement to raise money, and issue stock to increase its number of shareholders. The filing of the Registration Statement allows the registered shares to be freely tradable. The filing of the Form 8-A then makes the company subject to the Securities Exchange Act.

In order for a company to be listed on the OTCBB, a market maker must file a Form 211 and act as a market maker for the stock. The market maker will provide the bid and ask prices for an orderly market. Once the shares are trading, it will be easier for the company to raise additional money by selling additional shares of through an underwritten offering or a self-directed offering by the company by filing another Registration Statement covering such new shares. Subsequent Registration Statements are easier since the SEC already commented on the first one. Furthermore, the company should be able to raise more money this way since investors would more likely want to invest in a company that already has a liquid market for its stock so that they could have an exit strategy for this investment.

### ***Differences between a Reverse Merger and a Self-Registration***

#### 1. Advantages of Reverse Merger versus Self-Registration

- The reverse merger process generally takes about 1 month less than self registration.
- The company will be a publicly-traded company immediately after merger if the shell was previously trading and will not have to wait until SEC clearance
- A suitable shell company will already have the adequate number of shareholders and freely trading shares.

#### 2. Disadvantages of Reverse Merger versus Self-Registration

The costs of buying a shell (up to \$500,000 and up to 10% of the combined company) and conducting due diligence can be costly. Furthermore, it is our experience that in many instances the shell company has problems that do not become evident until the due diligence process is completed, at which point a lot of time was wasted or worse, if the transaction is completed, the new public company has problems that it must deal with.

### ***Final Thoughts***

Becoming a public company via a reverse merger, APO or self registration can offer a company many benefits, including access to capital and a higher profile. However, great care must be undertaken in structuring and implementing these transactions in order to properly obtain the benefits. In particular, recently, regulators have taken a negative view of companies that went public through a reverse merger, including requiring them to meet additional thresholds for exchange listing. In the end, each private company that contemplates going public through these structures must carefully weigh the benefits and drawbacks and carefully plan in order to mitigate associated risks.