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

About Reverse Mergers

A “reverse merger” is a transaction whereby 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 review by the SEC of the transaction is required. However, certain fillings, procedures, and approvals will be required depending on where the public company is trading (NASDAQ, NYSE or OTCQX) and whether the public company is DTC eligible and has market makers. 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 percentage of the 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 the private operating company, (ii) type of shell (whether it files 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).

Frequently a substantial majority of the shares of the public company are owned by a few (or one) larger shareholders and control of the public company can be obtained by simply purchasing the shares representing the substantial majority of the shares from the few shareholders. Once control of the public company is obtained, the timing of the contribution of the new business, or assets, and the operations of the company and consideration to be received is largely in the hands of the new substantial shareholders.

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 via an underwriter (known as an IPO). Another key goal, one which is often overlooked, is that once the reverse merger is completed, the conditions should be set for the private company to operate successfully as a publicly reporting and trading 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 holding unlegended, freely trading shares (a minimum of 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 to 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, a majority of which have a value in excess of $2,500, are not restricted from trading whether by a legend or a lock up agreement of any sort, since 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 small percentage post-reverse merger due to the reverse merger structure described above). This is also key to helping establish a liquid market. OTCQB requires a minimum of 10% of the shares be owned by non-affiliates.

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 OTCQB Market. Ideally, there should be an active market for the public vehicle's stock (although this is typically not the case for shell companies). The shares should be DTC eligible (shares could be held in street name).

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 debt or pending litigation) and no other matters which would impair the operation of the private company's business going forward.

6. There should be sufficient number of shares of authorized, but unissued, common stock available for future issuance.

7. There should be no actions which will need to be taken by the public company to consummate the transaction with the private company, which requires a public company shareholder vote.

8. There should be at least 3 market makers for the public company.

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.

"Seasoning" Rules

In order to address certain reporting issues that arose with companies that had become public via reverse mergers, the SEC and the national securities exchanges adopted the so called "seasoning rules" to place heightened requirements on reverse merger companies before they can be eligible to be listed on an exchange. Generally speaking, under the seasoning rules, a reverse merger company is prohibited from applying to up-list its shares on a national exchange until:

- The company has completed a one-year "seasoning period" by trading in the U.S. over-the-counter market or on another regulated U.S. or foreign exchange for a minimum period of one year commencing after the public company filed its audited annual financial statements showing the completed merger.
- The company maintains the requisite minimum share price ($4, $3 or $2 per share, depending on the exchange and the type of company) for a sustained period, and for at least 30 of the 60 trading days, immediately prior to its listing application and the exchange's decision to list. It will also need to meet all other requirements for the original listing.

Under the rules, the reverse merger company generally will be exempt from these special requirements if it is listing in connection with a substantial firm commitment underwritten public offering ($40 million or more), or the reverse merger occurred long ago so that at least four annual reports with audited financial information have been filed with the SEC.

The adoption of the seasoning rules creates an additional considerations for companies planning for a reverse merger as the ability to list on a national exchange post-reverse merger is limited for a year.

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 OTCQB Market or NASDAQ, while others may be listed on the OTC Pink Market (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 "shell" company, within 4 business days following the transaction, the combined company will be required to file an 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. This includes all necessary financial statements and other reports required to be filed post-closing (could be form 13-F, 10-Q, or 10K for completed periods before the merger) and corporate files of the public company.

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 significantly 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. The shareholders of the private company must ensure that the auditors for both the old public company and the private company are on board and paid up at the time of closing.

7. **Impact of "Shell Company" States on Rule 144.** In order to publicly sell "restricted shares" ,(defined as shares received from the company or affiliate of the company, without being registered at the time of the purchase) they must be registered by the company by filing, on a selling shareholder registration or be exempt under Rule 144. If the shares are of a company that was ever, since its inception, a shell company then Rule 144 requires, for a sale to take place under Rule 144, that

a) one year elapses since the company filed a report indicating it is no longer a shell company, and

b) at the time of resale under Rule 144 , the company must be current in its fillings of Forms 10-K and 10-Q.

Therefore, removing the "33 Act" legend from a "restricted stock" certificate will be complicated.

There may be other restrictions on a shell company that must be considered when considering a reverse merger with a shell company.

About 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 restricted 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. This filing will allow the holders of these share to publicly trade the shares without restrictions. 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 blow) 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 OTCQB.

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 will be required to file quarterly reports, annual reports, make the company subject to the SEC's proxy rules, and makes the company's senior management team and/or five percent greater shareholder subject to Section 16 and Section 13 filings whereby they publicly report their ownership and their sales of the company shares.

After a self-registration, a company will want its shares to be listed on OTCQB or on an exchange. The procedure is described below.

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 with the SEC then makes the company subject to the SEC's ongoing reporting requirements (although even if a Form 8-A, which is not required, is not filed, certain reporting requirements must still be filed following the effectiveness of the Registration Statement).

In addition, you will require a transfer agent, stock symbol and DTC eligibility. In order for a company to be listed on the OTCQB, a market maker (i.e., a brokerage firm) must file a Form 211 with the Financial Industry Regulatory Authority (known as FINRA) and act as a market maker for the stock. The market maker will provide the bid and ask prices for an orderly market. It is often difficult to get a market maker to file a form 211 on your behalf since (i) the market maker may not be paid for making the filing, (ii) it is reviewed by FINRA, and (iii) requires the market maker to have a reasonable basis for making the bid which requires significant "due diligence" to be performed by the market maker. Once the shares are trading, it will be easier for the company to raise additional money by selling additional shares 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.

Regular A Plus Offerings

In March 2015, the SEC enacted regulations allowing certain companies to file a simpler registration statement registering shares to be sold to the public which will be freely trading. Pursuant to these rules the company files a Form 8-A to become subject to the 34 Act filings described above and list on either the OTCQB or a senior exchange (if the company meets the listing requirements).

Differences between a Reverse Merger and a Self-Registration

1. Advantages of Reverse Merger versus Self-Registration

   - The reverse merger process generally takes about 1-3 months less than self-registration, although the Reg A Plus option could shorten this time frame.

   - 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 of the Registration Statement (as is the case in the Self Registration).

   - A suitable shell company will already have the adequate number of shareholders and freely trading shares for subsequent uplisting to a national exchange.

2. Disadvantages of Reverse Merger versus Self-Registration

   - The impact of the seasoning rules described above. In a Self-Registration, the subject company is not a shell company.

   - The ability for shareholders of a former shell company to utilize SEC Rule 144 is limited if the company subsequently is not current in its SEC filings.

   - The costs of buying a shell (up to $500,000 and up to 10% of the combined company and significantly more for a shell on a national exchange) 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, especially utilizing Reg A Plus, 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, in many cases over the years, 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. Furthermore, in all cases, the bottom line is not just becoming a public company but using the public company as vehicle to raise money to expand or to use the company's shares as currency to incentivize employees and/or to purchase other companies. This requires an (i) active trading market for your shares and a (ii) market price that reflects the success of the company which is best accomplished by making the public company a successful business.