Reverse Mergers + PIPEs:

The New Small-Cap IPO

Reprinted and updated from *PIPEs: Revised and Updated Edition—A Guide to Private Investments in Public Equity* (Bloomberg Press, 2005)

By David N. Feldman[1]

Blockbuster Entertainment, Occidental Petroleum, Turner Broadcasting, Tandy Corp. (Radio Shack), Texas Instruments, and Muriel Siebert are just a few well-known companies that went public through a "reverse merger." To the uninitiated, a reverse merger is a deceptively simple concept. Instead of pursuing a traditional initial public offering ("IPO") utilizing an investment bank serving as underwriter, a company arranges for its stock to be publicly traded following a merger or similar transaction with a publicly held "shell" company. The public shell has no business other than to look for a private company with which to merge. Upon completion of the merger, the private company is publicly held instantly.

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The process is generally quicker, cheaper, simpler, less dilutive, and less risky than an IPO, but has its own unique risks and challenges. Reverse mergers are typically complex transactions with traps into which even experienced practitioners with limited knowledge of this technique can easily fall. When done right however, these hidden dangers can be avoided, and the transaction can proceed quickly and smoothly.

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Why Now?

In the last several years, investors and investment bankers have discovered the reverse merger—with the "pile on" mentality that is common in any Wall Street trend. In this case, however, there are good reasons for reverse mergers and private investments in public equities ("PIPEs") to come together. In particular, investors in PIPE transactions have been extremely active in the reverse merger space. Why have reverse mergers suddenly become so popular and legitimate? The short answer is, it has not been sudden, but rather an evolution that has taken about a dozen years. Most recently, however, a confluence of factors has caused this market to really take off.

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Since 2001, the initial public offering market has been effectively shut down for all but the largest private companies, making a reverse merger more attractive to middle-market businesses. In addition, the private equity markets for growing private companies have been soft at best, making it tougher to stay private if large amounts of capital are needed for growth. The PIPE market has been experiencing tremendous growth and creating more potential benefit to being a public company if access to the capital markets is important. Also, until recently, the mergers and acquisitions market had been very weak—and still remains so for many companies—therefore limiting the exit options that entrepreneurs and investors have had.

An additional factor is a recent change in the PIPE market. In the past, PIPE investors were more interested in short-term liquidity and arbitrage in their investments, but typically they did not look at companies in detail beyond trading volume. Because of Securities and Exchange Commission ("SEC") scrutiny and issuer concerns, PIPE investments now more closely resemble "true" longer-term investments. Investors conduct due diligence, meet with management, take more warrants to benefit from a stock's upside, and generally are more willing to wait for a larger return. As a result, PIPE investors are more active in pursuing investments in reverse mergers, where liquidity will probably take a little longer, but where a greater upside exists. This, combined with the increased competitiveness for deals, has shown PIPE investors and investment banks the benefits of what is sometimes called "public venture capital."

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The most recent positive development in this area has come from the regulators. In April 2004, the SEC proposed a new regulation requiring a significant increase in the amount of disclosure immediately following most reverse mergers. This new regulation was approved in June 2005 and became effective in November 2005. This helped improve the reliability and acceptability of these transactions. In its adopting release, in part resulting from strong encouragement from the private sector (including this writer), the SEC declared that it acknowledges the legitimate use of the reverse merger technique. This is a major development. Given the history of abuse accompanying reverse mergers, it is very helpful that the SEC is prepared to encourage their proper use while continuing to penalize their abusers.

Basics of Reverse Mergers

A public shell is basically a publicly listed company with little or no assets or liabilities. Shells formed from scratch specifically to engage in a merger or acquisition are called "blank check companies," whereas shells resulting from the sale or liquidation of an operating public company are called "public shells." In either case, the industry tends to use the terms shell or public shell to refer to either a public shell or blank check company. In its 2005 rulemaking, the SEC defined shell company as a public reporting company with only nominal assets (other than cash) and operations.

Some shells have cash in them that will be used to entice a private company to merge while others do not. The most valuable shells are the so-called reporting companies—those obligated to file periodic and other reports with the SEC. Shells that trade on the Over the Counter ("OTC") Bulletin Board are more valuable than those trading on the Pink Sheets. Some do not trade at all but may still have value if they are reporting and have a shareholder base. A few shells trade on the NASDAQ and American Stock Exchange.

Reverse Mergers

A reverse merger is a method by which a private company merges with a shell and becomes public without a traditional public offering. The private company's shareholders generally receive between 65% and 95% of the public shell's stock. Four factors tend to affect this valuation:

1. **"Cleanliness" of the shell.** This is primarily dependent on how recently an operating business existed in the shell.
2. **Valuation of the private company merging in.** A start-up will retain less of the merged company than a sales-generating company with $1 million in earnings.
3. **Cash.** Cash in the shell increases the shell's value.
4. **Shell management.** The value of the shell will improve if those managing the shell have reputable backgrounds.

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Reverse Triangular Mergers

In general, a direct merger between a public shell and a private company requires shareholder approval of both companies. In the case of a public reporting company, this requires the expensive and time-consuming process of preparing, filing, mailing, and seeking SEC approval of a somewhat complicated proxy statement.

One way around this is through a reverse triangular merger. In this transaction, the public shell creates a wholly owned

subsidiary. That subsidiary merges into the private company. Shares of the private company are exchanged for shares of the public shell. As a result, the subsidiary disappears, and the private company becomes a wholly owned subsidiary of the shell, with the owners of the formerly private company owning the majority of the shares of the shell following the deal's closing.

One major advantage of this structure is that as an entity, the operating business remains intact. If it has valuable vendor numbers with customers, they do not need to be changed. Bank accounts, employer identification numbers, and virtually all contracts (even leases) remain the same because only the ownership of the private company changes. Even "change-of-control" provisions in contracts generally are not triggered because the same people control the enterprise both before and after the reverse merger.

If the shell trades on a major exchange such as NASDAQ, any reverse merger—even a reverse triangular merger—requires shareholder approval and a full proxy under exchange rules. Following a change in control, most exchanges require a "new listing" application, which requires the company to meet all initial listing standards—not just "maintenance standards"—following the merger. Thus, to avoid the shareholder approval, it is sometimes recommended that a NASDAQ shell delist from NASDAQ and move to the OTC Bulletin Board prior to the merger. This may seem illogical for a company planning to trade on NASDAQ following the merger, but as indicated above, the process starts from the beginning because of the need for a new initial listing application, rendering the benefit of being a NASDAQ shell somewhat illusory.

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Sometimes reverse mergers are actually structured as an exchange of shares or a simple asset acquisition. This is generally necessary when the private company is not a United States entity, and it is sometimes required by accountants advising the parties. But in the end, the transaction generally ends up as a tax-free reorganization under IRS regulations. Whether a merger, share exchange, or asset acquisition takes place, the net result is usually the same (except that in the case of an asset acquisition when the private company's existence generally ends).

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With all this effort to avoid shareholder approval of the merger itself, sometimes approval is necessary for other contemplated actions such as a reverse stock split or name change. It is common in reverse mergers for the public shell to have insufficient authorized but unissued shares to provide as much as 95% of the company's stock to the owners of the private company. Depending on the circumstances, it may be possible to delay this shareholder approval until after the merger. In some cases though, it is necessary. In the discussion of legal issues that follows, there is a bit more detail on this issue.

A Little History

In the 1970s and 1980s, the reverse merger technique was effectively discovered and put to immediate and extensive use. During this period, a number of unsavory players got into the market and began engaging in fraudulent practices, by forming new blank check companies, raising money in IPOs of the blank checks, and simply taking the money as fees for themselves rather than finding mergers for the newly created shells. Other abuses, some relating to trading of the stock of the shells, also were rather rampant. At the same time, a small number of legitimate players emerged, forming shells but not taking fees unless a merger was found, and investing their own money along with others.

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This was only part of a broader pattern of fraud and abuse during this period in what is known as the penny stock market. This requires a brief turn back to discuss the development of the OTC Bulletin Board, where many shells reside, and the penny stock reform that created it. Use of the term *over the counter* began when the U.S. Atomic Energy Commission announced it was seeking to purchase all available quantities of uranium in the 1950s, and thousands of people lost millions of dollars in worthless, low-priced uranium stocks that were literally sold "over the counters" of coffee shops in Salt Lake City.

Throughout the 1980s, the penny stock market was regional and a number of boiler room–type brokerage firms engaged in enormous amounts of fraud in the over-the-counter markets. For example, a firm would buy a large amount of an undervalued, thinly traded penny stock, float a false rumor about a proposed transaction, watch the price rise, and then sell their holdings only for the new shareholders to find the stock falling back down when the rumor turned out to be false. These swindles cost investors over $2 billion per year in losses.

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In 1990, Congress passed the Penny Stock Reform Act,[2] which, among other things, focused on reverse mergers because it directed the SEC to segregate registration statements (including IPOs) that relate to offerings by blank check companies and to impose disparate treatment on these offerings. To address this direction, in 1992 the SEC passed Rule 419 under the Securities Act of 1933.

Rule 419

Rule 419 sought to eliminate the four major concerns about abusive blank checks: promoters milking the shells for cash, abusive trading practices, the fact that no time limit existed to find a reverse merger candidate, and the fact that investors were not generally given an opportunity to review or vote on a proposed merger.

The rule has three main components. First, it provides that a blank check company going public through an IPO must take all money raised in that public offering (minus up to 10% for expenses and underwriting commissions), as well as the shares issued in the offering, and leave them in an escrow account until a merger is undertaken. This way, unscrupulous players cannot convert those funds, and no improper trading is possible because there is no trading.

Second, the blank check must find and complete a merger within eighteen months after the IPO, or all remaining funds must be returned to investors. Following this period, under some circumstances the company could continue as a public shell and get a second life but without the IPO investors.

Third, the investors in the blank check IPO may "opt out" and get their money back (minus any deductions taken) if they do not like the proposed merger. This optout feature requires the blank check to prepare, file, and obtain SEC approval of a prospectus-like document providing detailed information about the company (including audited financial statements) that will merge into the blank check company.

If at least 80% of the investors do not opt in, the merger cannot be completed and all money is returned to investors, minus any deductions previously taken. If more than 80% opt in, the others still get their money back, but the transaction can be completed. At that point, the money and shares are released from escrow. In truth, the language in the rule concerning this 80 percent approval is rather vague and at times inconsistent, but the foregoing represents what this author believes is the SEC staff's current view of the language. There are also specific requirements to be met for a particular merger to "qualify" for release of the funds, including the fact that the value of the private business merging in must be equal to at least 80 percent of the amount being raised in the blank check's IPO.

Rule 419 does not apply to a blank check that has $5 million or more in assets prior to its IPO, or which seeks to raise at least $5 million in a "firm commitment" IPO underwriting. Thus, these companies are free to operate much like pre-419 blank checks, without escrow arrangements, trading restrictions, and time limits. This exemption created the opportunity for an entity known as a specified purpose acquisition company (SPAC) to develop.

Post-419 Developments and SPACs

Rule 419 had a dramatic and positive effect on abusers of reverse merger transactions, eliminating most of them from the market (many moved on to municipal securities and Regulation S transactions). But the rule also hurt many quality players, and initially many thought that this might mean the end of reverse mergers.

Through the 1990s, however, and into the current decade, three major trends developed. First, given the apparent unattractiveness of Rule 419, many players moved to acquire or merge with public shells that had been created through the sale or liquidation of operating public companies. These shells are not restricted by Rule 419. They also may have the added attraction of a larger shareholder base and a trading market. In exchange, however, one must carefully "scrub" the shell and make sure there are no problems in its past.

The second trend was the development of SPACs. By raising as much as $40 million to $100 million or more in a blank check IPO promoters avoid the proscriptions of Rule 419. They shrewdly adopt a number of the Rule 419 protections in order to market investment in the SPAC. All the money (minus commissions) goes into escrow. Investors can opt in or out of the deal with prior full disclosure. There is generally a two-year window to complete a merger or else all money is returned. Each SPAC generally has an industry or geographic focus with a high-caliber board to approve deals.

Unlike Rule 419 shells, however, the stock of the SPACs is permitted to trade, earning money for the promoters and affiliated investment banks for commissions, and allowing investors to trade out of the stock (and retain affiliated warrants) even before a merger is completed. For investors, this has been a relatively low-risk investment, because they have the right to opt out if they are unhappy with the proposed merger. Consequently, SPACs have become very popular with structured finance and traditional PIPE investors.

In general, SPACs have flourished only at times when the IPO market is weak as they are not able to compete with a strong initial offering market. In contrast, generally speaking, reverse mergers are not market-sensitive.

The third trend to emerge since the passage of Rule 419 is the use of Form 10-SB or "virgin" shells. A legal way around Rule 419 when forming a blank check is to simply file with the SEC Form 10-SB, under the Securities Exchange Act of 1934, rather than conduct an IPO that would be subject to Rule 419. This filing is a request to voluntarily become a reporting company; no offering is conducted, except perhaps a private offering that is not subject to SEC scrutiny if consummated prior to or after the Form 10-SB filing. After the SEC declares the Form 10-SB effective, the company is public and is obligated to file periodic and other reports. The stock, however, does not and cannot trade until following a merger and a process of registering individual shares of stock with the SEC. At this point a reverse merger can be completed, shares registered, and trading can commence.

Initially, after the passage of Rule 419, the SEC tried to declare Form 10-SB shells improper, citing Rule 419. Eventually, however, the founders of these shells correctly succeeded in convincing the SEC staff that Rule 419 cannot and does not apply to a filing under the Securities Exchange Act. Currently, the SEC staff's view is that Form 10-SB shells are legal, viable, and not in need of separate regulation because no public offering is involved. Further, NASDAQ has informed this author that it also does not view a merger with a Form 10-SB shell as negative, as it considers the company itself and not the method by which it went public. Indeed, several companies which merged with the virgin shells have gone on to start trading their securities following a registration process after their merger. Others have raised significant money ($48 million in one case) at the time of their reverse merger with a virgin shell.

A registered broker-dealer seeking to have its affiliates serve as founders of a blank check generally is much better off using a Form 10-SB shell. This is because the National Association of Securities Dealers ("NASD") reviews all underwriter compensation in the case of a public offering, such as when a Rule 419 shell goes public through an IPO. Even if the broker-dealer forming the blank check takes no direct compensation for the IPO, the issuance of "founder" stock to broker-dealer affiliates prior to the IPO likely will be deemed compensatory if it occurs within twelve months of the IPO. Because a Form 10-SB shell does not involve a public offering, no NASD scrutiny applies.

The timetable, costs, and benefits of both Rule 419 shells and Form 10-SB shells are about the same. In early 2005, the SEC made significant comments to Rule 419 shells, but allowed Form 10-SB shells to effectively sail through registration with few or no comments. Thus, at the time of this writing, the author is advising clients to pursue Form 10-SB shells rather than shells under Rule 419.

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Advantages and Disadvantages of Going Public

Advantages of Being Public

Why go public at all? In some cases, companies considering going public should not do so. There are five major advantages of being public:

1. **Access to capital.** It is easier to raise money as a public company than as a private company. Investors are more comfortable because there is sufficient information available in public filings. Also, there is an easier and faster exit for the investor. Finally, a public company likely will receive a higher valuation resulting from its public status.
2. **Liquidity.** Owners, entrepreneurs, and prior investors have a way to cash out, assuming there is an active trading market in the stock.
3. **Growth through acquisitions or strategic partnerships.** A public company can use its stock as currency or "scrip" for acquisitions, preserving needed cash for other uses.
4. **Stock options to incentivize.** Stock options encourage board members and senior management to perform well and remain with the company. Vesting of options promotes long-term commitment to the company.
5. **Management is much more answerable to its owners than in a private company.** In a public company, business information such as related party transactions and financial information such as executive compensation is available to the public. The company must explain changes in performance. Financial and other results become publicly known and changes in performance need to be explained. In a private company, shareholders generally have limited rights to access information.

Advantages of using a Reverse Merger as opposed to an IPO

If going public makes sense, is an IPO preferable? This analysis assumes a company has the option to consider either a reverse merger or an IPO. The following are the advantages of a reverse merger over an IPO.

1. **A reverse merger involves much lower cost.** IPOs cost millions of dollars, whereas a reverse merger, even including the cost of purchasing a public shell, which has increased substantially in the last few years, generally costs less than a million dollars. Costs are substantially less if the merger is with a blank check or a nontrading shell. Costs are also reduced if the company's financial statements have been consistently audited. Furthermore, law firms sometimes charge a flat fee to complete a reverse merger.
2. **A reverse merger utilizes a much speedier process.** An IPO from start to finish can easily take a year or more, while reverse mergers can be completed in a matter of weeks. More commonly, reverse mergers have taken two to three months prior to the new SEC rule requiring enhanced disclosure and now take about three to four months.
3. **A private company is not subject to watching the IPO "window."** Nearly four hundred IPOs were completed in 2000; since 2002, there have been fewer than one hundred most years, and a little under 200 in 2006. Most companies going public in the past few years were much larger than the average IPO of the 1990s. This means the IPO window has been effectively closed for small and middle-market companies since 2000. Additionally, the IPO market is still reeling from the scandal-plagued Internet era where billions of dollars in fines and settlements were levied in connection with allegations of fraud and favoritism in IPOs of the 1990s. This does not bode well for the likely return of a strong IPO market for smaller companies anytime soon.
4. **There is no risk of withdrawal.** In an IPO, an underwriter can cancel a deal or dramatically lower an offering price at the last minute because of market conditions at the time, even after a year of work and millions of dollars in expense. Reverse mergers are not market-sensitive, so investors in reverse mergers typically do not change or cancel transactions due to market conditions.
5. **Management attention to a reverse merger is much less than in an IPO.** Most senior executives do not realize what they are getting themselves into when they pursue a traditional IPO. Endless road shows, due-diligence meetings, late nights at the printer, and international travel are the norm. Pursuing an IPO can indeed impact a company's ability to pursue its business plan.
6. **Reverse mergers experience lower dilution of ownership control.** Often in an IPO, an underwriter suggests or even insists that the company raise more money in the offering than it reasonably needs. In a reverse merger, lower amounts are raised,allowing earlier investors, entrepreneurs, and management to retain a higher portion of the company's ownership.
7. **Reverse mergers lack an underwriter.** Companies complain that IPO underwriters seek to control many aspects of a company's business. This creates a real risk of divert-

ing the company's mission. For example, an underwriter may suggest shedding an unprofitable business, even though it has long-term potential, in order to shore up the company's financials while going public.

Disadvantages of Being Public

Five of the negative aspects of losing private-company status follow.

1. **Public companies face much more emphasis on short-term results.** The need to meet or beat Wall Street expectations each quarter is a real and pervasive problem that public companies face. This tends to reduce incentives to invest in long-term capital expenditures that hurt current earnings.
2. **Public disclosure of executive compensation, financial results, related party transactions and the exposition of all the company's dirty laundry.** This may give competitors an unwanted advantage. (On the other hand, good news helps public status from a public relations standpoint.)
3. **Pressure to report favorable earnings may lead to increased fraud.** Unfortunately, even after the criminal cases resulting from the debacles at Enron, WorldCom, and others, as well as the Congressional response in the form of the Sarbanes-Oxley Act of 2002 ("SOX") bill, fraud and greed are still alive and well in corporate America. Unsavory management may engage in Enronomics, or "A fiscal policy or business strategy that relies on dubious accounting practices, overly optimistic economic forecasts, and unsustainably high levels of spending."[3] Management may report uncompleted sales as revenues or delay the reporting of expenses because it has more to gain by falsifying the results.
4. **Being public is expensive, especially after SOX.** Complying with SOX and other obligations of being public adds costs of $500,000 to $700,000 for taking even the smallest company public. Rather than reducing the number of reverse mergers, the trend of going public has prompted larger companies, that are better equipped to bear these additional costs, to seek these transactions. Companies that are able to raise large amounts of capital generally have not been deterred by the extra expense. The average post-merger market capitalization has risen to over $50 million in 2006, according to industry publication *The Reverse Merger Report.*
5. **Being public subjects a company to greater risk of being sued, even in shareholder claims lacking any merit.** In 2004, more money was paid in class action settlements than in any previous year. A class action bill signed into law by President Bush in 2005 may help reduce some of the more egregious cases.

Disadvantages of using a Reverse Merger as opposed to an IPO

There are two perceived disadvantages of reverse mergers as compared to a traditional IPO.

1. **There is less funding obtained in a reverse merger than an IPO.** There are two responses to this. First, in many cases the extra money to be raised in an IPO simply is not needed. Second, after going public in a reverse merger, a company can proceed with a larger, IPO-size secondary offering, which is likely to be completed at a more favorable valuation than a straight IPO would have been.
2. **Obtaining market support following a reverse merger is challenging.** After an IPO, a syndicate of underwriters works to support the stock and keep it trading at a reasonable level. However, this support fades quickly if the company does not perform as expected. This is not the way a healthy stock market should develop, and unfortunately the post-IPO market support tends to remain only long enough to protect the underwriters and their initial investors.

By contrast, market support for a company in a reverse merger tends to develop over a period of time, often months. The key to overcoming this concern includes ensuring that a strong, experienced investment banker is assisting the company, and that a reputable and aggressive investor relations firm is engaged to introduce the company to key Wall Street players.

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Legal Issues and Traps

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In most states, shareholder approval and a proxy statement (if the shell is reporting) is required for a reverse stock split or increase in authorized shares if these actions are necessary to provide for the number of shares to be issued to owners of the private company merging in., If the parties seek to delay this approval until after a merger, it is generally possible with the use of preferred stock (if available) to the former owners of the pri-

vate company. In return, the former owners get enhanced voting rights and ensure approval of the matter in question immediately following the merger. Alternatively, controlling shareholders of the shell can create voting agreements which promise to vote in the affirmative after the merger in order to achieve a similar result.

If shareholder approval is required for a matter prior to the merger, additional caution applies. If the matter for approval is a condition to the merger, the SEC will insist that the proxy be completed as if the merger itself was being approved. This requires extremely detailed and complex disclosure of the transaction, each discussion that took place between the parties, the manner in which they determined the value, and financial statements. This can be avoided by ensuring that the matter to be approved will not be an express condition to the merger, if possible.

Due Diligence

Due diligence in these transactions is absolutely critical. In addition to the typical due-diligence investigation one would conduct on any business, there are six key questions to ask in reviewing the cleanliness of a shell.

1. **How recently did the shell have an operating business?** The further back in time an operating business existed in the shell, the lesser the risk. If there was an operating business there less than six years ago, disclosed or undisclosed vendors and creditors may come out of the woodwork, and there is only limited ability to go after the former operators of the shell.
2. **Does the shell have any pending SEC or regulatory investigations?** Even if initial inquiries may be several years old, this author views any unresolved investigation as presumptive of a no-go decision with a shell. Even a shell that has been through bankruptcy does not relieve itself of the risk of these inquiries.
3. **Is the shell's management problem-free with regard to their background?** It is important to do background checks on the shell company's management such as online searches to gauge their involvement in other public companies and a review of pending and recent litigation. This includes reviewing how the shell has been managed. Has shell management taken fees for itself, paid out amounts to investor relations and other firms, or repeatedly raised money? These are potential signs of problems.
4. **If the shell is reporting, has it completed all SEC filings, and is it indeed a full reporting company?** Some companies claim to be reporting yet the proper filings were never made.
5. **If the shell is a blank check, has it fully complied with all rules and regulations?** For example, a legitimate start-up company is exempt from Rule 419 and could do a regular IPO without the burdens of Rule 419. A number of fraudsters have used this to bring public a number of supposed start-ups, conduct a small IPO avoiding Rule 419, allow trading on the OTC Bulletin Board, and then market the companies as public shells. In its adopting release for the new reverse merger rule in June 2005, the SEC acknowledged this practice and effectively declared these "companies" to be treated the same as shells.
6. **What are the shell's trading patterns in and during the transaction?** If shell management and their friends begin trading in and out of the stock before major announcements, this is not just their problem. The company itself could be sued on an "alter ego" theory of insider trading. This illustrates one of the advantages of working with a non-trading shell. If you are representing the shell, the due-diligence process in reviewing the private company generally is the same as looking at any business to be acquired. Another often overlooked filing is under Section 14(f) of the Securities Exchange Act. If, as part of the merger, there is an agreement to change a majority of the board, the public shell must prepare, file, and mail to shareholders information about the nominees to replace current board members. This mailing must occur at least ten days prior to closing the merger. Occasionally, this mandatory board change is removed as a condition to the transaction in order to avoid the 14(f) filing. In this case, the company merging in simply hopes the shell directors will resign on their own following the transaction.

Sarbanes-Oxley Act of 2002

Passage of SOX prompted some negative changes for small public companies. In late 2004, the SEC announced the formation of an advisory committee on smaller public companies. The committee recommended a plethora of regulatory changes to relieve some of the burdens on smaller companies, and as of this writing the SEC is poised to release a series of proposals in response to these recommendations. The proposals are expected to be favorable in reducing some of the burdens on smaller public companies. The committee did not tackle proposed SOX amendments, but very recently an independent committee of prominent CEOs and other leaders was organized to seek its potential overhaul.

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In the meantime, SOX has increased both accountability and expenses. Senior executives now must personally certify that they believe their company's financial statements are correct, reporting time for insider trading has been cut from one month to two days, and quarterly and annual periodic reports will be filed faster.

Major Developments in New SEC Rulemaking

In April 2004, the SEC proposed a rule change requiring substantial and timely disclosure following a reverse merger with a public shell. The rule, which became effective in November 2005, requires the public entity to complete a detailed filing within four business days after the reverse merger. This filing, known as a Current Report on Form 8-K, must include all the information that would have been in a Form 10-SB filing (or Form 10 for larger companies) for the merged entities. This information includes detailed audited financial statements presented on a pro forma basis with the shell.

The purpose of this change is to close a major area of abuse. Under previous rules, after a reverse merger with a public shell, the entity had up to seventy-one days before submitting financial statements to the SEC. Then, full prospectus-like disclosure did not need to take place until the company's next annual report on Form 10-KSB, which could be many more months away. This led to a large amount of abuse, especially during the seventy-one-day period, where companies issued positive press releases, pumping the stock, but with no obligation to yet disclose certain negative aspects of the merged company.

The 2005 rule change also eliminated the use of Form S-8 to register for resale shares of stock of a public shell. This form is used to register securities for offer and sale in connection with an employee benefit plan, but can also be used to compensate consultants and other third parties. Although commentators called for continuing to allow Form S-8 to be used to register shares held by shell management, but not third parties, the SEC chose not to make these changes.

This author believes the rule has indeed helped correct a major area of abuse. Some commentators, however, were hopeful that the SEC would provide more time than four business days, especially where a shell's stock is not trading and no potential for abuse exists. Instead the SEC remained consistent with its other recent rulemaking regarding Form 8-K filings which must be filed within four days. Experts generally do not believe the new rule has resulted in major delays in the completion of otherwise legitimate transactions as a result of the new rule.

Latest Trends

One current trend includes the creation of shells through the "strip out" of assets of a public company. Here, a company seeing no benefit to remaining public sells its assets to a third party or member of management, leaving behind the public shell to be sold. This transaction generally requires shareholder approval.

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Another major trend is the spate of private companies from the People's Republic of China effecting U.S. reverse mergers. Since China's recent encouragement of foreign investment, a virtual torrent of deals has hit American shores. Some of these deals are either not legitimate or are outright shams, but many are exciting companies that just recently received the opportunity to go public thanks to Chinese business privatization. The complexities in these transactions are numerous; including reconciling U.S. and Chinese generally accepted accounting

principles, language, and cultural barriers; but the rewards for most have outweighed the costs. Other countries with strong activity include Canada, the United Kingdom, and, more recently, Israel.

Biotechnology companies are going public very actively through reverse mergers also. As the stocks of public biotech companies remain strong, a reverse merger allows a private equity investor to turn to PIPEs for further capital raises where it may be unable to further fund a promising company not yet ripe for an IPO.

Another current trend is the unification of the PIPE and reverse merger markets. Many deals now are propelled by the activities of PIPE investment banks and investors who are actively seeking to manufacture blank checks and purchase shells. They realize that, in addition to the typical fees, they can obtain 5% to 10% of the resulting merged entity by supplying the shell, adding more upside to the transaction than a typical PIPE. And, unlike the ordinary income tax normally charged on the investment banks' compensation, gains on their shell ownership generally would be taxed at lower capital gains rates.

Another major development is the proliferation of SPACs. Merrill Lynch, Citibank, and Deutsche Bank are just some of the major players who have become underwriters of IPOs involving SPACs. These are shell companies that have significant cash (many have over $100 million) to offer a company seeking to merge and go public. Unlike virgin shells, SPACs' shares trade publicly before a transaction. There are certain advantages and disadvantages to their structure but, in general, they offer a viable alternative to traditional IPOs.

The available supply of shells has decreased as well while demand has clearly increased. This has resulted in a spike in the price and decrease in quality of shells. A 90% stake of a publicly trading OTC Bulletin Board shell might have cost $150,000 four years ago; to acquire the same stake today might cost $600,000 to $700,000 or more. Investors are willing to pay higher prices because the value of companies they are merging with continues to increase. Thus, it becomes a no-brainer to pay $700,000 for a stake that may have a $2,000,000 (or greater) value upon completion of a merger a few months later.

A Few Other Simple Ways to Go Public

One of the secrets of reverse mergers is that any private company can go public without an IPO and without a shell. If your company's management or key advisers include experienced Wall Street professionals, you have a good number (say more than one hundred) of shareholders, and you engage competent investment professionals to assist with developing a market, "self-filing" is worth considering. There are two principal ways to do this.

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The first way is to simply file your own Form 10-SB, seeking to become a reporting company. In this case, it is better if your shareholders have held their shares for at least two years, because then the shares can trade even if they are not individually registered with the SEC, pursuant to Rule 144, which allows trading of unregistered shares if they have been held for a sufficient period of time.

Under this approach, when the Form 10-SB, which provides significant disclosure about your company, is approved and becomes effective under SEC rules, as with a Form 10-SB shell, your company is then public and can raise money through a PIPE and apply for a trading symbol. This assumes it otherwise meets the requirements of the exchange you are seeking to be listed on.

Another, more popular method of self-filing is to file a Form SB-2. Here, any shares that the company has issued, even if not held for two years, are registered for resale with the SEC and can trade immediately following effectiveness of the filing. This can be more useful than a Form 10-SB if your company has few shareholders who have held stock for the applicable Rule 144 period. It may also be a preferable choice if it follows a private offering or equity line of credit, as the shares of the new investors also can be registered at the same time. In recent months the SEC has sought to limit the percentage of a company's "public float" (e.g. nonaffiliate stock) that can be registered for resale at one time in the manner described. Currently, keeping a registra-

tion to no more than one-third of the non-affiliate stock should be acceptable.

In either case, the result is that the company has obtained a publicly tradeable stock without the need to merge with a shell. The major advantages of these approaches include avoiding issuances of shares and payments of cash to the owners of the shell and to intermediaries who built the deal. In addition, it removes a third party, namely the shell and its attorneys, auditors, and other advisers, from the mix and makes the entire transaction a "company-side only" event. Given the rising prices and reduced supply of shells, self-filing has become increasingly more popular.

There are, however, several reasons to do a reverse merger instead of simply filing a Form 10 or SB-2.

1. **A reverse merger generally is much quicker.** A Form 10 or SB-2 has to include detailed information about the company and that form must pass through the SEC's review, which can take months.
2. **Investment bankers who promote shells generally provide a turnkey service.** This includes financing, a shell, lawyers, accountants, public and investor relations, and market makers, to name a few. A company completing a Form 10 or SB-2 on its own must have connections in order to act as its own general contractor and find these experts itself.
3. **In a number of cases, the shell has a ready shareholder base.** This can sometimes number in the thousands and makes it easier to develop a public market for the stock.

Conclusion

There is no question that a reverse merger involves risks and disadvantages for some companies. However, for the right company working with the right people, it can be a tremendously beneficial way to help bring a growing business to the next level. When combined with PIPE financing, the reverse merger also proves an effective way to raise equity capital. For companies seeking a cash infusion, and for PIPE investors seeking investment alternatives, these deals represent new opportunity.

If you are contemplating a reverse merger transaction, remember to be careful of the people you get involved with, and to make an effort to carefully check out the promoters and the deals they have done in the past. The continuing importance of due diligence remains a high priority. At times when financing is practically unavailable, if a company is careful to deal with the right advisers, has a realistic set of expectations, and is indeed a company that could truly benefit from being public, a reverse merger can be an extremely successful technique and the benefits generally outweigh the costs. BLB

ENDNOTES: *David N. Feldman*

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[2] *See* Securities Enforcement Remedies and Penny Stock Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990).

[3] Word Spy, Enronomics, http://www.wordspy.com/words/enronomics.asp (last visited Jan. 3, 2007

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