

Reverse Mergers aren't all bad. Even the New York Stock Exchange did one¹.

Reverse Mergers, however, like Pit Bulls, have a bad reputation, often well deserved, but not always. Reverse Mergers are a quick and relatively inexpensive way to become a Public Company, but there are limitations and pitfalls, as many Chinese companies that did reverse mergers with U.S. Shells have learned.

Definitions for purposes of this article

Insiders = officers, directors and large shareholders of a Public Company, or any affiliates of any of these, as more precisely defined by SEC Regs.

IPO = an Initial Public Offering of the shares of a Company that has not previously been Public, managed by an underwriter and qualified in most if not all states.

Pink Sheet stocks = stocks quoted by the National Quotation Bureau, some of which trade and others that do not, that are usually not required to maintain current reporting status nor annual audits. Pink Sheet companies are quasi-Public.

Public Company (Public) = a company that files reports with the U.S. Securities and Exchange Commission (the "SEC") and whose shares may be legally purchased and sold in Public markets throughout the country.

Public Shell or **Shell** = a Public company with no business, assets or (known) liabilities, but with enough shareholders to qualify as a Public Company or quasi Public Company..

Reverse Merger = a merger (or stock for assets Type C reorganization) of a private company with a significantly smaller Public Company, in which the shareholders of the private company end with a large majority of the shares of the Public Company.

Determining Why You Want To Be Public Is The First Step

Before considering becoming a Public Company, by whatever means, the first step is to achieve a clear understanding as to:

- The reasons why the company thinks it should be Public.
- The regulatory and compliance requirements involved in being Public.
- The ongoing cost and effort of fulfilling those requirements.

The desirability and feasibility of being Public is a trade-off between the needs and objectives of the private company and how they expect to benefit from being Public vs. the costs and demands of being Public.

¹ The NYSE completed its acquisition of Archipelago Holdings via a "double dummy" merger on March 7, 2006 in a \$10 billion deal to create the NYSE Group.

Public Companies can enjoy significant benefits.

The primary benefit of being Public is that, other things being equal, it is easier for a Public Company (vs. a private Company) to raise new equity (or debt) capital because

- certified detailed information about the Company is publicly available;
- investors know that the government enforces strict regulations with respect to Public Companies;
- and c. if an investor is buying equity, there is a presumption of future liquidity.

In addition, being Public makes a company visible to potential acquirers because a Public Company's name pops up in any search and because the vital information about the company is readily available. Also, if the company is performing well and the stock price reflects it, the price a buyer offers might be higher than it would be for a private company with the same attributes.

Other benefits of being Public can be the ability to offer meaningful stock options to employees and to use shares to purchase other companies. Being Public can also provide credibility with customers and suppliers because of the availability of information about the company and government oversight. The ability of Insiders to sell their shares is also a definite plus, but has limitations.

All these benefits are premised on there being a viable market for the Company's shares, which requires a business and story that motivates brokers to trade your shares, their clients to want to buy your shares, and enough shares available to allow them to do so.

Also, they are premised on the company doing well. If it isn't doing well, the world knows about it, the share price languishes and many of these benefits go away.

Being Public Isn't Cheap Or Easy

Once a company becomes Public, by whatever means, numerous requirements must be met for the company's stock to be legally traded or new shares sold in Public markets to raise capital. Failure to comply can result in severe civil and/or criminal penalties for both the company and individuals. These include:

- Annual certified audits in accordance Generally Accepted Accounting Principals ("GAAP"), which are precise and rigorous.
- Filing with the SEC an annual report, called a 10K, with the audit plus a great deal more information, including all compensation paid to management and directors and disclosure of any dealings between the company and Insiders. A 10K is almost equivalent to a Registration Statement required for an IPO.
- Quarterly reports, called 10Q's, with interim financial reports and other information filed with the SEC within 45 days after the end of each quarter.

- 10K's and 10Q's must be personally "certified" by the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), for which they are personally liable.
- A Board of Directors with a majority of "independent" directors who are not Insiders nor are related to or affiliated with any Insiders.
- A separate "Audit Committee" of the Board, which hires and oversees the auditors.
- A prohibition against any Insiders buying or selling shares during specified "Blackout Periods" and a requirement to report to the SEC all purchases or sales by insiders during other periods within two days of such transactions.
- Prohibitions against loans to officers or directors.

Compliance with such requirements including legal and audit services from firms with credibility in the Public financial community, director's fees, D&O insurance and minimum required shareholder communications costs a minimum of \$500,000 a year in direct expenses.

This does not include "Investor Relations" services to keep the financial community and the public informed about the Company, director fees, higher salaries required for a qualified Public Company CEO and CFO, nor the considerable time of management to deal with compliance and regulatory issues and shareholders relations.

All told, the minimum direct and indirect costs for even a small company to be properly Public is close to \$1,000,000 a year. If the Company isn't realizing significant benefits from being Public, then it is obviously a losing proposition

IPO's And A Reverse Mergers Are Not Equal Opportunity Alternatives

Prerequisite to success of a Reverse Merger is a clear understanding of the differences between an IPO and a Reverse Merger. The desirability and feasibility of one vs. the other depends upon the circumstances, needs and objectives of the private company.

The primary difference is that an IPO raises money and creates a bona fide Public Company with shares to trade and credibility in the financial markets. An IPO is the traditional means of becoming Public, but requires a certain size and type of company to find a reputable investment bank/underwriter to take it on.

Note that there are offerings of shares that may be termed IPO's, but are not what we are addressing in this article. SCORE and Reg D 504 or 505 offerings are perfectly legal, but distribute a limited number of shares to a few shareholders and do not

achieve the same result as a bona fide registered offering managed by an underwriter and qualified in most if not all states.

A Reverse Merger makes the company Public quickly and inexpensively, but does not raise capital. After a Reverse Merger the company has all the same expensive regulatory and filing requirements as a Company that has had an IPO.

In addition the company that becomes Public through a Reverse Merger must invest heavily in creating credibility in the financial community for it to enjoy the benefits of being Public. In the long run this can cost as much as an IPO; and if it later wants to raise money publicly, it needs to go through basically the same process as an IPO.

A Reverse Merger can, nonetheless pay off under the right circumstances, such as facilitating private investment from financing sources which as a policy will invest only in Public companies (see box below).

Another example is visibility as a potential acquisition candidate. Public companies show up on buyers' radar and acquirers like Public companies because audited financials and other detailed information are readily available.

A small Public medical technology company was struggling because R&D investments weren't producing the hoped-for results. A large pharmaceutical house offered to buy all their assets for an amount just sufficient to pay off debt. The company had un-broken audits from a major national firm and was current on all SEC filings.

At the same time a \$100,000,000 a year privately held auto parts company was available for sale. There was no time for an IPO to raise financing. There was, however, a major life insurance company that liked the auto parts business but had a policy of investing only in Public Companies.

The Public medical company's assets were sold and all debt retired, immediately after which the insurance company purchased convertible debt from the Company simultaneously with the acquisition of the auto parts company with the cash proceeds from the sale of the convertible notes. The auto parts company went on to thrive as a Public company, acquiring several other smaller companies for stock.

An IPO is A Long, Complex And Expensive Process, But Does The Whole Job In One Step.

The purpose of an IPO is to raise capital by selling shares to the Public. IPO's sell primarily new Company shares. Shares held by existing shareholders are sometimes included in the offering, but in smaller quantities and generally only for later stage companies with a history of sustained profitability. An IPO requires:

- A substantial and successful underlying business and a compelling story as to the use of the funds being raised. IPO's to raise less than \$10 to \$20 million or for Companies with less than \$50-100,000,000 in sales are rare today. With few exceptions (e.g. Google), the start-up dot com IPO's of the 1990's are history.
- Filing a detailed Registration Statement, which is closely scrutinized by the SEC because the shares will be purchased by unsuspecting public investors.
- An "Underwriter", an investment banking/brokerage firm that manages the process and sells the shares to their customers and through other brokers.
- Hundreds of thousands of dollars of expenses paid in advance without any guarantee that the IPO will take place. (IPO's can be canceled if the Company develops problems or if the stock market becomes weak). In addition the stock brokers receive sales commissions of 5% or more.
- Management's active participation in both the preparation as well as presentations to brokers across the country (called "road shows")
- Six months or more, even when the Company is relatively well prepared with historical audits and experienced managers, directors and attorneys.

The end result of a successful IPO, however, is that the Company has capital to finance its growth plan, credibility in the financial community that knows and has confidence in the Company and its stock, thousands of shareholders who chose to invest in the Company, millions of shares in the Public market and an infrastructure to fulfill the company's ongoing regulatory obligations.

Reverse Mergers Can Make A Company Public Quickly And Cheaply

Not every company is eligible for an IPO or can afford the up front expenses. A Reverse Merger by-passes most of the complexities of an IPO and can be done quickly and relatively inexpensively. Even a company that might not qualify for an IPO can become technically "Public" virtually overnight through a Reverse Merger. This is a huge shortcut, but not without its costs.

A Reverse Merger gets you only part way to becoming a bona fide Public Company. Therein lies the pitfall: a Reverse Merger is relatively quick, cheap and easy, but what follows is not. First there are all the regulatory filings and compliance; and then In order to create a market for the shares, considerable additional effort and expense is required to get the financial community's attention, which can be difficult with a limited number of shares in Public hands.

This is not to say a Reverse Merger isn't a viable and desirable strategy under the right circumstances. Before continuing, however, one must distinguish between a Reverse

Merger with a Shell vs. a Reverse Merger with a company still in business, which may be termed a “Strategic Reverse Merger.

Reverse Mergers With Shells Can Be Unsavory and Fraught With Risks

Public Shells are abandoned Public companies that went out of business, or else a “blank check” shell that was created primarily for a Reverse Merger, which at least has the benefit of traceable parentage (vs. the “abandoned” company, which may not).

Such Shells typically trade, if at all, as “penny stocks” in the Pink Sheets or the OTC Bulletin Board. They may or may not have current filings, but after acquiring an operating business, they need to file.

In a typical Reverse Merger with a Public Shell someone usually purchases a controlling interest in the Shell sufficient to approve the merger. After the merger, the old Public shareholders, typically just a few hundred, end up with a minor percentage, say, 5%, of the total; and the balance is held by the former shareholders of the private company that was merged in.

The risks of a Reverse Merger with a Public Shell are (despite “guarantees” by whoever delivers the shell) undisclosed liabilities, incomplete shareholder records and/or regulatory or filing lapses, the consequences of which can be serious and stay with the company indefinitely.

In addition, Public Shells are notorious for abuse by stock promoters and who trade for quick profits after the merger (“pump and dump”), which at the least hurts the Company’s reputation, or worse.

A merger with a Shell gets you technically Public, but nothing more. You end with a few hundred shareholders, not enough to create a bona fide public “market”. Auditors and attorneys are typically very small firms or individuals, and the financial community that makes the difference isn’t going to take the company seriously. It leaves the company on the lowest rung of the Public Company ladder. Reverse Mergers with shells are what people have in mind when they dismiss Reverse Mergers as shady, suspect or quasi-legitimate transactions.

A variation of a Public Shell is a Public Company that recently divested all its business in an asset sale but has a clean unbroken history of audits, filings and stock ownership as well as reputable attorneys and accountants who were involved. Technically it may be a Public Shell, but if the divestiture is recent, it is in a completely different category (and has been termed a “warm” shell).

Strategic Reverse Mergers Can Work

The right way to do a successful Reverse Merger is to find a small Public Company in good standing that still has operations – and ideally in a related business - but too small to justify being Public. There are thousands of such small Public companies in that situation that went Public in a different era, and/or have suffered business setbacks.

A merger with such a company can have the advantage of an unbroken history of audits and filings, the basic infrastructure to fulfill the Public company’s ongoing regulatory obligations, e.g. auditors, attorneys and a functioning Board of Directors, as well as market makers, relationships with the financial community, and shareholders who haven’t forgotten they own the stock, not to mention a going business.

In summary: Three Steps To A Safe Landing

Step one:

Understand why you want to be Public and the cost and effort required afterwards in light of your goals, needs and resources.

Step two:

If you are confident that the benefits outweigh the costs, examine both an IPO (if feasible) and Reverse Merger and determine whether either can fulfill your objectives.

Step three:

If a Reverse Merger is considered, do it with an operating company. If tempted by an empty shell, think twice and proceed very, very carefully and understand that you may end up public in name only.

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