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Reverse Mergers & SPACs

Shell Mergers: Short Cut to Liquidity?

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A "shell merger" or "reverse merger" generally refers to the merger of a private operating company into a public shell company with few or no assets. For accounting purposes, the shell must only have nominal assets. A reverse merger with a shell is generally structured so that, upon closing, the private company shareholders receive, in exchange for their shares in the private company, shares of the public reporting company. Once the merger is complete, the private company shareholders, in the aggregate, will hold a substantial majority of the outstanding securities of the combined company, and the operations of the private company become the operations of the public company.

Perceived Advantages of Shell Mergers

Private companies enter into shell mergers for a number of reasons. They hope that the transaction will facilitate access to the capital markets and create a liquid market for the company's securities as the post-merger company will have shares that are quoted on the OTC Bulletin Board or the Pink Sheets and eventually, if eligible, a national securities exchange. Generally, as the post-merger securities will be registered securities, the company may have access to a broader universe of potential investors than it had as a private company[1] and access to different classes of investors. Last, private companies often enter into these transactions anticipating that they will be able to close the transactions in a shorter time frame and with the incurrence of fewer costs and expenses (including lower legal and accounting fees) when compared to an initial public offering.

Risks Related to Shell Mergers

These perceived advantages may not necessarily be realized. Realizing these benefits requires proper planning, diligent post-transaction efforts and probably a bit of good luck. In fact, many of the companies that elect to go forward with shell mergers do so in response to pressures from existing or potential investors or from financial intermediaries–not necessarily because management determined that the transaction is in the best interest of the company. Rather, the companies are aware that there is a good chance they will not realize all of these benefits, but nonetheless enter into the transactions to secure necessary financing and hope for the best.

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There are many risks to which a post-shell merger is subject, including, but not limited to, the following:

- fraud and other abuse;
- manipulative trading patterns after the merger;
- inability to remain viable after the merger;
- failure by auditors to identify circumstances in which the company is not complying with relevant accounting standards;
- no research coverage;
- no actual liquidity;
- legacy risks from shell;
- reputational concerns; and
- the combined entity fundamentally not accomplishing the goal of a "public" company.

Once a company completes a shell merger, a liquid trading market for the securities of the combined entity is far from guaranteed. In substantially all such transactions, the combined entity will initially be quoted on the OTC Bulletin Board or the Pink Sheets. The liquidity on those two mediums pales in comparison to the Nasdaq Stock Market, Inc., or the Nasdaq, and other national securities exchanges. Assuming that the company intends to eventually seek a listing on an exchange, the company faces an uphill battle. The listing qualifications of the national securities exchanges require minimum numbers of existing shareholders (300 to 400), minimum market valuations, minimum bid prices and other qualifications that a post-shell merger company may have a hard time achieving.

Listing Qualifications for Post-Shell Merger Companies

In addition to the foregoing, in response to recent scandals in the shell merger arena discussed below, applications have been filed in recent months with the Securities and Exchange Commission, or the SEC, by each of the Nasdaq,[2] the New York Stock Exchange,[3] or the NYSE and the NYSE Amex.[4] The Nasdaq filed its rule proposal in May 2010. If approved, in addition to other qualifications applicable to all Nasdaq-listed companies, a post-shell company will not be eligible for listing:

i. until there have been six months of trading of the combined entity on the OTC Bulletin Board or other exchange or foreign market;

ii. unless the company has maintained a bid price of at least $4.00 per share for 30 out of the 60 days prior to the filing of the applicable initial listing application; and

iii. if a domestic company, unless the company has filed with the SEC (or other regulatory authority) its most recent two required periodic financial reports or, if a foreign private issuer, the company has similar information as that for domestic companies but on a Form 6-K, 20-F or 40-F.

The SEC is currently required to act on this application by September 12, 2011.

The NYSE and the NYSE Amex each filed their rule proposals with the SEC in July 2011. The proposed rules are similar to the Nasdaq proposed rules, but there are differences. Under the proposed NYSE rule, the combined entity must comply with one of certain enumerated listing standards and must have:

i. traded for at least one year in the U.S. over-the-counter market, on another national securities exchange, or on a regulated foreign exchange following the consummation of the merger and (A) in the case of a domestic issuer, have filed with the SEC a Form 8-K containing all of the information required by Item 2.01(f) of Form 8-K, including all required audited financial statements, or (B) in the case of a foreign private issuer, have filed all of the information described in (A) above on Form 20-F;

ii. maintained, on both an absolute and an average basis, for a sustained period a minimum stock price of at least $4.00; and

iii. timely filed with the SEC all required reports since the consummation of the merger, including the filing of at least one annual report containing audited financial statements for a full fiscal year commencing on a date after the date of filing with the SEC either the Form 8-K or Form 20-F referred to above. In addition, a post-shell company will be required to maintain on both an absolute and an average basis a minimum stock price of at least $4.00 through listing.

Notwithstanding the foregoing, a post-shell company will not be subject to the requirements of the proposed rule if it is listing in connection with an Initial Firm Commitment Underwritten Public Offering (as defined in the proposed rule), provided the proceeds to the company from the offering will be sufficient on a stand-alone basis to meet the aggregate market value of publicly-held shares requirement for Initial Firm Commitment Underwritten Public Offerings set forth in Section 102.01B of the NYSE Listed Company Manual and the offering is occurring subsequent to or concurrently with the merger transaction. In that case, the post-shell company will only need to meet the requirements of one of the initial listing standards in Section 102.01C of the NYSE Listed Company Manual. The NYSE proposed rule will be codified in two substantially similar sections, one for domestic companies and the second for companies that are eligible to list under the non-U.S. companies criteria of Section 103.01 of the NYSE Listed Company Manual.

Under the proposed NYSE Amex rule, a post-shell merger company will not be eligible for listing when the combined entity has, immediately preceding the filing of the initial listing application:

i. traded for at least one year in the U.S. over-the-counter market, on another national securities exchange or on a regulated foreign exchange following the consummation of the merger and (A) in the case of a domestic issuer, filed with the SEC a Form 8-K including all of the information required by Item 2.01(f) of Form 8-K, including all required audited financial statements, or (B) in the case of a foreign private issuer, filed the information described in (A) above on Form 20-F;

ii. maintained on both an absolute and an average basis for a sustained period a minimum closing stock price equal to the stock price requirement, including all requirements based on stock price, applicable to the initial listing standard under which the post-shell merger company was qualifying to list; and

iii. timely filed with the SEC all required reports since the consummation of the shell merger, including the filing of at least one annual report containing audited financial statements for a full fiscal year commencing on a date after the date of filing with the SEC of the filing described in (i) above.

The proposed rules for each of the NYSE and the NYSE Amex provide that the applicable exchange, in its discretion, may impose more stringent requirements than those described in the proposed rule if the NYSE believes they are warranted in the case of a particular company.

In addition, under the proposed NYSE Amex rule, a post-shell merger company that submits an initial listing application would be required to maintain through the time of listing, on both an absolute and an average basis, a minimum closing stock price equal to the stock price requirement, including all requirements based on stock price, applicable to the initial listing standard under which the company was qualifying to list. Last, a post-shell merger company under the proposed NYSE Amex rule would not be subject to the new requirements if it is listing its securities in connection with a firm commitment underwritten public offering where the proceeds to the company are at least $40,000,000 and the offering occurs subsequent to or concurrently with the merger. In that case, the post-shell merger company would only need to meet one of the NYSE Amex initial listing standards.

The proposed rules for each of the NYSE and the NYSE Amex provide that the applicable exchange, in its discretion, may impose more stringent requirements than those described in the proposed rule if the NYSE believes they are warranted in the case of a particular company. Additional requirements may be necessitated by, among other things, an inactive trading market in the company's securities, the existence of a small number of publicly-held shares that are not subject to transfer restrictions, whether the company has not had a Securities Act registration statement or other filing subjected to a comprehensive review by the SEC, or whether the company has disclosed that it has material weaknesses in its internal controls which have been identified by management and/or the company's independent auditor and has not yet implemented an appropriate corrective action plan. The rules for both exchanges also make clear that the proposed rules do not apply to exemptions for special purpose acquisition companies (SPACs); SPACs remain eligible to rely on the listing standards of the applicable exchange.

An exchange listing is the most likely way that a post-shell merger company may realize some of the anticipated benefits of the transaction. Assuming that an exchange listing is the goal, one would expect that the target shells would have large holder bases so the combined entity would be closer to achieving the applicable listing qualification. Yet we have noted of late that many companies have merged with shell companies with few shareholders, making them less than optimal participants in these transactions. In recent years, so-called "virgin shells" have been introduced to the market. Virgin shells are blank-check entities formed specifically to serve as the shell in shell mergers. Virgin shells have only one or up to a handful of shareholders. They are not quoted on the OTC Bulletin Board or the Pink Sheets and experience no trading prior to the merger. Accordingly, the combined entity realizes no benefits from merging with the shell insofar as moving toward an eventual listing. Virgin shells may, however, help the combined entity become eligible to use a registration statement on Form S-3 sooner because they are reporting companies and, therefore, have a history of reporting. However, other factors may make S-3 eligibility unlikely or irrelevant.

Other Limitations Faced by Post-Shell Merger Companies

Post-shell merger companies will face a number of obstacles in completing post-transaction securities offerings. The combined entity will be an "ineligible issuer" for a three-year period after the filing of the required Form 8-K announcing the merger. Ineligible issuers may not use a short-form S-3 registration statement for primary offerings unless the market value of the company's public float is $75 million or more. Shell merger companies often have low valuations and relatively large holdings by affiliates making this an obstacle for many post-shell companies. Ineligible issuers are prohibited from using free-writing prospectuses. They also may not issue "graphic communications," which means they many not use many forms of electronic road shows and will be forced to use live road shows in connection with offerings or for other investor relations purposes. In addition, other conveniences allowed by the SEC for other issuers are not available for ineligible issuers. Last, the research departments of investment banks that follow the company, if the company has successfully attracted the attention of the analyst community, are prohibited from taking advantage of certain conveniences allowed by the SEC relating to research coverage of securities that are the subject of an offering.

Adverse Consequences for Shareholders of Post-Shell Merger Companies

Shell mergers also result in adverse consequences for shareholders. The shareholders of the private company will receive restricted securities of the combined entity. Accordingly, they will not be able to resell the shares until they are registered for resale or are eligible for an exemption under Section 5 of the Securities Act of 1933, as amended (Securities Act). Rule 144 under the Securities Act is the most common exemption used by shareholders for the unregistered resale of restricted securities. However, Rule 144 is not available for the resale of securities of a post-shell company for one year after the company has filed "Form 10 information" disclosing that it is no longer a shell company (ordinarily, the period for non-shell, newly-public companies would be six months), provided that the company has filed the Form 10 information, is current with its reporting requirements under the Securities Exchange Act of 1934 (Exchange Act) and other conditions. "Form 10 information" generally includes the same type and scope of information that is required to be included in a registration statement on Form S-1 used in an initial public offering. In addition, under Rule 144, shareholders of a company that was previously a shell may not take advantage of the rule at any time after it files the Form 10 information unless it is current, over the previous 12 months, with its Exchange Act filings. For this reason, many practitioners will not issue a legal opinion allowing the removal of a restrictive legend from a certificate evidencing restricted securities issued by a company that was ever a shell unless the securityholder has a bona fide intention to sell the securities. Filing a resale registration statement also presents hardships, as it is uncommon for a post-shell company to be eligible to use a short-form S-3 resale registration statement for at least some time after the merger. Accordingly, the company will generally be forced to use a registration statement on Form S-1, a more detailed filing that requires the filing of supplements and amendments, in order to keep the registration statement current.

Recent Scrutiny of Shell Mergers

In the last year, and particularly in the last few months, there has been heightened scrutiny regarding shell mergers, particularly with respect to foreign companies. The financial news is full of stories regarding fraudulent practices by post-shell companies, particularly companies that are China-based. In July 2010, the Public Company Accounting Oversight Board (PCAOB) issued guidelines regarding auditing statements for foreign companies. In March 2011, the PCAOB issued a research note specifically concerning the audit implications of reverse mergers involving companies from China and the region (including the People's Republic of China, Hong Kong Special Administrative Region and Taiwan) raising concerns about the quality of the audit because of the work completed by other domestic accounting firms and consultants.

The SEC also has been very active with respect to shell mergers. In a letter dated April 27, 2011, SEC Chairman Mary L. Schapiro responded to a letter from Congressman Patrick T. McHenry regarding the SEC's efforts to protect investors from shell companies based outside of the United States that violate U.S. securities laws. Chairman Schapiro noted some of the SEC's efforts that are discussed below (although other SEC initiatives were undertaken after the letter was sent). She stated that the SEC had taken action against a U.S. audit firm relating to improper professional conduct in connection with audit work for a Chinese post-shell merger company. Chairman Schapiro also explained that the SEC experienced significant difficulty and delay in obtaining work papers from foreign auditors, a problem that is addressed in Section 929J of the Dodd-Frank Act which relates to the production of foreign audit documentation. Finally, Chairman Schapiro advised that the office of the Chief Accountant was working with the Division of Enforcement, the Division of Corporation Finance and PCAOB to identify problematic audit practices and auditor conduct in connection with post-shell merger companies, a significant portion of which are from China. The SEC also issued an investor bulletin in June 2011 warning the public of the potential risks relating to investments in post-shell merger companies.[5]

The SEC and the PCAOB are continuing to focus on Chinese post-shell companies.

In recent months, the SEC has suspended trading in a number of post-shell merger companies and has revoked several registration statements. Common issues leading to these actions include the following:

- questions regarding accuracy and completeness of information, including information relating to cash balances and accounts receivable;
- failure to disclose the resignation of the company's auditor due to accounting irregularities;
- failure to disclose the filing of a 10-Q without review by independent auditors;
- failure to disclose resignation by auditors, and auditors having notified the company that certain financial statements could no longer be relied upon;
- failure to disclose resignation of law firm and forensic accountants hired by audit committee to investigate alleged financial fraud;
- failure to report resignation of independent directors;
- questions as to size of operations, number of employees and existence of material contents;
- existence of different sets of books and accounts; and
- failure to file periodic reports.

The SEC and the PCAOB are continuing to focus on Chinese post-shell companies. On August 8, 2011, the SEC issued a release to announce certain details of the Sino-U.S. Symposium on Audit Oversight held in Beijing on July 11 and 12, 2011.[6] Officials from the SEC and PCAOB, as well as officials from comparable Chinese agencies, were in attendance. According to the SEC release, the symposium represented "an important step toward Sino-U.S. cooperation on audit oversight of public companies."[7]

In addition to the foregoing, the exchanges have begun to scrutinize reverse mergers, as seen with the recent efforts by the NYSE, NYSE Amex and Nasdaq to introduce heightened listing standards for post-shell merger companies.

Conclusion

In order to complete a shell merger and attempt to mitigate the risks, a company must take a number of steps, including most importantly, diligence. Private companies should research the shell carefully. All public filings should be read closely, and there should be a focus on any past delistings and trading halts. Diligence should decrease risks relating to the shell, including risks relating to management and controlling stockholders. Background checks on management are also highly advisable, as are litigation searches. Shells that use more well-established auditing firms should be pursued. Most important, a dose of skepticism during the review may serve a company's interests.

It is also quite important that the private company identify its goals in entering into the transaction. A clear understanding of both the goals and risks will help ensure that the company not be disappointed by the results. For example, if the goal is a quick listing on an exchange, the company must identify a shell with a large shareholder base. It would not be prudent to rely on post-merger trading to increase the size of the shareholder base. If a resale registration is important, a shell with filing history may shorten the wait for S-3 eligibility, which would make the resale registration statement more efficient. The use of a registration statement on a Form S-1 will take longer to prepare and, because forward incorporation by reference of Exchange Act filings made by a company after the filing of the registration statement is unavailable, will require constant supplementing and amending. The continuous filing of supplements and amendments to a Form S-1 will not only increase those filing/printing/legal costs–it may also result in trading halts while amendments are waiting to be declared effective.

A foreign company that merges with a U.S. shell will not be eligible for foreign private issuer status. Foreign private companies must be sure they understand that they will lose the advantages available to foreign private issuers with respect to reliance on home country corporate governance practices and with respect to SEC filing requirements.

Last, the post-transaction company will be a public company like any other public company. Accordingly, it will be subject to Sarbanes-Oxley compliance, corporate governance issues and other public company issues. These obligations will be greater if the company is listed on a national securities exchange. Many companies find that these costs quickly make the savings realized by pursuing a shell merger over other transactions insignificant.

Although there are many reasons to pursue a shell merger, these transactions are fraught with risk. The risk of fraudulent transactions with Chinese companies is interesting, but the risks relate to all companies interested in these transactions. The decision to complete a shell merger should not be made lightly. A company should make sure that it has considered all alternatives and understands the implications of completing such transactions.

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[1] In an era where there are many opportunities for private companies to access capital, the incremental liquidity associated with an OTC Bulletin Board listing or Pink Sheet trading may on a relative basis be less significant.

[2] NASDAQ Stock Market LLC, Form 19b-4 Proposed Rule Change by NASDAQ Stock Market LLC (May 26, 2011), *available at* http://nasdaq.cchwallstreet.com/NASDAQ/pdf/nasdaq-filings/2011/SR-NASDAQ-2011-073.pdf. The application replaced a previous application made by the Nasdaq in April 2011.

[3] New York Stock Exchange LLC, Form 19b-4 Proposed Rule Change by New York Stock Exchange LLC (July 22, 2011), *available at* http://www.nyse.com/nysenotices/nyse/rule-filings/pdf;jsessionid=324477F072495DE42570F3B6F3E0644B?file_no=SR-NYSE-2011-38&seqnum=1.

[4] NYSE Amex LLC, Form 19b-4 Proposed Rule Change by NYSE Amex LLC (July 22, 2011), *available at* http://www.nyse.com/nysenotices/nyseamex/rule-filings/pdf?file_no=SR-NYSEAmex-2011-55&seqnum=1.

[5] "Investor Bulletin: Reverse Mergers," *available at* http://sec.gov/investor/alerts/reverse mergers.pdf.

[6] "U.S. and Chinese Regulations Meet in Beijing on Audit Oversight Cooperation," *available at* http://sec.gov/news/press/2011/2011-164.pdf.

[7] *Id.*