Going Public by "Direct Filing" vs. Reverse Merger

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Self-Filing To Become Public

If the objective of your company is to be public and you are not large enough to attract a big-time Wall Street underwriter for a traditional IPO, you need to consider the significant benefits of a direct filing with the SEC as an IPO alternative. Often referred to as a "self-filing" or a "direct public offering", when you file directly with the SEC (either on Form 10 or Form S-1) your company becomes a fully-reporting public company. If you choose a Form S-1 filing, shares of the company and its shareholders can be registered for resale. In contrast, a Form 10 filing subjects the company to the SEC's public information reporting requirements only, without any registration of shares. A Form S-1 would have to be filed following a Form 10 if you want to register shares for investors and others to enable a trading market beyond any non-restricted shares held by shareholders at the time.

This article will focus primarily on reverse mergers with companies that are (or have ever been) public shell companies vs. filing a Form S-1 for your company directly with the SEC, referred to by some as *"going public through the front door."*

Self-Filings vs. Reverse Shell Mergers

Over the years, transactions using trading shell companies, which I will generally refer to in this article as "reverse mergers" (including reverse triangular mergers, "asset" acquisitions or otherwise), have gained some validity through their use by investment bankers and some major companies. Even the SEC has given credence to shell transactions by conforming rules and regulations to address "shell companies". (SEC has defined them as companies "with no or nominal operations and either no or nominal assets, assets consisting solely of cash and cash equivalents, or assets consisting of any amount of cash and cash equivalents and nominal other assets"). At the same time, however, the SEC has created several new issues with regard to shells that have complicated things substantially.

With apologies to my friends in the shell community, I have to say that while there are limited situations where a reverse merger with a shell may make sense, there are plenty of reasons not to go the shell route. Some important ones include:

- Shells transactions may easily cost five times more than self-filings
- Misperceptions regarding shareholder base and value
- Actual time for a self filing is not that much more than a reverse merger
- A company that has ever been a shell must remain current forever
- Difficulties in removing stock certificate restrictive legends
- Private financing is substantially complicated

By the way, we have successfully guided clients through both self-filings and reverse mergers so I don't necessarily have a horse in this race – we can certainly accomplish whatever a client needs. We will, however, make sure any client thoroughly understands all of the options (and the long-term ramifications) in order to make a fully-informed choice regarding these or other IPO alternatives.

Let's examine some of the key considerations:

1. Cost

Reverse Mergers. When current OTC Bulletin Board shells are being offered at prices in the $400,000-$600,000 range and up, the cost to complete a business combination with a shell is a significant issue, especially because that is the base cost of the shell only. You still have to add in audited statements, significant due diligence costs, legal fees and a variety of other costs just to hit the ground running.

Perhaps you can lower your out of pocket cost by using shares of your company to cover part of your acquisition costs. Now your transaction just got really expensive. You have just given away a big piece of your company, for no cash, at a price you might not ever consider accepting on a straight investor proposal. Since you have had to negotiate a purchase using stock instead of the cash price requested, the likelihood that you have to agree to other items increases (e.g. paying off liabilities or granting registration rights). Given the relatively low valuation you have just established in the transaction for your company and the significant dilution resulting from the arrangement, you might find the transaction is much more expensive in the long run.

Self-Filings. Conversely, legal fees for a self-filing will be less. I can't speak for other law firms but we can file an S-1 and register shares for a client for well under $100,000. We can also provide introductions to experienced SEC-approved accounting firms that are accustomed to working with smaller companies and can provide some extremely competitive pricing. Being able to tell investors that they can invest in your company today and you will use their funds wisely, including promptly registering their shares with the SEC, makes for a compelling presentation. If you structure the investment properly to include both shares and warrants, you have just taken care of your second round of financing if your company performs. (And, since you didn't go the shell route, you have an extra half million dollars in the bank that you can use to pay salaries and generally make sure your company performs.) Many things will affect the price of your shares – cash in the bank or lack thereof will affect pricing both with respect to your balance sheet and the ability to keep your professionals paid and your reporting current. A self-filing allows you to hold on to your cash to the extent possible and should help you avoid the ongoing search for financing that is the fate and the downfall of many smaller public companies.

2. Misperceptions regarding Shareholder Base

Reverse Mergers. While the term "going public" has traditionally referred to an initial public offering of shares to raise money, IPO alternatives like self-filings and shell combinations make your company public but are not funding techniques. If your company does not already have sufficient revenues to carry it through the process and comfortably cover the extra costs of being public, a separate financing transaction should occur before, or contemporaneous with, the commencement of the IPO alternative.

One of the chief arguments for the cost of a shell (dollars and dilution) is that there is a ready-made float of public non-affiliated shareholders, sometimes numbering in the hundreds, and that this is necessary for a healthy trading market. It is argued that institutional investors may pass on an investment with your company prior to going public if, afterwards, the shareholder float is neither large nor developed. Further, it is argued that a reverse merger results in an <u>active</u> and <u>meaningful</u> trading market commencing immediately following completion of the transaction and regulatory approvals.

This argument requires some careful analysis. While there are always exceptions, the actual percentage of shares owned by public shareholders with no affiliation to the company, or its principals and promoters, is typically very small – maybe two or three percent, so perhaps one to two percent is actually being traded by public. Everything else is controlled by the principals and the typical terms might be delivery of up to 95% of the shares, give or take a percent or two. In some cases, virtually all the float is controlled, directly or indirectly, by insiders. In fact, a colleague recently advised me that someone was selling a shell and was able to deliver 100% of the shares if requested. Hundreds of thousands of dollars for a shell with a symbol only and no real trading market?

So does the argument mentioned earlier - that a shell combination results in an active and meaningful trading market – really end up being valid? It may certainly be "active" since you have long-time shareholders who invested in a different company and who have been hoping for a way to cash out, especially when they see a bit of movement in the price of the stock resulting from optimistic merger press releases. True, some may stay in to see how the new company works out but many of these hopefuls will also be tempted to dump their shares the moment the new company's plans fail to materialize as fast as these shareholders expect (often unreasonably).

The question regarding whether the trading market is "meaningful" depends on who you ask. The fact that there is a trading market is a positive in general terms however there is often a good bit of insider trading going on initially. If you ask an institutional investor whether two percent is meaningful and demonstrates a trading market with depth, I am fairly certain the answer is no, unless the investor is not a long-term institutional investor and, instead, is an investor whose goal is to flip blocks of shares up to the limits allowed once they are registered – actions highly likely to depress the per share price with a thinly-traded stock.

<u>Self-Filings</u>. As an executive of your company, the question you may wish to ask yourself is whether such a thinly-traded and essentially illusory market is worth a half million dollars to you, give or take some. Everyone around you will be looking to make money on the stock market with the company's shares when everything is underway. Due diligence with a shell is a major undertaking and it is often extremely difficult to tell who all of your shareholders are because of ownership in street name, untraceable ownership entities and so forth. It is not uncommon for shell combination companies to watch their stock rise and fall drastically from unknown parties taking short positions and generally affecting the price of a company's stock much more than the company's activities or when there has been no change at all.

What is truly in the interest of your company is the growing of your business. A self-filing means that you know who your shareholders are because your company grows organically. In fact, 40-50 shareholders are all you really need to begin trading and you build from there. Sometimes we'll do a Regulation D offering or similar private placement immediately before the self-filing to secure some funds and increase the number of shareholders if needed. You may find that it is not that difficult to reach the requisite number of shareholders needed for a public float. You may also find that "meaningful" trading is more likely to come from a base of shareholders who have invested because of the business plan and management of the company rather than a base of shareholders who invested in the past in business of a different company or who have invested recently solely as speculators (nothing wrong with any of that of course but the focus here is on the stability of your public shareholder base).

Once again, I can't speak for other law firms, but we can introduce our self-filing clients to a team of market makers, investor relations and PR companies, and transfer agents that can assist our clients in their efforts to build their shareholder base in an organized and professional manner. (You would of course discuss your company directly with these firms so that you can mutually decide whether you have a good fit.) If you don't have one already, you can also bring in a Wall Street-savvy officer or investment banker to help establish your presence in the market and introduce your company to new investors.

3. Little Difference in Timing

Reverse Mergers. One of the benefits conventionally attributed to reverse mergers is speed when compared to IPO's. Indeed, IPO's take much longer to complete than reverse mergers, or self-filings for that matter (an often-used rule of thumb for IPO transactions is 9-12 months, although that varies of course). Not only are you dealing with a more complex filing but you are dealing with other parties, like syndicates of underwriters and their counsel, which involve wholly separate negotiations, due diligence and various agreements and expenses, even before you can commence the filing process for the IPO with the SEC. These factors are not present when filing directly with the SEC.

A proper comparison of the timing differences between a self-filing and a reverse merger can only be accomplished by looking at each transaction in its entirety. A reverse merger can easily take you, as an executive of your company, several months or more. From the point you make the decision, you have to go about the task of finding candidates for a merger. You will likely talk to several sources including investment bankers and brokers. Many of them are professionals with a track record of successful reverse merger transactions and they can provide good advice and experience with their services. Assume that at some point in the process you have located two shell companies and you begin to analyze whether one of these is the right company, with the right principals, to merge with your company. The principals with both shells have represented that their shell is "clean" and the transaction is very straightforward. You will begin to negotiate the price to be paid in cash, the equity of your company to be transferred to shell insiders, the proposed capitalization, including any required stock splits, and similar issues.

At this point, your attorneys will have to commence serious and detailed due diligence with respect to the shells. Did they have a bona fide, fully-operating business when they first went public or would the SEC view them as "Footnote 32" companies? How did the shell become reporting? What were the past circumstances with all past share issuances and does a complete shareholder transfer register exist? What about non-disclosed liabilities? These and other important due diligence items may not seem crucial with respect to the actual closing of a reverse merger and becoming public. The real problems might arise if you have promised investors that you will register their shares promptly following the merger because the registration of shares for sale to the public prompts the SEC to take a closer look at items such as the validity of registrations or exemptions relied on by the company with respect to shares already issued by the company as reflected in the registration statement under review.

Performing thorough due diligence on shells is not an easy task, and is the subject for an entire article on its own. Your attorneys will spend significant time performing a proper due diligence review and, if you are lucky, one of the shells will pass muster. Sadly, the likelihood is that you will have to look at other shells and go through the entire process again before finding one that you and your attorneys are comfortable with. There is often a search for funding at the same time (after all, the reverse merger is going to have a big price tag) and you may find that an investor prefers a different structure or has its own shell so you have to stay uncommitted to a certain extent. I have seen this dynamic play out for months at a time with the company relying on third parties, never being fully in charge of the process and more often than not unable to work out terms it prefers. Often, by that point, a company imposes on itself an urgency to complete a deal. It is so far down the road with so much invested in the process, in time and expenses, that it has difficulty backing out and is saddled with terms it would ordinarily reject.

At the same time, you will have to work with your attorneys so that they can draft the company's "Super 8-K" filing (so-called because of the substantial amount of information now required in a filing for a reverse merger), draft merger documents, make filings with the state, and so forth. You will also be working with your accountants so your company will have audited financial statements. In fact, getting final audited statements can often take longer than virtually everything else.

<u>Self-Filings</u>. So - the reverse merger process from beginning to end can easily take several months, if not more. On the other hand, it may only take only one to two months longer, if that, to complete a self-filing. (Our firm will generally quote four to five months but we have been successful in obtaining SEC approval for many of our self-filing clients in less time.) During this period, you would have more direct control over the process and the timeline and will not be relying on third parties to the extent generally necessary for a successful shell merger. Instead of qualifying merger candidates and negotiating different terms with different parties, a self-filer can spend that time concentrating on funding and running the business. As an aside, our firm works with several different SEC accountants who are accustomed to dealing with small public companies on a fast-track basis and at a very competitive cost. If they wish, our self-filing clients can speak directly to these firms to discuss their needs.

4. <u>Companies Formed from Reverse Mergers Need to Remain Current Forever</u>

<u>Reverse Mergers</u>. One of the most significant problems faced by any reverse merger company, or <u>any company that has ever been a shell</u>, has resulted from the SEC's recent rulemaking with respect to Rule 144.

Since 2000, no resales of shares issued in connection with a reverse merger with a shell were permitted without registration of the <u>shares</u> (as opposed to registration of the company) with the SEC. This was applicable to <u>all</u> holders of restricted and non-restricted shares of trading shells and non-trading shells, regardless of whether they were reporting or non-reporting (I'll refer to all of these categories of holders, including those of operating companies that have ever been shells, as "Shell Stockholders"). With a release issued by the SEC in December 2007, the SEC reversed its "registration or hold" policy with respect to shell transactions and opened a window slightly for Shell Stockholders. Upon the February 15, 2008 effective date of the release, a Shell Stockholder became able to resell securities in reliance on Rule 144 if the issuer of the securities has ceased to be a shell and at least one year has elapsed from the time the issuer filed current Form 10 type information with the SEC reflecting its non-shell status. The issuer must also have filed all reports and material required to be filed under Section 13 or 15(d) of the Securities Exchange Act, as applicable, during the preceding 12 months.

While the SEC has offered some limited liquidity to Shell Stockholders – and that was good news in view of the prior no-sale rule – the SEC mandated at the same time that the company <u>must</u> remain current in its reporting requirements, essentially forever, if its shareholders ever desire to sell their shares after the initial 12 months of reporting. If for any reason the issuer falls behind in its reporting filings, its shareholders would be unable to avail themselves of Rule 144 regardless of how long they have held their shares. It is far from clear what is required for a non-current reverse merged company before reliance on Rule 144 is once again possible but a strict reading of the release could require another 12 months of uninterrupted current filings before unregistered shares might once again be sold in reliance on the rule.

Further, while there are efforts among private practitioners to get the SEC to relent from this treatment (e.g. perhaps if it has been a number of years since the termination of the company's status as a shell or some other arbitrary factor) there is still no further revision or interpretation to rely on and no way to tell when or if such a change will be forthcoming. Despite the consternation in the reverse merger industry in 2000 with the SEC's prohibition of all sales without registration, it took eight years for the SEC to loosen the grip slightly.

<u>Self-Filings</u>. This is not an issue with a company that has self-filed with the SEC because it was never a shell company and does not have the associated limitations placed on it. Not only can holders of unregistered shares sell their shares without concerns regarding any potential lags in reporting filings, their holding period is only six months after completion of the filing with the SEC.

5. <u>Difficulties in Removing Stock Certificate Restrictive Legends</u>

<u>Reverse Mergers</u>. While Shell Stockholders may now have the right to have restrictive legends removed after their company has become an operating company and has been reporting for at least 12 months, actually accomplishing the legend removal has become more problematic (and, in some cases, impossible). Since the reporting filings of a company must be perpetually current, attorneys (who must render opinions of counsel that a restrictive legend may be removed) and transfer agents (who must cancel the share certificates on behalf of the company and reissue non-legend free trading shares) are simply unable to do what is normally done for companies that have never been shell companies.

Traditionally, a shareholder may request that a legend be removed after the expiration of the applicable waiting period and a process involving the company, its counsel and the shareholder's broker begins and finally culminates with the request made to the transfer agent. Once the restrictive legend on the share certificate is removed, the shares become freely tradable from that point forward. In the case of shares of a Shell Stockholder's shares, an opinion of counsel cannot be issued to remove the legend indefinitely because, while the company may be current in its reporting on the date of the opinion, there can be no assurance that the former shell company will be current in its reporting at the time the shareholder desires to sell the shares, as is required by the SEC.

There are ways to draft Rule 144 opinions artfully to deal these new hurdles but if not done correctly, you may face problems at the transfer agent stage. Many transfer agents hesitate to lift the restrictive legend in close cases because, even if the company is current in its reporting on the date the legend removal is requested, if the transfer agent removes the legend it is possible that the former shell company will not be current in its reporting at the time the shareholder actually decides to sell the shares in the future. In such case, the transfer agent does not want the liability of having removed a legend from a certificate which would enable the shareholder to sell the stock without compliance with Rule 144.

<u>Self-Filings</u>. Once again, a company that files directly with the SEC has none of the foregoing issues with respect to removal of restrictive legend because it became public through the front door with a direct filing. When a shareholder desires to sell his unregistered shares after the six month holding period, he or she uses the traditional legend removal process and the transfer agent cancels the old certificate and issues a new, free-trading certificate to the shareholder for deposit with a brokerage firm.

6. <u>Private Financing Substantially Complicated</u>

<u>Reverse Mergers</u>. Obtaining new financing for a company that has ever been a shell has also been substantially complicated. Financing obtained through a PIPE (private investment in public equity) and similar private funding will include "registration rights." The company is typically required to complete and file a registration statement registering the investor's shares so that they become free-trading as soon as possible after the investment. The company is also typically required by the investment documents to keep the registration of the investor's shares <u>effective until the earlier of</u> (i) the sale of all shares that were registered by the company for the investor, or (ii) such time as the holder of the shares can sell in reliance on Rule 144. In the case of a former shell company, the holder will face the new, more encumbered regime of restrictive legend removal and will likely rely strongly on the Company's pledge to keep the registration effective (possibly for years). The former shell company in need of financing may find itself in an untenable position. It must either agree to maintain the effectiveness of the registration indefinitely (at significant financial, administrative and operational costs and at the risk of facing stiff penalties under the registration rights provisions) or negotiate terms from a weaker position and give up more to escape the onerous requirements of maintaining an effective registration for years.

<u>Self-Filings</u>. These difficult issues do not exist if your company self-files. While you will agree to register the investor's common stock to the extent permitted by SEC guidelines, six months is the limit of your liability to maintain the effectiveness of the registration

statement. After six months, investor shares will not require registration because the investor can secure an appropriate opinion of counsel and have the restrictive legends on their shares removed through cancellation of the legend certificates and reissuance of clean certificates by the transfer agent.

Conclusion

There are indeed compelling reasons to consider self-filing as an IPO alternative but remember that this article only addresses this complicated area in very general terms. If your company is currently considering your options or long-term strategies in this regard, we'd be pleased to discuss them with you. Be sure to send me an e-mail and let me know if this article was helpful to you or if you would like to learn more about how we can assist you in your ventures.

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