

Skeletons in the Closet

Nine Steps to Unearthing a Dirty Shell

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Shell company due diligence is a key element in any reverse merger transaction. If there are problems with the shell, you shouldn't do the deal. However, the basic difficulty with shells is that you can never really know what happened in their past. There may be skeletons hidden so deep in the closet and so far off the record that you can never find them—no matter how long and hard you look. To get the most complete story of a shell company, you often have to use unorthodox methods before beginning traditional corporation finance due diligence.

The Intangibles

In the first phase of my shell due diligence, I focus primarily on intangible factors unrelated to the shell itself. I'm examining the players involved on the shell side of transaction and their past track record. My theory is that if I am satisfied with the background of the people involved with the shell, it is much less likely that there will be any unpleasant surprises further down the road. I only move forward with my due diligence of the shell company itself, if I am satisfied with the players.

Step 1. Know who you're dealing with.

If you have been in the reverse merger business for some time, you will know or have heard of most of the reputable attorneys and accountants in the business. It's generally a positive sign if professionals I know and trust from past experience are on the other side of the shell transaction. I'll call them and get the real scoop on this particular shell and the promoters and principals involved.

Of course, there are transactions where I don't know the shell's professionals. In this case, I call attorneys and accountants that I do know to get a lead. If no one knows anyone on the other side of the transaction, that's not a positive sign, but I continue on by running their names through Google and EDGAR to see if anything shows up one way or another.

Step 2. Hire an investigator.

If I am still concerned, or my client requests, I spend the money and have an independent search firm do a background, litigation and liability check on the shell promoters and principals. I also have the search firm simultaneously run a litigation and liability check on the shell itself.

When you are paying hundreds of thousands of dollars for a shell, the cost of a formal search firm investigation is minor compared to the potential benefit of information that might be discovered.

Step 3. Muckrake a shell promoter's past deals.

In this step, I put together a list of deals that a shell's promoters and principals have been involved in over the past several years to look for any questionable signs.

Any shell that came into existence through a spin off is extremely suspect.

The first thing I review is trading history surrounding the mergers. A spike in trading activity just before a merger

announcement is a negative sign, as is lots of trading activity and downward pressure after a deal is closed. I also pay attention to any press releases distributed near to the time of a merger—who distributed them and how accurate were they?

I also identify the principals of the private companies that merged with these prior shells. I'll call and ask them what they thought of the transactions and the shell promoters and principals after the reverse mergers had closed and all the dust had settled.

Step 4. Be wary of failed deals.

I always ask my contacts if they have seen this deal before. In today's hot shell market, any shell that has been shopped and not sold for several months or more or has had a potential merger break down is a bad omen. I dig further and try to find out why.

Step 5. Follow the money.

I always want to know how the person that brought me the deal found this shell. Are there any intermediaries or finders involved in any way? If so, are they getting any form of compensation if we acquire or merge with the shell?

The Securities and Exchange Commission's position on this issue is quite clear. Any intermediaries or finders who are getting any form of compensation in a shell reverse merger transaction are violating federal securities laws if they are not registered broker/dealers. (See SEC Releases 34-43708 - 43713, Dec. 12, 2000.)

The Financials

Financial filings are an important source of information on a reporting shell company. The lack of audited financial statements can kill a deal, and not just because they're not worth the paper they're printed on. If the shell is non-reporting or trading only on the Pink Sheets, the inability to secure an audit will doom any attempt to move the post-merger company up to the OTC Bulletin Board and beyond. If I want to move forward with this type of shell and eventually trade on the OTC Bulletin Board, I consult with a Public Company Accounting Oversight Board (PCAOB) member accounting firm and confirm that they can deliver the required audits to get the company reporting after the deal closes.

If the shell company is not reporting or trading and the private company just wants to get to the Pinks, remember the NASD will require GAAP financials as part of filing a Form 211, which a market maker must submit in order for the company to trade.

Step 6. Review prime sections in filings.

Form 10-K and 10-Q filings are filled to the brim with important clues about a shell company. I pay close attention to the management discussion and analysis sections and spend lots of time with the financial statement footnotes, because that's where the really good stuff is usually located. For example, options, warrants, convertible securities and agreements to issue securities may be hard to locate in a due diligence investigation, but they have to be disclosed in the financial statement footnotes.

There's another goldmine in financial statements: management letters. Every year in the audit process, the auditors write company management about deficiencies and related issues and the management responds. There may be negative signs found in them that don't appear on the face of the financial statements or in footnotes.

I make a particular point to look at Section 16 and the internal control reporting compliance disclosures in financial filings because they reveal the character of the shell and its principals in addition to other factual information about the shell.

I also look for ownership issues, such as disclosure of any proposed or anticipated change in control transactions and any voting trusts or similar combined voting agreements, both of which are required to be disclosed in the "Security

Ownership of Certain Beneficial Owners and Management" section of filings. Schedule 13D's also disclose similar information.

Ownership reports can help determine how much the parties selling the shell paid for it—a figure that can prove quite difficult to discover otherwise. The terms of acquiring a controlling interest in a shell are not required to be included in a change of control Form 8-K because the transaction involves individual sellers and individual buyers, and the company is generally not a party to the transaction. However, if the company is a 12(g) reporting company, the sellers will have had to

file a Form 4 disclosing the price per share they received for sale of their controlling interest, hence the price paid for a controlling interest.

Finally, I ask for SEC and NASD comment

letters and responses, which can often yield an interesting correspondence containing information not available elsewhere.

Step 7. Look out for Worm/Wulff stock.

Stock transfer ledgers can indicate if a shell has restricted stock. I obtain the stock transfer ledger and review all stock issuances and transfers back to the inception of the shell. I'm looking to see if the shell has any Worm/Wulff stock, and, if so, that the stock is identified as restricted until registered and thus Rule 144 ineligible. This won't necessarily kill the deal, unless I see transfers done in contravention of the Worm/Wulff guidelines, in which case I won't proceed with the deal.

Absent any such transfers, I just have to make sure I take into consideration the fact that these shares exist if the merger is completed. For example, if I plan to obtain an OTC Bulletin Board ticker symbol, and most if not all of the shell's stock is subject to Worm/Wulff, Rule 144 isn't available. I may have to register this selling stockholder stock on a Form S-1 or SB-2 after the reverse merger to get enough shareholders with enough free-trading stock required for the ticker symbol.

Next, I review transfers of unregistered securities. I want to see all supporting legal opinions and Rule 144 paperwork. Would I have given this opinion based on these facts? If not, it's a negative sign. If the shell trades on the Pink Sheets, I am particularly interested in how the shell obtained a trading symbol. Did the NASD issue the symbol or did the shell acquire the symbol on the gray market by having market makers post quotes? Gray market shells demand special scrutiny because no regulatory authority has examined how the sup-

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posedly free-trading shares came to exist. I request the legal opinion concerning the free-trading status of the shares. If I wouldn't have given the opinion, the stock isn't really free trading and the shell's ticker symbol may be invalid, in my estimation.

Any shell that came into existence through a spin off is also extremely suspect. I again request the legal opinion concerning the free-trading status of the shares and examine the transaction for adherence to the requirements for free-trading stock in spin-offs as set forth in the SEC's Staff Legal Bulletin 4 from Sept. 16, 1997. Most pink sheet spin-offs, and indeed many other spin-offs, fail to meet the valid business purpose test requirements set out in the SLB 4, which states that when there is a valid business purpose for a spin-off, it is less likely that the parent indirectly will receive value for the spun-off shares through the creation of a market in those securities.

Step 8. Begin traditional corporation finance diligence.

If I've made it this far, I will perform all the traditional corporation finance due diligence generally undertaken in connection with a 1933 Act registration statement. However, in shell due diligence, I'm particularly focused on corporate organization, corporate contracts, commitments and obligations, and tax issues.

I obtain and review the corporate minute book, including articles, by-laws and minutes. I make sure the corporation is in good standing. I review all entries on the state of incorporation's corporate database website to make sure the shell I'm doing due diligence on is in fact the right one. One of my attorney friends tells of double checking the date of formation in the shell's articles of incorporation against the date of formation in the state's records. It turned out to be a case of identity theft in which the shell he was looking at had taken over the name of a previously defunct company in that state. The real shell was the old defunct company. The new shell did not have any of the claimed characteristics that existed in the defunct shell, such as shareholders.

I also do the standard review of all past corporate contracts, commitments and obligations that may have existed at any time in the shell's life. If the shell isn't supposed to have any now, I want to make sure they really don't. I look for any evidence that a shell may have been involved in any activity or

property ownership that could create potential environmental liability down the road.

Sometimes shell companies forget to file tax returns. Sometimes the tax returns are inconsistent with the financial statements or other things I have found in the previous due diligence steps. Either is a negative sign. I don't just look at federal and state income tax returns. If the shell ever had employees, I check to see that all payroll taxes have been paid. I also check to see if other types of taxes such as property taxes or intangible taxes were paid.

Step 9. Determine what SEC filings are required for a merger.

Will the shell have to seek shareholder approval for an increase in authorized shares, a reverse split, a change in corporate domicile or other similar matters before the reverse merger can close?

If the shell is a 12(g) company and the merger is announced, the SEC will require most of the Form 10 information, including audited and pro-forma financial statements, to be included in the Schedule 14A or 14C required for these actions. This will materially slow down the process as, unlike the post-merger "Super 8-K," which is not reviewed in advance of the merger closing, the information in a 14A or 14C is reviewed in advance and is subject to comments. On top of the time it takes to clear comments, there is also the 20-day closing date wait imposed by the 14A and 14C rules.

If my client is closing a merger instead of just purchasing control, I double check to make sure everyone is on board to meet the Super 8-K disclosure and financial statement requirements on a timely basis.

Just as there is no certainty in life, there is no certainty in shell due diligence. If I haven't discovered any skeletons in the closet and I still have a warm and fuzzy feeling about the transaction after completing these steps, I can proceed with as high a degree of confidence as one can ever have in a shell reverse merger transaction.

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