The Alchemy of Restricted Securities

The Quest for Free Trading Shares

by Michael T. Williams, The Williams Law Group

In recent history, promoters of public shell companies have launched a variety of crusades in their quest to secure the holy grail of reverse merger transactions: securities that can be transferred free and clear of all restrictions under federal securities laws, commonly called free trading securities.

Shell promoters have used the following three types of shell companies in their quest:

- An Original Public Shell: A company that had a real business when the company went public but thereafter the business became defunct.
- A Blank Check Company Shell: A development stage company that: (i) has no specific business plan or purpose or has indicated its business plan is to engage in a merger or acquisition with an unidentified company, and (ii) is deemed to be an issuer of penny stock in that, among other potential reasons, it has less than $5 million in stockholders' equity.
- An SEC-Defined Public Shell: A company with no or nominal operations and no or nominal non-cash assets.

Although generically called "reverse mergers," transactions between a private company and a shell company with the ultimate purpose of making the private company a public company can involve any type of business combination.

Unlike the crusades of old, which were primarily undertaken for religious purposes, the recent crusades of shell company promoters are economically motivated. Shell company reverse mergers that involve free trading securities have proven to have more value to promoters than those that don't. Shareholders prefer to own free-trading rather than restricted securities. This article will examine the successes and failures of the various crusades of shell company promoters and shareholders in their quest to locate their holy grail of free trading securities.

Pre-Merger Free Trading Shells

In the earliest attempt to create pre-reverse merger shell company free trading securities in the '80s and '90s, promoters either sold shares under Rule 504 or registered securities of shell companies with the Securities and Exchange Commission, making the shell company's securities free trading prior to the closing of a reverse merger. These deals were thwarted by the SEC when it amended Rule 504 in 1999 to restrict the issuance of free trading shares to very limited situations. With respect to registrations, the SEC effectively outlawed the practice by adopting Rule 419 concerning blank check shell companies in 1992.

Promoters soon began using a different route. Rather than registering shell company securities, the promoters had shell companies issue their securities in non-registered, private placement transactions. The promoters took the position that these securities became free trading under SEC rules two years after they were issued, even before the closing of a reverse merger. In early 2000, in what is known as the Worm/Wulff Letters, the SEC quashed these deals by taking the position that private placement shell securities owned by both insiders and affiliates, as well as non-affiliates, no matter how acquired, may not be resold as free trading securities, absent registration, both before and after a reverse merger is completed. This has been confirmed in subsequent NASD Notices to Members.

Undaunted, shell company promoters began a new quest by again trying to register shell company securities, this time using a non-blank check shell company and a special SEC form designed for registration of securities issued by an employee benefit plan. Once again, the SEC stepped in by taking the position that shell companies are prohibited from using this form to register securities and thus have their securities become free trading in this manner (Release 33-8587, "Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies.")

Finally, however, shell company promoters found a back door leading straight to their holy grail. Again they used the process of registration of shell company securities with the SEC, but in this attempt they utilized a special kind of a shell company called a specified purpose acquisition company. By registering sufficient securities that a SPAC had stockholders' equity of $5 million or more following the closing of the offering, SPACs didn't fall under the SEC's definition of a blank check company. Thus, although subject to many of the same business combination restrictions as blank check shell companies, with SPACs, shell company promoters finally secured the holy grail of shell companies with pre-reverse merger free trading securities.

Mythical Free Trading Securities in Shell Reverse Mergers

Several failed attempts by shell company promoters have been based upon a sound premise: Shareholders can own pre-reverse merger free trading securities in an original shell company if the securities were acquired in a real capital formation transaction from the company when it had a real business, or as the company's business had begun to become defunct. However, shell promoters' crusades grounded upon this type of free trading securities failed because the shell company promoters took a wrong turn and went down either the "round up" path or the "I'm not an affiliate anymore" path, both of which ultimately led to the destruction of the free trading status of these securities.

Shell company reverse mergers that involve free trading securities have proven to have more value to shell company promoters than those that don't.

In the "round up" transaction structure, shell company promoters generally do some variation of the following:

- Round up stock certificates from non-insider, non-affiliate shell shareholders who own free trading securities in the shell, as described above;
- Secure stock powers in blank with medallion guarantees from these shareholders for the transfer of these securities;
- Bring these share certificates and stock powers to the closing of the reverse merger all together in a package;
- Present this package of stock certificates and stock powers simultaneously to the incoming parties in a reverse merger; and
- Tell the incoming parties receiving these securities that they now own free trading securities because the securities being transferred to them were free trading securities owned by a non-insider, non-affiliate of the shell company.

What the incoming parties are being told is not correct. In this transaction structure, the sellers are transformed into affiliates and thus the securities they are transferring are not free trading.

The class of persons deemed affiliates at the time of securities transfers is not limited to officers, directors and more than 10% shareholders of a company. Under the SEC's definition of "affiliate," the class of persons who meet the definition is much broader in that an affiliate of an issuer is a person that directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with, such issuer. The percentage of a company's voting securities a person owns, although an indicia of affiliate status, is not a part of this definition. The determining factor of whether or not a shareholder is deemed an affiliate at the time of a securities transfer is control of the transferring shareholder by the company or its intermediaries such as shell company promoters.

In the round up structure, the securities from all these non-insider shell shareholders that were rounded up by the shell company promoters are not being transferred in an unrelated series of non-directed, non-controlled individual transactions by these non-insider shareholders. Quite the opposite, these securities are being transferred as part of a single simultaneous transaction undertaken at the direction and control of the shell company promoters or other insiders who rounded up these securities. For the purpose of this transaction, the non-affiliates have become controlled by the company or its shell promoter intermediaries and thus have become affiliates. Therefore, their securities may not legally be transferred as free trading securities. Any claim that the securities being transferred are free trading is just a myth.

There is not much SEC guidance on this issue, perhaps because the answer seems so clear-cut. However, the SEC did confirm this conclusion in the matter of Jacob Wonsover (Admin. Proc. File No. 3-8584, Rel. No. 41123, March 1, 1999.)

The "I'm not an affiliate anymore" transaction structure is based upon the fact that most reverse mergers are structured so that insiders or affiliates in the shell company are no longer insiders or affiliates after the reverse merger closes. Normally, these persons will own free trading securities: (i) if they acquired their securities in an original shell company before that company's business became defunct, and (ii) if they have held their securities for two years or more on or before a date 90 days after they cease to be insiders or affiliates.

In this transaction structure, promoters arrange for agreements or understandings which provide that more than 90 days after the reverse merger closes, former insiders and affiliates will sell to the incoming parties some or all of former insiders' and affiliates' securities retained following the closing. The promoters again tell the incoming parties that the securities they are receiving are free trading. However, once again what the incoming parties are being told is not correct.

The SEC's position on this type of transfer is clear. In the SEC Division of Corporation Finance's *Manual of Publicly*

Available Telephone Interpretations, the SEC staff indicated that if an affiliate enters into a binding contract for the sale of restricted securities within three months after ceasing to be an affiliate, the affiliate's securities may not be transferred as free trading, even if the delivery of the securities takes place more than three months after such person loses affiliate status, when these securities might otherwise be considered free trading.

Accordingly, in the "I'm not an affiliate anymore" transaction, because agreements or understandings to transfer securities are made by or on behalf or insiders or affiliates earlier than 90 days after the reverse merger closes, the insiders' and affiliates' securities are not eligible to be transferred as free trading securities. Any claim that free trading securities are being transferred in this transaction is another myth.

Post-Merger Free Trading Securities

Normally, non-insider, non-affiliate shareholders in the private company that is merging with the shell company who have held their securities for at least two years do not have to embark upon a quest: They already own fully free trading securities. However, once again, because of SEC rules related to transaction structure, their fully free trading securities become transformed into restricted securities following the reverse merger.

The SEC considers the issuance of shell company shares to the incoming shareholders of a private company in a reverse merger to be a brand new sale of securities to the incoming shareholders. Therefore, absent registration, the two-year waiting period for fully free trading securities under SEC regulations starts all over again for these shareholders on the date of closing of the reverse merger.

What are these shareholders to do if they want fully free trading securities but don't want to wait until the new holding period has elapsed? They can shorten the period by having some or all of their securities registered with the SEC.

What happens to those poor Worm/Wulff shell shareholders? After the closing of a reverse merger with their shell, they too can have some or all of their securities become free trading through inclusion in an SEC registration statement. Of course, if they remain insiders or affiliates of the surviving company after the reverse merger closes, their securities would still remain restricted.

In addition, following the closing of a reverse merger, former shell companies can legally issue free trading securities under the employee benefit plan registration form to persons eligible to receive such securities the latter of: (i) 60 days after the company ceased to be an SEC-defined shell company; or (ii) 60 days after the SEC-defined shell company has filed all disclosure and financial information now required by the SEC to be filed within four days of the closing of a reverse merger.

Taking Reverse Merger Securities Offshore

There is much current interest in securities transactions involving citizens or residents of the offshore "BRIC" countries of Brazil, Russia, India and China. Under U.S. federal securities laws and regulations, shell company reverse merger securities sold or resold to citizens or residents of BRIC and other foreign countries or resold within such foreign countries are always free trading. This free trading status is a result of the sale and resale of these securities in these offshore transactions being covered by Regulation S, the SEC regulation that governs offshore securities transactions.

Securities sold in covered offshore transactions are—subject to a very short holding period—free trading whether or not the company is a shell company, the seller is an insider or affiliate, or the reverse merger has closed. However, a citizen or resident of a BRIC or other foreign country who acquires these securities in this type of a qualifying offshore transaction will find their stock certificates legended in a manner that requires any subsequent resale of these securities back into the U.S. to be subject to the same provisions and restrictions concerning pre- and post-reverse merger shell company securities described previously.

Michael T. Williams is the principal of Tampa, Fla.-based Williams Law Group. He represents clients primarily in going-public transactions, directly or through reverse mergers, and SEC compliance matters. He may be reached at wmslaw@tampabay.rr.com