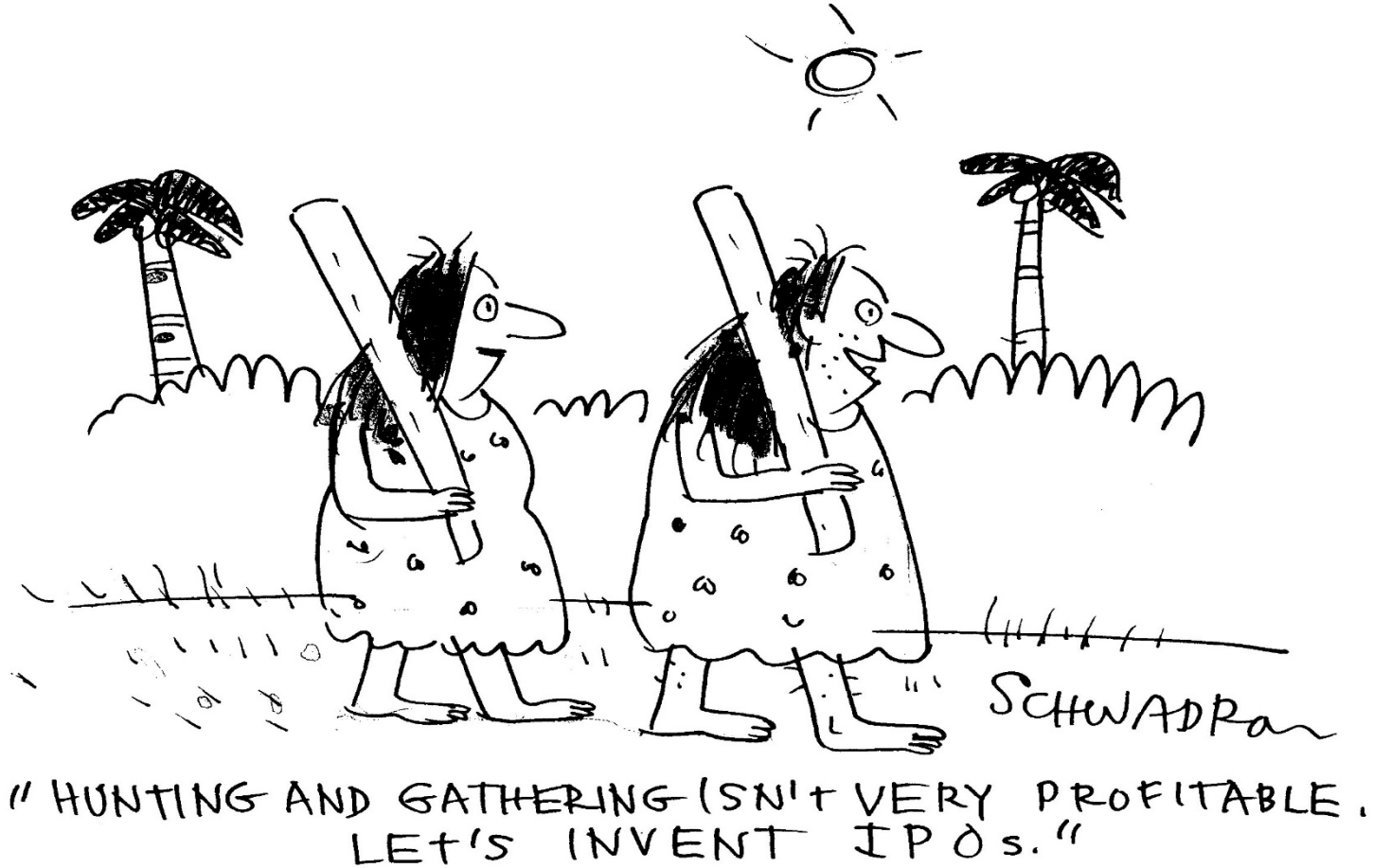


# Reverse Mergers

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Ellenoff Grossman & Schole LLP is a New York City-based law firm comprised of more than 65 professionals (30+ Securities Lawyers), offering its clients legal services in a broad range of business related corporate and litigation matters. Founded in 1992, the Firm specializes in many areas of commercial law, including corporate and securities '33 Act and '34 Act representation (we represent nearly 65 public companies in various industries: biotechnology, medical devices, information technology, financial services, alternative energy, shipping, consumer products and business services throughout the world – including China, Greece, India and Israel), Reverse Mergers, PIPEs, SPACs, Crowdfunding, M&A, Hedge Fund Formation and Regulation; Broker-Dealer Regulation, transactional Real Estate (leasing, financing and buy/sell); Taxation; Intellectual Property; Regulatory Defense and commercial Litigation.

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# Barry I. Grossman

- Barry I. Grossman, a member of Ellenoff Grossman & Schole since its founding in 1992, is a corporate/tax attorney who specializes in business transactions, corporate finance and associated tax matters. Mr. Grossman's practice focuses on representing both foreign and domestic public and private companies in connection with their financing activities, regulatory compliance, as well as general corporate matters. Mr. Grossman's transactional experience includes public and private financings, structuring sales and acquisitions of companies, mergers and reorganizations, and organizing partnerships/limited liability companies. As a member of Ellenoff Grossman & Schole LLP, he has been involved in numerous public offerings for domestic and foreign entities (including pool offerings or SPACs which have raised more than \$1.5 billion), reverse mergers for domestic and foreign companies, private placements, many into public companies (commonly referred to as PIPEs) and crowdfunding. In connection with financings Mr. Grossman has represented issuers and underwriters in initial public offerings, secondary public offerings, and other various public financing (such as, at the market, registered direct confidentially marketed public offerings) and private debt and equity financings. Mr. Grossman's clients include a variety of industries including shipping, bio-tech, medical devices, technology, mining and natural resource, FINRA members and other companies involved in the financial sector. Mr. Grossman has represented a broad range of foreign companies including Greek, Chinese, Israeli, Indian and Korean entities.

# Methods to Become A Publicly Traded Company in the United States

- Initial Public Offerings (IPOs)
- Reverse Mergers (RTOs/APOs)
- Self Underwritings
- Form 10 Filing
- Special Purpose Acquisition Companies (SPACs)

# Initial Public Offerings

- Traditional IPO Structure
- Finding an Underwriter
  - Business Plan/Projections
  - Execution of Engagement Agreement
- Registration Statement Process – SEC
  - Generally takes between six and nine months
  - Very expensive
  - No certainty of success

# Results Of An IPO

- Capital Infusion
- Ability to Immediately List on National Exchange in the US
- Freely-Trading Shares
- Stock Price Supported by Underwriter
- Research
- Perception

# Self-Filings, Form 10 Filings, SPACs

## Self-Filings

- Self-underwriting without the assistance of a professional broker, firm or intermediary (requires an S-1 filing)
  - Generally takes three to six months and requires the Company to make all selling efforts
- No certainty of success

## Form 10 Filing

- Does not provide shareholders a public float
- Usually not associated with raising money

## Special Purpose Acquisition Companies (SPACs)

- Newly formed corporation by prominent sponsor/ management team in a particular geographic or market niche for the purpose of raising capital in an IPO in anticipation of identifying and consummating a business combination
- Delivery of Trust amount uncertain

# Corporate Responsibility

- Conduct Internal Due Diligence
  - Organization Documents
  - Material Contracts
  - Liabilities (Litigation, Product Liability)
  - Employment Agreements
  - Intellectual Property
- Corporate Governance Structure – Committees
- Capital Structure
- Management Lock Ups
- Accounting Issues - GAAP



# Reverse Mergers

## Reverse Mergers

- Private Company Merges with Public Shell
  - Locating a “Clean” Shell
- No Underwriter, No Registration Statement, Etc.
  - Reduced Expenses, More Certainty – Self-Control
- Corporate Responsibility – Due Diligence

# The Shell Corporation

- Public Company No or Nominal Operations or Liabilities
    - may hold cash
  - How Did Shell Become a Shell?
  - Limited Liquidity/Freely Trading Stock
  - Due Diligence!!
  - Types of Shells
- (Form 10, Prior Operating Company)

# What is a Public Shell?

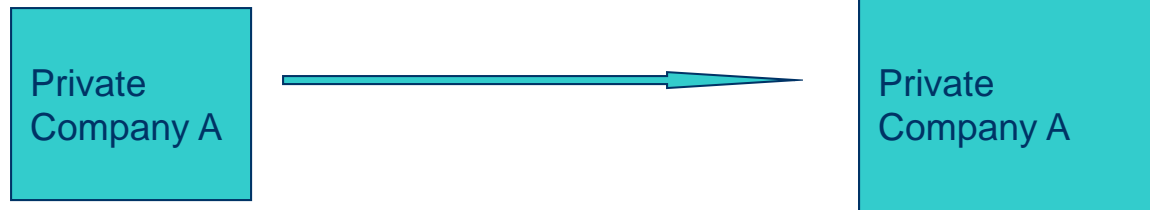
- **Types of Public Shell Companies:**
  - OTCBB Traded Shell
    - An operating company that became a shell (loss of operations, sale of subsidiaries, bankruptcy, etc.) but continues to be listed or quoted on the OTCBB
    - One year Seasoning Rule
  - SEC Reporting but Non-Trading Shell (e.g. Form 10 Shell)
    - A company formed for the purpose of becoming a shell
    - Is not listed or quoted but does comply with all '34 Act reporting requirements
    - Never had an operating business
  - Non-Reporting Shell (Pink Sheet Shell)
    - Is not listed or quoted and does not currently comply with '34 Act reporting requirements
    - Usually had an operating business but stopped reporting based on the number of shareholders of record
  - Nasdaq/AMEX Shells
    - Must requalify upon reverse merger
    - Technically non-existent
- **The type of public shell company used can alter the process and timing of consummating a reverse merger**

# Reverse Merger Process

- Shell Acquires 100% of Private Company
- Shell Shareholders Retain Small Percentage of Shell Company
- Private Company Becomes a Subsidiary of Public Company
- Super 8-K Filed (Similar to Registration Statement)  
- Audited Financials – US GAAP/IFRS
- Change Directors and Cap Structure  
(Forms 14F and 14C)

# Steps to a Reverse Merger

1. Public Shell creates a wholly-owned subsidiary
2. Stockholders of Private Company A negotiate with the controlling shareholders of the Public Shell in order to merge with the subsidiary
3. Private Company A merges into the subsidiary, usually with the Private Company surviving and shares of Public Shell issued to shareholders of Private Company A
  - Simultaneously with this transaction, the Public Shell can also conduct a PIPE (private placement)
  - A financing occurring simultaneously with (or immediately subsequent to) a reverse merger is referred to as an Alternative Public Offering
4. Private Company A becomes a wholly-owned subsidiary of the Public Shell with the controlling stockholders of Private Company A (and the PIPE investors collectively) usually owning 95% or more of the Public Shell and the shareholders of the Public Shell owning the remainder
  - Private Company A's management team becomes the directors and officers of the public company



# RTO vs. IPO

- More Certainty of Closing
- Quicker to Complete – 6 to 9 months versus less than 3 months
  - Merger Agreement
  - No Registration Statement
  - No SEC or Exchange Review Until Transaction Closes
- Lower Transaction Costs (accounting, legal and investment banker)
  - Shell Purchase – Equity or Cash
- No Underwriter – Limited Liquidity
- Liability Issues – Due Diligence
- OTCBB vs. National Exchange – Seasoning Rules
- Raising Capital – APO
- Financial Audit
- Disclosure – Registration Statement vs. Super 8 - K

# OTCBB or Exchange Traded Shell

- **Process**
  - Due diligence, Due Diligence and more Due Diligence
  - Negotiation of merger agreement (and financing terms if a simultaneous PIPE)
  - Schedule 14f-1 (10 days prior to closing) if change in control of the Board
  - Initial listing application for the combined entity (if an Exchange listed shell)
  - “Super” Form 8-K (with full audited financials) due within 4 days of closing
- **Timetable**
  - Generally takes between 1-3 months
    - Due Diligence and Audit of Private Company
- **Advantages**
  - Full disclosure
    - Exchanges require substantial disclosure to remain listed, making it easier to obtain and sift through all necessary disclosures
  - More investor friendly
    - More willing to invest because it is on an exchange (heightened governance and greater liquidity)
  - Already public
    - The Shell will have a shareholder base, a symbol, a market maker, will be DTC eligible, and will have been trading
- **Disadvantages**
  - Requires independent audit of combined company to be done at time of merger
  - Prior history of the shell company may be “messy”
  - Longest reverse merger process
  - More Expensive (legal, accounting and price of shell)

# Form 10 Shell

- **Process**
  - Some Due diligence
  - Negotiation of merger agreement (and financing terms if a simultaneous PIPE)
  - Schedule 14f-1 (10 days prior to closing)
  - “Super” Form 8-K (with full audited financials) due within 4 days of closing
- **Timetable**
  - Generally faster than exchange traded shells because the due diligence process is faster (Form 10 shells have fewer disclosures, documents and potential liabilities because they never had an operating business)
- **Advantages**
  - Quicker due diligence
  - Fewer surprises
  - Less expensive
  - Ability to adjust capitalization table
- **Disadvantages**
  - Non-trading – No Liquidity
  - Not DTC eligible
  - Potential prior history of shell promoters
  - Smaller shareholder base
  - No market maker



# Reverse Merger Process

- Phase One: Company Internal Preparation
- Phase Two: Due Diligence and Negotiation of Acquisition Terms
- Phase Three: Closing the Reverse Merger

# Phase One: Company Internal Preparation

Often the most time consuming and complex piece of the Reverse Merger process

- Locate a Suitable Public Shell
- U.S. Securities Counsel and qualified Independent Auditors
- Financial Staff
  - Organize a team of financial experts to support public audits and filings
- Financial Audits
  - Obtain SEC qualified audited financial statements of both the private company and the shell for at least the last two fiscal years or the date of organization if less than two years
  - The financial statements of the private company will need to be consolidated with the public company's financial statements prior to closing
    - This process can take six months if the company and shell do not provided proper financial statements but generally takes at least two to three months

Assuming that the Company's and the shell's current and existing financial statements are IFRS or GAAP compliant, and the auditors only need to reconcile the financial statements for US GAAP compliance, Phase One should take no longer than three months.

Note: Phase Two should occur while the audit portion of Phase One is being conducted and should be completed prior to the audit's completion.

# Phase Two: Due Diligence and Negotiation of Acquisition Terms

- Letter of Intent
  - Private company and public shell enter into a letter of intent
  - Private company and investors negotiate a letter of intent for financing, if applicable
  - The major terms of the reverse merger are negotiated at this point (i.e. percentage ownership, board membership, management of the company, ability to sell stock, representations and warranties, claw backs, etc.) as well as any simultaneous financing component
- Due Diligence
  - Gather due diligence on the Public Company and its shareholders (number of shareholders, round lot shareholders)
  - Digest all material information
    - This process can take two to four weeks
  - Before closing, the private company must make sure to conduct thorough due diligence on the shell
    - Clean Shell v. Messy Shell v. Dirty Shell
  - Review of all public filings and other material documents; litigation/background checks
  - Look to make sure that the shell:
    - Does not have any potential/unforeseen liabilities related to past businesses or management
    - Clarity as to number of shareholders
    - Has been compliant in regulatory filing and listing obligations
    - Can, without undue difficulty or delay, consummate the reverse merger transaction
    - Is DTC eligible
    - Has a capitalization structure that allows for a sufficient amount of shares to be issued
    - Shareholder base allows the target to take control

It will take about two weeks to negotiate the letter of intent and another two to four weeks to complete due diligence, which should be done simultaneously.

# Phase Three: Closing the Reverse Merger

- Transaction Documentation
  - Drafting begins immediately after the letter of intent is signed and usually takes two to four weeks to complete
  - Transaction documents include:
    - Share exchange agreement
    - Financing documents (if applicable)
    - Super 8-K
    - Board and Shareholder consents
- Super 8-K Preparation
  - Super 8-K involves comprehensive disclosures regarding the prospective acquisition and the change of control, including all information required in a Form 10 (i.e. information regarding the Company's business, material agreements, risk factors and directors and officers), MD&A, and two years of audited financial statements
  - Must be filed within four days of closing of the reverse merger
  - Begin drafting this document after the letter of intent is signed, but cannot be finalized without the audit and definitive documents
- Stock Certificates
  - Issue and distribute stock certificates

The timetable for Phases One through Three takes approximately one to three months.

# Listing Requirements

- The SEC approved new rules of the three major U.S. listing markets (NYSE, NYSE Amex, NASDAQ) that toughen the standards that companies going public through a reverse merger must meet to become listed on those exchanges
  - One Year Seasoning Period
    - The equity securities of the reverse merger company must have traded in the U.S. over-the-counter market, on another national exchange, or a regulated foreign exchange **following** the consummation of the reverse merger for at least **one year** prior to applying for listing
    - Timing also dependent on 10-K filing: A company must file at least one annual report which contains audited financial statements for full fiscal year which commences after filing of Super 8-K prior to being approved for listing.
      - Ex: If a Company with a 12/31 fiscal year end consummates a reverse merger in January and files its 10-K in March, the Company will not be able to list until the Company files its next 10-K.
    - These rules are in response to increased allegations of fraud in the preparation of financial statements, particularly with respect to Chinese reverse mergers
  - Minimum Trading Price
    - The reverse merger company must have maintained a minimum closing price of between \$2 and \$4 (depending on the exchange) for no less than 30 of the most recent 60 trading days

# SEC Activity on Reverse Mergers

- Amendments to Rule 144
  - Permits holders of shell shares to sell under Rule 144 commencing 12 months after “Super” Form 8-K with Form 10 Information
  - Evergreen Rule for Companies that were at any time Shell Companies
    - The shareholders of a company that was at one point a shell cannot sell their shares under Rule 144 unless the company is current in its regular SEC filings for the 12 months prior to the sale
  - Non-Shell Companies
    - The non-affiliated shareholders of non-shell company can sell their shares under Rule 144 after holding the shares for six months if current in SEC filings; the company must remain current in its filings for the next six months for sales under Rule 144
    - After the one year holding period, unlimited resales under Rule 144 are permitted

# Listing Requirements, Cont.

- Disclosure Requirement
  - NASDAQ – According to NASDAQ Rule 5110(c), a company must file “all required information about the reverse merger transaction with the SEC or other regulatory authority, including audited financials for the combined entity”
  - NYSE/NYSE Amex – Form 8-K and Form 10-equivalent (or Form 20-F for foreign issuer) information as well as required audited financials
- Exemptions:
  - Listing in connection with an initial firm commitment underwritten public offering of at least \$40M (occurring concurrently or after the reverse merger); or
  - Satisfied the one-year trading requirement and filed with the SEC at least four annual reports (must have all required audited financial statements) while satisfying all other applicable requirements for listing, including the minimum price requirement and the requirement not to be delinquent with SEC filings
- Possible Form 10 Exception
  - If the privately held company files a Form 10 registration statement prior to the reverse merger, the merged entity can avoid the one year seasoning period

# Why go public: Advantages

- Increased liquidity more attractive to top quality directors, officers and consultants
  - Ability for shareholders to “cash out”
- Company can become more widely known
- Increased access to capital - larger pool of potential investors for debt or equity
- Known market value for company
  - Usually a premium to private valuation
- Shares can be used for acquisitions and employee compensation



# Why go public: Disadvantages

- Reporting requirements pursuant to the Securities Exchange Act of 1934
  - Required to file annual, quarterly and periodic reports (disclosure issues)
- Sarbanes-Oxley reporting requirements
- Increased liability
  - Risk of litigation
- Increased costs
  - Legal, accounting, filing
- Decrease in managerial flexibility
  - Shareholder approval of actions
  - Independent board members
- Management ability to focus on business rather than stock price

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