

Alternative Public Offerings: What Companies Need to Know

Barry I. Grossman, Esq.
Ellenoff Grossman & Schole LLP

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What is a Reverse Merger?

- **Means of taking a private company into the public marketplace**
 - In a reverse merger transaction, an existing public “shell company” acquires a private operating company

What is a Reverse Merger? Cont.

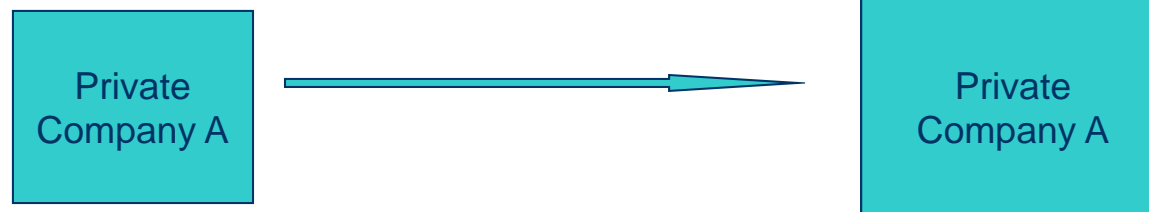
- **Avoids the time constraints, costs and disclosure requirements of traditional “going public” transactions, which include:**
 - Initial Public Offering (IPO)
 - Lengthy process
 - Generally takes between six and nine months
 - Very expensive
 - No certainty of success
 - Self-Filings
 - Self-underwriting 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
 - 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
 - Trust amount uncertain
 - Form 10 Filing
 - Does not provide shareholders a public float
 - Usually not associated with raising money

What is a Public Shell?

- A registrant with no or nominal operations and either no or nominal assets, assets consisting solely of cash and cash equivalents and generally no liabilities
 - The type of public shell company used can alter the process and timing of consummating a reverse merger
- 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
 - 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

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, 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 90% 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



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**
 - 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
 - Not DTC eligible
 - Potential prior history of shell promoters
 - Smaller shareholder base
 - No market maker

Non-Reporting Shell

- Process
 - Due diligence
 - Most complex because non-reporting
 - Negotiation of a merger agreement and potential financing
 - **NO** Schedule 14f-1
 - **NO** “Super” Form 8-K
- Timetable
 - Generally 1 to 2 months, can be done quicker
- Advantages
 - Fast
 - Fewer filings
 - Shell is less expensive
- Disadvantages
 - No freely tradable shares available (plus one year holding period for restricted securities as per Rule 144(i) which applies to all shells)
 - More difficult due diligence process because there are no public filings
 - Not investor friendly - lack of disclosure before and after the reverse merger
 - Can only trade on the Pink Sheets until it becomes reporting
 - Costly and time consuming to become a reporting company
 - Least attractive to investors - no real liquidity, highly volatile stock price

Reverse Merger Versus IPO

- Time
 - An IPO generally takes between six and nine months
 - Major Events include:
 - Financial Audit
 - Preparation of the Registration Statement
 - SEC review process – takes between three and nine months
 - Stock exchange review process, if applying to list on a national exchange
 - A reverse merger generally takes less than three months
 - Financial Audi
 - No Registration Statement (Super 8-K) and therefore no SEC review
- Cost
 - IPO has greater legal and accounting fees
 - IPO requires an underwriter, unless self underwritten
 - An alternative public offering generally includes a private placement with subsequent registration statement
- Disclosure
 - Registration Statement (i.e. Form S-1) versus “Super” Form 8-K
 - Going public through an IPO requires the filing of a registration statement that is both costly and time consuming
 - SEC controls the process
 - A reverse merger circumvents this filing requirement because the shares of the combined entity have already been registered by the shell
 - The shell is only required to file a “Super” Form 8-K disclosing the merger, and all material information about the private company, including audited financial statements, but the 8-K is not subject to SEC review prior to the transaction

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 recently 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

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

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
- SEC Probe of China-based Companies – December 2010
 - SEC Identifies Several Small Audit Firms Outsourcing Work to Local Chinese Audit Firms
 - Focus on Reverse Merger Transactions
 - Follows PCAOB Audit Practice Alert in July 2010
 - U.S. Audit Firm Sanctioned for Signing Off on Fraudulent Financial Statement of Chinese Company
 - Failure to Exercise Professional Skepticism and Due Professional Care
 - 81 of 246 Reverse Mergers in 2010 Involved Chinese Companies

SEC Activity on Reverse Mergers (Cont'd)

- Speech by SEC Commissioner – Louis A. Aguilar – Foreign Companies Abusing U.S. Capital Formation Process – April 2011
 - Since January 2007 – 600 “Backdoor” Registrations, over 150 of which have been Chinese Companies
 - There is Growing Accounting Deficiencies and Outright Fraud
 - SEC has set up Internal Task Force to Investigate Fraud with Emphasis on Reverse Mergers
 - Greater Enforcement by SEC

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

Contact Information

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Barry I. Grossman
Ellenoff Grossman & Schole LLP
150 East 42nd Street, New York, NY 10017
(212) 370-1300
bigrossman@egsllp.com;

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