

THE TRUTH ABOUT REVERSE MERGERS

WILLIAM K. SJOSTROM, JR. *

This article examines the reverse merger method of going public. It describes the principal features of reverse mergers, including deal structure and legal compliance. Although reverse mergers are routinely pitched as cheaper and quicker than traditional IPOs, this article argues that such pitches are misleading and, for many companies, irrelevant.

I. INTRODUCTION

A reverse merger (“RM”) is a non-traditional method of going public. Instead of hiring an underwriter to market and sell the company’s shares in an initial public offering (“IPO”), a private operating company works with a “shell promoter” to locate a suitable non-operating or shell public company.¹ The private operating company then merges with the shell company (or a newly-formed subsidiary of the shell company).² In the merger, the operating company shareholders are issued a majority stake in the shell company in exchange for their operating company shares.³ Post-merger, the shell company contains the assets and liabilities of the operating company and is controlled by the former operating company shareholders.⁴ The shell company’s name is changed to the name of the operating company, its directors and officers are replaced by the directors and officers of the operating company,⁵ and its shares continue to trade on whichever stock market they were trading prior to the merger.⁶ Hence, the operating company’s business is still controlled by the same group of shareholders and managed by the same directors and officers, but it is now contained within a public company. In effect, the operating company has succeeded to the shell company’s public status and is therefore now public.

RMs have been around for years but have recently regained popularity. Closed RMs totaled 46 in 2003, 168 in 2004, 179 in 2005,⁷ and

* Associate Professor, Salmon P. Chase College of Law, Northern Kentucky University.

¹ See Today’s Shell Game, The Corporate Counsel, Vol. XXIV, No. 4, July-August 1999.

² DAVID N. FELDMAN, REVERSE MERGERS: TAKING A COMPANY PUBLIC WITHOUT AN IPO 37 (2006).

³ *Id.*

⁴ *Id.*

⁵ *Id.* at 100–101.

⁶ *Id.* at 36.

⁷ See *id.* at 2.

69 through the first half of 2006.⁸ Notwithstanding this resurgence, RMs should be viewed critically. Although RMs are often pitched as IPO substitutes, they provide neither a large infusion of equity capital nor share liquidity, the two primary benefits of an IPO.⁹

This Article proceeds as follows: Part II describes the principal features of an RM, including the origin of shell companies, RM deal structure, and legal compliance. Part III takes a critical look at RMs arguing that comparisons to IPOs are misleading and, for many companies, irrelevant. Part IV discusses why companies nonetheless undertake RMs. Part V briefly discusses RMs involving special purpose acquisition companies (“SPACs”). Part VI states a brief conclusion.

II. REVERSE MERGER FEATURES

A. *Shell Characteristics*

A public shell company is a company that has a class of securities registered under the Securities Exchange Act of 1934¹⁰ (the “Exchange Act”) but has only nominal operations and no or nominal assets other than cash and cash equivalents.¹¹ A public shell company exists because either (1) it was a former operating company that went public and then for some reason ceased operations and liquidated its assets or (2) it never had any operations but was formed from scratch for the specific purpose of creating a public shell.¹² In the former situation, shell promoters gain control of defunct operating companies by buying up a majority of their shares.¹³ In the latter situation, shell promoters incubate the shells—they incorporate a company, voluntarily register its shares under the Exchange Act, and then timely file with the Securities and Exchange Commission (“SEC”) the required quarterly, annual and other reports.¹⁴ Because the shell has no operations, it is fairly simple and inexpensive to make these filings.¹⁵ In exchange for letting an operating company merge into a shell, the promoter charges the operating company a fee and retains an ownership interest in the shell post-merger.¹⁶

⁸ Andy Peters, *Analysts Warn of Dangers of Reverse Mergers*, 184 N.J.L.J. 729, 753 (Jun. 5, 2006).

⁹ William K. Sjostrom, Jr., *Going Public Through an Internet Direct Public Offering: A Sensible Alternative for Small Companies?*, 53 FLA. L. REV. 529, 572-73 (2001).

¹⁰ Securities Exchange Act of 1934 § 1, 15 U.S.C. § 78a (2006).

¹¹ 17 C.F.R. § 240.12b-2 (2007).

¹² FELDMAN, *supra* note 2, at 32–33. See also Aden R. Pavkov, *Ghouls and Godsenders? A Critique of “Reverse Merger” Policy*, 3 BERKELEY BUS. L.J. 475, 478 (2006).

¹³ FELDMAN, *supra* note 2, at 33.

¹⁴ See *id.* at 32.

¹⁵ See *id.* at 199.

¹⁶ See *id.* at 23, 37.

Shells may or may not have stock that trades publicly. Typically, the stock of a former operating company does trade publicly.¹⁷ The company will have listed its stock or otherwise facilitated trading on a public market back when it completed its IPO. When it ceases operations, the publicly-traded stock remains outstanding and continues to trade, although probably infrequently. The shares of former operating company shells typically end up being traded on the OTC Bulletin Board or Pink Sheets, electronic quotation services for over-the-counter stocks, even if they were originally listed on the New York Stock Exchange (“NYSE”), NASDAQ or some other exchange.¹⁸ Given that the companies no longer have any business operations, they are unable to meet the continued listing criteria of the exchanges.¹⁹ The OTC Bulletin Board and Pink Sheets have minimal requirements for a company’s shares to be quoted on their services.²⁰ A shell formed from scratch by a shell promoter typically does not have publicly traded stock.²¹

B. *Legal Structure and Compliance*

¹⁷ See *id.* at 33.

¹⁸ For a brief description of the OTC Bulletin Board and the Pink Sheets, see Sjostrom, *supra* note 9, at 568.

¹⁹ For the NYSE’s continued listing criteria, see NYSE, Inc., Listed Company Manual § 802.01(2007), available at <http://www.nyse.com/regulation/listed/1182508124422.html>. For NASDAQ’s continued listing criteria, see NASDAQ, Inc., NASDAQ Manual § 4310 (2007), available at http://nasdaq.complinet.com/nasdaq/display/display_display.html?rbid=1705&element_id=2.

²⁰ See Michael K. Molitor, *Will More Sunlight Fade the Pink Sheets? Increasing Public Information About Non-Reporting Issuers With Quoted Securities*, 39 IND. L. REV. 309, 333–34 (2006) (“Unlike NYSE and NASDAQ, there simply are no quantitative or qualitative requirements for issuers whose securities are quoted on the OTCBB or the Pink Sheets.”).

²¹ FELDMAN, *supra* note 2, at 33. This is in large part because the SEC views the promoters of shells formed from scratch and their transferees as “underwriters” regardless of how long they have held their shares. Hence, “the securities involved can only be resold through registration under the Securities Act. Similarly, Rule 144 would not be available for resale transactions in this situation, regardless of technical compliance with that rule, because these resale transactions appear to be designed to distribute or redistribute securities to the public without compliance with the registration requirements of the Securities Act.” NASD Regulation, Inc., SEC No-Action Letter, 2000 WL 64968, at *2 (Jan. 21, 2000). As a result, there are no freely tradable shares available to trade in a secondary market. Note that the SEC recently codified this position, with some modifications, as part of its recent amendments to Rule 144. See Revisions to Rules 144 and 145, Securities Act Release No. 8869, at 46-47 (Dec. 6, 2007), available at <http://www.sec.gov/rules/final/2007/33-8869.pdf> [hereinafter “Rule 144 Revisions Release”].

An RM is typically structured as a reverse triangular merger.²² Specifically, the public shell (“ShellCo”) forms a new, wholly-owned empty subsidiary (“Merger Sub”).²³ Merger Sub then merges into the private operating company (“OpCo”) pursuant to the applicable state corporate statute.²⁴ Upon consummation of the merger, OpCo’s shares are converted into shares of ShellCo constituting a majority stake in ShellCo (typically an 80 to 90 percent stake).²⁵ Following consummation of the merger, OpCo is a wholly-owned subsidiary of ShellCo and OpCo’s former shareholders own a majority of the outstanding shares of ShellCo.²⁶

Alternatively, the transaction could be (and sometimes is) structured as a direct merger where ShellCo merges directly into OpCo.²⁷ The reverse triangular merger structure is preferable, however, because it reduces transaction costs.²⁸ Since OpCo survives the transaction, there is no need to change vendor numbers, employer identification numbers, bank accounts, real estate titles, etc.²⁹ Additionally, structuring the transaction as a reverse triangular merger *may* eliminate the requirement of getting ShellCo shareholder approval to close the transaction. This would allow ShellCo to avoid holding a shareholders meeting and therefore the time and expense associated with filing with the SEC for review and mailing to its shareholders a detailed proxy statement and other materials as required by SEC proxy regulations.³⁰

Whether shareholder approval of ShellCo is required depends on ShellCo’s state of incorporation and whether its shares are listed on an exchange. The general rule under state corporate law is that approval is required only from the shareholders of the companies that will merge in the transaction.³¹ In an RM structured as a reverse triangular merger, ShellCo shareholder approval would not be required because Merger Sub and not ShellCo will be merging with OpCo in the transaction.³² However, many states and the stock exchanges also require shareholder approval before a company can issue shares constituting more than 20% of its pre-transaction outstanding shares.³³ ShellCo would fall under these rules, if applicable, because it will be issuing well over 20% of its pre-transaction outstanding

²² See FELDMAN, *supra* note 2, at 37.

²³ See *id.*

²⁴ *Id.*

²⁵ See *id.*

²⁶ *Id.*

²⁷ See FELDMAN, *supra* note 2, at 37.

²⁸ See *id.* at 38.

²⁹ See *id.*

³⁰ See *id.* at 39.

³¹ See, e.g., DEL. CODE ANN. tit. 8, § 251(c) (2006); MODEL BUS. CORP. ACT § 11.04(b) (2002).

³² See FELDMAN, *supra* note 2, at 37.

³³ See, e.g., MODEL BUS. CORP. ACT § 6.21(f)(1)(ii) (2002); NASDAQ, Inc., NASDAQ Manual, *supra* note 19, at § 4350(i)(1)(D)(ii).

shares as part of the RM. Note, however, that Delaware, among other states, does not have a 20% rule.³⁴ Hence, if ShellCo is a Delaware corporation and does not have shares listed on an exchange, ShellCo shareholder approval is not required. Merger Sub shareholder approval is obtained from its sole shareholder, ShellCo, acting through its board.³⁵ Shareholder approval by OpCo is required, but since OpCo is private, it is not subject to SEC proxy regulations; normally it can obtain the requisite shareholder approval quickly through written shareholder consent in lieu of a meeting.³⁶

The exchange of OpCo's shares for ShellCo's shares in the RM is considered an offer and sale of securities and therefore must be made in compliance with the Securities Act of 1933 (the "Securities Act").³⁷ Typically, ShellCo relies on Rule 506 of Regulation D under the Securities Act for an exemption from registration.³⁸ Hence, all that is necessary for securities law compliance is for ShellCo to prepare and circulate to OpCo's shareholders a private placement memorandum ("PPM") describing the terms of the deal and basic information about ShellCo³⁹ and file a Form D with the SEC setting forth some basic information about the offering.⁴⁰ In fact, ShellCo can forgo preparing a PPM if all of OpCo's shareholders qualify as "accredited investor[s]."⁴¹ State blue sky law compliance is a non-issue because Section 18 of the Securities Act preempts state securities offering registration or qualification requirements with respect to Rule 506 offerings, with the exception of notice filings.⁴² It should be noted that

³⁴ See MOD. BUS. CORP. ACT ANN. § 6.21 Historical Background § 3 (Supp. 2000).

³⁵ See FELDMAN, *supra* note 2, at 37.

³⁶ See *id.* at 38.

³⁷ See 17 C.F.R. § 230.145 (2007) (An offer and sale of securities "occurs when there is submitted to security holders a plan or agreement pursuant to which such holders are required to elect, on the basis of what is in substance a new investment decision, whether to accept a new or different security in exchange for their existing security.").

³⁸ See FELDMAN, *supra* note 2, at 105.

³⁹ See 17 C.F.R. § 230.506(b) (2007).

⁴⁰ 17 C.F.R. §§ 230.503, 239.500 (2007).

⁴¹ See 17 C.F.R. § 230.502(b)(1) (2007). Rule 501(a) of Regulation D defines "accredited investor" as, among other things, banks, insurance companies, mutual funds and certain other specified institutional investors, "[a]ny natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds \$1,000,000," "[a]ny natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year," and executive officers and directors of the issuer. See 17 C.F.R. § 230.501(a) (2007).

⁴² See 15 U.S.C. §§ 77r(a)(1), 77r(b)(4)(D), 77r(c)(2) (2006). Rule 506 was issued by the SEC under § 4(2) of the Securities Act. See 17 C.F.R. § 230.506(a) (2007) ("Offers and sales of securities by an issuer that satisfy the conditions . . . of Rule 506 shall be deemed to be transactions not involving any public offering within the meaning of section 4(2) of the [Securities] Act.").

securities issued in reliance on Rule 506 are considered “restricted securities.”⁴³ This means the former OpCo shareholders will generally not be able to sell their ShellCo shares for at least one year from the closing of the RM, unless the subsequent sale is registered with the SEC.⁴⁴

III. RMs ≠ IPOs

An RM is routinely pitched as a cheaper and quicker method of going public than a traditional IPO.⁴⁵ This may be technically true but the comparison is misleading and, for many companies, irrelevant.

A. *Misleading Comparison*

The pitch is misleading because RMs and IPOs are not substantively equivalent. With an IPO, a company retains an underwriter to manage the sale of millions of dollars of newly issued shares of the company’s common stock to the public.⁴⁶ Thereafter, the underwriter helps develop a liquid secondary market in the company’s stock by facilitating the listing of the company’s shares on a stock exchange, making a market in the stock, and issuing analyst reports and recommendations to develop

⁴³ See 17 C.F.R. §§ 230.144(a)(3)(ii), 230.502(d) (2007).

⁴⁴ Rule 144 was recently amended to allow resales of restricted securities following as short as a six month holding period. See Rule 144 Revisions Release *supra* note 21, at 1. However, the amendments also included a provision addressing the availability of Rule 144 for securities issued by former shell companies that requires a holding period of one year from the time the company files a Form 10 with the SEC indicating it is no longer a shell company. *Id.* at 50.

⁴⁵ See, e.g., Venture Associates, *Reverse Mergers with Public Companies*, <http://www.venturea.com/shell.htm> (last visited Jan. 11, 2008) (“saves time” and “saves money”); -Mergers-R-Us.Com, *Reverse Merger – Overview*, <http://www.mergers-r-us.com/rm.html> (last visited Jan. 11, 2008) (“The costs are significantly less than the costs required for an initial public offering.” “The time required is considerably less than for an IPO.”); ReverseMergers.Net, *Advantages of Going Public through a Reverse Merger*, <http://www.reversemergers.net/advantages.html> (last visited Jan. 11, 2008) (“Initial costs are much lower and excessive investment banking fees are avoided.” “The time frame for becoming public is considerably shorter.”); Go Public Institute, *What is a Reverse Merger with a Public Shell?*, <http://www.gopublic.com/reversemerger.html> (last visited Jan. 11, 2008) (“The costs are significantly less than the costs required for an initial public offering.” “The time frame requisite to securing public listing is considerably less than that for an IPO.”); IPO-MERGE dot com, *Advantages of Going Public Without an IPO*, <http://www.ipo-merge.com/advantages.html> (last visited Jan. 11, 2008) (“The costs are significantly [sic] less than the costs required for an IPO.” “The time is considerably less than that for an IPO.”); FELDMAN, *supra* note 2, at 23 (“lower cost” and “speedier process”).

⁴⁶ See NASDAQ, GOING PUBLIC: A GUIDE FOR NORTH AMERICAN COMPANIES TO LISTING ON THE U.S. SECURITIES MARKETS 15 (Nicole Lew ed., White Page LTD 2005) available at http://www.nasdaq.com/about/listing_guide.stm.

investor interest.⁴⁷ Once a public market is established, pre-IPO investors and insiders can cash out some or all of their holdings by selling their shares into the market and the firm can use its stock as currency for future acquisitions as well as incentive compensation.

Conversely, an RM is not a capital raising transaction. No shares are sold for cash in the transaction—OpCo's shareholders are issued ShellCo shares in exchange for their OpCo shares; ShellCo's shareholders just retain the shares they already owned. The only cash that changes hands as a result of the transaction are the fees paid by OpCo to the promoter, attorneys, and accountants for putting together the deal. To be sure, an RM is often coupled with a PIPE financing.⁴⁸ The amount of PIPE financing that can be raised, however, will likely fall well short of the tens to hundreds of million dollars that can be raised in an IPO.⁴⁹ Additionally, PIPE financing is typically expensive relative to other financing options and may contain onerous terms.⁵⁰

Post-RM, the operating company is technically public in the sense that its shares are registered with the SEC under the Exchange Act and perhaps quoted on the Pink Sheets or OTC Bulletin Board. Undoubtedly, however, its shares will be thinly traded, if at all, and therefore will be relatively illiquid.⁵¹ This is because there will be no post-deal underwriter support to help develop an active secondary market because no underwriter was involved in the deal. An active trading market could potentially develop down the line if the company performs well and gets noticed, but getting noticed can take years.⁵² In the absence of an active trading market, it will be difficult for insiders to cash out (the market will not be able to absorb a trade of any significant size) and the company's shares will not be particularly attractive as an acquisition currency or employee incentive compensation tool.

Additionally, if an RM company's shares do trade, they will likely trade at a lower price than those of a comparable IPO company. As discussed below, generally only low-quality companies undertake RMs because more attractive financing options are available to higher quality

⁴⁷ See Sjostrom, *supra* note 9, at 574.

⁴⁸ See FELDMAN, *supra* note 2, at 3 & 59. For an analysis of PIPE financing, see generally William K. Sjostrom, Jr., *PIPEs*, 2 *ENTREP. B. L.J.* 383 (2007). See also *infra* sec. IV.A.

⁴⁹ See FELDMAN, *supra* note 2, at 51.

⁵⁰ See *infra* text accompanying notes 71 to 73.

⁵¹ See Terzah Ewing, *Pink Sheets Begin Quote Service in a Bid to Boost Market's Image*, WALL ST. J., Aug. 14, 2000, at C7 (noting that stocks quoted on the Pink Sheets are some of the most thinly traded); Phyllis Plitch, *NASD Tacks Up Strong New Rules on Bulletin Board*, WALL ST. J., June 22, 2000, at C1 (noting that OTC Bulletin Board stocks are thinly traded). See also U.S. Securities and Exchange Commission, *Pink Sheets*, <http://www.sec.gov/answers/pink.htm> (last visited Jan. 11, 2008) (noting that Pink Sheet stocks are thinly traded).

⁵² See FELDMAN, *supra* note 2, at 29-30.

companies. Hence, going public through an RM signals to the market that the company has likely been passed over by underwriters and is therefore of low quality. Further, an IPO company implicitly receives underwriter certification, a certification backed by the underwriter's reputational capital and liability exposure under federal securities laws.⁵³ Because there is no underwriter involved in an RM, there is no implicit underwriter certification of the company. As a result, the company's stock price will trade at a discount to reflect these factors and the stock's relative illiquidity.

At the end of the day, an RM company enjoys few of the benefits associated with going public through an IPO and none of the benefits to the same extent as an IPO company. At the same time, it faces the same disadvantages of being public—increased expense, increased liability exposure, loss of flexibility, and loss of confidentiality⁵⁴—as faced by an IPO company. Yes, an RM *may* be quicker and cheaper than an IPO just as a motorcycle is quicker and cheaper than a Cadillac. It would, however, be absurd to pitch a motorcycle by comparing it to a Cadillac, unless consumers do not appreciate the significant differences between the two, in which case it would be misleading.

B. *Not Necessarily Cheaper and Quicker*

Completing a \$50 million IPO will roughly run a company 18% of the offering proceeds, including underwriter discounts, under pricing, and legal, accounting, filing, listing, printing, and registrar fees,⁵⁵ or \$9 million. Conversely, an RM “generally costs between \$100,000 and \$400,000 to complete.”⁵⁶ This cost range does not, however, include the value of the equity stake retained by the shell promoter and its affiliates. As described above, when the RM closes, OpCo shareholders are issued ShellCo shares equal to 80% to 90% of ShellCo's post-merger outstanding shares and the remaining 10% to 20% of shares are retained by the promoter and its affiliates. Hence, in addition to the \$100,000 to \$400,000 in cash paid by OpCo to complete the RM, OpCo has also “paid” a 10% to 20% stake in its

⁵³ John C. Coffee, Jr., *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation*, 52 BUS. LAW. 1195, 1210-11 (1997). See also Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 620 (1984) (“In essence, the investment banker rents the [company] its reputation. The investment banker represents to the market . . . that it has evaluated the [company's] product and good faith and that it is prepared to stake its reputation on the value of the innovation.”).

⁵⁴ See generally Sjostrom, *supra* note 9, at 575-80 for a description of the disadvantages of going public.

⁵⁵ See Jay R. Ritter, *Initial Public Offerings*, in HANDBOOK OF MODERN FINANCE D11, D11-20 (1999).

⁵⁶ See Halter Financial Group, ‘Reverse Merger’ offers alternative to the traditional IPO, http://www.reversemerger.com/in_the_news_detail.cfm?InTheNews_ID=20 (last visited Jan. 11, 2008).

company. If ShellCo's market capitalization is \$50 million post-RM, this stake is worth \$5 to \$10 million.

As for quickness, an RM can be completed in as little as a few weeks but in any event should take no more than four months.⁵⁷ Estimates vary for IPOs. One source states that "[a]n IPO can generally be completed in 15 to 20 weeks,"⁵⁸ while another states that an IPO "usually takes nine to twelve months from start to finish."⁵⁹ Obviously, the speed advantage for an RM disappears when one compares four months, the high-end of the range for an RM (which now may be more typical following the June 2005 adoption of new disclosure requirements for shell companies completing reverse mergers),⁶⁰ to fifteen weeks, the low-end of the range for an IPO. In the end, the speed advantage, if any, of an RM versus an IPO will depend on many factors including deal complexity, market conditions, and management competence.

C. Irrelevant Comparison

The comparison of RMs to IPOs is irrelevant for many companies that desire to go public because for many companies that desire to go public an IPO is not an option. Completing an IPO requires a company to convince an investment banking firm to underwrite the offering, and many companies stand no chance of doing so. As a general matter, no underwriter will take a company public unless the company has, at a minimum: (1) annual revenue of \$20 million, (2) net income of \$1 million, and (3) "the potential to achieve and sustain significant growth rates (i.e., 20% or greater in revenues) for the next five to ten years."⁶¹ If a company

⁵⁷ See FELDMAN, *supra* note 2, at 23. See also ReverseMergers.Net, *Advantages of Going Public through a Reverse Merger*, <http://www.reversemergers.net/advantages.html> (last visited Jan. 11, 2008); Mergers-R-US.com, *Reverse Merger – Overview*, <http://www.mergers-r-us.com/rm.html> (last visited Jan. 11, 2008).

⁵⁸ NASDAQ, GOING PUBLIC: A GUIDE FOR NORTH AMERICAN COMPANIES TO LISTING ON THE U.S. SECURITIES MARKETS 18 (Nicole Lew ed., White Page LTD 2005), available at http://www.nasdaq.com/about/listing_guide.stm.

⁵⁹ See FELDMAN, *supra* note 2, at 24.

⁶⁰ See Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, Securities Act Release No. 33-8587, Exchange Release No. 34-52038, 70 Fed. Reg. 42,234 (July 21, 2005).

⁶¹ See U.S. GEN. ACCOUNTING OFFICE, SMALL BUSINESS: EFFORTS TO FACILITATE EQUITY CAPITAL FORMATION 21-22 (2000), available at <http://www.gao.gov/archive/2000/gg00190.pdf>. The revenue and net income minimums are likely higher today than in 2000 when this GAO report was published. See also FELDMAN, *supra* note 2, at 19 ("Many companies could benefit from being public but are not good candidates for IPOs. The investment bankers who are responsible for finding people to invest in the new stock look for very specific characteristics in the companies they represent. Companies that are in a stage of development considered premature for an IPO or who wish to go public at a time when

does not meet these criteria, an IPO is not an option. This observation is consistent with a recent study that found companies who have gone public through RMs or self-underwritings were, on average, significantly less profitable, had significantly lower balance sheet liquidity, and had significantly more leverage than comparable IPO firms in the year they went public.⁶² Thus, a prominent feature of RMs is that they allow companies to go public even though the companies cannot secure the support of underwriters, the primary gatekeepers to the public markets.

IV. WHY DO COMPANIES UNDERTAKE REVERSE MERGERS?

A. PIPE Financing

It should be noted that going public is not an end in itself but a means to an end. As mentioned above, the primary benefits a company enjoys from going public through an IPO is a large infusion of additional equity capital and share liquidity. I have contended that the typical RM company receives neither of these benefits. So why then do companies nonetheless pursue RMs? The answer is that RMs open up PIPE financing as a funding option, an option not available to private companies.⁶³

PIPE is an acronym for *private investment in public equity* which is a type of financing transaction undertaken by a public company, normally with a small number of sophisticated investors.⁶⁴ In a typical PIPE, the company relies on an exemption from SEC registration requirements to issue investors common stock or securities convertible into common stock for cash. The company then registers the resale of the common stock issued in the private placement, or issued upon conversion of the convertible securities issued in the private placement, with the SEC.⁶⁵ Generally, investors must hold securities issued in a private placement for at least one year.⁶⁶ However, because the company registers the resale of the PIPE shares, investors are free to sell them into the market as soon as the SEC

the IPO market is inhospitable or who are in an unfashionable industry will find it impossible to find an underwriter for their IPO.”).

⁶² Kimberly C. Gleason, Ravi Jain & Leonard Rosenthal, *Alternatives for Going Public: Evidence from Reverse Takeovers, Self-Underwritten IPOs, and Traditional IPOs* 18 (2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=890714.

⁶³ See FELDMAN, *supra* note 2, at 3.

⁶⁴ See James R. Tanenbaum & Anna T. Pinedo, *The Law: Legal and Regulatory Framework*, in PIPES: A GUIDE TO PRIVATE INVESTMENTS IN PUBLIC EQUITY REVISED AND UPDATED EDITION 77, 93 (2006).

⁶⁵ See *id.* at 99.

⁶⁶ See *supra* text accompanying notes 43 & 44.

declares the resale registration statement effective (typically within a few months of the closing of the private placement).⁶⁷

PIPEs have emerged as a vital financing source for small public companies because many of these companies have no other financing alternatives.⁶⁸ Hence, if a private company has tapped out its financing options, it can go public through an RM and thereby open the door to PIPE financing. PIPE financing is fairly plentiful for small public companies, even underperforming companies with relatively illiquid stock, because PIPE investors (typically hedge funds) are often able to lock in gains on PIPE investments as a result of favorable deal terms and short selling regardless of how the company's stock performs post-deal.⁶⁹ These investors generally are not looking to invest in private companies because the investors' strategies depend on quickly obtaining publicly tradable stock.⁷⁰

Considering that for many small companies PIPE financing represents the only realistic financing option, it can, of course, be very expensive. In a PIPE deal, not only does the company typically issue PIPE investors common stock or common stock equivalents at a discount to market price, but PIPE deals often involve other cash flow rights such as dividends or interest (typically paid in kind not cash) and warrants.⁷¹ After taking into account these cash flow rights and protective features such as floating conversion prices, a recent study found that the "all-in net purchase discount"⁷² for PIPE deals ranges from 14.3% to 34.7%.⁷³

B. *Reverse Mergers vs. Self-Filings*

The fact that an RM is really a means to an end (e.g., PIPE financing) and not an end in itself raises the question of why companies do not employ a different, and perhaps less costly, means to the end. Specifically, any company can go public in the RM sense through a "self-filing," i.e., voluntarily filing an Exchange Act registration statement with the SEC⁷⁴ (this is exactly what shell promoters do to incubate shells from scratch as discussed above). Historically, companies have typically not

⁶⁷ See Susan Chaplinsky & David Haushalter, *Financing Under Extreme Uncertainty: Contract Terms and Returns to Private Investments in Public Equity 1* (Working Paper Series, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=907676.

⁶⁸ Sjostrom, *supra* note 48, at 386.

⁶⁹ *Id.* at 390.

⁷⁰ *Id.* at 388.

⁷¹ See Chaplinsky & Haushalter, *supra* note 67, at 3.

⁷² *Id.* at 16 (estimated value of the PIPE securities at time of issuance relative to amount invested).

⁷³ See *id.*

⁷⁴ See generally FELDMAN, *supra* note 2, at 167-170 for a description of the self-filing process.

gone the self-filing route, at least in part, because of time considerations.⁷⁵ An Exchange Act registration statement requires extensive disclosures including a description of the company's business operations, risk factors, finances, properties, and management.⁷⁶ Additionally, the registration statement must include audited financial statements for the last two or three years.⁷⁷ Putting together this disclosure for an operating company takes some time— typically, at least sixty days. Further, the registration statement does not become effective until sixty days after filing and may be scrutinized by the SEC prior to effectiveness, resulting in required revisions.⁷⁸ Hence, it will take a company at least four months from deciding to pursue a self-filing to the registration statement becoming effective and various securities regulation clocks tied to effectiveness will not start running.

Conversely, by merging with a public shell, historically an operating company could reduce the four month or longer timeframe to as little as a few weeks.⁷⁹ For a company running out of cash, this timing difference could be critical to its survival. An RM is quicker than a self-filing because a public shell, by definition, has already been registered under the Exchange Act. The operating company succeeds to this registration, which typically dates back at least a year (meaning various securities regulation clocks tied to effectiveness began running a year or more earlier),⁸⁰ upon completion of the RM. Hence, with an RM, there is no need for the operating company to prepare and file an Exchange Act registration statement.

This RM time advantage, however, has greatly diminished, if not disappeared, with the new shell company rules adopted by the SEC in June 2005.⁸¹ Under these rules, a former shell company (i.e., the newly public operating company) is required to file with the SEC within four business days after the RM closing the same information (a description of the

⁷⁵ See *id.* at 176.

⁷⁶ See Items 1-14 of Exchange Act Form 10, the form that dictate the information that must be included in an Exchange Act registration.

⁷⁷ See *id.*, Item 15.

⁷⁸ See 15 U.S.C. § 78l(g)(1) (2006).

⁷⁹ See FELDMAN, *supra* note 2, at 24.

⁸⁰ This concept of clock running used to be critical to the prompt availability of Rule 144 for resales of securities issued in an RM because the Rule generally requires a company to have had securities registered under the Exchange Act for at least 90 days. See 17 C.F.R. § 230144(c)(1). While this provision is still in place, as mentioned above, the SEC recently added another provision to Rule 144 making the Rule unavailable for securities issued by a former shell company until a holding period of one year has elapsed from the time the company files a Form 10 with the SEC indicating it is no longer a shell company. See *supra* note 44.

⁸¹ See Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, Securities Act Release No. 33-8587, Exchange Release No. 34-52038, 70 Fed. Reg. 42,234, 42,235 (July 15, 2005) [hereinafter "2005 SEC Rule Amendments"].

company's business operations, risk factors, finances, properties, and management, audited financial statements, etc.) required to register securities under the Exchange Act.⁸² Prior to this rule change, former shell companies could delay disclosing much of this information for up to seventy-five days from the closing of the RM.⁸³ Hence, required SEC disclosure preparation would not impact the timing of an RM closing because there was plenty of time post-closing to prepare it. With the change to four days, this is obviously no longer the case.

As a result, RM closings now have to be delayed so that the operating company can prepare the necessary disclosure in advance of closing in order to meet the greatly shortened deadline. As the SEC pointed out, "we believe shell companies should complete a transaction that is required to be reported only when they can timely provide investors with adequate information to make informed investment decisions."⁸⁴ As noted above, putting together the disclosure required to register securities under the Exchange Act typically takes at least sixty days. Therefore, the new rules essentially increase the timeframe for an RM by sixty days and thereby eliminate the time advantage RMs have historically enjoyed over self-filings.

The remaining advantage RMs have over self-filings is the involvement of a shell promoter. Reputable shell promoters are RM experts. They have facilitated numerous RM transactions and therefore can provide invaluable advice from experience. In addition, they will likely have contacts with brokerage firms who could potentially serve as market makers in the company's stock post-RM (a company has to have at least one market maker willing to quote its stock in order for the stock to be quoted on the Pink Sheets or OTC Bulletin Board)⁸⁵ and PIPE investors interested in RM companies. The question is whether this expertise and these contacts are worth \$100,000 to \$400,000 in cash plus a 10%-20% equity stake. For many companies, the answer may be yes because there is little point to a self-filing if it will not lead to PIPE financing, and PIPE financing will be difficult to secure if no one will make a market in the stock.

⁸² Form 8-K, Item 2.01(f).

⁸³ See Use of Form S-8 and Form 8-K by Shell Companies, Securities Act Release No. 33-8407, Exchange Act Release No. 34-49566, 69 Fed. Reg. 21,650, 21,652 & n.31 (April 21, 2004) [hereinafter "2004 SEC Proposal"]. The SEC reduced the timeframe to four days in order "to decrease opportunities to engage in fraudulent and manipulative activity." 2005 SEC Rule Amendments, *supra* note 81, at 42, 238.

⁸⁴ 2005 SEC Amendments, *supra* note 81, at 42, 239.

⁸⁵ See Pink Sheets: Electronic OTC Markets, *How to Get your Company Quoted on the Pink Sheets*, at http://www.pinksheets.com/otcguide/issuers_getquoted.jsp (last visited A Jan. 11, 20087); Frequently Asked Questions, OTC BULLETIN BOARD, at http://www.otcbb.com/faqs/otcbb_faq.stm#Listing (last visited Jan. 11, 2008).

V. SPAC PROVISIO

The story is a bit different for an RM with a special purpose acquisition company (“SPAC”). A SPAC is a shell company taken public through an IPO with the intent of acquiring an unidentified operating business within eighteen to twenty-four months. Since 2003, more than seventy SPACs have gone public raising over \$5.6 billion and many more are currently in the pipeline.⁸⁶

SPACs represent the reincarnation of blank check companies (“BCCs”), vehicles frequently used by boiler rooms in the 1980s for “pump and dump” schemes.⁸⁷ In fact, the nefarious activities associated with BCCs resulted in federal legislation. In 1990, Congress, through an amendment to the Securities Act,⁸⁸ directed the SEC to “prescribe special rules with respect to registration statements filed by any issuer that is a blank check company.”⁸⁹ In 1992, the SEC responded by adopting Rule

⁸⁶ See Karen Richardson & Peter Lattman, *Financiers Now Say 'Trust Us': Like the Blank-Check Offerings of Yore, SPAC Investors Are Asked to Buy In—on Faith*, WALL ST. J., Feb. 1, 2007, at C1.

⁸⁷ As described in a 1990 House of Representatives Report:

The stated purpose of the blank check company is to merge with an operating business after the securities being registered are sold. In some cases, manipulative activity may take place without any merger. False rumors are put out about a possible merger and the profitability of the alleged target and the price of the blank check company's stock increases on the basis of such rumors. In other cases, the merger is accomplished by issuing additional securities in the blank check company for the assets of the private company. These types of mergers are often reverse mergers, that is a merger where the shareholders of the company being acquired own a majority of the shares of the surviving company after the merger is consummated. A private firm which goes public through a merger with a blank check company generally escapes the scrutiny to which it would be subject if it were forced to go through the routine process involved in Commission and state registration.

Once the stock in the blank check company is distributed, often in large part to the underwriting broker, his business associates, relatives and friends, the occurrence of the sudden merger or rumors of possible merger provides the basis for engineering an upward manipulation in the price of the stock as brokers, in calls to potential investors, fervently depict the blank check as having just merged with an emerging growth company with tremendous prospects. The price then continues skyward until the broker decides to unload his own and his friends' shares upon the public, sending the price plummeting.

H.R.REP. NO. 617, 101st Cong., 2d Sess. 9 (1990), as reprinted in 1990 U.S.C.C.A.N. 1408, 1424.

⁸⁸ See Securities Enforcement and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, § 508, 104 Stat. 931.

⁸⁹ 15 U.S.C. § 77g(b)(1) (2006).

419.⁹⁰ Rule 419 defines a “blank check company” as “a company that: (i) is a development stage company⁹¹ that has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies, or other entity or person and (ii) is issuing ‘penny stock,’ as defined in Rule 3a51-1 under the [Exchange Act].”⁹² Among other things, Rule 419:

- Requires a BCC to hold 90% of the net IPO proceeds in an escrow or trust account until it completes an acquisition;⁹³
- Restricts a BCC from acquiring a business or businesses unless “the fair value of the business(es) or net assets to be acquired represents at least 80 percent of the maximum offering proceeds;”⁹⁴
- Prohibits trading of the BCC’s securities by requiring them to be held in an escrow or trust account until consummation of an acquisition;⁹⁵ and
- Requires a BCC to return to investors all offering proceeds held in the escrow or trust fund if an acquisition is not consummated within eighteen months of the closing of the IPO.⁹⁶

While the business plan of a SPAC is to acquire “an unidentified company or companies,”⁹⁷ it avoids the application of Rule 419 by not issuing penny stock. Specifically, Rule 3a51-1 under the Exchange Act excludes from the definition of “penny stock” securities of an issuer that has been in continuous operation for less than three years and which will have total net tangible assets (total assets less intangible assets and liabilities) in excess of \$5,000,000 following its IPO.⁹⁸ SPAC IPOs range in size from \$20 million⁹⁹ to \$900 million.¹⁰⁰ Hence, post-IPO, SPACs

⁹⁰ See Blank Check Offerings, Release No. 6932, Release No. 30577, Release No. 33-6932, Release No. 34-30577, Release No. IC - 18651, 51 S.E.C. Docket 284, 1992 WL 81725.

⁹¹ Regulation S-X defines a development stage company as a company “devoting substantially all of its efforts to establishing a new business and either of the following conditions exists: (1) Planned principal operations have not commenced. (2) Planned principal operations have commenced, but there has been no significant revenue therefrom.” Regulation S-X, Rule 1-02(h), 17 C.F.R. § 210.1-02(h) (2007).

⁹² 17 C.F.R. § 230.419(a)(2) (2007).

⁹³ See *id.* § 230.419(b)(2)(i) & (vi).

⁹⁴ *Id.* § 230.419(e).

⁹⁵ See *id.* § 230.419(b)(3).

⁹⁶ See *id.* § 230.419(e)(2)(iv).

⁹⁷ *Id.* § 230.419(a)(2).

⁹⁸ See Rule 3a51-1(g)(1), 17 C.F.R. § 240.3a51-1(g)(1) (2007).

⁹⁹ See, e.g., Restaurant Acquisition Partners, Inc., Prospectus 1 (Dec. 15, 2006),

available at

<http://www.sec.gov/Archives/edgar/data/1340995/000104746906015057/a2175203z424b4.htm>.

easily exceed the \$5,000,000 net tangible assets threshold given they have no operations and therefore minimal liabilities.¹⁰¹

Although SPACs are exempt from Rule 419 compliance, they nonetheless voluntarily incorporate a number of Rule 419-type provisions in their IPO terms in order to attract investors. For example, a SPAC typically agrees to hold 90% or more of the offering proceeds in an escrow account, restricts itself from acquiring an initial business unless the business has a fair market value equal to at least 80% of the SPAC's net assets, and sets a deadline on completing an initial acquisition of eighteen to twenty-four months after closing of its IPO.¹⁰² Additionally, a SPAC typically agrees to proceed with an initial proposed acquisition only if the acquisition is approved by a vote of a majority of IPO shares, even if shareholder approval is not required by applicable law.¹⁰³ However, in contrast to Rule 419, a SPAC does not restrict post-IPO/pre-acquisition trading in its securities,¹⁰⁴ and typically its securities begin trading immediately following the IPO on the OTC Bulletin Board or even the American Stock Exchange.¹⁰⁵

From an operating company's perspective, a merger with a SPAC may compare favorably with a traditional IPO depending on how the transaction is structured. If it is structured as an RM, the operating company will receive a large cash infusion because the SPAC with whom it merges will contain the proceeds from its IPO. It will also enjoy share liquidity because there is already an established trading market for the SPAC's securities to which the operating company will be succeeding and one or more underwriters (those involved in the SPAC's IPO) will have a vested interest in supporting the market post-RM. It should be noted, however, that not all SPAC acquisitions are structured as RMs; it all

¹⁰⁰ See, e.g., Liberty Acquisition Holdings Corp., Prospectus 1 (Dec. 6, 2007), available at <http://www.sec.gov/Archives/edgar/data/1407539/000095014407010983/g08943b4e424b4.htm>.

¹⁰¹ The SEC allows a SPAC to aggregate the cash to be raised in its firm commitment underwritten IPO with its other tangible assets in making the net tangible asset calculation provided that the SPAC files a balance sheet with the SEC promptly after the closing of its IPO. Penny Stock Definition for Purposes of Blank Check Rule, Exchange Act Release No. 33-7024, 1993 SEC LEXIS 2918 at *7 (Oct. 25, 1993).

¹⁰² See M. Ridgway Barker & Randi-Jean G. Hedin, *Special Purpose Acquisition Corporations: Specs To Consider When Structuring Your SPAC - Part I*, 14 METRO. CORP. COUNS. 12 (Aug. 2006). See also, e.g., Services Acquisition Corp. International, Prospectus 35-36 (Jun. 29, 2005), available at <http://www.sec.gov/Archives/edgar/data/1316898/000104746905018484/a2160393z424b3.htm>.

¹⁰³ See Barker & Hedin, *supra* note 101, at 12.

¹⁰⁴ See, e.g. Services Acquisition Corp. International, Prospectus, *supra* note 28, at 37.

¹⁰⁵ See M. Ridgway Barker & Randi-Jean G. Hedin, *Special Purpose Acquisition Corporations: Specs To Consider When Structuring Your SPAC - Part II*, 14 METRO. CORP. COUNS. 6 (Sept. 2006).

depends on negotiations between the parties.¹⁰⁶ Additionally, similar to an IPO, an operating company has to pass through a gatekeeper (the SPAC's management team) in order for the deal to go forward. Hence, for many companies, an RM with a SPAC is not an option.

VI. CONCLUSION

I am not suggesting that RMs are illegitimate or should be further regulated. RMs open the door to PIPE financing for private companies with limited alternative funding options and exemplify the dynamism of our capital markets. I do, however, take issue with pitching RMs as cheaper and quicker than IPOs. With the exception of a SPAC RM, the end result of an RM is simply not comparable to the end result of an IPO. Thus, the pitch is misleading, may not even be true, and, with respect to companies for whom an IPO is not an option, irrelevant.

¹⁰⁶ For example, Service Acquisition Corp. International's acquisition of Jamba Juice was structured as a cash-out merger meaning a large portion of the SPAC's IPO proceeds were used to buyout the operating company's shareholders and therefore not available to the operating company post-merger. *See* Service Acquisition Corp. International, Proxy Statement (Nov. 11, 2006), *available at* <http://www.sec.gov/Archives/edgar/data/1316898/000095013606009259/file1.htm>.

