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Direct Public Offering or Reverse Merger; Know Your Best Option for Going Public

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

Introduction

For at least the last twelve months, I have received calls daily from companies wanting to go public. This interest in going public transactions signifies a big change from the few years prior.

Beginning in 2009, the small-cap and reverse merger, initial public offering (IPO) and direct public offering (DPO) markets diminished greatly. I can identify at least seven main reasons for the downfall of the going public transactions. Briefly, those reasons are: (1) the general state of the economy, plainly stated, was not good; (2) backlash from a series of fraud allegations, SEC enforcement actions, and trading suspensions of Chinese companies following reverse mergers; (3) the 2008 Rule 144 amendments including the prohibition of use of the rule for shell company and former shell company shareholders; (4) problems clearing penny stock with broker dealers and FINRA's enforcement of broker-dealer and clearing house due diligence requirements related to penny stocks; (5) DTC scrutiny and difficulty in obtaining clearance following a reverse merger or other corporate restructuring and significantly DTC chills and locks; (6) increasing costs of reporting requirements, including the relatively new XBRL requirements; and (7) the updated listing requirements imposed by NYSE, AMEX and NASDAQ and twelve-month waiting period prior to qualifying for listing following a reverse merger.

However, despite these issues, the fact is that going public is and remains the best way to access capital markets. Public companies will always be able to attract a PIPE investor, equity line or similar financing (the costs and quality of these financing opportunities is beyond the scope of this blog). For cash-poor companies, the use of a trading valuable stock is the only alternative for short-term growth and acquisitions. At least in the USA, the stock market, day traders, public market activity and the interest in capital markets will never go away; they will just evolve to meet ever-changing demand and regulations.

What is a Reverse Merger? What is the Process?

A reverse merger is the most common alternative to an initial public offering (IPO) or direct public offering (DPO) for a company seeking to go public. A "reverse merger" allows a privately held company to go public by acquiring a controlling interest in, and merging with, a public operating or public shell company. The SEC defines a "shell company" as a publically traded company with (1) no or nominal operations and (2) either no or nominal assets or assets consisting solely of any amount of cash and cash equivalents.

In a reverse merger process, the private operating company shareholders exchange their shares of the private company for either new or existing shares of the public company so that at the end of the transaction, the shareholders of the private operating company own a majority of the public company and the private operating company has become a wholly owned subsidiary of the public company. The public company assumes the operations of the private operating company. At the closing, the private operating company has gone public by acquiring a controlling interest in a public company and having the public company assume operations of the operating entity.

A reverse merger is often structured as a reverse triangular merger. In that case, the public shell forms a new subsidiary which the new subsidiary merges with the private operating business. At the closing the private company shareholders exchange their ownership for shares in the public company, and the private operating business becomes a wholly owned subsidiary of the public company. The primary benefit of the reverse triangular merger is the ease of shareholder consent. That is because the sole shareholder of the acquisition subsidiary is the public company; the directors of the public company can approve the transaction on behalf of the acquiring subsidiary,

avoiding the necessity of meeting the proxy requirements of the Securities Exchange Act of 1934.

Like any transaction involving the sale of securities, the issuance of securities to the private company shareholders must either be registered under Section 5 of the Securities Act or use an available exemption from registration. Generally, shell companies rely on Section 4(a)(2) or Rule 506 of Regulation D under the Securities Act for such exemption.

The primary advantage of a reverse merger is that it can be completed very quickly. As long as the private entity has its "ducks in a row," a reverse merger can be completed as quickly as the attorneys can complete the paperwork. Having your "ducks in a row" includes having completed audited financial statements for the prior two fiscal years and quarters up to date (or from inception if the company is less than two years old), and having the information that will be necessary to file with the SEC readily available. The SEC requires that a public company file Form 10 type information on the private entity within four days of completing the reverse merger transaction (a super 8-K). Upon completion of the reverse merger transaction and filing of the Form 10 information, the once private company is now public. The reverse merger transaction itself is not a capital-raising transaction, and accordingly, most private entities complete a capital-raising transaction (such as a PIPE) simultaneously with or immediately following the reverse merger, but it is certainly not required. In addition, many Companies engage in capital restructuring (such as a reverse split) and a name change either prior to or immediately following a reverse merger, but again, it is not required.

There are several disadvantages of a reverse merger. The primary disadvantage is the restriction on the use of Rule 144 where the public company is or ever has been a shell company. Rule 144 is unavailable for the use by shareholders of any company that is or was at any time previously a shell company unless certain conditions are met. In order to use Rule 144, a company must have ceased to be a shell company; be subject to the reporting requirements of section 13 or 15(d) of the Exchange Act; filed all reports and other materials required to be filed by section 13 or 15(d) of the Exchange Act, as applicable, during the preceding 12 months (or for such shorter period that the Issuer was required to file such reports and materials), other than Form 8-K reports; and have filed current "Form 10 information" with the Commission reflecting its status as an entity that is no longer a shell company, then those securities may be sold subject to the

requirements of Rule 144 after one year has elapsed from the date that the Issuer filed "Form 10 information" with the SEC.

Rule 144 now affects any company who was ever in its history a shell company by subjecting them to additional restrictions when investors sell unregistered stock under Rule 144. The new language in Rule 144(i) has been dubbed the "evergreen requirement." Under the so-called "evergreen requirement," a company that ever reported as a shell must be current in its filings with the SEC and have been current for the preceding 12 months before investors can sell unregistered shares.

The second biggest disadvantage concerns undisclosed liabilities, lawsuits or other issues with the public shell. Accordingly, due diligence is an important aspect of the reverse merger process, even when dealing with a fully reporting current public shell. The third primary disadvantage is that the reverse merger is not a capital-raising transaction (whereas an IPO or DPO is). An entity in need of capital will still be in need of capital following a reverse merger, although generally, capital raising transactions are much easier to access once public. The fourth disadvantage is immediate cost. The private entity generally must pay for the public shell with cash, equity or a combination of both. However, it should be noted that an IPO or DPO is also costly.

Finally, whether an entity seeks to go public through a reverse merger or an IPO, they will be subject to several, and ongoing, time-sensitive filings with the SEC and will thereafter be subject to the disclosure and reporting requirements of the Securities Exchange Act of 1934, as amended.

What is a Direct Public Offering? What is the Process?

One of the methods of going public is directly through a public offering. In today's financial environment, many Issuers are choosing to self-underwrite their public offerings, commonly referred to as a Direct Public Offering (DPO). An IPO, on the other hand, is a public offering underwritten by a broker-dealer (underwriter). As a very first step, an Issuer and their counsel will need to complete a legal audit and any necessary corporate cleanup to prepare the company for a going public transaction. This step includes, but is not limited to, a review of all articles and amendments, the current capitalization and share structure and all outstanding securities; a review of all convertible instruments including options, warrants and debt; and the completion of any necessary amendments or changes to the current structure and instruments. All past

issuances will need to be reviewed to ensure prior compliance with securities laws. Moreover, all existing contracts and obligations will need to be reviewed including employment agreements, internal structure agreements, and all third-party agreements.

Once the due diligence and corporate cleanup are complete, the Issuer is ready to move forward with an offering. Companies desiring to offer and sell securities to the public with the intention of creating a public market or going public must file with the SEC and provide prospective investors with a registration statement containing all material information concerning the company and the securities offered. Such registration statement is generally on Form S-1. For a detailed discussion of the S-1 contents, please see my white paper here. The average time to complete, file and clear comments on an S-1 registration statement is 90-120 days. Upon clearing comments, the S-1 will be declared effective by the SEC.

Following the effectiveness of the S-1, the Issuer is free to sell securities to the public. The method of completing a transaction is generally the same as in a private offering. (i) the Issuer delivers a copy of the effective S-1 to a potential investor, which delivery can be accomplished via a link to the effective registration statement on the SEC EDGAR website together with a subscription agreement; (ii) the investor completes the subscription agreement and returns it to the Issuer with the funds to purchase the securities; and (iii) the Issuer orders the shares from the transfer agent to be delivered directly to the investor. If the Issuer arranges in advances, shares can be delivered to the investors via electronic transfer or DWAC directly to the investors brokerage account.

Once the Issuer has completed the sale process under the S-1 – either because all registered shares have been sold, the time of effectiveness of the S-1 has elapsed, or the Issuer decides to close out the offering – a market maker files a 15c2-11 application on behalf of the Issuer to obtain a trading symbol and begin trading either on the over-the-counter market (such as OTCQB). The market maker will also assist the Issuer in applying for DTC eligibility.

A DPO can also be completed by completing a private offering prior to the filing of the S-1 registration statement and then filing the S-1 registration statement to register those shares for resale. In such case, the steps remain primarily the same except that the sales by the company are completing prior to the S-1 and the 15c2-11 can be filed immediately following effectiveness of the S-1 registration statement.

Basic Differences in DPO vs. Reverse Merger Process

Why DPO:

As opposed to a reverse merger, a company completing a DPO does not have to worry about potential carry-forward liability issues from the public shell.

A company completing a DPO does not have to wait 12 months to apply to the NASDAQ, NYSE MKT or other exchange and if qualified, may go public directly onto an exchange.

A DPO is a money-raising transaction (either pre S-1 in a private offering or as part of the S-1 process). A reverse merger does not raise money for the going public entity unless a separate money-raising transaction is concurrently completed.

As long as the company completing the DPO has more than nominal operations (i.e., it is not a very early-stage start-up with little more than a business plan), it will not be considered a shell company and will not be subject to the various rules affecting entities that are or ever have been a shell company. To the contrary, many public entities completing a reverse merger are or were shells.

A DPO is less expensive than a reverse merger. The total cost of a DPO is approximately and generally $100,000-$150,000 all in. The cost of a reverse merger includes the price of the public vehicle, which can range from $250,000-$500,000. Accordingly, the total cost of a reverse merger is approximately and generally $350,000-$650,000 all in. Deals can be made where the cost of the public shell is paid in equity in the post-reverse merger entity instead of or in addition to cash, but either way, the public vehicle is being paid for. NOTE: These are approximate costs. Many factors can change the cost of the transactions.

Why Reverse Merger?

Raising money is difficult and much more so in the pre-public stages. In a reverse merger, the public company shareholders become shareholders of the operating business and no capital raising transaction needs to be completed to complete the process.

A reverse merger can be much quicker than a DPO.

Raising money in a public company is much easier than in a private company pre going public. A reverse merger can be completed quickly, and thereafter the now public company can raise money.

Reverse Mergers and DPO's are both excellent methods for going public

As I see it, the evolution in the markets and regulations have created new opportunities, including the opportunity for a revived, better reverse merger market and a revived, better DPO market. A reverse merger remains the quickest way for a company to go public, and a DPO remains the cleanest way for a company to go public. Both have advantages and disadvantages, and either may be the right choice for a going public transaction depending on the facts, circumstances and business needs.

The increased difficulties in general and scrutiny by regulators may be just what the industry needed to weed out the unscrupulous players and invigorate this business model. Shell companies necessarily require greater due diligence up front, if for no other reasons than to ensure DTC eligibility and broker dealer tradability, prevent future regulatory issues, and ensure that no "bad boys" are part of the deal or were ever involved in the shell. Increased due diligence will result in fewer post-merger issues.

The over-the-counter market has regained credibility and supports higher stock prices, especially since exchanges are forcing companies to trade there for a longer period of time before becoming eligible to move up. Resale registration statements, and thus disclosure, may increase to combat the Rule 144 prohibitions. We have already seen greater disclosure by non-reporting entities trading on otcmarkets.com.

The bottom line is that issues and setbacks for going public transactions since 2008 have primed the pump and created the perfect conditions for a revitalized, better reverse merger and DPO market beginning in 2014.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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