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Guide to Reverse Merger Transactions

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.

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 pre-closing controlling shareholder of the public company either returns their shares to the company for cancellation or transfers them to individuals or entities associated with the private operating business. 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 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.

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. Form 10 information refers to the type of information contained in a Form 10 Registration Statement. Accordingly, a Super 8-K is an 8-K with a Form 10 included therein.

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 Transaction

A reverse merger is a merger transaction with the difference being that the target ultimately ends up owning a majority of the acquirer. However, the documentation and process to complete the transaction is substantially the same as a forward merger.

Generally the first step in a reverse merger is executing a confidentiality agreement and letter of intent. These documents can be combined or separate. If the parties are exchanging information prior to reaching the letter of intent stage of a potential transaction, a confidentiality agreement should be executed first.

In addition to requiring that both parties keep information confidential, a confidentiality agreement sets forth important parameters on the use of information. For instance, a reporting entity may have disclosure obligations in association with the initial negotiations for a transaction, which would need to be exempted from the confidentiality provisions. Moreover, a confidentiality agreement may contain other provisions unrelated to confidentiality such as a prohibition against solicitation of customers or employees (non-competition) and other restrictive covenants. Standstill and exclusivity provisions may also be included, especially where the confidentiality agreement is separate from the letter of intent.

Next is the letter of intent ("LOI"). An LOI is generally non-binding and spells out the broad parameters of the transaction. The LOI helps identify and resolve key issues in the negotiation process and hopefully narrows down outstanding issues prior to spending the time and money associated with conducting due diligence and drafting the transaction contracts and supporting documents. Among other key points, the LOI may set the price or price range, the parameters of due diligence, necessary pre-deal recapitalizations, confidentiality, exclusivity, and time frames for completing each step in the process. Along with an LOI, the parties' attorneys prepare a transaction checklist which includes a "to do" list along with a "who do" identification.

Following the LOI, the parties will prepare a definitive agreement which is generally titled either a "Share Exchange Agreement" or a "Merger Agreement." In a nutshell, the Merger Agreement sets out the financial terms of the transaction and legal rights and obligations of the parties with respect to the transaction. The Merger Agreement sets forth closing procedures, preconditions to closing and post-closing obligations, and sets out representations and warranties by all parties and the rights and remedies if these representations and warranties are inaccurate.

The main components of the Merger Agreement and a brief description of each are as follows:

1) Representations and Warranties – Representations and warranties generally provide the buyer and seller with a snapshot of facts as of the closing date. From the seller the facts are generally related to the business itself, such as that the seller has title to the assets, there are no undisclosed liabilities, there is no pending litigation or adversarial situation likely to result in litigation, taxes are paid and there are no issues with employees. From the buyer the facts are generally related to legal capacity, authority and ability to enter into a binding contract. The seller also represents and warrants its legal ability to enter into the agreement.
2) Covenants – Covenants generally govern the parties' actions for a period prior to and following closing. An example of a covenant is that the private company must continue to operate the business in the ordinary course and maintain assets

pending closing and if there are post-closing payouts that the seller continues likewise. All covenants require good faith in completion.

3) Conditions – Conditions generally refer to pre-closing conditions such as shareholder and board of director approvals, that certain third-party consents are obtained and proper documents are signed. Closing conditions usually include the payment of the compensation by the buyer. Generally, if all conditions precedent are not met, the parties can cancel the transaction.
4) Indemnification/remedies – Indemnification and remedies provide the rights and remedies of the parties in the event of a breach of the agreement, including a material inaccuracy in the representations and warranties or in the event of an unforeseen third-party claim related to either the agreement or the business.
5) Schedules – Schedules generally provide the meat of what the seller is purchasing, such as a complete list of customers and contracts, all equity holders, individual creditors and terms of the obligations. The schedules provide the details.

In the event that the parties have not previously entered into a letter of intent or confidentiality agreement providing for due diligence review, the Merger Agreement may contain due diligence provisions. Likewise, the agreement may contain no-shop provisions, breakup fees, and/or non-compete and confidentiality provisions if not previously agreed to separately.

The next and final steps are the actual closing in which the shares of stock and reverse merger consideration change hands and a Super 8-K is filed with the SEC.

Reverse Merger Consideration; The Cost of the Shell

In a reverse merger transaction, the private operating business must pay for the public shell company. That payment may be in cash, equity or both. Although the cash price of shell entities can vary and changes over time as does the value of all assets, as of the day of this blog, the average cash value of a fully reporting public entity with no liabilities, no issues (such as a DTC chill) and which is otherwise “clean” is between $280,000 – $400,000. The price variance depends on many factors, such as pre- and post-closing conditions (such as a requirement that the public entity complete a name change and/or stock split prior to closing); the ultimate percent ownership that will be owned by the private operating company shareholders; how quickly the transaction can close; whether the private entity has its “ducks in a row” (see below); whether the entities have complete due diligence packages prepared; and whether any broker-dealers or investment bankers must be paid in association with the transaction.

Where the private operating business is paying for the public shell entity with equity, the current shareholders of the public shell company keep a larger portion of their pre-closing equity and therefore own a greater percent of the new combined companies post-closing. That is, the current public company shareholders have a lower level of dilution in the transaction.

For example, in a cash reverse merger transaction, generally the current control shareholders of the public company cancel or otherwise divest themselves of all of their share ownership and the post-closing share ownership is anywhere from 80%/20% to 99%/1% with the private operating company shareholders owning the majority. In an equity transaction, the current control shareholders keep some or all of their current share ownership. In addition, the final post-closing capitalization will generally be anywhere from 51%/49% to 80%/20% with the private operating company shareholders owning the majority.

The percentage of ownership maintained by the public company shareholders will depend on the perceived value of the private operating company and an expectation of what the value of their share ownership could be in the future. Clearly there is risk involved for the public company shareholders. That is, control shareholders may have to decide whether to accept $300,000 today or maintain a stock ownership level that they hope will be worth much more than that at some time in the future. From the private operating company's perspective, they are diluting their current ownership and giving up a piece of the pie.

Accordingly, in an equity transaction, the parties to the reverse merger will negotiate the value of the private operating business. For business entities with operating history, revenue, profit margins and the like, valuation is determined by mathematical calculations and established mathematically based matrixes (usually 1x to 8x EBITDA). For a development stage or start-up venture, the necessary elements to complete a mathematical analysis simply do not exist. In this case, valuation is based on negotiation and a best guess.

Establishing valuation for a development stage or start-up entity ultimately comes down to an investor's (i.e., in a reverse merger, public company shareholders who agree to forgo cash and keep equity instead) perception of risk versus reward. Risk is easy to determine: If I could get $300,000 cash for the public shell today, I may lose that $300,000 by accepting equity instead. Reward, on the other hand, is an elusive prospect based on the potential success of a business.

In determining value, an analysis (due diligence) should be conducted on a minimum of the following: market data; competition; pricing and distribution strategies; assets and liabilities; hidden liabilities; inflated assets; technology risks; product development plans; legal structure; legal documentation; corporate formation documents and records; and management, including backgrounds on paper, and face-to-face assessments.

Areas of Consideration in Determining Valuation

The following areas should be researched and considered in valuation. The below list is in no particular order.

1) Investment Comps: Have investors, either private or public, recently funded similar companies, and if so, on what terms and conditions and at what valuation;
2) Market Data: What is the product market; what is the size of the market; how many new players enter the market on a yearly basis and what is their success rate;
3) Competition: Who are the major competitors; what is their valuation; how does this company differ from these competitors;
4) Uniqueness of Product or Technology: How is the product or technology unique; can it easily be duplicated; patent, trademark and other intellectual property protections;
5) Pricing and Distribution Strategies: What are the major impediments to successful entry into the marketplace; what is the plan for successful entry into the marketplace; has order fulfillment, including transportation costs, been considered; connections to end users for the product or service; what are profit margins and will the margins increase as the business grows and scales;
6) Capital Investments to Date: What capital investments have been made to the company to date, including both financial and services;

7) Assets and Liabilities: What does the balance sheet look like; are there hidden liabilities; any off-balance sheet arrangements; how are assets valued; are any assets either over- or undervalued; is there clear title to all assets;
8) Technology Risks: What technologies are relied upon; what is the state of evolvement of those technologies; can they keep up;
9) Product Development Plans: Are there a model and samples; have they been tested; have manufacturing channels been established; exclusive contracts with manufacturers; what is the overall plan to bring the product to market and subsequently become a competitor in the industry;
10) Legal Structure: Legal structure of current outstanding equity – just common equity or common and preferred, and if preferred, what rights are associated therewith (redemption rights; liquidation preferences; dividends; voting rights);
11) Legal Documentation: Not only whether corporate records are in order, but are all contracts and arrangements properly documented;
12) Future Financing Needs: Will significant future financing be necessary to achieve the business plan; what is the risk of a future down round (note that a down round is a future financing at a lower valuation resulting in dilution to the current investors);
13) Exit Strategies: How will the current shareholder be able to sell; will the shares have piggyback or demand registration rights; reliance on Rule 144?; lockup or other additional holding periods?;
14) Management: This is perhaps the most important consideration – Does the management team have a proven history of success; prior business experience in this and other industries; work ethic; general management skills; organization skills; presentation skills; research skills; ability to attract others with strong credentials who believe in the business and are willing to work to make the business a success; does management present well in meetings and face-to-face discussions;
15) Developmental Milestones: Has the company achieved its developmental milestones to date?

Advantages of a Reverse Merger

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 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.

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. Accordingly, companies that may be less mature in their development and unable to attract sophisticated capital financing can use a reverse merger to complete a going public transaction and still benefit from being public while they grow and mature. Such benefits include the ability to use stock and stock option plans to attract and keep higher-level executives and consultants and to make growth acquisitions using stock as currency.

Disadvantages of a Reverse Merger

There are several disadvantages to 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 that 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.

Another 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.

In addition, the NYSE, NYSE MKT (formerly AMEX) and NASDAQ exchanges have enacted more stringent listing requirements for companies seeking to become listed following a reverse merger with a shell company. The rule change prohibits a reverse merger company from applying to list until the combined entity had traded in the U.S. over-the-counter market, on another national securities exchange, or on a regulated foreign exchange for at least one year following the filing of all required information about the reverse merger transaction, including audited financial statements. In addition, new rules require that the new reverse merger company has filed all of its required reports for the one-year period, including at least one annual report. The new rule requires that the reverse merger company "maintain a closing stock price equal to the stock price requirement applicable to the initial listing standard under which the reverse merger company is qualifying to list for a sustained period of time, but in no event for less than 30 of the most recent 60 trading days prior to the filing of the initial listing application." The rule includes some exceptions for companies that complete a firm commitment offering resulting in net proceeds of at least $40 million.

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.

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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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