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Direct Public Offerings by Shell Companies; Tread Carefully

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.

As I've written about previously, recently (albeit not officially) the Securities and Exchange Commission ("SEC") has materially altered its position on offerings by shell companies that are not blank check companies. In particular, over the past year, numerous shell companies that are not also blank check companies have completed direct public offerings using a S-1 registration statement and successfully obtained market maker support and a ticker symbol from FINRA and are trading.

Rule 419 and Blank Check Companies

The provisions of Rule 419 apply to every registration statement filed under the Securities Act of 1933, as amended, by a blank check company. Rule 419 requires that the blank check company filing such registration statement deposit the securities being offered and proceeds of the offering into an escrow or trust account pending the execution of an agreement for an acquisition or merger.

In addition, the registrant is required to file a post-effective amendment to the registration statement containing the same information as found in a Form 10 registration statement, upon the execution of an agreement for such acquisition or merger. The rule provides procedures for the release of the offering funds in conjunction with the post-effective acquisition or merger. The obligations to file post-effective amendments are in addition to the obligations to file Form 8-K to report both the entry into a material non-ordinary course agreement and the completion of the transaction. Rule 419 applies to both primary and resale or secondary offerings.

Within five (5) days of filing a post-effective amendment setting forth the proposed terms of an acquisition, the company must notify each investor whose shares are in escrow. Each investor then has no fewer than 20 and no greater than 45 business days to notify the company in writing if they elect to remain an investor. A failure to reply indicates that the person has elected to not remain an investor. As all investors are allotted this second opportunity to determine to remain an investor, acquisition agreements should be conditioned upon there being enough funds remaining in escrow to close the transaction.

The definition of "blank check company" as set forth in Rule 419 of the Securities Act is a company that:

1) Is a development-stage company 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
2) Is issuing "penny stock," as defined in Rule 3a51-1 under the Securities Exchange Act of 1934.

Shell Companies

The definition of "shell company" as set forth in Rule 405 of the Securities Act (and Rule 12b-2 of the Securities Exchange Act of 1934) means a company that has:

1) No or nominal operations; and
2) Either none or nominal assets;
3) Assets consisting solely of cash and cash equivalents; or
4) Assets consisting of any amount of cash and cash equivalents and nominal other assets.

Clearly, the definitions are different. Although a shell company could also be a blank check company, it could be a development-stage company or start-up organization or an entity with a specific business plan but nominal operations. Until recently, however, the SEC has firmly held the position that Rule 419 applies equally to shell and development-stage companies.

In fact, the SEC Staff Observations in the Review of Smaller Reporting Company IPO's published by the SEC Division of Corporate Finance contains the following comments:

"Rule 419 applies to any registered offering of securities of a blank check company where the securities fall within the definition of a penny stock under the Securities Exchange Act of 1934. We frequently reviewed registration statements of recently established development stage companies with a history of losses and an expectation of continuing losses and limited operations. These companies often stated that they may expand current operations through acquisitions of other businesses without specifying what kind of business or what kind of company. In other cases, the stage of a company's development, when considered in relation to the surrounding facts and circumstances, may raise questions regarding the company's disclosed business plan. We generally asked companies like these to review Rule 419 of Regulation C. We asked these companies either to revise their disclosure throughout the registration statement to comply with the disclosure and procedural requirements of Rule 419 or to provide us with an explanation of why Rule 419 did not apply."

SEC Policy

The SEC will now allow a shell company, as long as it is not also a blank check company, to embark on an offering using an S-1 registration statement without the necessity to comply with Rule 419. As noted above, an entity can be a shell company, but not a blank check company, as long as it has a specific business purpose and plan and is taking steps to move that plan forward, such as a start-up or development-stage entity. In the last couple of years, several companies have filed S-1 registration statements with little more than a specific business plan, and such S-1's have been declared effective, the shares have been successfully placed, and the company's common stock is trading on the over-the-counter market. A review of the comment letters associated with these shell company S-1 filings has not shown a single comment requesting that the issuing company comply with or explain why they did not have to comply with Rule 419.

Such entities clearly need to disclose that that they are a shell company as defined by Rule 405 of the Securities Act and accordingly, shareholders would not be able to rely on Rule 144 for resales unless all of the conditions of Rule 144(i) were met. Although investors that buy directly in the S-1 will receive registered securities and not need to

rely on Rule 144, other investors would. In order to use Rule 144, the 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.

A question arises as to when a development-stage or start-up company ceases to be a shell. Generally shell companies complete a clear transaction removing them from shell company status, such as a merger or acquisition, and file Form 10 information on the newly acquired business. I would suggest that at some point, such as when the company generates its first revenues or launches its product, or upon some other identifiable marker that would reasonably be interpreted as a change in shell company status, the company file Form 10 information disclosing its own business and operations and thereafter begin the one-year holding period for use of Rule 144.

Unfortunately, some individuals have been taking companies public with little more than a business plan for the sole purpose of creating public vehicles, despite the assertions, subject to SEC enforcement, in the S-1 as to the intended business plan. That is, some people have been claiming shell status when in fact the entity is a blank check company and should be subject to Rule 419.

SEC Actions

On February 3, 2014, the SEC initiated administrative proceedings against 19 companies that had filed S-1 registration statements. The 19 registration statements were all filed with an approximate 2-month period around January 2013. Each of the companies claimed to be an exploration-stage entity in the mining business without known reserves, and each claimed they had not yet begun actual mining. Each of the 19 entities used the same attorney. Each of the entities was incorporated at around the same time using the same registered agent service. Each of the 19 S-1's read substantially the same. Among other allegations, the SEC alleges that the claims of a mining business are false. Presumably, the SEC believes that the S-1's were filed to

create public companies for resale as opposed to pursuing the business plan set forth in the S-1 which the officer/director signed under penalties of law.

The SEC is playing hardball with this group as well. An S-1 does generally contain language that it may be amended or modified (or even withdrawn) until it is declared effective by the SEC. This pre-effective S-1 is not deemed filed by the SEC or a final prospectus for Section 5 and broker-dealer prospectus delivery requirements. Upon initiation of the SEC investigation, all 19 S-1 filers attempted to withdraw their S-1 registration statements. The SEC suggested that they withdraw their requests to terminate the S-1 and cooperate fully with the investigation. The entities did not comply. Accordingly, in addition for claims related to the filing of false statements in the S-1, the SEC has also alleged that the "Respondent's seeking to withdraw its Registration Statement constitutes a failure to cooperate with, refusal to permit, and obstruction of the staff's examination under Section 8(e) of the Securities Act."

In addition, I am aware that many entities that completed direct public offerings by filing an S-1 registration statement, and then subsequently completed changes of control and/or businesses within a relatively short period of time, are now the subject of active SEC investigations.

Section 11 of the Securities Act of 1933, as amended provides for civil actions by investors against a company and its officers and directors for the filing of a false registration statement. Section 8 of the Securities Act provides for SEC civil administrative proceedings related to a false registration statement filing.

In addition to civil proceedings, the Securities Act provides that any person who "willfully" makes a false or misleading statement in a registration statement (or otherwise violates a provision of the Securities Act of 1933 or any rules or regulations promulgated thereunder) can be fined up to $10,000 and/or imprisoned for not more than five years.

Unfortunately, each time there is a change in the business surrounding small-cap entities, there will be a few unscrupulous players that will seek to illegally capitalize on policies that, in general, can benefit small business enterprises.

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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 Producer and host of LawCast.com, The Securities Law Network.

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