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REVERSE MERGERS WILL REQUIRE INCREASED DISCLOSURE IN SHORTER PERIOD

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This article appeared in the New York Law Journal column 'Outside Counsel" July 25, 2005.

The Securities and Exchange Commission (SEC) has adopted new rules[1] that will make reverse mergers much more time consuming to complete and require substantial advance work by lawyers and accountants before the merger can become effective. Public Former Shell Company

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The new rules will require the public former shell company to file a Form 8-K within four business days of the effective time of the reverse merger which contains the same type of disclosure that would be provided if the former shell company were registering its securities under the Securities Act of 1934, as amended (the Exchange Act), for the first time on Form 10, Form 10-SB or Form 20-F (referred to in this article as Form 10 information). The Form 8-K will also be required to include audited financial statements for the formerly privately held business and pro forma financials for the combined businesses. As a result, the lead time needed to prepare both the "Form 10 information" and the financial statements will be substantial and will mean that the merger cannot be effective until all of the required information will be available within four business days.

The amendments to Form 8-K are effective Nov. 7, 2005. Thus, attorneys who have pending matters that may be subject to the new rules should consider the timing of their proposed transaction in light of this effective date.

The rules on reverse mergers are part of a final rule on shell companies that the SEC voted to adopt on June 29, 2005. The SEC had proposed these rules on April 15, 2004.[2] The new rules are intended to assure that investors in public shell companies that acquire or are acquired by ongoing businesses have access on a timely basis to the same kind of information as is available to investors in public companies with continuing operations.

In addition, the new rules will prohibit shell companies from using Form S-8, the form used to register offerings of employer securities under employee benefit plans, until 60 days after they cease being shell companies. The prohibition on using Form S-8 is intended to prevent shell companies from avoiding the registration requirements under the Securities Act of 1933, as amended (the Securities Act) by using a simplified registration form intended for offering securities pursuant to employee benefit plans in what is really a capital raising transaction.

In addition, a check box has been added to various Exchange Act reporting forms, namely the annual and quarterly reports on Form 10-K, 10-KSB, 10-Q, 10-QSB and Form 20-F, to identify shell companies filing these reports.

The changes made by the new rules other than to Form 8-K are effective 30 days after publication in the Federal Register.

Reverse mergers using shell companies have become a relatively quick and inexpensive way in which private companies may become public. Unlike with an initial public offering, (IPO), no underwriter is involved and, as a result, the deal can be done on a much more expedited basis. The SEC releases adopting the proposed and final rules indicate that two typical types of transactions involving public shells are: (1) a "reverse merger," where the private business merges into the public shell company or its subsidiary, with the shell company surviving or continuing in existence, and the former shareholders of the private company controlling the surviving company; and (2) a "back-door registration," where the shell company merges into the formerly private company, with the formerly private company surviving and the shareholders of the shell company becoming shareholders of the surviving entity.

PIPES

Often, shell company transactions are done in conjunction with PIPES, or so called "private investment in public equities," as a method to raise capital for the private company. In the transaction, PIPES investors typically buy restricted shares in a private placement, often at a discount from the offering price, and are able to sell the securities of the surviving public company following the merger on the public market via a resale registration statement. Investors will be provided with a private placement memorandum covering the private company, and buy into that company because they are promised that they will be able to dispose of their stock publicly under a resale registration statement following the reverse merger.

DEFINITIONS

A "shell company" is defined in the new rules as a registrant that has no or nominal operations and meets one of three alternate criteria: (1) has no or nominal assets; (2) has assets consisting solely of cash and cash equivalents; or (3) has assets consisting of any amount of cash and cash equivalents and nominal other assets.[3] For purposes of this definition, the determination of a company's assets (including cash and cash equivalents) must be based on the amounts that would be reflected on the company's balance sheet prepared in accordance with U.S. generally accepted accounting principles. The definition is intended to cover the common type of a shell, even if has a minimal ongoing business. It should be noted that the term "nominal assets" was not defined by the SEC.

Footnote 31 to the final SEC release indicates that "living dead" companies, i.e., former operating companies with minimal or limited operations, that meet the assets and operations standards in the definition of "shell company" will be subject to the new rules.

Footnote 32 to the final SEC release states that promoters will not be able to avoid the new rules by placing assets or operations within an entity with the intent of causing that entity to fall outside the definition of "shell company" by utilizing an agreement that those assets will be returned to the promoter upon completion of the business transaction. Footnote 32 also raises the issue of whether the SEC considers such shell companies with nominal operations to be "blank check companies"[4] subject to very significant restrictions under Securities Act

Rule 419. While a discussion of "blank check companies" is beyond the scope of this article, the SEC and NASD have issued guidance to the effect that Securities Act Rule 144 would not be available to promoters or affiliates of blank check companies or their transferees either before or after a business combination with an operating company or other person.[5]

The new rules also define the term "business combination related shell company" to identify the subset of shell companies for which certain of the amendments to Form S-8, Form 8-K and Form 20-F will not apply. A "business combination related shell company" is a shell company that is used to change a non-shell company's domicile or a shell company that is formed to effect a business combination transaction between two non-shell companies.[6]

The new rules also revise the definition of "succession" under Exchange Act Rule 12b-2 to include the "back door registration" method of taking a company public. Thus, in a "back door registration," the surviving company in the merger, the private company, succeeds to the Exchange Act reporting obligations of the public shell without filing a new Exchange Act registration form, but rather by filing the Form 8-K which calls for registration-level disclosure.

Currently, shell companies engaged in reverse mergers are required to file Form 8-K within four business days of the transaction, but that form is only required to have limited disclosures about the transaction itself under Item 1.01 (Entry Into Material Definitive Agreement) and Item 2.01 (Completion of Acquisition or Disposition of Assets). A "back door registration" transaction would generally fall under Item 1.01 and Item 5.01 (Changes in Control of Registrant) of Form 8-K. Under Item 9.01 of Form 8-K (Financial Statements and Exhibits), the public former shell company in a reverse merger currently has 71 calendar days after filing the Form 8-K to file the audited financial statements of the businesses acquired and the pro forma financial information required by the relevant provisions of Regulation S-X.

The problem with the existing rules is that the substantive information about the business resulting from the reverse merger is often not available until the company's next Form 10-K is filed, which can be up to almost 15 months after the transaction for a transaction occurring early in the shell company's fiscal year. Financial information about the combined business does not have to be filed until 71 days after the 8-K is filed. In the interim, the stock of the former shell is trading on the public market without sufficient publicly available information for investors to make informed business decisions. While reverse mergers are currently subject to this less-rigorous scheme, the SEC had indicated in a no action letter issued in year 2000 that "back door registrations" involving reporting "blank check companies" would be subject to Form 8-K disclosures similar to what the new rules require.[7]

The new rules add a new Item 5.06 to Form 8-K to require disclosures of when shell companies cease to be shell companies. The new rules require the Form 8-K to contain "Form 10 information," the same information as is required by Form 10 or Form 10-SB (for small business issuers). These are the forms whereby issuers register their securities under §12 of the Exchange Act for the first time and are very comprehensive. Clearly the reporting burden will increase vastly. Issuer's counsel would be well-advised to perform an appropriate due diligence investigation with respect to the private company, as well as to review the SEC filings of the public shell. Particular areas of focus may be the description of the business of the combined company and the risk factors entailed in making the investment. The SEC's final release estimated that the time needed to prepare the average filing would increase from five hours (for the current Form 8-K filing) to 133 hours (for a Form 10-SB).

In addition, the audited financial statements of the acquired business and pro forma financials of the combined company will be due at the same time as the Form 8-K. A company eligible for Form 10-SB will need to include a Management's Discussion and Analysis or Plan of Operation in the Form 8-K, whichever is required by Item 303 of Regulation S-B.[8]

While the Form 8-K is not required to include certifications of the Chief Executive Officer and Chief Financial Officer under §§302 and 906 of the Sarbanes-Oxley Act of 2002, the certifications will be due with the next Form 10-Q or 10-K for the period in which the merger occurs, so that private companies planning to engage in reverse mergers will need to get their disclosure controls, and internal controls, once the internal controls are fully phased in, ready to be able to make the certifications required for the next quarterly or annual filing on Form 10-Q or 10-K.

Currently, there are many cases where the private company will not have audited financials at the start of the reverse merger transaction. The disclosure and internal controls required by Sarbanes-Oxley are generally not in place in a private company.

Clearly the lead time in preparing the filing on Form 8-K as well as audited and pro forma financials, and a management's discussion and analysis or plan of operation where applicable, and getting the disclosure controls implemented will be significant. The very short time frame for filing a Form 8-K after the reverse merger closes will make the burden quite substantial, and in many cases will delay the effective time of a reverse merger until the Form 8-K and financial information are almost completed.

Under the new rules, foreign private issuer[9] shell companies, other than business combination related shell companies, must report transactions that cause them to cease being shell companies on Form 20-F, providing disclosure comparable to that which domestic companies must report on Form 8-K.[10] However, the §§302 and 906 certifications under Sarbanes-Oxley will not be required. The report on Form 20-F must be filed within four business days of completion of the transaction, and Rule 12b-25 is not available to extend the due date of the report.[11]

The new rules prohibit shell companies from using Form S-8 until 60 days after (1) they cease to be shell companies and (2) file current "Form 10 information" with the SEC at least 60 days previously reflecting the entity's status as an entity that is not a shell company.[12] A "business combination related shell company," i.e., a shell company used to change a non-shell company's domicile or to effect a merger among non-shell companies, may use Form S-8 immediately upon ceasing to be a shell company and filing "Form 10 information" reflecting its status as an entity that is not a shell company.[13]

The prohibition on use of Form S-8 by shell companies is directed at fraudulent schemes to raise capital in the public market with minimal disclosure. In some of these schemes, companies would issue securities to promoters who were employees or consultants and register these securities on Form S-8. Form S-8 is a form designed for registration of securities offered pursuant to employee benefit plans, and it does not require a prospectus to be filed with the SEC. In these fraud cases, the employees or consultants would resell their shares on the public market. Some shell companies would file multiple Forms S-8 and sell a large number of shares to the public in this fashion. This use of Form S-8 was contrary to General Instruction A.1(a)(1)(iii) to the form as currently in effect, which states that Form S-8 is limited to securities offered to employees or consultants as compensation for services and is not to be used to offer securities to persons in connection with capital raising transactions.

Since shell companies have few employees, they may not have a need to use Form S-8 to register securities under their employee benefit plans. In any event, shell companies may qualify for an exemption from registration for their employee benefit plans, for example under Rule 501 under the Securities Act for officers and directors (who are considered "accredited investors") or may need to use a form that takes more time to prepare, such as Form SB-2 or S-1, to register securities under their employee benefit plans.

In summary, these new rules will vastly change the landscape in reverse mergers as well as PIPES transactions involving formerly private companies by making these transactions most costly and time consuming to complete.

For private companies that want to raise money using the public marketplace without the expense and advance planning of an IPO, a reverse merger will still be the best way to proceed. However, given the legal and accounting expenses that the new SEC rules will entail, it makes sense for lawyers and accountants to obtain an agreement that they will be paid for what will likely be substantial time needed to prepare the documentation triggered by the new rules, whether or not the reverse merger transaction closes.

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1. SEC Release No. 33-8587, Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies (July 15, 2005) [70 FR 42233].
2. Release No. 33-8407, Use of Form S-8 and Form 8-K by Shell Companies (April 15, 2004) [69 FR 21650].
3. 3. See new Rule 405 under the Securities Act, 17 CFR 230.405; and new Rule 12b-2 under the Exchange Act, 17 CFR 240.12b-2.
4. A "blank check company" is defined in Rule 419(a)(2) under the Securities Act as 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 Exchange Act.
5. NASD Notice to Members 00-49 (July, 2000); Ken Worm, Assistant Director, OTC Compliance Unit, NASD Regulation, Inc. (interpretive letter) (Jan. 21, 2000).
6. See new Rule 405 under the Securities Act, 17 CFR 230.405; and new Rule 12b-2 under the Exchange Act, 17 CFR 240.12b-2.
7. Lisa Roberts, Director of NASDAQ Listing Qualifications (interpretive letter) (April 7, 2000). The Lisa Roberts letter also indicated that a Form 8-K filing with Form 10 or Form 10-SB information would be subject to its standards of review selection; that the SEC may issue substantive comments on the sufficiency of the disclosures presented and that these comments would have to be cleared by SEC staff.
8. See Form 10-SB, Item 2.
9. The term "foreign private issuer" is defined in Exchange Act Rule 3b-4(c), 17 CFR 240.3b-4(c). A foreign private issuer is a non-government foreign issuer, except for a company that (1) has more than 50 percent of its outstanding voting securities owned by U.S. investors and (2) has either a majority of its officers and directors residing in or being citizens of the United States, a majority of its assets located in the United States, or its business principally administered in the United States.
10. New Rules 13a-19 and 15d-19 under the Exchange Act, new 17 CFR 240.13a-19 and 15d-19.
11. Id.; See also new General Instruction A to Form 20-F.
12. See Forms Prescribed Under the Securities Act, new 17 CFR 239.16b.
13. See new General Instruction A.1 to Form S-8.