Secrets of the Reverse Merger

By Joseph B. LaRocco

For those of you that are not familiar with the term "Reverse Merger," let me start by explaining that a reverse merger is a transaction in which a private company merges with a public company. The public company is a public shell company, meaning that although it has a stock symbol and stock that trades in the public market place, usually on the over the counter markets, the public entity represents a failed business, that is, only a "shell." This shell company has no active business or operations. It just has a stock symbol and little or no assets.

Why Choose a Reverse Merger?

The main reason companies want to do a reverse merger, is to become a public company in order to raise capital. Raising capital is the absolute number one reason. A second less likely reason, used by more seasoned companies, is to allow existing shareholders an exit strategy. Public companies have stock that can be sold into the public marketplace so investors can recoup some or all of their initial investment in the company. This exit strategy may be preferable to some investors if a buyout is not likely or if investors have already been waiting several years for a return on their investment, which the company has not been able to deliver.

Start-ups and development stage companies have usually tried to obtain financing from banks, angel investors or venture capital firms before making the choice of going the reverse merger route. Most either don't have the assets to get bank financing or are such early stage start-ups that they can't attract angel or venture capital investors.

The Reverse Merger Process

What happens when a private company reverse merges with a public company is that the two companies enter into a "Share Exchange Agreement." This Agreement basically sets forth the terms under which the two companies merge. The public company is the surviving entity so that it maintains its public identity and that all important stock symbol. The business that was once the private company now is part of the public company and takes on a new identity with a stock symbol.

Other essential elements of the reverse merger process include a reverse stock split, name changes and a stock symbol change. The reverse stock split is almost always required of the public company to achieve the percentage ownership the private company is looking for upon closing. For instance, if the private company has three officers that own 19,000,000 shares of common stock and want 95 percent ownership upon closing of the reverse merger, then the public company shareholders would have to be reversed down to 1,000,000 shares. That means if the public company has 30,000,000 shares issued and outstanding the reverse stock split will be at a ratio of one for 30, leaving those shareholders with only 1,000,000 shares after the reverse split is effective. When this happens, some of the public company shareholders will likely be disappointed and voice their discontent by calling the new company officers. The likely response of new management should be an explanation that the public shell was out of business and the reason why the stock price had plummeted was because this previous business model had failed. This necessitated a reverse stock split so that new management and a new business could come in and try to make the company a success. Existing shareholders will hopefully welcome the new management team that is trying to breathe new life into the company that was headed toward bankruptcy anyway.

Upon closing, the private company's management team will want to do a name change and then request a new stock symbol. If the public shell was listed on the Pink Sheets (www.pinksheets.com) or Over the Counter Bulletin Board (OTCBB) (www.otcbb.com), then counsel for the company taking over the shell will request a symbol change from NASDAQ, which usually takes about two weeks.

A competent and thorough attorney and auditor are important for conducting due diligence on the shell. If at all possible find out who the former attorney and accountant for the company were and talk to them before you spend too much time and money reviewing voluminous documentation and paying professional fees to your own attorney and accountant. The prior attorney and accountant can quickly tell you if they are owed any money on past bills and can probably tell you some history about the shell. Many times it is easier to use them to bring the financials and legal filings of the shell current and then transition your legal and accounting time into place.

The due diligence process is a very important step in determining whether or not the shell has "skeletons in its closet." Most public shells will be carrying some sort of debt that the private company will have to assume when the reverse merger is completed. This debt usually involves outstanding legal or accounting fees and possibly wages or taxes that have not been paid. In an extreme situation these amounts can be quite high and may also involve judgments that have entered against the shell in the past for breach of contract or even an employee discrimination case.

Cost of Purchasing a Shell

I have heard from colleagues and business contacts that pink sheet shells cost about $150,000 to $200,000 to get a controlling interest of 90 percent to 95 percent. This amount does not include legal and accounting fees to help with the due diligence process and closing documentation. A Pink Sheet shell is a public company with a stock symbol that is not required by the U.S. Securities and Exchange Commission (SEC) to report its financials on the Electronic Data Gathering and Retrieval System (EDGAR). Some Pink Sheet companies do report their financials voluntarily however, especially if they are in good financial shape. If they are doing financially well they may then decide to get listed on the OTCBB.

An OTCBB shell can cost $400,000 to $500,000 to get a controlling interest of 90 percent to 95 percent. Usually larger companies, with gross revenues of at least $3,000,000 will reverse into an OTCBB shell. The main differences between a Pink Sheet and OTCBB listing are compliance requirements with the SEC. Those compliance requirements include quarterly filings, annual audits, material events filings and compliance with the Sarbanes-Oxley Act which covers issues such as auditor independence, corporate governance and financial disclosure. The time and cost of meeting Sarbanes-Oxley compliance is usually a deterrent to small less capitalized companies obtaining an OTCBB listing.

Evolution of Investor Relations

In the last three years or so, an interesting development has occurred with investor relations efforts for penny stock companies. The reason for the change is the Internet. First, let me start by explaining that in the years before the Internet became popular, the only way investors would find out about most penny stocks was through cold callers, brokers, friends and the mail. Then, when the fax machine became popular, investor relations groups started mass faxing people about the latest hot penny stock.

The Internet has changed the way these investor relations firms disseminate information about penny stocks. Some actually still use mail and fax, but by far it seems the most effective tool they use today is the Internet. Investor relations websites have started popping up all over the Internet. They create a database of penny stock investors that want updates on penny stocks. These websites then use the database to send investors updates and newsletters via e-mail. They feature penny stocks on their websites so that investors become aware of certain companies, what they do and what current news is available about them.

The purpose of these websites is to help penny stocks with their trading volume, and hopefully their stock price. After all a company's stock price can be strongly influenced by investor supply and demand, even if the company is not yet profitable. We all remember the dotcom days. Strong trading volume translates into the ability to raise capital to finance operations. These websites charge between $2,000 and $25,000 per month for an investor relations program. There are literally dozens of these websites on the Internet now with more being created.

What seems to have developed as a result of there being so many of these websites around now, is that a penny stock must budget significant dollars for an investor relations campaign. If the company does not, its stock will not trade much and the company will be unable to raise capital to survive.

Low Success Rate

The cold hard facts about most companies that do a reverse merger is that most of these companies fail to succeed. They trade well under $1.00 per share with many trading even below a penny. This happens because they have to keep selling more and more stock to finance operations, which dilutes the company, so the stock price keeps dropping. While the company is selling more and more stock, if management cannot show revenues are growing and losses are shrinking, the stock price will keep dropping. If the company has to keep raising more money while the stock price keeps dropping it becomes a vicious cycle that is extremely difficult to reverse.

Most financing raised for penny stock companies is done as a private placement. Discounts can be as much as 50 percent of the current price of the stock. This huge discount is demanded by investors and usually accepted by the company because they are desperate for cash and because investors are making a very risky investment. Penny stocks can easily drop 50 percent in a matter of a few days.

As often happens with many of these companies that did a reverse merger, they may get to the point where they can no longer pay management or expenses to carry out the business plan. Investors refuse to fund them any further because their business model is not working as planned. What happens next? Well, usually management abandons the company, except for maybe one or two officers or directors. They then work out a deal where they sell their controlling interest to another group and the reverse merger process starts all over again with a new management team, a new business plan and a new identity. Some shells have gone through many new identities over the years.

The decision to enter into a reverse merger transaction should not be made hastily. Careful consideration should be made by the management team before they decide to take the plunge. As with most business enterprises, always remember two things:

- Everything always takes longer than you expect it will take, and
- Anything that can go wrong, will go wrong.

The management team will be under a very high stress level while running the business and trying to raise capital at the same time. Another problem they will encounter is the stock price will be bouncing around like a super ball and may hardly be trading at all. This will make it very difficult to raise capital, since most investors in penny stocks like to see a heavy trading volume because it makes their investment more liquid in case they have to sell right away because the stock price is falling. Needless to say, the reverse merger is not for the faint of heart.

The Regulation "A" Alternative

If you don't have enough capital to purchase a shell or are afraid of those skeletons in the closet if you do purchase one, there is another alternative. The new kid on the block is Regulation A of the Securities Act of 1933. Although Regulation A has been around for many years, it is a relatively unknown and seldom used offering exemption that allows private companies to register shares. It is best used by existing companies with a few hundred thousand dollars in revenues, not start-up companies.

The process requires the company to have two years of financials in order, although the SEC does not require them to be audited financials. The two years of financials are part of the filing made on Form 1-A. The company needs to disclose detailed information on Form 1-A such as identification of the officers, directors and principal shareholders, prior securities sales, description of the business, risk factors, corporate structure, use of proceeds and other material factors that should be disclosed. Needless to say this should not be attempted without competent legal help.

Once the Form 1-A is filed with the SEC it goes through one to three rounds of comments in which further explanation or detail is requested by the SEC before it is approved. Once approved the company now has registered stock that can be sold, or has already been pre-sold to investors, to establish a shareholder base and begin the process of obtaining a listing on Pink Sheets.

Be sure to look at the next issue of NBIZ when I will explain the steps to obtain a Pink Sheet listing once the SEC approves the company's Form 1-A filing. **N**

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