INSIGHTS

THE CORPORATE & SECURITIES LAW ADVISOR

ASPEN PUBLISHERS Volume 25 Number 2, February 2011

MERGERS AND ACQUISITIONS

Back to the Future: The Re-IPO Phenomenon and Five Steps for Greater Growth and Capital Markets Access

The resurgence of the public equity markets following years of reverse merger transactions by smaller companies has culminated in a new breed of follow-on public offering called re-IPO's. They finally are redressing the disadvantages with which reverse mergers have been associated historically and allowing these companies to enter the mainstream of U.S. markets.

By Spencer G. Feldman

The past year has witnessed the emergence of re-IPO's—traditional underwritten public offerings by post-reverse merger issuers coupled with a reverse stock split and uplisting to a national securities exchange. The re-IPO marks the next business stage in the evolution of the fittest reverse merger companies over the past few years, and re-entry of small and midcap investment banking firms to the public offering arena.

Common from 2004 to 2008, reverse mergers with concurrent private placements emerged as the primary going public route for smaller companies, resulting from a dormant initial public offering (IPO) market but relatively easy availability of PIPE (private-investment, public-equity) financing. In a typical reverse merger transaction, at the closing of a private placement, a private operating company merged with a wholly-owned subsidiary of a publicly traded corporation, which will not have had any material assets or liabilities. The publicly traded corporation, whose shares were quoted on the OTC Bulletin Board, changed its corporate name to that of the private operating company and, with the proceeds of the private placement, continued the existing business of the private operating company under its management as a publicly traded company. From the company's perspective, the key benefits of the reverse merger were speed in terms of implementation and simplicity of valuation. The reverse merger required only a comparatively simple SEC filing under the Securities Exchange Act of 1934 (Exchange Act) with no prior review process.

But, by the third quarter of 2007, the deal environment dramatically deteriorated, leaving many of these small companies "stranded" as publicly

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traded companies with SEC reporting obligations and corresponding expenses, but without a lifeline to continual investor funding.

Since the fall of 2009, the vastly improved condition of the public equity markets and a number of changes in the federal securities laws[1] have rewarded those post-reverse merger companies that survived the economic downturn and capitalized on strategic consolidation opportunities.

The fittest of these companies, *i.e.,* those with market-accepted product lines, scalable business models, proprietary technology, and experienced management teams, are now entering the mainstream of U.S. public companies through re-IPO's, a process that typically requires three to four months to complete. The re-IPO can be divided into the following five steps.

Step 1: Prepare and File Nasdaq/NYSE Amex Application

The first step in the process is preparing and filing an application to list the company's common stock for trading on a national securities exchange (known as an "uplisting" from the less prestigious and less rigorous over-the-counter market quotation services), most commonly on the Nasdaq Capital or Global Market or NYSE Amex (formerly the American Stock Exchange). This approach has the benefit of being a psychological launchpad for the company in formally commencing the re-IPO process and brings into that process a regulator whose ultimate approval (as well as guidance along the way) is the crucial success factor in the entire transaction. In this context, the application process should include more than simply the completion of the exchange's "fill-in-the-blanks" application and listing agreement. It is recommended that a letter to the exchange accompany these materials that briefly describes the company and its background, business, management, capital structure, and equity ownership.

At this stage, it is unlikely that the company will satisfy all the eligibility criteria, such as quantitative requirements for stockholders' equity, market value for publicly held shares and minimum bid price per share, and qualitative requirements for corporate governance including rules relating to the independence of directors.[2] The accompanying letter to the exchange should outline the steps the company intends to take to meet these requirements particularly with regard to the proposed reverse stock split and public offering. Through dialogue with the staff of the exchange during the application process, the company will be better informed with respect to the minimum requirements to successfully complete the entire transaction.

Step 2: Effect Reverse Stock Split of Outstanding Shares

A reverse stock split is typically required to (a) increase the per share price of the company's common stock to lift it out of the realm of penny stocks[3] or ultracheap issues and meet the minimum bid price listing requirements for Nasdaq and NYSE Amex, and (b) reduce the outstanding shares of common stock to reconcile the number of outstanding shares to the overall size of the planned public offering and the company's pre-money "fair market" valuation. Because a reverse stock split is considered a charter amendment in most states, a company's board of directors and holders of a majority of the company's outstanding shares of common stock must approve the reverse stock split.[4] As this step needs to be completed before the closing of the public offering (and is best completed before commencement of the offering for reasons described below), it is recommended that the board and shareholders grant discretionary authority to the company's executive officers to implement the reverse stock split. The split should be effected at such an exchange ratio within a specified range and at such a time to be evaluated at a later date when the other elements of the re-IPO are fleshed out, such as the underwriters' estimate of an appropriate valuation for the company given market conditions at the time of the public offering.

While, from a mathematical standpoint, the price for shares of the company's common stock after the reverse split will be greater than the price for shares of common stock immediately before the reverse stock split (depending on the actual exchange ratio), experience shows that the new price level is infrequently sustained. As a result, Nasdaq and NYSE Amex routinely require some period of time (ranging anywhere from five consecutive trading days to one month) for the stock to trade above the minimum bid price before an application is approved.

To effect a reverse stock split, in most states, the company will be required to prepare and file preliminary proxy materials with the SEC and, following SEC review, final proxy materials for dissemination to the company's shareholders in advance of a special meeting of shareholders.[5] Many post-reverse merger companies with a small group of controlling shareholders may be able to act by written consent, and file an information statement with the SEC instead of a proxy statement (but which includes substantially the same information).[6] In parallel with the SEC process, a company whose shares are quoted on the OTC Bulletin Board also will need to make certain submissions to FINRA to coordinate the timing and pricing of the stock split.[7] Absent significant SEC review, the proxy or information statement process should last, from preparation to SEC clearance, approximately four to six weeks, with an additional four weeks for the mailing of a proxy statement and the holding of a stockholders meeting.

Step 3: Support Stock Price at Exchange Minimum Levels

A strategy to support a company's stock price following the reverse stock split is necessary to sustain the minimum listing level through the public offering. Without a broad institutional investor base or equity analysts covering the stock at this stage, a company relies heavily on its existing shareholders to keep the share price at this level. Unsolicited promotional fax and e-mail blasts touting the company's stock and paid-for research reports during this time present a host of securities law issues and generally are viewed negatively by the listing staffs of both Nasdaq and NYSE Amex.[8] Purchases of stock in the market by the company's own executive officers and directors (and their affiliates) should be encouraged, if permissible, before the public offering begins. These purchases obviously should be for investment, as purchases with no intention of holding for investment could amount to market manipulation, which not only would be illegal for the investor but also would taint the company's prospects.

An essential element of this strategy is clear communication in the company's proxy or information statement, which is mailed to the company's shareholders in printed format and easily accessed through the EDGAR system,[9] that the purpose of the reverse stock split is to facilitate both an uplisting and future equity offering. These materials will form the talking points for the company's investment banking firm and investor relations firm, if they are already in place, in elaborating on the company's re-IPO process. In this regard, the company should attempt to convince the market of the appropriateness of its proposed course.

Step 4: Conduct Underwritten Public Offering

Some of the perceived disadvantages of reverse mergers are, at least initially, too few freely-tradable shares, a small stockholder base and the lack of institutional investors and analysts. For the company, a traditional firm commitment underwritten securities offering that is marketed by the underwriters through a management road show presentation in the United States and abroad and through the direct marketing efforts of the underwriters and is widely disseminated addresses these drawbacks. It enhances the visibility of the company's common stock, generating greater interest among professional investors and institutions, and increasing the likelihood of prospective analyst coverage and brokerage recommendations. For investment banking firms, investors appear more recently to be favoring registered transactions, weary of the valuation uncertainty of holding restricted securities until a registration statement is declared effective or the Rule 144 holding period expires.

Often, the Form S-1 will feature a fresh positioning of the company and its business.

As a result, post-reverse merger public companies—many of which have not had any prior "Wall Street sponsorship," especially Chinese-based businesses—are attracting the interest of small and midcap investment banks as the equity markets have opened up. Although acting formally as underwriters in the capital-raising phase of the public offering, the investment banks actually serve a much broader corporate structuring and advisory role in the re-IPO process. As contrasted with follow-on public offerings by mature exchange-listed issuers, post-reverse merger public companies with limited trading volume often require a second look at valuation. Potential investors are not inclined to assume that the trading price is truly reflective of the value of the company and the risk involved. Instead, offerings appear to be priced based on the company's earnings multiples and stock prices of larger public companies in the same industry during a comparable period in their corporate lives. Post-reverse merger public companies also typically require simplification of their balance sheets through conversions of outstanding preferred stock and shareholder loans.

Depending on the stage of the company's development and prevailing market conditions, re-IPO public offerings have commonly ranged in size from between $5 million and $50 million in aggregate gross proceeds. At the top end of the offering size range, multiple investment banking firms have acted as co-managers. A company with a sizable accumulated deficit on its balance sheet will need to raise a greater amount of offering proceeds to satisfy the exchange's minimum stockholders' equity listing standard. For a company that also is not profitable, the exchanges have required an even higher stockholders' equity threshold, increasing that minimum level by an amount equal to a year's cash burn rate.

The company's registration statement on Form S-1 filed with the SEC may be its first public disclosure written with the assistance of the critical eye of an investment banker and its counsel. Often, the Form S-1 will feature a fresh positioning of the company and its business that goes beyond the Exchange Act reports previously filed by the company.[10] In addition, given the registration process, the company's counsel and underwriter's counsel can be expected to scrub the disclosure far more thoroughly than typically done in connection with periodic reports. The staff of the SEC's Division of Corporation Finance does not generally review the "jumbo" Form 8-K filed by a company in connection with its reverse merger (except for certain accounting-related matters involving its change in certifying accountant) or subsequent periodic reports (except for controls and procedures disclosures). Companies that completed concurrent PIPE financings with their reverse mergers may have filed shelf registration statements covering the resale of the PIPE securities. In many cases, however, these registration statements are formulaic and crafted hastily to avoid registration rights default penalties.

Investment banks and their counsel typically aid in the preparation of a more complete and accurate business description, following significant legal and business due diligence. At this point, the company's business description should focus on the reverse merger company, with only a brief overview on the background of the predecessor public entity and the reverse merger or similar transaction. In the offering and capitalization sections of the registration statement relating to outstanding shares (as well as in the company's historical financial statements including its balance sheet, stock-based compensation, and earnings per share disclosures), giving effect to post-reverse stock split share and per share amounts adds to the "new company" feel of the transaction. With the active participation of company management and its underwriters, and with its new company focus, a full-blown SEC review process lasting from six to eight weeks may be limited or avoided altogether. This will allow the company to more quickly distribute a "red herring" prospectus and commence its marketing efforts.

Additionally, the public offering process provides an opportune time for the company, with the advice and assistance of its investment bankers, to:

- fill key management positions,
- enlarge and reconfigure its board of directors and its committees,
- upgrade its independent accounting firm,
- retain an investor relations firm,
- for China businesses, engage a special liaison advisory firm in the United States to facilitate investor communications,
- "cleanse" the company's capitalization table through the conversion of its outstanding preferred stock and stockholder loans to common stock, or extending the maturity date of the debt,
- create or enlarge an employee stock option plan, and
- possibly allow the sale of insider stock.

Finally, key to a re-IPO is the use of the public offering proceeds for growth-oriented purposes, such as mergers and acquisitions, and product development programs to expand into ancillary businesses. A smaller amount of the proceeds also might be used to purchase outstanding warrants issued in prior private placement financings to reduce the negative "overhang" effect on the company's stock. During the time prior to the re-IPO, the company's PIPE financing (and, if applicable, any bridge financing) already should have been used to ensure sufficient working capital to implement and execute its core business plan.

Step 5: Commence Trading on Nasdaq/NYSE Amex

The initial goal in the public offering process is to receive conditional approval from Nasdaq or NYSE Amex allowing the company to state on the cover page of its preliminary prospectus that its common stock has been approved for listing on the exchange concurrently with the public offering. Aside from the obvious benefit of exchange trading of the stock, this approval precludes the need to register and qualify the shares being sold in the public offering under state "blue sky" laws.[11] By filing with the exchange early in the process, the exchange will be more likely to accommodate the timing demands of the company and its underwriters. Ultimately, through dialogue, the company, the underwriters and the exchange come together when the underwriters have built up their book of orders, the underwriting agreement is signed, the offering is priced and the common stock is listed and begins trading on the new exchange.

Conclusion

A re-IPO can take reverse merger companies to a new level by eliminating many of the disadvantages of "unsponsored" public company life. For the right candidate, and if executed according to the plan outlined above, a re-IPO can position a reverse merger company for greater growth and increased capital markets access.

NOTES

1. Among other changes, the SEC adopted its smaller reporting company rules in Release 33-8876 (Dec. 19, 2007), which eliminated the "stigma" of the old SB forms for smaller publicly traded companies and created scaled disclosure rules for smaller reporting

companies, including less burdensome executive compensation information required by Reg. S-K, Item 402. More recently, the Dodd-Frank Wall Street Reform and Consumer Protection Act finally exempted smaller reporting companies from the requirement of Section 404(b) of the Sarbanes-Oxley Act of 2002 to have external auditors report on the effectiveness of companies' internal controls over financial reporting. *See also* note 10, below.

2. For Nasdaq Capital Market and Nasdaq Global Market initial listing requirements, *see http://www.nasdaq.net/publicpages/listingstandards.aspx*. For NYSE Amex original listing standards, *see http://www.nyse.com/regulation/nysealternextus/1232068109l1.html.*

3. Brokers effecting transactions in a "penny stock" are subject to additional customer disclosure and record keeping obligations, including disclosure of the risks associated with low price stocks, stock quote information, and broker compensation. Brokers effecting transactions in a "penny stock" are also subject to additional sales practice requirements under Exchange Act Rule 15g-9, including making inquiries into the suitability of "penny stock" investments for each customer or obtaining a prior written agreement for the specific "penny stock" purchase. Because of these additional obligations, some brokers will not effect transactions in "penny stocks."

4. A reverse stock split is considered an amendment to the certificate of incorporation under Delaware General Corporation Law (DGCL) Section 242(a)(3)(reclassification of stock), requiring board vote under DGCL Section 242(b)(1), as well as the vote of a "majority of the outstanding stock entitled to vote thereon" under DGCL Section 242(b)(1) (*i.e.*, a majority of the stock entitled to vote generally, which includes common stock, plus any preferred shares generally entitled to vote together with the common stock). If a corporation is not also changing the par value, the aggregate authorized number of shares or the terms of a class or series of stock, class vote as outlined in DGCL Section 242(b)(2) is not normally required. If there are preferred shares outstanding, the corporation should confirm the terms thereof to ensure that the protective provisions do not give the preferred shares a series or class vote on a stock split.

5. *See* Exchange Act Rule 14a-6(a) and (b).

6. *See* Exchange Act Rule 14c-5(a) and (b).

7. In order for an OTC Bulletin Board company to effect a reverse stock split, it must submit to FINRA the following completed documents: (i) a cover letter containing the company's corporate history; (ii) the OTC Equity Issuer Notification Form; (iii) a certified copy of the company's certificate of incorporation; (iv) the certificate of amendment to the certificate of incorporation (if applicable); (v) the executed written consent of board of directors and/or stockholders; (vi) a notarized officer's certificate relating to the written consent; (vii) a new CUSIP number from CUSIP Service Bureau; and (viii) the transfer agent verification form. Additionally, FINRA requires the payment of a fee with respect to certain corporate actions.

8. Absent research and trading support post-reverse merger, many smaller public companies (especially in the life sciences field) purchase research coverage, which may be considered biased and sometimes discounted.

9. Although smaller reporting companies (phased-in to the e-proxy rules in 2009) have the option to furnish proxy materials to shareholders through a "notice and access" model using the Internet pursuant to Exchange Act Rule 14a-16, a majority of them appear to continue to favor mailing paper copies of the proxy materials to shareholders.

10. Typically, a post-reverse merger company meets the definition of a "smaller reporting company," in that it has less than $75 million in public float, as of the last business day of its second fiscal quarter, under Securities Act Rule 405 or Exchange Act Rule 12b-2, whichever is applicable to the filing. *See also* Reg. S-K, Item 10(f)(1) for the less onerous disclosure requirements available to smaller reporting companies under that item. It should be noted that 48 percent of all public companies that filed annual reports on Form 10-K for the period from October 1, 2009 through September 30, 2010 (the SEC's latest fiscal year for which data is available) identified themselves as a "smaller reporting company," according to Gerald J. Laporte, Chief, Office of Small Business Policy of the SEC's Division of Corporation Finance, from a panel discussion at the ABA Business section Fall meeting in Washington, D.C. (as reported on TheCorporateCounsel.net, "'Smaller Reporting Companies': A Surprising Number" (Dec. 9, 2010), excerpting Mark Borges on CompensationStandards.com's "Proxy Disclosure Blog").

11. See the definition of "covered securities" in Securities Act Section 18(b).