

Use of Reverse Mergers to Bypass IPOs: A New Trend for Nanotech Companies

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ABSTRACT:

The costs and uncertainties involved with an initial public offering of securities by privately owned companies have led to a new avenue for such companies to enter the public market by merging with and into a “public shell” in a reverse merger transaction. In this transaction, the business of the private company becomes the business of the previously empty public shell company, and the shareholders of the private company end up controlling the public company. This “back door” method of becoming a public company is gaining popularity with many types of companies, including nanotech companies, which are capital intensive businesses that need access to greater and more readily available sources of capital than are traditionally only available for public companies. In this article, Thomas L. James, a partner in the national law firm of Foley & Lardner LLP, summaries how this process works and the potential pitfalls to watch out for by any interested nanotech company.

The costs and uncertainties involved with an initial public offering (IPO) of securities by privately owned companies have led to a new avenue for such companies to enter the public market by merging with and into a “public shell.” A public shell is an existing public company that has continued to satisfy its reporting obligations under the Securities Exchange Act of 1934, but has little to no existing business. This “back door” method of becoming a public company is gaining popularity with many types of companies, including nanotech companies, which are capital intensive businesses that need access to greater and more readily available sources of capital that are traditionally only available for public companies.

I. REVERSE MERGERS

When the private company merges with and into such a public shell, the transaction is called a “reverse merger” because the business of the target company (in this case being the privately owned company) ends up being the all or substantially all of the business of the public company, with resulting financial statements of the public company becoming the financial information of the target company. While this process saves a significant amount of costs and uncertainties involved in an IPO, the reverse

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merger avenue is nevertheless something to be very careful of when considering which public shell company to merge with (there are “clean” shells and “dirty” shells), how to structure the transaction, and how to deal with the disfavor of the U.S. Securities and Exchange Commission (SEC) with such transactions.

Nanotech companies have been using the reverse merger avenue to an increasing degree each year in order to access larger sources of capital, such as hedge funds and other sources, which normally only invest in public companies. For example, in November 2006, Ecology Coatings (www.ecologycoatings.com), which makes nanotech-based protective coatings for metals, plastics, paper, and more that claim to protect products from abrasion and humidity but also claim to not damage delicate electronic parts, announced that it had signed a letter of intent to go public via a reverse merger with OCIS. In March 2006, micro fuel cell company Neah Power (www.neahpower.com) did a reverse merger with Growth Merger to go public. Other successful reverse mergers involving nanotechnology companies include Altair Nanotechnologies (www.altairnano.com), a supplier of advanced nanomaterials, and Arrowhead Research (www.arrowres.com), a provider of nanotech products and applications, including anti-cancer drugs, RNAi therapeutics, carbon-based electronics and compound semiconductor materials.

Whenever any entity is considering engaging in a merger with a public shell, one of the most important factors to consider and determine is whether the public shell company is “clean” or “dirty.” A “clean” public shell has few, if any, problems within the company. A “dirty” public shell has a sufficient number of problems within the company so as to make it an undesirable merger candidate.

The only way to discover whether a public shell company is clean or dirty is to conduct a thorough legal, accounting and business due diligence investigation of the public shell and all persons professionally involved with it (such as its management, Board of Directors, accountants, and attorneys). Examples of problems in a public shell that can make it “dirty” include wayward members of management and/or the Board of Directors, unresolved liabilities and other financial problems, accounting or legal irregularities, lingering disputes with shareholders, poor books and records, and/or not being up to date in all filings required with the SEC and any applicable securities exchange or stock quotation service on which the shares of the shell company are listed or quoted (just to name a few of the many issues to be careful about when investigating a public shell company).

If a proper due diligence investigation reveals that the public shell is relatively clean, then the next step is to structure the transaction in a manner so that the privately held target company will end up controlling the public shell after the merger between the two companies. The first step is to legally structure the combination transaction between the two companies as either a “reverse merger” or a “reverse triangular merger.”

A reverse merger is a direct merger between the public shell company and the target, privately held company, with the result of that transaction being that the shareholders of the target company end up with more than a majority of the total issued and outstanding shares of the public shell company. This is called a reverse merger because the shareholders of the target company end up controlling the public shell company. In contrast, a “forward merger” is when the acquiring company ends up controlling the target company.

A reverse triangular merger involves three parties (hence the reference to it being a “triangular” merger), being (i) a public shell company, (ii) a newly formed subsidiary of the public shell, which subsidiary was formed solely for purposes of the acquisition of the target company, and (iii) the target company. In a reverse triangular merger, the newly formed subsidiary is merged with and into the target company, with the target company being the surviving company in such merger and resulting in the target company becoming a wholly-owned subsidiary of the public shell parent company, and with the merger consideration being the issuance by the parent shell company of shares of its equity securities, usually its

common stock, to the shareholders of the target company in exchange for their shares of the target company. Again, the key issue here is that the shareholders of the target company need to receive a sufficient number of shares of the parent shell company so that they end up controlling the public shell company.

The most important red warning flag in the structuring of any combination transaction with a public shell is to be wary of any assertions by the public shell company that claim that the shares of the public shell company to be received by the target company shareholders will supposedly be “freely tradable” shares that the recipients can promptly sell in the public marketplace after consummation of the merger transaction. In many cases, the shares of the public shell may not even be then currently trading on any securities exchange or quotation system. Nevertheless, in almost all cases, the public shell will not be qualified to issue shares which are already registered under the Securities Act of 1933 in order to permit the public resale of such shares promptly after issuance. Rather, in almost all cases, the public shell would have to issue its shares in a private transaction to the shareholders of the target company and thereafter the public shell would have to undertake to register such shares under the Securities Act of 1933 by filing a registration statement with the SEC to cover the subsequent public resale of such shares by the holders thereof (being the former shareholders of the target company).

II. SEC TREATMENT

The SEC is currently treating most resale offerings following reverse mergers as primary offerings for the benefit of the issuer rather than resale offerings by the selling shareholders. Registration statements relating to primary offerings are as onerous and expensive to prepare as registration statements relating to IPOs, and achieving SEC effectiveness of the registration statement can be very difficult and time consuming. Since the SEC does not favor companies “going public” via reverse mergers with public shells, the SEC can delay or derail a registration statement by issuing an unending number of comments, questions and required changes to the registration statement and/or relating to the public shell company which can prove to be insurmountable. In such a case, the public shell might be faced with the prospect of having to withdraw its registration statement from the SEC versus trying to spend more money with its attorneys and accountants attempting to satisfy, address or correct issues raised by the SEC. In such a result, the former shareholders of the target company may end up with shares of the public shell that cannot be sold at all except pursuant to the resale provisions of the SEC’s Rule 144 under the Securities Act of 1933.

Rule 144 provides that such privately issued shares cannot be resold by the original holder at all for one year from the date of issuance of the shares. If the original recipient of such shares nevertheless transfers such shares within such one-year period, then the new recipient would have to start a whole new one-year holding period during which such shares could not be transferred (there are limited circumstances when a new holder might be able to “tack” onto the prior holding period of the prior holder, but the majority of people should not count on such things). Thereafter, if the holder has held such shares for more than one year but less than two years, then during this period of time the holder can resell a small portion of such shares through a registered broker in compliance with the resale restrictions contained in Rule 144. Finally, after holding such shares for at least two years, then the holder could sell all such shares without any limitations as contained in Rule 144, so long as the holder has not been an affiliate (i.e., a director, officer or 10% shareholder) of the issuer for the past three months.

Of course, all of the above is dependent upon a market existing for such shares of the public shell, meaning that there must exist a sufficient number of buyers in the public marketplace that wish to purchase shares of the public shell that are trying to be sold by an existing holder of such shares, such as a former shareholder of the target company. This is yet another example of determining through due

diligence whether the public shell is clean or dirty so that shareholders of a strong private company do not end up being shareholders of a weak or crippled public company.

III. CONCLUSION

In dealing with public shells, the old adage of “caveat emptor” or “buyer beware” must always be foremost in the minds of the parties. Nevertheless, there are legitimate public companies out there that have for proper business reasons sold off or ceased their existing lines of business and are seeking new areas of business to pursue, with such public shells being “clean” in most all material respects and offering a real opportunity for a private company to enter the realm of becoming a public company without the high cost, time delay and uncertainty associated with an IPO.

As indicated above, nanotech companies are increasingly availing themselves of reverse merger transactions with public shells in order to access greater amounts of capital that are normally only available to public companies (such as money from hedge funds and many institutional investors) and needed for the capital intensive growth of most nanotech companies. However, be careful what you wish for because the cost and regulatory scrutiny of being a public company in today’s post-Enron environment must be balanced against the benefits of accessing broader ranges of capital for any nanotech company seeking greener monetary pastures.