Weighing Reverse Mergers For Private Chinese Cos.

Law360, New York (June 25, 2012, 2:02 PM ET) -- In a reverse merger transaction, an existing “shell company” — which is a public reporting company with few or no operations — acquires a private operating company with a viable business — usually one that is seeking access to funding in the U.S. capital markets (Chinese reverse merger or CRM). Typically, the shareholders of the private operating company exchange their shares for a large majority of the shares of the public company. Although the public shell company survives the merger, the private operating company’s shareholders gain a controlling interest in the voting power and outstanding shares of stock of the public shell company. The assets and business operations of the post-merger surviving public company are primarily, if not solely, those of the former private operating company.

A reverse merger often is perceived to be a quicker and cheaper method of going public than an initial public offering. For most private Chinese companies, bank lending is out of reach since most large banks are state-owned and favor large, state-owned enterprises. IPOs involve a three-year application process with an uncertain outcome since regulators carefully control the supply of new shares to ensure a buoyant market. A company’s ability to obtain approval for an IPO often depends on whether the company is in a favored industry and the relationships the company’s management has with the Chinese government.

The uncertain IPO process also deters some investors who would prefer greater clarity about their exit strategy. In addition, once a company launches its IPO, there is a three-month or longer holding period for shares held by the pre-IPO investors. Private equity is gaining in popularity but is still relatively new. In this climate, it is not surprising that some impatient Chinese entrepreneurs view the reverse merger, for all its pitfalls, as a viable shortcut to a public listing.

In the past several years, reverse mergers were once very popular among Chinese companies seeking U.S. listing. Around three-quarters of the 215 Chinese companies listing in the United States from 2007 to early 2010 are listed in the U.S. capital markets through reverse mergers. In the period from Jan. 1, 2007, through March 31, 2010, out of the 603 reported reverse merger transactions, 159 of those involved Chinese companies, representing 26 percent of all reverse merger transactions reported during that time period.

What Happened to CRMs? Securities Class Actions, Enforcement Actions and Going Private

As a result of prevalent accounting irregularities, blatant fraud, or inaccurate filings with the U.S. Securities and Exchange Commission, CRMs have been subject to dozens of securities class actions as well as focused enforcement actions by the SEC, Public Company Accounting Oversight Board, and the exchanges. These actions have resulted in a storm of negative publicity in the United States and China, and almost all Chinese companies listed in the United States have been tainted. Like other reverse merger stocks, CRMs also have attracted attention from a large number of short-sellers who tend to make money as these activities cause a decline in the CRMs’ stock prices.

Since the beginning of 2010, more than 33 securities class actions have been filed against CRMs. Nine of the 12 Chinese companies named in U.S. securities class actions in 2010 were listed in the United States through reverse mergers.

In August 2010, the SEC set up an internal task force to investigate fraud in overseas companies listed in the United States through reverse merger. The SEC recently revoked the securities registration of several reverse merger companies for failure to make required periodic filings. In addition, by Oct. 8, 2011, at least six CRMs had been suspended from trading. NASDAQ and NYSE Amex also have suspended trading in several CRMs.

The PCAOB and SEC have been trying to address the systemic problems with the quality of the auditing and financial reporting for CRMs. CRMs are required to be audited by PCAOB-registered accounting firms. The problem is that the PCAOB cannot inspect those qualified Chinese accounting firms due to jurisdictional limitations, while U.S. accounting firms typically outsource part or all of the auditing work to Chinese accounting firms or assistants without proper supervision.

The SEC has suspended several accounting firms and CPAs for issuing inaccurate or fraudulent auditing reports. On July 12, 2010, the PCAOB published Staff Audit Practice Alert No. 6, Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm. The PCAOB and SEC also are negotiating with their Chinese counterparts for authority to inspect PCAOB-registered Chinese auditors. As a result of the disciplinary actions and securities class actions, accounting firms will exercise more diligence when carrying out auditing work for Chinese companies.

Noticeably, CRMs have been targeted by short-sellers who might be credited for first discovering the accounting irregularities. In recent years, short-sellers have been scrutinizing CRMs' disclosure documents or even carrying out onsite investigations to discover potential targets for shorting. Some of them shorted stocks of CRMs around the peak of the stock prices and have gained huge profit out of short-selling.

Interestingly, because of the low valuation, high maintenance costs and bad publicity, in recent months, an increasing number of CRMs are in talks with PE funds and investment banks to be taken private. Some of them plan to relist in two or three years in Hong Kong or mainland China, where compliance costs are lower and valuations for such companies now are higher than in the United States.

What Are the New Listing Requirements?

In response to prevalent accounting irregularities and fraud, on Nov. 8, 2011, the SEC approved new rules proposed by NASDAQ, NYSE and NYSE Amex that toughen the initial listing requirements for reverse merger companies. With limited exemptions, the SEC imposed higher thresholds for reverse merger companies to migrate to the main board:

•One Year's "Seasoning Period." The reverse merger company must have traded for at least one year in the U.S. over-the-counter market, on another national securities exchange, or on a regulated foreign exchange following the filing of all required information about the reverse merger transaction, including audited financial statements, with the SEC.

•One Year's SEC Filings. Following the reverse merger transaction, the reverse merger company also must have timely filed all required reports, including the filing of at least one annual report containing all required audited financial statements for a full fiscal year commencing after the date of the company's initial SEC filing relating to the reverse merger transaction.

•Minimum Stock Price. In the case of listings on NASDAQ and NYSE, the reverse merger company must have maintained a closing stock price of $4 or higher for a sustained period of time, but in any event for at least 30 of the most recent 60 trading days prior to each of the date of the initial listing application and the date of listing. In the case of NYSE Amex, the stock price minimum is $2 or $3 depending on the type of listing.

•Exemptions. These new requirements do not need to be satisfied if the reverse merger company is listing in connection with a firm commitment underwritten public offering that meets certain offering size requirements. Also, the new minimum stock price requirement generally does not apply if the reverse merger company has satisfied the seasoning period requirement and has filed at least four annual reports with the SEC that each contain all required audited financial statements for a full fiscal year commencing after making all required filings in connection with the reverse merger transaction.

In addition, NASDAQ, NYSE and NYSE Amex have the discretion to impose more stringent standards on the reverse merger company based upon certain factors, including, among others, an inactive trading market, a low number of publicly traded shares, or disclosure by the company of a material weakness in its internal controls.

The new rules aim to protect investors by requiring a pre-listing seasoning period, during which the reverse merger company would have produced and filed required financial and other information. The seasoning period could make it more likely that analysts have followed the company for a sufficient period of time to provide an additional check on the validity of the financial and other information made available to the public. By requiring that minimum price to be maintained for a meaningful period of time, the proposal should make it more difficult for a manipulative scheme to be successfully used to meet the exchange's minimum share price requirements.

Are Reverse Mergers Still a Viable Financing Tool for Chinese Companies?

The heightened listing standards for CRMs make the reverse merger's advantage over an IPO less obvious. In addition to the time required to complete the restructuring of the Chinese operating companies and the reverse merger, it would take at least one year to satisfy seasoning period requirement and the SEC filing requirement. The additional time results in higher transaction costs, and the minimum stock price requirement would make the timing for listing less predictable.

Chinese companies need to rebuild their credibility among investors in terms of financial controls, corporate governance and disclosure. They also need to carefully consider the costs and benefits of reverse merger transactions. In the short term, the higher costs of listing, stringent regulatory environment and negative publicity probably make reverse merger transactions less desirable. In the long term, however, the heightened listing standards and more rigorous auditing standards might revive investors' confidence and reshape reverse mergers as a viable alternative to IPOs.

--By Xueqing Linda Ji, Foley & Lardner LLP, and attorney Hunter Qiu

Linda Ji is is vice chairwoman of Foley & Lardner's China practice and focuses on inbound and outbound business transactions across the U.S. and China. Based in Boston and Shanghai, she is a member of the firm's international, transactional & securities and private equity & venture capital practices, as well as the emerging technologies and life sciences industry teams. Attorney Hunter Qiu is a recent graduate of Washington University School of Law.