Reverse Merger

written by Kulin Dave | July 1, 2019

A reverse merger is a non-traditional method of going public. Instead of hiring an underwriter to market and sell the company's shares in an initial public offering ("IPO"), a private operating company works with a "shell promoter" to locate a suitable non-operating or shell public company.

1. The private operating company then merges with the shell company (or a newly-formed subsidiary of the shell company).
2. In the merger, the operating company shareholders are issued a majority stake in the shell company in exchange for their operating company shares.
3. Post-merger, the shell company contains the assets and liabilities of the operating company and is controlled by the former operating company shareholders.
4. The shell company's name is changed to the name of the operating company, its directors and officers are replaced by the directors and officers of the operating company.
5. Its shares continue to trade on whichever stock market they were trading prior to the merger.
6. Hence, the operating company's business is still controlled by the same group of shareholders and managed by the same directors and officers, but it is now contained within a public company. In effect, the operating company has succeeded to the shell company's public status and is therefore now public.

REVERSE MERGER TRANSACTIONS

1. POTENTIAL RISKS

- POSSIBLE REMEDIES
- POTENTIAL RISKS

Combined business risks: Every Reverse Merger requires a public shell company to complete the transaction. As found, the transaction can be competed with two different kinds of public shell companies. First kind is a public company that once had operations but is no longer active but continues to have its name listed on the stock exchange with the status of being public and second kind is a newly formed with no operating history, which has been formed solely for the purpose of entering into a Reverse Merger transaction called as "clean" company. The greatest risk lies in entering into the Reverse Merger transaction with a public shell that was formerly an operating company i.e., shell companies of the first kind. Since this type of company typically has run an unsuccessful business and could have a history of outstanding liabilities, litigation and potential litigation they turn to be high risks in future, whereas the second kind of “Clean’’ companies are opting for the transaction and carries no risks with them.

The Risk of Being New: Another substantial risk a company may face is the possibility of encountering the new creditor when the new company is formed out of a Reverse Merger transaction. Mostly in few of such transactions the public company which is involved in the transaction may turn out to be badly perforating company with little or no profit. When the new company is created through a Reverse Merger and new capital is transferred to the company this may offer a very good opportunity for the old creditors to get their money back, which they treated as a credit loss before the Reverse Merger. This becomes very difficult for the new company to take into account the new creditors because they are not there when the due diligence is done. Even if the public company shifts out the business activity to a new established subsidiary, it is important that these responsibilities follow in to the subsidiary. Therefore, in order to minimize such risks, it is crucial to carry out a due diligence at this stage which can include the tax, legal and financial aspects.

Risk of low liquidity in terms of stock trading: The above mentioned compliance requirements, financial controls and costs involved are worth if the company's stock will have a value after the compilation of the transaction. Further, that value is to be supported and in fact increased in the market so that the company's stockholders will have a liquid market for their stock. Unfortunately, with Reverse Mergers, this is often not the case. While a financing transaction to inject capital into the company is typically part of a Reverse Merger, that financing almost always raises significantly less capital than an IPO and is certainly not enough to take the company to the next step of self-supporting profitability. On the other hand, there is no involvement of an underwriter the company's stock publicly traded post-closing, and fails to gain long term market support. Thus there will be a significant decrease in the company’s stock price, even the price may not be able to go above the value at which the financing transaction takes place, and the trading volume of the company's stock will also decrease, as result of which there is little or no resulting in little or no liquidity for the company's stock.

REMEDY TO THE POTENTIAL RISKS

- Diligent due diligence mechanism

It is evident that buying another company may generate some risks for both the shareholders in the buying company and the acquired company.
To reduce these potential risks some actions can be taken i.e., by an accurate and precise due diligence. This due diligence if it is done at the right time will definitely minimize, but not eliminate the risks that are prevalent in any Reverse Merger transaction. During the preparations for the Reverse Merger the two company's advisors should analyse potential risks and try to minimize them by an accurate due diligence. This due diligence process helps in analysing the performances and the economic situation of the company, and also reveals the unforeseen difficulties. When the control is transferred from the old management to the new these problems may occur. Most of the potential risks are generated during this time. Even if the unforeseen costs (Like advisory and audit costs) comes up, the same has to be settled immediately either by the old or the new management. The old management can also have a performance based incentive program which the new management can have some problems handling program. Further by having an effective sales and purchase agreement risks can be minimized. This agreement has to be well drafted avoiding questions of which part that should be responsible for the costs that are involved in the transaction.
If the agreement is drafted properly the unforeseen costs like extra audit and advisory and the risks associated with them can be reduced. Thus it is very crucial to analyse the balance sheet before the Reverse Merger is carried out.
A good thing is to have a consultation with the domestic Tax Agency before and during the process in order to avoid indistinct problems come up later on.

- Better
Corporate Governance through Increased Shareholder Voting Rights
Acquisitions of public firms are usually associated with negative or insignificant announcement returns for acquirers especially in terms of value. And some value -destroying acquisitions rise red flags to the shareholders.
However, these value-destroying acquisitions can be mitigated through a number of corporate governance mechanisms. In this context the role of shareholder voting rights in acquisitions is significant. Interestingly, acquisition transactions offer an opportunity to the shareholders to exercise direct oversight and control over business decisions. In most of the jurisdictions' corporate laws, shareholder voting rights are limited to the election of directors and approval of extraordinary matters. Shareholder voting rights in takeovers are also limited. Therefore, all acquisitions must be approved by

target shareholders because such investments might lead to eventual sales of target firms. This is essentially required beside the approval of the shareholder of the acquirer company. Additionally, structuring the transaction as a reverse triangular merger may eliminate the requirement of getting Shell Co shareholder approval to close the transaction. This would allow Shell Co to avoid holding a shareholders' meeting and therefore the time and expense associated with filing for review and mailing to its shareholders a detailed proxy statement and other materials as required.

REVERSE MERGERS IMPACT ON THE SHAREHOLDERS

Shareholders of public firms engaged in Reverse Merger gain from such transactions. As we have seen before, generally Reverse Merger transactions are structured as an acquisition by a public firm of all the shares in or assets and business operations of a private firm. As consideration, the former pays for the acquisition by issuing a large quantity of new shares with voting rights in the company to the owners of the latter. The consideration shares may be supplemented by other forms of consideration, which include cash, stock options, convertible notes and earn-outs (e.g., performance shares) The decision to opt for Reverse Merger as opposed to traditional methods of going public with an initial public offering offer different benefits and costs to different class of stakeholders such as management of the private entity, the private shareholders and the shareholders of the combined, post-transaction corporation. These shareholders include both the "promoters" who hold the vast majority of shares as well as the "bystanders" who control only a tiny slice of the entity in Reverse Merger transactions. Promoters and bystanders would not be implicated in an IPO, since the private company would issue shares directly to the public in such a transaction, rendering a shell unnecessary. Recognizing that the benefits and risks of Reverse Mergers impact various groups differently, the study addresses each functional party individually below.

- Shareholders of Private Entity

Private shareholders face certain pre and post-transaction costs in taking a private company public. Reverse Mergers and IPOs are both dilutive, meaning that each pre-transaction interest or share will be a smaller piece of the post transaction pie (regardless of whether the pie grows). In Reverse Mergers, the promoter may retain 2% to 8% of the equity and a portion of the equity also remains in the hands of bystanders, the larger the portions that go to promoters and bystanders, the smaller the amount of equity that will be held by the pre-transaction private shareholders. In IPOs, the issuance of new shares to the public makes IPOs fundamentally dilutive. Since prior shareholders do not receive pro-rata portions of the new equity, their positions are diluted accordingly. Shareholders should consider the relative costs and benefits that flow to them in IPOs vis-A-vis Reverse Mergers. Either transaction will result in increased information disclosure, more liquidity, and dilution.2Reverse Mergers are touted as being less expensive and involving less time. Although generally ignored by promoters, the costs in Reverse Mergers exceed the actual outlays to purchase the public shell and to hire advisors to the transaction, as a portion of the equity stays on the table for the promoters and bystanders. In order to fairly weigh the net benefits to shareholders of pursuing a Reverse Merger versus an IPO, one would have to compare, for both transaction types, the relative value of the pre-transaction equity to the post-transaction equity held by pre-transaction shareholders.

- Shareholders of Public Shell
  Shareholders of the public shell entity may be categorized as promoters and bystanders, promoters. They have good incentives to engage in Reverse Mergers. They also control a stable of shell companies reserved for that purpose. Bystanders, on the other hand, most likely have never closed out a position in an operating public company that is wrapping up its affairs sending the company's common stock to a virtual zero prices. At this stage, Promoters receive cash fees for their financial advisory services related to the transaction as well as a small slice of the equity in the post-transaction combined entity. And Bystander hold the same small amount of common stock in the public shell both before and after the transaction, receive an economic benefit only through their equity position. Since they have no out-of-pocket costs related to the deal (indeed they are unlikely to even know of the deal in advance). Interestingly, they only experience the upside of the increase in value of their equity after the shell acquires assets and operations through the Reverse Merger.
- Feasibility of reverse merger as compare to IPO’s in the capital market
  Reverse Mergers are intriguing because of their low cost and the short processing duration therefore, they are attractive to small firms, and in addition, it enables firms which are otherwise not ready for the market to go public. Firms not ready for an IPO might not have the infrastructure to withstand the pressures of public listing such as regular audits and increased disclosure requirements, and are more likely to fail soon after they go public.
  RMs provides a platform wherein, small firms can stand to become public.
  A company with poor performance, relatively small turnover and short history, prefers Reverse Mergers compared to IPOs. However, the same can be avoided when the shell companies are subjected to a careful

examination
coupled with clean transaction.
The vast majority of IPOs are underwritten by an investment
bank and the issuing firm depends largely upon the underwriter to guide them through the process. The investment bank prices the offering, allocates it to potential investors, and maintains price support in the aftermarket period. The
underwriter support for IPOs and the absence of an underwriter in RMs are manifested
in the higher survival rates of IPO firms as compared with reverse merged firms. Because of which Reverse Mergers have higher short-term stock returns, higher volatility, lower trading liquidity, and lower institutional ownership as compared to traditional IPOs.
Unlike an IPO, market conditions have a low impact on
determining the timing of a Reverse Merger. Lower cost due to lower investment
banking fees and lower professional fees, Lower market discount (IPOs typically
require 10-20% discount at offering), potential for liquidity to existing shareholders. While these are certainly attractive merits, owners and management teams must carefully consider whether the private company is prepared for a public investor base.

Conclusion

Seeing the importance Reverse Mergers are getting in the recent years, it is clear that in the time to come, it would become one of the most preferred methods of public listing all over the world. Both developed and developing countries are realizing that reducing time and cost are the best ways for companies to gain competitive advantage over their competitors, all the more highlighting the importance of such methods which serve both the objectives comprehensively. All in all, a country with a good corporate law with greater control and more credible auditing agencies is the best place where the benefits of Reverse mergers can be enjoyed to the fullest

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