REVERSE MERGER OR IPO?

Consider the former when you take your family business public

BY VINCENT C. BRENNER AND WILLIAM K. SCHROFF

What happens when a family business decides the benefits of being public outweigh the drawbacks and opts to take the plunge? As a public company, the family's wealth and liquidity will almost always be increased. The company will have greater access to capital, increased ability to expand and acquire other companies, and a new "negotiable" instrument that can be used for a variety of purposes.

But the process of "going public" through an initial public offering (IPO) is time-consuming, expensive, and a drain on executive time and talent. An alternative is a reverse merger in which a privately held company acquires a controlling interest in a publicly traded company that is dormant, or nearly so, and usually has few, if any, assets. In 1950, Armand Hammer "fathered" the reverse merger strategy by merging his oil company into a shell, thereby creating Occidental Petroleum. Ted Turner used this procedure in 1970 to launch the Turner Broadcasting System by merging into the failing Rice Broadcasting. And more recently, in 1996, Muriel Siebert took her brokerage firm public by merging it into J. Michaels, a defunct furniture company.

Should your company follow suit? Let's look at some advantages and disadvantages of a reverse merger so you can decide or help your boss decide the best course of action.

PUBLIC COMPANY ADVANTAGES

Being a public company has numerous advantages for a family business. A public company generally has more creditability with customers, suppliers, and capital providers. From a family business perspective, the primary advantages of becoming a public company are enhanced exit strategies, greater access to capital, and enhanced executive recruitment and retention.

Enhanced Exit Strategies

Family members or business partners frequently want to withdraw from the business, and having publicly traded stock provides greatly enhanced exit strategies through a registered secondary offering, a 144 sale of stock, or a private sale. Withdrawal, or the desire to diversify investments of family members or partners, creates family business valuation problems. Typically, the principal or founding parties enter into a buy/sell agreement between them at the time or very near the time the business is established. Such agreements usually become outdated and do not reflect the current value of the business or the proper valuation method, so a business valuation expert is usually employed to determine the value.

Even when this is done, though, both sides of the exiting transaction may not agree with the valuation. For example, the selling partner may place a higher value on earnings, whereas the buyer may look at book value as a more accurate method of determining value. The business valuation expert will typically look at both these and other values, assigning a weight to each. While most observers and practitioners consider this method to be the most valid, there is still a great deal of subjectivity in the weighting and the "other" factors. This can result in animosity between the parties and can lead to legal action, which becomes more time-consuming and expensive. The obvious question, then, is, "Where does the money come from for the actual buyout?" The company may be forced to divert valuable cash from operations.

With a public company, there's no question of value because market forces set a value for it, and the company keeps its cash because the exiting party can either sell their shares on the open market or in a private transaction.

Estate and gift taxes are another consideration. Again, a professional must do the valuation; sometimes two or more are used and at significant expense. After everyone agrees on a value, the money to pay the taxes frequently is withdrawn from the much-needed operating funds of the business. In the instance of the public company, the markets set the value, and the shares are typically sold to third parties, thereby not depleting the assets of the company.

Greater Access to Capital

A primary reason for becoming a public company is to significantly enhance opportunities to raise the funds needed for new product development and expansion. A public company has much greater access to the capital

> Future expansion or strategic alliances can be accomplished through issuance of stock rather than the use of needed cash.

markets through stock and debt offerings as well as banks. This access allows the company to grow, either through internal expansion or through acquisition. It becomes more attractive to potential business partners, and future expansion or strategic alliances can be accomplished through issuance of stock rather than the use of needed cash.

Several avenues exist for public companies. Additional stock can be issued in a secondary offering to the public or through a private offering. In a private offering, investors know that they have a way to "cash out" when the company is successful because the company is already public. With a successful private company, the investor can't be sure that a market will exist for its shares because market conditions, the economy, the industry, and the like may not be favorable when an IPO is planned.

A third avenue for raising funds is through stock warrants, which are certificates that the company may distribute to shareholders and management that let them buy additional shares at a specified price. When the warrants are exercised, additional funds flow into the business. Occasionally the principal shareholders of the acquired company are willing to invest in the acquiring company once the transaction has been completed.

Another alternative is to use the company's stock to acquire other entities or part of an entity. These transactions may involve stock only or any combination of stock, debt, and cash. The company being acquired is more likely to view a stock or partial stock transaction favorably when the acquiring company's stock is actively traded. This provides the acquired company's shareholders with a realistic exit option as well as tax benefits.

Enhanced Executive Recruitment and Retention

Management and other key employees are putting increased emphasis on stock ownership, or the potential thereof, in making employment decisions. A public company is better able to attract and retain key personnel because it can offer stock-based compensation plans. Everyone is aware of all of the millionaires and billionaires that have been created through stock incentives at companies such as Microsoft, Dell, Apple, and Oracle.

At times, key executive talent seems more interested in future stock payoffs than current salary and benefits. Only a public company can offer meaningful stock ownership benefits to potential and current employees, and this provides much greater flexibility in compensation packages and is a competitive advantage. Stock-based plans can be effective in reducing cash compensation as well as employee turnover, thereby decreasing costs and increasing productivity. The ability to use its stock greatly enhances the public company's position in the ever more competitive executive marketplace. (We'll see what happens in this arena, though, when/if the Financial Accounting Standards Board (FASB) requires companies to expense stock options.)

PUBLIC COMPANY DISADVANTAGES

A public company is subject to more government regulation and outside scrutiny. It must meet Securities & Exchange Commission (SEC) and other reporting requirements and incur the additional expense of providing such information. Because it will be under the scrutiny of the investing public, analysts, and others, the company will most likely need to employ an investor relations firm or, at a minimum, internal public relations personnel. It's hard to sell your stock if the market doesn't know you're there.

Another disadvantage is that the family ownership of the company will be diluted, and the family's ability to control may be lessened. Also, the possibility of a hostile takeover exists. The family should initially control enough shares for this to be of minimal concern, and steps can be taken to avoid such a takeover as the family's ownership is diluted. In addition, the value of the company and the wealth of family members will be impacted by the volatility of the market and by other forces and events not under their control. Many times such events aren't even related to the nature of the business or its immediate operating environment.

REVERSE MERGER ADVANTAGES

There are several significant advantages to becoming public through a reverse merger rather than an IPO. These relate to timeliness and cost, stock marketability, and possible tax benefits.

Timeliness and Expense

An IPO is a time-consuming, expensive process. In a reverse merger, the process takes significantly less time and money. In fact, it can sometimes be accomplished in 45 days instead of the year or more frequently needed for an IPO. The reduced time frame lets key executives concentrate more on continuing operations and planning for the future and less on meeting with underwriters, lawyers, and outside accountants. The more management is distracted from their normal duties and functions, the more likely there will be a detrimental effect on the company's operations. Such effects can be particularly disastrous at the time of an IPO and immediately thereafter. The extended period of time in an IPO also increases the risk that market or industry conditions may deteriorate and eliminate the window of opportunity. Internet companies such as Stamps.com Inc., Nettaxi Inc., and PhotoLoft.com Group Inc. were able to go public through reverse mergers while the market was "hot" for dot-coms.

On the expense side, a reverse merger may be accomplished at a cost of $75,000 to $100,000 vs. $400,000+ for an IPO (not including sales commissions, which may add another 10% or more). These estimates don't include savings in management time spent on a reverse merger instead of an IPO. iChargeit Inc. estimated the cost of an IPO to be $3 to $5 million in underwriting fees, but it was able to do a reverse merger for about $300,000.

In addition, there are no SEC registration or Blue Sky fees in a reverse merger. There are filing fees, though, which are significantly less.

Marketability

In cases where a company's product or service is a new, untested concept, a successful IPO may be difficult at best. On the other hand, the company's business may be mundane, albeit profitable, and have a good historical record but not be of great interest to investors. Even if the company is able to sell its ideas to brokers, there's still no assurance that the public will buy the stock. The uncertainty of market acceptance increases the risk that the time and money spent for an IPO may be wasted.

This isn't the case with a reverse merger because the shell company is already public. A shell company is one that has suspended operations and has little or no assets but is still registered with the SEC. LCA-Vision Inc. wanted to go public with freestanding eye centers, but their product, laser refractive eye surgery, hadn't received FDA approval. They used a reverse merger with Maxoil Incorporated and were able to raise funds for expansion when FDA approval was received. They also were able to expand by using their stock to purchase a chain of centers from Toronto Laservision Centre Inc.

IPOs are risky for companies because they depend on the economy, the stock market, and other factors over which the company has no control. If the market drops, the company or the underwriter may suspend the offering. Even if general market conditions are favorable, bad press regarding a company's industry may dramatically impact the appeal and success of the offering. The decade of the 1990s experienced thousands of IPOs, many with

Years of unsuccessful operations means that the shell company may have net operating loss (NOL) carryforwards, which can provide excellent tax shelter opportunities for the family business.

spectacular results. The press was filled with examples of companies going public and their stock increasing hundreds fold, some even on the first day of trading. In the last three-and-a-half years, however, the market has turned, and many companies have withdrawn their IPOs to wait for better conditions. Yet no one can predict this cycle with any accuracy, so companies are still taking a chance with an IPO. A reverse merger isn't as subject to market conditions because its success rests with what happens *after* the shell is acquired.

Possible Tax Advantages

Frequently a shell company disposes of its assets because its operations were unsuccessful. Years of unsuccessful operations means that the shell company may have net operating loss (NOL) carryforwards, which can provide excellent tax shelter opportunities for the family business. Under tax law, such carryforwards may, in certain circumstances, be used to offset future income for 12 years from the year of loss. Such benefits mean cash savings for future operations. Rymac Mortgage Investment Corp. combined with a unit of Navistar through a reverse merger. Rymac, a former real estate investment trust (REIT), was able to offset its income against $30 million in NOLs from the Navistar unit. While large net operating loss carryforwards benefit the acquiring company, they are also a valuable negotiating chip for the shell company shareholders.

REVERSE MERGER DISADVANTAGES

As with any business event, there are both advantages and disadvantages. The disadvantages vary significantly with the shell company chosen, so great care is needed to minimize the detriments. Here are the primary disadvantages.

Shell's History

The shell company is a "shell" for a reason. Most shell companies are reporting companies under the Securities Exchange Act of 1934, although they may not be current in their filings thereunder. Most shells are companies that have wound down or sold off their operating business, while some were formed for the sole purpose of being available for reverse merger opportunities. The latter don't have a long or dangerous history and should have significantly fewer pitfalls. Yet such "clean" companies may have a higher cost in terms of the percent of equity given up, and they generally are more prone to scrutiny from the SEC. They may also have less market recognition and/or shareholder demographics and aren't likely to have a stock exchange listing.

Frequently a company is a shell because it's a failed company. As a result, remaining shareholders may have grievances with the company and its management. They may be reluctant to get into a reverse merger because they see it as a significant dilution of their equity in the company. Of course, a prudent investor would normally prefer a small piece of a valuable company to a large piece of a worthless company. Yet even when shareholders are convinced to sell most of their shares, or perhaps even invest additional funds, they may want to quickly recoup their investment and get out of the restructured company. They may sell shares as soon as possible and cause the company's stock price to be depressed. KFx Inc., a Denver-based energy company, experienced a temporary decline in market value when several unknown shell shareholders surfaced and dumped their stock. To avoid this situation, the reverse merger agreement should contain some timing restrictions on the sale of stock.

Another problem with a shell that has a history is the possibility of unknown liabilities. Percept Business Services, a distributor of printed business products, was halfway through a reverse merger when it discovered potential liabilities relating to unsettled litigation with former suppliers of the shell. The family business must make a greater due diligence effort to uncover all potential liabilities. Efforts should be made to contact previous suppliers to make sure there are no outstanding claims against the company. Investigations also need to be made regarding any pending lawsuits, and the shell's legal counsel needs to provide all relevant information. Also, the status of the shell's required filings must be determined and be brought up to date.

Equity Dilution

There is definitely a cost to acquiring a shell. The private company is putting up its assets, reputation, and business to acquire the shell, but the shell's owners want a continuing equity interest in the restructured company. This means that the private company owner's equity and voting power are diluted as a result of the merger. The amount of dilution will depend on the value of what the two parties are bringing to the table and their negotiating skills. As discussed previously, a shell with significant net operating loss carryforwards adds value to the transaction, and this will come at a cost to the private company.

Restrictions on Sale of Stock

Owners of stock in the survivor after a reverse merger must register the sale of their shares with the SEC or find an exemption from full registration. For example, under Rule 144, they may sell limited amounts of stock over time. In a three-month period they are limited to selling the number of shares that is the lesser of 1% of the outstanding stock or the average weekly trading volume over the four weeks preceding the sale.

SEC Scrutiny

In a reverse merger, the purchasing company avoids the full SEC registration process. Not surprisingly, the Commission is very skeptical of such mergers and may judge individual cases to be illegal, so it's essential that the purchasing and subsequently the combined company strictly adhere to SEC laws to avoid sanctions or prosecution. For example, examiners for the SEC, the National Association of Securities Dealers (NASD), or both review reverse merger filings with the same degree of scrutiny as IPO documents. When the reverse merger is with a company that has a currently trading stock, a required filing is an 8-K. The SEC has taken the position that they will halt trading until a review of the 8-K is complete.

Image

Reverse mergers have had their share of controversy, resulting in a negative image. The image stems from the prior failed history of the shell as well as unscrupulous individuals. For example, in 1998, the SEC filed suit against International Heritage Inc., a reverse merger company, alleging it was a pyramid scheme.

Nonetheless, it is estimated that, in 1996, more than 50% of all companies going public did so through reverse mergers. This percent dropped significantly in the late 1990s and early 2000 as a result of the increased interest in IPOs from investment banking firms and the public. In recent years, reverse mergers have again begun taking a more prominent role as an alternative means to going public.

FINDING A SHELL

A good starting point is the nearest metropolitan law firm with a large securities practice because these firms frequently have a dormant public company as a client. National public accounting firms are another source. Investors who control dormant companies tend to keep financial information up to date. Other sources are investment bankers, financing consultants, and business brokers, who are generally aware of shell companies and may have created some shell companies that they want to sell. The advantage of the latter is that the shell doesn't have a history with possible unknown liabilities. In this case, the private company will most likely have a financial or business consultant as a minority shareholder. Although having a minority shareholder is a cost of doing business, it still will most likely be substantially less expensive than an IPO. Finally, check the classified section of *The Wall Street Journal* because companies looking to merge advertise there.

REVERSE MERGER STEPS

Here are the typical steps in a reverse merger. Some may be done by the principals of the acquiring company, but generally they will be done by, or in conjunction with, financial consultants.

1. Find a public company with few assets and no current operations.
2. A financing strategy must be developed. A reverse merger usually involves the desire to raise additional capital.
3. Shareholders of the shell company must be contacted to determine their interest in selling a substantial part of their shares or their willingness and ability to issue substantial additional shares. It's also possible that they may have an interest in reinvesting in the shell company, which will provide immediate additional capital to finance future operations.
4. Due diligence must be conducted on the shell.
5. A national public accounting firm, a prestigious law firm, and a good investor relations firm or individual need to be retained to provide creditability to the transaction and continuing comfort to investors, traders, and regulators. A family company may be judged by the quality of firms it retains, so it needs to put its best foot forward.
6. Securities brokers who will make a market for and help promote the company's stock must be located and "sold."
7. The private company frequently changes the name of the public company to one that more appropriately reflects the nature of the merged company's business.
8. If the shell has any remaining noncash assets, they are usually sold shortly after the merger is consummated.
9. Additional efforts should be made to get the merged company's stock traded actively. This may include a reverse split of the stock if it is trading at pennies per share. Find the right exchange. It's better to have the stock traded on a large exchange than on the bulletin board.

WHY PURSUE THESE OPTIONS?

There are many reasons for a private family business to go public. The primary ones are enhanced exit strategies for family members and business partners, greater access to capital markets, and enhanced opportunities in executive recruitment and retention. A reverse merger provides a vehicle that is quicker and less expensive than an IPO. And it isn't subject to uncontrollable factors such as market volatility. While there may be some pitfalls with shell companies that have a less than stellar past, proper investigation and due diligence can overcome these adversities. A reverse merger is a powerful vehicle for taking a family business public, and its success depends more on the individuals involved than on the numerous uncontrollable factors involved in an IPO. It is an effective way to become public in a short period of time and without the hassles of an IPO. ■

Vincent C. Brenner is the D.M. Beights Professor of Accountancy at Stetson University in DeLand, Fla. You can reach him at (904) 822-7439 or vbrenner@stetson.edu.

William K. Schroff is managing director of Finimex S.A., a Panama City, Panama-based privately held company engaged in various facets of business, real estate, and financial consulting. You can reach him at 011 507 263-0649 or finimex@cwpanama.net.