The "Shell Game"

By MARK T. HIRAIDE, Petillon & Hansen
mhiraide@corplawp-h.com

Publicly traded shell corporations are often touted (usually by the organizers and promoters of the shell) as a cost-effective means of "going public." While shell corporations may appear to be an attractive alternative to a conventional registered initial public offering ("IPO"), the true cost of going public through a shell corporation is usually much greater than a conventional IPO. This article evaluates the purported benefits of shell corporations and discusses the true costs "going public" in this fashion.

It is important to understand the process of taking your company public using a shell corporation. There are two types of shells: (i) those with common stock registered with the Securities and Exchange Commission ("SEC") and traded on Nasdaq or on the NASD's OTC Bulletin Board ("OTCBB") and (ii) those with common stock that is not registered with the SEC and traded in the "pink sheets" at www.pinksheets.com. In order for securities to trade on Nasdaq or on the OTCBB, the common stock must be registered with the SEC.

Regardless of the type of shell, typically, the first step in going public with a shell is a "reverse merger" of your company into the shell corporation: your company is acquired by the shell corporation, which issues newly issued shares to the stockholders of your company, in exchange for your company's stock. The shell corporation is the surviving corporation in the merger, and you and your shareholders end up owning 80-90% of the outstanding shares of the shell after the merger. Conversely, the existing "public" shareholders of the shell end up with the remaining 10-20% of the shares.

Assuming that the shell's securities are registered with the SEC, immediately upon consummation of the merger, the shell (i.e., you) must file a current report with the SEC on Form 8-K. This Form 8-K report is considered by the SEC to be like a registration statement, which must provide a full description of the merger and the business of your company. The requisite disclosures are essentially identical to those required in a conventional IPO prospectus. Audited financial statements are also required but may be filed on a delayed basis.

Once the merger takes place, your company becomes "public." The consummation of the reverse merger can occur in a matter of weeks within locating the shell. The short time in which it takes to become a public company is one of the benefits touted by shell promoters. To be sure, upon the effective date of the merger, you and your company become subject to all of the reporting obligations and liabilities under the federal securities laws. But the process of going "public" really just begins at this point.

The following are a few of the purported benefits of going public through a shell and the true costs associated with it:

- **"Save Time"** - using a public shell to 'go public' saves time, taking as little as 45 days to complete." In a conventional underwritten IPO, after locating an underwriter and working with them to carefully craft a disclosure document or prospectus, the prospectus is filed with the SEC in a registration statement that is subject to SEC review and clearance before the public offering can commence. This SEC review typically takes between 45-60 days.

In the case of shells with common stock already registered with the SEC, there is no registration to be filed. The Form 8-K current report of the merger, however, is considered by the SEC staff to be a registration statement, and, most importantly, is subject to the same SEC review procedures applicable to a registration statement. Unlike a registration statement for a conventional IPO, SEC review of the Form 8-K filed in a shell transactions can take several months, because the SEC staff scrutinizes any filing by a public shell. The staff typically issues several comment letters on these filings and likely will require substantial information about the shell's prior history in an effort to ascertain whether the shell and its promoters have ever violated federal or state securities laws. Moreover, because your company's stock continues to trade during this period of review, if the SEC finds material deficiencies in you Form 8-K disclosure document (and they likely will), the SEC review could give rise to claims by shareholders against you and your company for damages.

- **"Saves Money"** - using a public shell is less costly than an underwritten IPO, and there are no underwriter commissions or fees when using a shell." Shell corporation promoters charge between $50,000 to $150,000 for shells. In a conventional underwritten offering, investment banking fees and commissions to the underwriter may exceed 10% of the total offering proceeds. These fees, however, are to compensate the underwriter for raising funds from investors. Becoming public through a shell transaction, in and of itself, will not generate any financing for the company…if the shell transaction also contemplates an offering to investors following the reverse merger, there likely will be similar costs and fees associated with such financing.

  The real cost of going public using a shell is the 10-20% equity you give up to the existing shareholders of the shell, who do not contribute anything - other than being public shareholders - to the shell merger transaction.

  The real cost of going public using a shell is the risk you assume by inheriting unforeseen problems with the 10-20% of the shares that are in the hands of the "public." Many promoters of shells or their affiliates, profit not from the fees they charge for the shell, but, rather, by selling their shares into a market that may be artificially supported following the shell merger. Using a variety of schemes and artifices, it is not uncommon for shell promoters or their affiliates to cause the trading price of your company's stock to rise dramatically after the announcement of your merger with the shell. In the worst case, the promoters sell into the artificial market to unsuspecting investors, and, when the promoters are no longer supporting the price of the stock, its trading price plummets. It is not uncommon for this spike in price and trading activity to occur during the period that the SEC is reviewing and commenting on the Form 8-K disclosures. As a result, the unsuspecting investors who purchased your company's shares during this time may have a claim against the company, and possibly against you personally, for damages if they purchased your company's securities while the public disclosures in the Form 8-K were inadequate.

  Conducting due diligence on a public shell in an attempt to determine whether it is a "clean" shell is costly. It is difficult, and in many cases impossible, for you to ascertain whether the shell's public shareholders ("public float") are bona fide stockholders or are nominees controlled by the shell promoters.

- **"Liquidity and Exit Strategy** - Investors can readily buy and sell your stock and original investors and founders have an "exit" strategy for their investment." The shares you receive in the shell corporation will be "restricted stock," that is, they may not be transferred without registration or without an exemption from registration. As part of the shell transaction, however, shell promoters may attempt to transfer unrestricted stock to the new owners and their affiliates. The SEC and NASD view promoters of shells, as well as their transferees, as "underwriters" of the securities issued to them. Therefore, the re-sale of shares transferred by such promoters, affiliates and their transferees without SEC registration will be restricted. Although the stock certificates evidencing such shares may not bear restrictive legends, the transfer of those shares is in fact restricted by law.

In summary, although the traditional IPO in the current financial market environment is difficult, at best, to accomplish, sometimes its best to do things the old fashion way.