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Shell Transactions Revisited

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With so many shells available and the number of interested private vend-in companies growing why aren't more shell transactions closing?

Having been retained by several new clients that are either shell companies, or private companies looking for a public company to merge with, I have been closely monitoring the current shell market over the past 6-12 months. In representing these clients one thing has become clear: the shell market is changing and many shells, shell providers and those seeking shells are not adjusting to the new marketplace. The reasons for the shift are easy to understand, but the results of the shift are leaving many people left to rely on inaccurate information related to shell companies. The misinformation is causing some companies to realize that more due diligence and up-front work is needed in searching for a proper candidate company, and leaving others even worse off having consummated the shell transaction without doing sufficient up front due diligence on the public company shell and being left with a public company vehicle that does not meet their needs.

This article explores what public company shells and private companies looking for shells should be looking for as well as what companies can do to improve their chances of completing a successful shell transaction.

The Change in the Marketplace

The old issues in shell transactions still exist. Shell companies still must be reviewed for old operations, hidden lawsuits and liabilities, shareholder issues, capital structure, legitimacy of stock issuances, etc. Those issues have not changed. However, the amendments to Rule 144 issued by the SEC in February 2008 increased what needs to be reviewed when looking at a shell company. The bottom line of the amendments was that shareholders of companies that are, or have ever been, a shell cannot rely on Rule 144 to remove the restrictions for the resale of their shares into the public marketplace. The only way to “cure” this status is for the company to have operations sufficient to not be considered a shell, file “Form 10” type information, be a “reporting company” under the Securities and Exchange Act of 1934, as amended, for at least the last twelve months, and be current in its reporting obligations (here is a link for a [detailed overview of the amendments to Rule 144 and its impact on shell companies](#)).

The second change that has occurred in the marketplace relates to DTC-eligibility. DTC provides the electronic basis through which stock sales bought and sold through brokers are transferred from the seller’s brokerage account to the buyer’s account. If a company is not “DTC-eligible” then its shares cannot be electronically transferred between brokerage accounts, which, based on the realities of the marketplace, means it will be more difficult to trade shares of the company. Historically, approval by DTC was a matter of course after a company cleared SEC comments on its registration statement and cleared FINRA comments on its 15c2-11. However, in January 2009, FINRA issued Regulatory Notice 09-05. In a nutshell this release was a reminder to FINRA’s member firms (broker-dealers) of their

responsibility to ensure that federal securities laws and FINRA rules are complied with when they are participating in the sales of unregistered securities. The result is that company's newly going public must undergo a review process by a clearing firm willing to consider filing a DTC-eligibility application on its behalf, as well as undergo a review process by DTC itself. Additionally, and most importantly for shell transactions, any name change, stock split or other corporate action that requires a company to obtain a new CUSIP number may cause the company to need to re-apply for DTC-eligibility, as DTC is now re-reviewing DTC-eligibility for companies that undergo this type of transactions (for a detailed overview of these changes see the article entitled: [DTC: The Final, Final Hurdle](#)).

As a result of these two changes, it is not only important for those interested in shell transactions to review shells in terms of what has historically been reviewed when it comes to shells (old operations, hidden lawsuits and liabilities, shareholder issues, capital structure, legitimacy of stock issuances, etc.), but also the shell company's "shell status" as well its DTC-eligibility.

The Shell Marketplace

So, given the above changes in the shell marketplace, how should shells be categorized and reviewed? The changes in the industry have resulted in several different categories for shells and shifted the way both sellers and prospective purchasers of shells should be approaching the transaction. The wide-variety of different factors in reviewing a shell are too numerous to name, but some of the new factors that exist in addition to the historical ones, include: shell status (the term "shell" herein is being used to define a public company looking for a private company merger partner, not necessarily a true "shell" which is a company with no or nominal operations and assets), DTC-eligibility, OTCBB or Pink Sheets, '34 Act reporting company, current in its reporting obligations, if not current then how delinquent, etc.

Without getting into each issue that needs to be reviewed in a shell transaction, here are some tips for private companies looking for a shell to help find one this is appropriate for your purposes:

1) Determine Shell Parameters: Determining if you want a shell that has current operations or one that is actually a shell, one that is on the OTC Bulletin or the Pink Sheets, one that is '34 Act reporting or Pink Sheet Current Information or no information, are among the numerous questions that will determine what type of shell you should be pursuing. For instance, some shells are '34 Act reporting companies, current in their reporting obligations and have current, material operations. These shells are ideal because Rule 144 may be applicable immediately for the company's shareholders. However, they are also among the most expensive shells and require a more complex shell transaction structure to ensure that operations sufficient to not be considered a shell are put into the public company at the same time the existing public company operations are removed to ensure the company does not become a shell for even a moment in time, which would require new Form 10 type information and a one year holding period for Rule 144 purposes. For clients putting an existing business in the public company immediately, this type of shell may meet their every need. However, for a purchaser looking to acquire a public company in order to later put in assets (like a roll-up strategy) or develop a new business inside the public company, this shell is still a good option, but an expensive one. For clients not putting an existing business into the public company vehicle, purchasing a shell like the one mentioned above will likely cause the purchaser to spend more than they need to spend since a shell that has no operations will work just as well and cost less. Additionally, some purchasers only wish to acquire a Pink Sheet company, never been a shell, in order to put in operations, get to current 15C2-11 information on the Pink Sheets news service, and still be able to use Rule 144 (again, must never have been a shell), and are not looking for a OTCBB company or a '34 Act reporting company. There are many, many variables in shells, and finding one that fits your needs, starts with determining your needs. To just say you are looking for a shell is no longer sufficient

and may cause you to spend extra time and money reviewing shells that don't meet your requirements or are more than you are willing to spend.

2) Due Diligence: This starts by hiring legal counsel familiar with shell transactions and experienced in conducting due diligence reviews of shells. As noted above, there are now a wide variety of variables involved in every shell, such as, has the company ever been a shell, if it has did it cure that status by filings Form 10-type information, did it file that information after it acquired assets sufficient to ensure the company was no longer a shell, is it current in its '34 Act reporting obligations, etc. Another key review point worth mentioning since it has caused many issues and can cause quite a headache (and wallet ache) for the unwary purchaser applies to Pink Sheet shells. Not all Pink Sheet shells are equal, obviously. But one major distinguishing factor is how did the company get to the Pink Sheets? If the company applied with FINRA and was listed directly on the Pink Sheets that is much different than a company that is a '34 Act reporting company but is delinquent in its reporting obligations and was delisted from the OTCBB, since the latter company is still responsible for its past, delinquent filings even if it files a Form 15, unless it gets a waiver from the SEC. Additionally, assuming the company is still a '34 Act reporting company, just behind in its filings, then a "Super 8-K" is still required within four days of closing the shell transaction, which must include audited financial statements of the private company. This is drastically different in many ways, including cost and time, than a Pink Sheet company that is not a '34 Act reporting company. These are just a couple examples of the due diligence that needs to be done of any potential shell.

3) DTC-eligibility: As noted above, this has become a very material issue. Some shells have DTC-eligibility and some do not. Some have it now, but may be reviewed once it undergoes a reverse merger and name change or stock split. Understanding the risks of DTC-eligibility will not only assist you in determining a good shell vehicle, but also help you understand the costs and timing of what needs to occur in the event a company isn't DTC-eligible or the company has its DTC-eligibility "chilled" by DTC due to a corporate action.

4) What are you getting?: As much as shells differ in their corporate structure and history, they also differ in what they are able to deliver to the buyer of the shell in terms of voting control and stock ownership. Some shells are cash and carry where they are delivering to the purchaser almost all the outstanding stock (95%+), while others are not cash and carry and only delivering 60%-70% of the voting control. Some transactions offer some free trading shares from non-affiliate stockholders willing to participate in the transaction, and some do not. As you can imagine the ones delivering more, cost more, but sometimes getting 95%, and even up to 99%, is not what a purchaser is looking for and is not what will suit their needs the best.

5) Cost: As you can see, shells come in many different shapes and sizes, and so do the cost of one. OTC Bulletin Board shells can go as high as \$450,000 for a shell delivering upwards of 95% of the outstanding stock, as well as some free trading share participants, and some are as cheap as free if you are just willing to take it off the buyer's hands. The cost is only one factor. Understanding the marketplace and what a good price for what you are getting is as important as the actual cost.

From the seller's perspective, here are some tips regarding selling a shell company:

1) Understand your Shell: As mentioned above, there is a great deal of misinformation and misunderstanding regarding shells and shell transactions. While some of it is the result of unscrupulous participants, far more times it is the result of the shell owner or shell promoter not understanding the true nature and status of their public company. Having a shell vetted by an attorney is not only a good tip for prospective buyers of shells, but for current owners of shells as well. Also, have a plan for the issues with

your shell. If your company has accounts payables, accrued compensation and debt on its balance sheet have an up-front plan of how you plan to deal with such items in connection with a shell transaction.

2) Stay Current: Regardless of what platform you trade on (OTC Bulletin Board or Pink Sheets), provide current information regarding the company. If you are an OTCBB company, try and stay current in your reporting obligations. The legal and audit work for a true shell with little or no operations is not overly costly. If you are Pink Sheet company, even if a delinquent '34 Act filer, you should provide information to the marketplace in the form of 15c2-11 disclosure on the Pink Sheets website utilizing the Pink Sheets news service. There is a cost involved in keeping up with current information requirements, but that should be offset by the decrease in risk from regulators and shareholders, as well as the perception of the company when vetted by potential suitors.

3) Be Honest: Call a spade a spade. If your company is a shell or has ever been a shell, be truthful regarding that fact in your disclosure. This will not only speed up the review process for potential private company vend-in candidates, but will help to prevent problems between the selling shareholders and the purchasing shareholders in the future. Obviously, the other disclosure regarding the company, its history, its operations, etc. should be truthful as well. Due to change in the Rule 144 requirements many companies are fearful of having their companies classified as "shells." However, in my experience there are as many, if not more, potential purchasers looking for a company that is truly a shell, as long as the liabilities are limited, rather than a company that claims to have operations which then must be removed in connection with the shell transaction.

4) Keep Records: Regardless of whether you can stay current with information a company should keep accurate records, especially financial statements and tax returns, particularly if the company wishes to claim it is not, and never has been, a shell company. This is essential. Considering attorneys are the up front adjudicators regarding shell status, if a company is not providing current information, including financial statements, the first thing an attorney will look for to determine shell status are financial statements of the company. If a shell company does not have these then overcoming the assumption of shell status is virtually impossible even with representations and warranties from management.

Conclusion

With the amendments to Rule 144 as well as the new DTC-eligibility issues, the marketplace for shells has changed dramatically over the past couple of years. In addition to all the old issues to review when vetting a shell, old operations, hidden lawsuits and liabilities, shareholder issues, capital structure, legitimacy of stock issuances, etc., the two new ones are every bit as important. Bottom line for companies that are a shells as well as private companies looking for a shell – there are many pitfalls out there that need to be avoided when entering into a shell transaction. The better prepared you are to deal with those issues the better experience you will have in completing a shell transaction.

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The Lebrecht Group, APLC provides comprehensive advice on a variety of [corporate and securities law matters](#). Please contact us if you have any questions.

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