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Direct IPO v. Reverse Merger: A Detailed Examination

With many smaller companies thinking about going public in order to take advantage of financing options, the preferred methods to get public deserves further examination

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In the middle of last year I authored a two-article series entitled *Can Your Company Afford to Become (Stay) a Public Company?..... Can It Afford Not To?* (see The Isolated Offering June 2010 and August 2010 editions) wherein I detailed the costs for a company to get public via direct public offering (“Direct IPO”) and reverse merger, the costs to stay a public company, as well primary financing options available to public companies that are not available to private companies. As a result of this series of articles I have received numerous requests to further detail both the cost and timing to get public vis-à-vis the Direct IPO versus the reverse merger. This article provides further details regarding these two alternate ways to go public.

It should be noted the legal costs referred to in this article are the approximate costs charged by The Lebrecht Group, APLC; the charges for the other services are estimates based on what we typically see in the marketplace. Certain charges, especially for audit fees, will differ depending upon the various factors, primarily the nature of the business of the company and the location of the business and its operations. The estimated times are averages and may vary depending on a variety of factors.

The Direct IPO

Under a Direct IPO a private company with the requisite number of shareholders files its own registration statement with the SEC to register its common stock, then a 15c2-11 with FINRA to get on either the OTC Bulletin Board or another trading marketplace, and then applies for DTC eligibility. The primary steps, including costs and timing, for the average smaller private company to get public via a Direct IPO are as follows:

Step One: Due Diligence Review/Recapitalization: Many smaller companies desiring to go public were not originally incorporated with the idea of taking the company public. As a result the first step in going public through a Direct IPO is a review of the existing corporate structure, including the classes of authorized stock (common, preferred, etc.), the number of authorized shares, the number of outstanding shares for each class of stock, the rights and preferences of any classes of preferred stock, its past stock issuances, any outstanding convertible securities (such as warrants, options, or convertible debt), and any applicable federal or state security exemption filings. Although there is not one capital structure that a private company needs to have to go public there are definitely some that are more ideal than others. In order to make most capital structure changes the company will need to amend its Articles of Incorporation. Due to the costs involved to complete these amendments, the time to make these structural changes is while the company is still a private company with a relatively low number of shareholders, rather than after the company is public, when the costs greatly increase (as does the time).

Legal Cost: Approx. \$2,000 to \$3,500

Estimated Time: Appox. 1-2 weeks

Step Two: Private Offering: Many smaller companies desiring to go public either do not have the money necessary to pay for the initial costs involved or the required number of shareholders to go public, or both. For the private company that has the funds to pay the initial costs for legal and audit expense to get public, and has at least 70-80 shareholders, this step may be skipped. For all other companies, the company will need to conduct a private offering of its securities in order to raise the money it needs to go public (legal and audit expenses) or obtain the desired number of shareholders, or both. For most companies, this private offering will be conducted through a private placement memorandum. This step has a variety of factors in play depending on the money the company needs or wants to raise and the number of shareholders it has or needs. These factors affect the time the offering will be open, not the legal fees associated with the offering. The Lebrecht Group, APLC charges a flat fee of \$17,500 to \$20,000 for a private placement memorandum. This fee includes strategizing the offering, preparation of the private placement memorandum, monitoring the offering (including escrowing the offering proceeds), closing the offering, and researching and filing necessary state blue sky exemption filings (flat fee does not include any state filing fees). Depending on the amount the company needs to raise and the number of shareholders it needs, the offering time can last between 30-120 days, hence the broad time range listed below.

Legal Cost: \$17,500 to \$20,000 (plus state filing fees – generally about \$250 per state – states vary greatly, some are free and some are up to \$1,000, but \$250 per state is a good estimate. The states a company must file in is based on the states where the investors that invest in the offering reside).

Estimated Time: Between 6 weeks and 4 months depending on the time the company needs to conduct the offering (of this time the PPM preparation is typically 2-3 weeks).

Step Three: Registration Statement: For the purposes of this article we will assume the private company does not wish to wait one year after filing for shares to become free trading and continue the process of going public, and, therefore, we will assume the company will be filing an S-1 registration statement (if the company wishes to wait the year it can file a registration statement on Form 10). The Lebrecht Group, APLC charges a flat fee of \$40,000 to \$50,000 for an S-1 registration statement, which includes drafting, filing (not including edgar fees) and responding to any comments from the Securities and Exchange Commission. The S-1 requires an audit of the company's financial statements - normally the last two fiscal years, plus a review of any stub periods in the current fiscal year. The S-1 will register most, if not all, of the company's shares of common stock held by non-affiliates, enabling those shareholders to have the restrictive legend removed from their share certificate and sell the shares pursuant to the S-1 prospectus once the S-1 goes effective with the SEC. This provides the shareholder base and free trading shares necessary to get through Step 4, below.

Legal Cost: \$40,000 to \$50,000 (plus registration fees of a few hundred dollars).

Audit Fees: Dependent on many factors which vary by company and auditor selected, so very tough to estimate, but a good benchmark for a company's 2 year audit is about \$15,000 to \$50,000, with the review of the applicable stub period costing an additional \$5,000 to \$7,500. Most auditors will also have a separate fee for reviewing the registration statement that will contain the audited and reviewed financial statements. This fee is typically between \$2,500 and \$5,000.

Estimated Time: Once the audit is complete, approximately 3 to 4 months. The audit can take anywhere from 2-3 weeks to 2-3 months depending on the complexity of the company, quality of its

internal financial statements, and the auditor chosen. The audit must be completed prior to filing the S-1. The preparation of the S-1 is about 2-3 weeks of this time.

Step Four: **Affiliate Filings:** In connection with the registration statement going effective, there are filings that must be completed by the officers and directors and 10% shareholders of the newly reporting company, primarily Section 16 filings (Forms 3s). Normally these expenses are covered by the company even though the filings are the responsibility of the affiliates, not the company. In order to file the Form 3s the affiliates must obtain edgar codes if they do not have them.

Legal Cost: \$500 per affiliate

Estimated Time: 1 day (we overlap obtaining the codes and drafting the Form 3s so we are prepared to file them in connection with the effectiveness of the registration statement)

Step Five: **15c2-11:** Once the registration is effective, the next step is the filing of a 15c2-11 with FINRA. This is technically done by a market maker on behalf of a shareholder of the company. The Lebrecht Group, APLC charges a flat fee of \$6,000 for the preparation of a 15c2-11 package to deliver to a market maker for submission. This includes the drafting, compiling necessary documents, and responding to comments from FINRA.

Legal Cost: \$6,000 to \$8,000

Estimated Time: Approx. 1 to 2 months (we prepare the 15c2-11 for filing as we near the end of the SEC review process on the registration statement so the 15c2-11 can be filed as close to the effectiveness of the registration statement as possible, the 1 to 2 months estimate is to get through the FINRA review and comment process on the 15c2-11).

Step Six: **DTC Eligibility:** Once the company receives approval from FINRA on the 15c2-11 application and has a ticker symbol, it can apply through a broker for DTC-eligibility. This area has been a major issue over the past two or so years and the issues are too lengthy to detail here (for more information [see here](#)). The keys here are finding the right broker and clearing firm combination and having a backup plan. For most companies going public the first time the market maker that submitted the 15c2-11 will be willing to submit the DTC materials to their clearing firm for submission to DTC. However, the ultimate decision to submit the application is left with the clearing firm, not the market maker and there are many variables in play, so having a backup plan with another broker is a good idea.

Legal Cost: \$1,500 (primarily for DTC legal opinion)

DTC/Clearing Firm/Broker Costs: Varies, but normally about \$3,500. Can be less if market maker that submitted 15c2-11 is submitting the application (possibly free), but can also be substantially more if the company must find a new broker/clearing firm to submit the application (upwards of \$15,000).

Estimated Time: Approx. 2-6 weeks.

The Direct IPO In Summary: As outlined above the Direct IPO process costs approximately \$70,000 to \$90,000 in legal fees and takes approximately 7-12 months depending on whether the company needs to go through the offering described in Step 2 and how long that offering remains open. If it does not, the process is likely to take around 7 months. If it does, and the offering is 90-120 days, the process will likely take around 1 year. In addition to the legal costs outlined above, the company will have audit costs for the 2 year audit, plus applicable stub period and registration statement review fee

(difficult to estimate as very company dependent but likely between \$25K and \$60K), edgar costs (likely \$2,500 to \$3,500 for registration statement), transfer agent costs (typically \$500 to \$1,000 one-time set up fee and \$125-\$250 monthly fee, not including ordering stock certificates and having shares issued to initial shareholders – likely total of \$2,500 for initial costs). Therefore, all in, most companies are looking at total costs to go public through a Direct IPO of \$100,000 to \$150,000, and anywhere from 7 to 12 months.

The Reverse Merger

Under a reverse merger a private company merges with an existing public company and assumes the public company's status with the operations of the private company becoming the operations of the public company (technically the private company usually becomes the operating subsidiary of the public company, which becomes a holding company). The primary steps, including costs and timing, for the average smaller private company to get public via reverse merger are as follows:

Step One: Due Diligence Review of Private Company: Although not as critical as in the Direct IPO route since the private company entity does not become the public company, there is still a due diligence process under the reverse merger route. This review is primarily related to the securities offerings and sales of the company due to the fact those shareholders will be exchanging their shares for shares of the public company.

Legal Cost: Approx. \$1,500 to \$2,500

Estimated Time: Approx. 1 week

Step Two: Due Diligence Review of Possible Shell Companies: This step is one that is many times overlooked or short-changed and it should not be. The old theory of just buy any shell company and then fix it later is an outdated one that does not make common, or economical, sense in current times. There are a variety of factors that need to be looked at when reviewing potential shell vehicles and in-depth reviews should be conducted for any serious shell candidates (for more information [see here](#)).

Legal Cost: Approx. \$2,500 for an in-depth review of each serious shell candidate. It usually takes between 1-3 in-depth reviews to find a shell company that works for a specific private company, so a good estimate here is \$5,000 (note, this does not include any legal fees for cursory reviews of shell candidates that obviously don't meet a private company's requirements. We do not charge for those reviews, only the in-depth reviews necessary for serious shell candidates).

Estimated Time: Between 2-4 weeks depending on how many shells need to be identified and reviewed.

Step Three: Private Company/Shell Transaction: Once the shell company has been identified the merger transaction needs to be properly documented. If the shell review in Step 2 was properly completed the structure of the transaction and the major deal points should be agreed upon by the parties. However, the deal documents still need to be structured properly to ensure the private company shareholders are protected as much as possible from contingent issues and any non-disclosed issues.

Legal Cost: Approx. \$10,000 - \$15,000

Estimated Time: Approx. 2-3 weeks

Shell Cost: The big additional cost between a Direct IPO and a reverse merger transaction is the cost of the shell. Currently, '34 Act reporting company shells listed on either the OTC Bulletin Board or the OTCQB tier of OTC Markets are going for anywhere between \$250K to \$485K, depending on a number of factors, and OTC Markets shells that are not '34 Act reporting companies are going for anywhere between \$60K and \$150K, also dependent on numerous factors (see the article on shell transactions listed above). There are cheaper shells for companies willing to get less than 70%-80% of the outstanding stock or put up with and correct the numerous other issues associated with most of those cheaper shells.

Step Four: Super ("Form 10") 8-K: If the shell company that is merged with is actually a "shell" as defined by the SEC, then within four business days after the close of the transaction the public company must file a Form 8-K, which includes a description of the transaction as well as Form 10 information regarding the private company operations that have become the operations of the public company. This Form 8-K is typically referred to as a "Form 10 8-K" or a "Super 8-K." The company must include audited financial statements for the past two years, plus reviewed financial statements for any stub periods, in the Super 8-K (Note: this audit should be completed prior to this step to ensure the company is "auditable" and so there are no delays in getting the Super 8-K filed within the short time frame. The audit should be completed by the time Step 2 is completed, since if the private company is not "auditable" the private company will not want to incur the costs after Step 2, at the latest).

Legal Cost: \$15,000 - \$20,000

Audit Fees: Dependent on many factors which vary by company and auditor selected, so very tough to estimate, but a good benchmark for a company's 2 year audit is about \$15,000 to \$50,000, with the review of the applicable stub period costing an additional \$5,000 to \$7,500.

Estimated Time: 2 weeks (does not include any time for the audit and we overlap the drafting of the Form 8-K with the end of the transaction documents to ensure it is filed timely).

Step Five: Affiliate Filings: In connection with the close of the reverse merger transaction set forth in Step 3, there are filings that must be completed by the officers and directors and 10% shareholders, primarily Section 16 filings (Forms 3s). Normally these expenses are covered by the company even though the filings are the responsibility of the affiliates, not the company. In order to file the Form 3s the affiliates must obtain edgar codes if they do not have them.

Legal Cost: \$500 per affiliate

Estimated Time: 5-10 days (unlike with the Direct IPO we usually do not advise the affiliates to get edgar codes and proceed with these filings until after the transaction closes)

Step Six: 14-C Information Statement: This step is not mandatory, but in most shell transactions the private company will want to change the name and/or capital structure of the newly acquired public company vehicle. This is done through a 14-C Information Statement, which must be mailed to the company's shareholders. Since the company is already incurring the cost, this is an ideal time to approve any other transactions that need shareholder approval to avoid having to file a second 14-C Information Statement. It should be noted that if a company does not elect to file a 14-C Information Statement, a 14f-1 filing will still be required if a majority of the Board of Directors is being replaced as a result of the change of control transaction. Since this is always the case, there will be legal costs here of at least \$3,500, plus mailing costs. However, most companies elect to go the 14-C route and include the 14f-1 disclosure in the 14-C, so that is what is estimated below.

Legal Cost: \$10,500

Mailing Costs: Normally the 14-C will require some mailing to the company's shareholders. This may be only a letter if the company can use the e-proxy rules, but if it cannot or does not wish to, the 14-C will need to be mailed to all shareholders. The costs for copying, stuffing and postage for the mailing can cost approximately \$500 to \$1,500.

Estimated Time: Approx.45-60 days

Step Seven: DTC Eligibility: This step may or may not be necessary. In a nutshell, DTC can review a public company's eligibility if the company undergoes a corporate change transaction (or at any time really). So if the private company merges with a shell company with problems and then changes the name or reverse splits the stock, for example, DTC could review the company's DTC-eligibility and may elect to freeze or chill the company's stock. If this occurs the process to regain eligibility can be a long and frustrating one, so this is a possibility companies should be aware of when making the decision between a Direct IPO and a reverse merger, and if it chooses the latter, then this should be a factor in determining what shell to select for the transaction.

Legal Cost: \$2,500 to \$3,500 (due diligence review and DTC legal opinion)

Estimated Time: Anywhere from 2 weeks for many months depending on various factors.

The Reverse Merger In Summary: As outlined above, the reverse merger process costs approximately \$45,000 to \$50,000 in legal fees and takes approximately six weeks to close the reverse merger transaction, and another 2-8 weeks for post transaction filings depending upon if the company files a 14-C Information Statement. If the company has DTC-eligibility issues it could take much longer. In addition to the legal costs outlined above, the company will have audit costs for the 2 year audit, plus applicable stub period and registration statement review fee (difficult to estimate as very company dependent but likely between \$25,000 and \$60,000), edgar costs (likely about \$2,500 to \$3,500 for the Super 8-K and 14-C), and, obviously the cost of the shell, which will likely be between \$60K and \$450K. Therefore, all in, most companies are looking at total costs to go public through a reverse merger of \$150,000 to \$550,000 (largely dependent on the cost of the shell) and anywhere about 6 weeks to acquire the shell and another 2-8 weeks of post-transaction filings.

Conclusion

This article gives a brief outline of the costs and time associated with a Direct IPO and a reverse merger for companies debating which of these two methods to use to go public. However, there are other factors in play in determining which path works best for any given company and there is no substitute for qualified legal counsel when it comes to making this decision. On a parting note, getting legal counsel involved in the early stages in either process will pay enormous dividends down the road since if you wait until once you have completed the shell transaction (reverse merger) or undertaken your private offering or registration statement (Direct IPO), the costs of clean-up if a bad decision has been made greatly exceed the costs outlined above.

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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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