

# Memorandum For Clients

## Financial Statement Requirements Relating To A Merger Between A Private Operating Company And A Public Shell Company

Since August 2005, a transaction which causes a public shell company to cease being a shell company is an event which requires mandatory disclosure of certain business and financial information within four (4) business days on a Form 8-K. Often, these types of transactions involve a merger of the shell company with a private operating company (an "OpCo"), commonly referred to as a "reverse merger." Former public shell companies usually exclude from such a Form 8-K the financial statements for a fiscal period ending prior to the completion of the reported event when such financial statements and other information were unavailable (i.e. the financial statements have not yet been reviewed or audited or the company has not completed its disclosure controls and procedures). While the Securities and Exchange Commission (the "SEC") permits this approach under the securities laws and the SEC's regulations thereunder, the SEC staff (the "SEC Staff") has made a recent pronouncement interpreting SEC rules to require supplemental disclosure of such excluded financial statements on an amendment to a Form 8-K within ninety (90) days of the filing date of the original Form 8-K reporting the shell company altering event. This memorandum discusses the steps that a former shell company must take to comply with the SEC Staff's position with respect to reporting such financial statements in connection with a public shell altering transaction, as well as other transitional reporting issues after the completion of mergers that cause a public shell company to cease being a shell company.

### *Background*

In August 2005, new rules adopted by the SEC relating to the use of Form 8-K by public shell companies became effective. The new rules amended Item 2.01 of Form 8-K to require a public shell company, within four (4) business days after an event that causes it to cease being a shell company, to disclose the same detailed information, including financial statements, as would be required if the company were registering a class of securities on Form 10 or Form 10-SB under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). This information is similar to the information requirements for the registration of securities in an initial public offering. To the extent that the transaction results in a change in control of the shell company, which is

almost always the case, Item 5.06 of Form 8-K requires identification of the material terms of the transaction, which may be accomplished by incorporating by reference the disclosure made under Item 2.01 of the Form 8-K. If the former public shell company is not the surviving entity in the transaction, the successor entity is required to complete the Form 8-K filing within the same four (4) business day timeframe.

The two most common types of transactions that cause a public shell company to cease being a shell company each involve a merger with an OpCo as follows:

1. an OpCo completes a reverse merger whereby it merges into a public shell company with the owners of the OpCo receiving a significant majority of the stock of the public shell company; and
2. a public shell company merges into an OpCo and the OpCo succeeds to the Exchange Act reporting obligations of the public shell company (a transaction commonly referred to as a “back door registration”).

Under Item 2.01, the detailed Form 10 or Form 10-SB disclosures relating to either of the foregoing merger transactions between an OpCo and a public shell company have to be made with respect to the business and management of the OpCo. Prior to the adoption of these new rules in August 2005, detailed information about the business and management of the OpCo was not required until the former public shell company filed its next annual report on Form 10-K or Form 10-KSB, thus allowing the newly merged company a greater period of time in which to gather up a significant amount of information.

In addition to the detailed business, management, and other non-financial disclosures required by Item 2.01, the new rules adopted in August 2005 also amended Item 9.01 of Form 8-K to require the Form 8-K reporting a merger with an OpCo that causes a public shell company to cease being a shell company to also include certain financial information as follows:

1. the audited financial statements the OpCo for the most recently completed fiscal year;
2. unaudited interim financial statements of the OpCo for any interim period subsequent to the most recently completed fiscal year, together with the financial statements from the prior year for the comparable period; and
3. pro forma information depicting the effects of the merger with the public shell company.

Prior to the adoption of the new rules, these financial statements were not required to be filed until seventy-five (75) calendar days after the completion of the merger.

The rules adopted in August 2005 did not explicitly address the fiscal periods for which financial statements would be required under the new rules. Subsequent to the adoption of these new disclosure rules, Form 8-K filings relating to mergers between an OpCo and a public shell company routinely excluded financial information of the OpCo for a recently completed fiscal period for which such information was unavailable and the deadline to file a periodic report under Sections 13 or 15(d) of the Exchange Act would not have passed if the OpCo had been a public, reporting company. Because it would be permissible to exclude such financial information from a Form 10 or Form 10-SB registration statement, the SEC Staff interpreted the August 2005 rules to permit the exclusion of such financial statements from a Form 8-K reporting an event that caused a public shell company to cease being a public shell company.

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RECENTLY, THE SEC STAFF ANNOUNCED INTERPRETATIVE GUIDANCE IN WHICH THE SEC STAFF ASSERTED THAT SUCH FINANCIAL INFORMATION WOULD HAVE TO BE FILED WITH THE SEC IN AN AMENDMENT TO THE FORM 8-K WITHIN NINETY (90) CALENDAR DAYS OF THE DATE THAT THE ORIGINAL FORM 8-K IS FILED TO REPORT THE TRANSACTION.

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## *Financial Statements for Fiscal Periods Ending Pre-Merger*

Under Financial Accounting Standards Board Statements of Financial Accounting Standards No. 141, which mandates the purchase accounting method for business combinations, the OpCo is almost always the accounting acquirer in a merger with a public shell company. Even if the transaction results in the reverse merger of an OpCo into a public shell company, the SEC Staff has stated that the reports filed by the former public shell company after such a merger should parallel the financial reporting required under U.S. generally accepted accounting principles as if the OpCo were the legal successor to the shell company's reporting obligation as of the date of the merger. The OpCo is treated as the continuing reporting entity and not the public shell company. Based on

this approach, the historical financial statements of the OpCo would become the historical financial statements of the former public shell company in all subsequent periodic reports.

Exchange Act Rules 13a-1 and 13a-13 require issuers to timely file annual reports once every twelve (12) months and quarterly reports once every three (3) months. In light of Rules 13a-1 and 13a-13, the SEC Staff has taken the position that, following a merger between an OpCo and a public shell company, the OpCo should likewise not have a gap in reporting after the merger and should ensure that its filings with the SEC result in timely, continuous reporting, with no lapse in periods presented in the financial statements and no audited period exceeding twelve (12) months.

The new rules adopted in August 2005 are designed, at least in part, to use the Form 8-K filed in connection with a merger between an OpCo and a public shell company as a vehicle to file the OpCo's financial statements under the Exchange Act to accomplish continuous reporting consistent with Rules 13a-1 and 13a-13. However, where financial statements of an OpCo for a recently completed fiscal period are excluded from such a Form 8-K filing, the possibility exists for a gap in such reporting. The SEC Staff has recently interpreted Rules 13a-1 and 13a-13 to require that such excluded financial statements of the OpCo be filed by an amendment on Form 8-K/A within ninety (90) calendar days of the date that the original Form 8-K is filed.

Such amendment on Form 8-K/A is required to include the following information:

- If the recently completed fiscal period was the fiscal year end of the OpCo, then the Form 8-K/A would have to include two (2) years of audited financial statements for an OpCo that qualifies for S-B reporting (three (3) years if it does not) together with all other information required by Form 10-K or Form 10-KSB, as applicable; or
- If the recently completed fiscal period was the fiscal quarter end of the OpCo, then the Form 8-K/A would have to include the latest three (3) month and year-to-date financial statements and comparative financial statements from the prior year, together with all other information required by Form 10-Q or Form 10-QSB, as applicable. Such financial statements would not have to be reviewed by an independent auditor in accordance with Rule 10-01(d) of Regulation S-X because such financial statements were being filed in a Form 8-K/A and not a Form 10-Q or 10-QSB.

Similarly, foreign private issuers that are public shell companies that file an acquisition Form 20-F within three (3) months after the OpCo's latest fiscal year end and exclude the OpCo's financial statements from the Form 20-F will be required to provide such financial statements, together with all other information required by Form 20-F, in an amendment on Form 20-F/A within six (6) months of the date that the acquisition Form 20-F is filed.

No certifications are required in the Form 8-K/A or Form 20-F/A because such amendments are made to file the most recent financial statements of the OpCo, which was a non-issuer at the time of the original Form 8-K or Form 20-F filing, as applicable, to avoid a lapse in reporting under Exchange Act Rules 13a-1 and 13a-13, as applicable.

The SEC Staff's position on the financial statement requirements under Items 2.01, 5.06 and 9.01 relating to a merger between an OpCo and a public shell company are discussed in a speech delivered to the 2006 AICPA National Conference by Louise M. Dorsey, the Associate Chief Accountant at the SEC's Division of Corporation Finance. A transcript of Ms. Dorsey's remarks at the AICPA conference is available online at <http://www.sec.gov/news/speech/2006/spch121206lmd.htm>.

## *Financial Statements for Fiscal Periods Ending Post-Merger*

In addition to the foregoing considerations which relate specifically to financial statements of an OpCo for periods ending prior to the consummation of a merger with a public shell company, consideration should also be given to transition issues for Exchange Act reports under Sections 13 or 15(d) for periods ending subsequent to the completion of such a merger. The SEC Staff believes that continuous reporting under Exchange Act Rules 13a-1 and 13a-13 may be accomplished after such a merger in either of two ways, depending on whether the former public shell company intends to report after the merger based on its previous fiscal year or if it is adopting the fiscal year of the OpCo.

It is customary for a public shell company to adopt the fiscal year and auditor of an OpCo after a merger. In such circumstances, the SEC Staff has stated that no transition report is necessary. Commencing with the periodic report for the quarter in which the merger was consummated, reports should be filed based on the fiscal year of the OpCo. Those financial statements would depict the

operating results of the OpCo, including the acquisition of the public shell company from the date of consummation, and would include the historical financial statements from prior year periods of the OpCo without regard for the financial statements of the former public shell company for such prior periods.

If the former shell company intends to continue to file its Exchange Act reports based upon its fiscal year end rather than that of the OpCo, the SEC Staff has stated the reporting company after the merger ordinarily should file a transition report on Form 10-K or Form 10-KSB containing the audited financial statements of the OpCo for the necessary transition period. The SEC Staff has clarified in no-action guidance that the period covered by this transition report should be the period from the end of the OpCo's most recently completed fiscal year to the next following date corresponding with the end of a fiscal year of the former public shell company. The transition report is due ninety (90) calendar days after the consummation of the acquisition.

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The foregoing analysis is intended solely as a summary of the financial statement reporting requirements in connection with a merger between a public shell company and a private operating company and the recently announced SEC Staff position relating thereto. If you want to learn more about the financial statement or other Form 8-K requirements in connection with a merger between a public shell company and a private operating company, or have specific questions about such a matter, please contact Nanette C. Heide or Michael Dunn in our New York office at 212-218-5500 or one of the Corporate Securities attorneys listed on our website at [www.seyfarth.com](http://www.seyfarth.com).



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