SEC Still Quiet On Rule 144(i) Evergreen Requirement

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In 2008, the U.S. Securities and Exchange Commission made a controversial amendment to Rule 144 of the Securities Act of 1933, one of the most commonly used exemptions shareholders use to publicly sell restricted securities. One of the effects of the 2008 amendment was to complicate the process by which companies formed by way of a reverse merger are able to authorize the removal of restrictive legends from their securities.

As this article will explain, despite the strong negative reaction to the amendment in the securities community, and despite the SEC's admission that the effect of the amendment was unintended, there has been no change to Rule 144(i) address these effects — and companies formed by reverse mergers must carefully consider requests for legend removal, and have a strategy for compliance with the amended Rule 144.

Companies become public reporting companies in order to help raise money, grow and provide shareholders with increased liquidity.

Taking a company public through a traditional Initial Public Offering is a highly regulated process, which can be expensive and often take up to a year to complete. In order to register its shares for sale to the public through an IPO, a company must, among other things, file a Form S-1 with the SEC.

In light of the relative complexity and cost of taking a company public by means of an IPO, the reverse merger has arisen in recent years as an increasingly popular option for large and small companies alike to become a public reporting company. In a reverse merger, a private company gets "acquired" by a public "shell" company, a public company with no real business or assets, in exchange for the shareholders of the private company receiving a majority stake in the public company. By virtue of the merger, the private company obtains control of the former shell and is able to trade on the same public market as the former shell, but with the operations and assets of the former private company.

Berkshire Hathaway, Occidental Petroleum, Turner Broadcasting and Texas Instruments, to name just a few, are companies that have all taken the less-traditional route of a reverse merger. The reverse merger has also been a popular option for smaller companies in need of capital, who are drawn to reverse mergers due to the generally quicker timeframe and lower cost as compared to an IPO, and the easier ability to retain ownership and control over the resulting public company. Popularity of reverse mergers peaked around 2010, and has since declined — at least in part due to the SEC's tightening of rules for reverse merger listings.

Even if a company becomes a public reporting company by virtue of a reverse merger, any securities that it issues will still be "restricted securities." Restricted securities are securities that have been acquired in transactions exempt from the registration requirements of the Securities

Act of 1933 — most often through private placements, like regulation D offerings. Certificates for restricted securities are stamped with a “restrictive legend,” which indicates that the securities may not be resold publicly unless the sale is registered with the SEC, or exempt from registration requirements.

Rule 144 is the most commonly used exemption from registration requirements, through which shareholders can sell their restricted securities. Once a prospective seller has met the conditions of Rule 144, he or she may apply to the issuer of the shares, in this case the former shell company, for consent that the restrictive legend be removed. The ultimate decision whether to remove the legend is at the discretion of the issuer, and consent of the issuer is granted in the form of an opinion letter from counsel of the shareholder, reasonably acceptable to the company, or the issuer’s counsel, provided only at the express direction of the issuer. Shareholders will often request that restrictive legends be removed as soon as the shares are eligible for the Rule 144 exemption, so that the shares can be sold without delay at a beneficial time in the market.

Under Rule 144, as amended in 2008, the exemption for resale to the public is available once the shareholder has held the securities for at least either six months if the issuer is a public reporting company, or one year if the issuer is not subject to reporting requirements. Affiliates (i.e., shareholders in a relationship of control with the issuer) can also sell their shares under Rule 144, but have additional volume restrictions on the number of securities they can sell during a three-month period.

Prior to the 2008 amendments to Rule 144 (discussed below), there was little SEC guidance on the use of Rule 144’s exemptions for former shell companies after a reverse merger. It was generally accepted in the securities law community that Rule 144 was available to shareholders of former shell companies, but not blank check companies (i.e., development-stage companies with no specific business plan or purpose, which may have indicated its business plan is to engage in a merger or acquisition).

In 2008, matters got more complicated for companies that became public reporting companies by way of reverse mergers. Effective Feb. 15, 2008, Rule 144 was amended to significantly change the requirements for shareholders to sell restricted securities issued by a former shell company.

Rule 144(i), as amended, states that Rule 144 is not available for the resale of securities initially issued by a former shell company:

- Until one year after the issuer has filed current “Form 10” information (i.e., the information that would be required if the company were filing a general form for registration of securities on Form 10 under the Exchange Act, which is in many ways similar to the information about the company that would be filed in a registration statement on Form S-1) with the SEC reflecting its status as an entity that is no longer a shell company; and

- Unless the issuer of shares is current on all reports and other materials required to be filed with the SEC during the 12 months before the shareholder sells the shares.

Due to the latter requirement — the so-called “Evergreen Rule” — the restrictive legend on shares of a former shell company can never be lifted in advance of a contemplated sale, because an open-ended lifting of the restrictive legend would mean that the actual sale could occur at a time when the company was no longer current in its filings. The Evergreen Rule against former shell companies continues forever, regardless of whether it has been years, or even decades, since the reverse merger. The Evergreen Rule is problematic, among other reasons, because in a market where share prices are subject to significant changes over time, even short periods of time, the delay caused by the process of having a legend removed only at the time of the intended sale can significantly affect the price at which the shares are sold.

Exactly how to implement Rule 144(i), and the new Evergreen Rule in particular, was and is far from clear. Five years after implementation of the amended Rule 144(i), there is no known regulation on how to implement the new Evergreen Rule. The burden of this lack of information falls to the former shell companies — as set forth on the SEC's website: "[t]he Removal of a legend is a matter solely in the discretion of the issuer of the securities." (http://www.sec.gov/investor/pubs/rule144.htm.)

What is clear is that under Rule 144(i), a former shell company cannot permissibly authorize a request to remove a restrictive legend pursuant to Rule 144 unless such company can reasonably conclude that the shares will be resold upon removal of the legend within a reasonable period of time from lifting the restrictive legend — i.e., during the period of time the company would be current in its SEC filing requirements.

For large companies such as Berkshire Hathaway or Occidental Petroleum, the determination of how many shares a shareholder could reasonably be expected to sell during the time the company is current in its SEC filing requirements should not be a problem — the trading volume of their shares is high, and they can expect that a shareholder could sell even a large number of shares quickly after any restrictive legend was lifted.

However, the analysis becomes much more complicated for smaller and less-established public companies, due to the combination of a smaller trading market for the stock of these companies, and the unique challenges less-established companies may have in staying current in their SEC filing requirements. For smaller companies the determination of whether to approve the removal of a restrictive legend from shares, and how many shares to approve, may be a time-consuming and case-by-case determination for the company, with results that could vary over time.

Despite the problems Rule 144(i) poses, particularly for smaller reporting companies, the SEC has not been forthcoming with any further amendments.

To that end, on Oct. 1, 2008, a group of lawyers from nine law firms submitted a formal petition letter to the SEC, requesting an amendment to Rule 144, as amended. (http://www.sec.gov/rules/petitions/2008/petn4-572.pdf.) The Oct. 1, 2008, letter identified that because of the amendment to Rule 144, the period for which a former shell company must remain current in its filings in order for a shareholder to have the restrictions removed from their shares "never ends." (Id., emphasis in original.) As the letter explained to the SEC: "both issuers and investors have experienced significant difficulties in dealing with" these issues. (Id.)

Shortly thereafter, at a Nov. 20, 2008, SEC panel on "Current Issues in Securities Regulation for Smaller Companies," a question was raised by an attorney regarding the "request from rulemaking from a number of prominent firms in the small cap space, asking the staff to address an issue under Rule 144(i) that has the impact of basically punishing any company that was ever a shell company in perpetuity and more importantly, really, the investors who were investors in those companies."

In response, Brian Breheny, then deputy director of the SEC Division of Corporation Finance, addressed the "unfortunate results of Rule 144(i)" and its application to any company that was ever a shell, and admitted that "that was probably not something the Commission intended." Mr. Breheny went on to say that the SEC "had already started to move on" potential amendments to Rule 144(i), and that "I think you could see something sooner rather than later on that."

More than four years later, the SEC has taken no action to amend Rule 144(i), nor has there been any further public guidance for former shell companies trying to comply with their obligations under Rule 144(i) — despite the fact that the SEC itself said that the result of Rule 144(i) was probably not intended.

As the U.S. economy continues to recover at a slow pace, more and more businesses may consider returning to the often more streamlined and cheaper reverse merger route of becoming a public reporting company. Yet, without further clarification or modification, Rule 144(i) remains the law of the land, including the Evergreen Rule. These companies must make sure they are complying both with the SEC rules, and balancing the needs of their shareholders.

If there is limited market for the issuer's shares the issuer may wish to consider alternate options to issuing blanket removals of restrictive legends — such as allowing "leakage agreements" that allow for sales of a limited number of shares over time, tied to a percentage of trading volume, or allowing periodic sales of a set number of shares the company determines in advance can be sold while it expects to still be current on its filing requirements.

In short, former shell companies must still pay careful attention to any request for legend removal, and should consult with securities counsel to develop a uniform policy for addressing such requests.

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