March 8, 2016

The Effect of "Shell Company" Status on Rule 144

By: John P. Cleary | 619.515.3221 | john.cleary@procopio.com

If you acquire stock from a public company, you cannot sell the stock until it is registered or there is an exemption from the registration requirements of the Securities Act of 1933, as amended (the "Securities Act"). Section 4(1) of the Securities Act provides an exemption from registration for transactions by any person other than an issuer, underwriter, or dealer. Rule 144 provides a safe harbor for resale of securities under the Section 4(1) exemption. It is called a safe harbor because if you meet all the requirements of Rule 144, the resale transaction is per se exempt under Section 4(1). If you meet all of the requirements for Rule 144, you can have the restriction lifted and can freely trade the shares in the open market.

Rule 144 is complex, and scholars and practitioners have written volumes of treatises and guidance on the topic. In its most simple sense, there are eight key factors under Rule 144.

- Whether the stockholder is an *Affiliate* of the company;
- The period of time the stockholder has held the shares (the *Holding Period*);
- Whether the company is a *Mandatory Reporting Company*;
- Whether the company has made available *Current Public Information*;
- Whether the company is, or ever has been a *Shell Company*;
- The amount of shares that may be resold by a particular stockholder (the *Volume Limitations*);
- Whether the sale needs to be effectuated through a broker transaction (the *Manner of Sale*); and
- Whether a Form 144 needs to be filed by the stockholder (*Form 144*).

Due to the complexity of Rule 144, you should engage qualified counsel to advise on its applicability. The analysis is fact intensive, and requires careful analysis of the issuer of the securities, the transaction whereby the shareholder acquired the shares, and the holder of the securities.

This article addresses perhaps the most complex, yet overlooked issue in the Rule 144 analysis - Shell Company status.

Although the information contained herein is provided by professionals at Procopio, the content and information should not be used as a substitute for professional services. If legal or other professional advice is required, the services of a professional should be sought.

© 2016 Procopio, Cory, Hargreaves & Savitch LLP

What is a Shell Company?

As defined in Rule 405 and Rule 12b-2 of the Securities Exchange Act of 1934, a "shell company" is a company that is now, or at any time previously was, a company with no or nominal operations, and any one of the following:

- no or nominal assets;
- assets consisting solely of cash and cash equivalents; or
- assets consisting of any amount of cash and cash equivalents and other nominal assets.

In adopting the rules, the SEC intentionally avoided defining the term "nominal" out of concern that creative companies and counsel would use a bright-line test to circumvent the rules. What results is a gray area for analysis and argument between shareholders attempting to remove the trading restriction and broker-dealers seeking certainty that removing restriction is appropriate.

What is certain is that at some point all companies had nominal operations and nominal assets. To be sure, it is best practice for company founders to form their company early, before creating significant value. What results is that on the date of incorporation, and for some time thereafter, every company met the definition of a Shell Company. Surely, this was not the SEC's intent. The rules were meant to curb abuses by holders of companies colloquially known as "shells", which have existed primarily as flailing, non-operating entities. Many times, a company has changed hands multiple times in its existence, at each stage inserting a new business endeavor that ultimately fails until the time a new operation merges in to make a run at it. Historically, promoters and shareholders of these entities have spurred trading in these stocks by flooding the market with shares that are ultimately sold to the public. Because these businesses have no predictability, in terms of stability and even whether management intends to operate a functioning business, the SEC developed the shell company restriction to avoid the creation of free-trading shares in these entities.

Practically, the determination of Shell Company status is fact intensive. As a result of the intentional ambiguities created by the SEC, the analysis requires a compare/contrast against the few circumstances where the SEC has weighed-in on a Shell Company issue. Experienced counsel in Rule 144 matters is crucial.

How does "Shell Company" status impact the availability of Rule 144?

According to the Rule 144(i), Rule 144 is not available for the resale of securities initially issued by either a reporting or non-reporting shell company. Moreover, Rule 144(i)(1)(ii) states that Rule 144 is not available to securities initially issued by an issuer that has been ***"at any time previously"*** a reporting or non-reporting shell company. This broad language of Rule 144(i)(1)(ii) prohibits shareholders from utilizing Rule 144 to sell their shares in a company that at any time in its existence was a shell company, and renders the word "initially" in Rule 144(i) virtually meaningless. However, according to Rule 144(i)(2), an issuer can "cure" its shell status if the issuer:

- has ceased to be a shell company as defined in Rule 144(i)(1);
- mandatorily files reports with the SEC;
- has filed all required SEC reports and other materials during the preceding 12 months (or for such shorter period that the issuer was required to file such reports and materials, other than Form 8-K reports); and

© 2016 Procopio, Cory, Hargreaves & Savitch LLP

- has filed current “Form 10 information” with the SEC reflecting the issuer’s status as an entity that is no longer a Shell Company, and at least one year has elapsed since such Form 10 information was filed.

To “cure” a company’s current or former shell company status, the conditions of Rule 144(i)(2) must be satisfied regardless of the time that has elapsed since the public company ceased to be a shell company and regardless of when the shares were issued. Thus, the availability of Rule 144 for resales of shares issued while the company is a shell company or thereafter may be restricted even after the expiration of the one-year period since it filed its Form 10 information if the company is not current on all of its periodic reports required to be filed within the SEC during the 12 months before the date of the shareholder’s sale. For example, if the company did not timely file a Form 10-Q at the time a shareholder wishes to sell shares issued by the public company long after it ceases to be a shell company, Rule 144 will not be available.

The Securities Exchange Act of 1934 requires companies with publicly traded securities to register their securities with the SEC, thus triggering reporting requirements. A mandatory reporting company, otherwise known as a “reporting company,” is a company that:

- is required to register the class of securities with the SEC under Section 12(b) of the Exchange Act because the company elects to list a class of securities on a national securities exchange;

- is required to register under Section 12(g) of the Exchange Act because the company has total assets exceeding $10 million and a class of equity securities held by 2,000 or more persons, or 500 or more persons who are not accredited investors; or

- files a registration statement under the Securities Act, thus being subject to 15(d) of the Exchange Act.

Whether under Section 12 or becoming subject to Section 15(d) of the Exchange Act, a company is required pursuant to Section 13 of the Exchange Act to file annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K. If a company is not required under Section 13 or 15 of the Exchange Act to file periodic reports with the SEC but nevertheless does so, such company is known as a voluntary reporting company. A company may become a voluntary reporting company if the company’s duty to file periodic reports under Section 15(d) is later suspended in accordance with Section 15(d) but it still continues to file. Regardless if a company is filing voluntarily, a company that is not a mandatory reporting company pursuant to Section 13 or 15(d) of the Exchange act is considered a non-reporting company for many purposes, and is not able to utilize Rule 144(i)(2).

What are the consequences of investing in a current or former Shell Company?

If an investor hopes to preserve liquidity, they need to be careful buying stock in a company that is currently or was at any time in its history a shell company. To clarify 144(i), below are some fact-specific analyses:

1. If a company issued stock when it was a shell and remains a shell, the use of Rule 144 would be disallowed under Rule 144(i)(1)(i).

2. If a company was a shell, then was not a shell when it issued stock, and is now a shell again, the use of Rule 144 would also be disallowed under Rule 144(i)(1)(i).

© 2016 Procopio, Cory, Hargreaves & Savitch LLP

3. What if a company was a shell, at any time in its existence, and issued stock when it was a shell, but is no longer a shell and has not cured under Rule 144(i)(2)? Under Rule 144(i)(1), the availability of Rule 144 is also prohibited because the shares were issued at a time the company was a shell, thus exemplifying the terms "initially issued" by a shell company in Rule 144.

4. Another possible scenario includes a company that was previously a shell company but is an operating company at the time that it issued securities and still remains an operating company. To clarify that Rule 144(i) does not have any room for interpretation, in the SEC's Compliance and Disclosure interpretations issued on January 26, 2009, the SEC confirmed that Rule 144(i)(1)(ii) prohibits the use of Rule 144 by shareholders of companies in this situation, even if they have not been a shell for some time. SEC further stated that if a company was a shell at some point, regardless of how long ago, but is not a shell company now, the only way to be eligible to use Rule 144 is for a company to comply with Rule 144(i)(2).

Shell Company status has an immense impact on Rule 144's availability to shareholders of companies that are, or ever were in their past, shell companies. Non-affiliate shareholders that purchase stock in fully operating and reporting companies at the time of purchase are often now left without Rule 144's safe harbor.[1] Typically, these shareholders had minimal or no say in the company becoming a shell company or failed to know that the company was a shell company at some point in its history before making their investment. In conclusion, investors must be careful to invest before considering the effect of shell company status on their ability to use Rule 144.

John P. Cleary advises clients in the areas of corporate, securities, mergers, acquisitions, and venture financing. John's practice focuses on securities offerings, both public and private, and represents publicly traded companies in capital raising, reporting and general business matters. He is also experienced in the representation of buyers and sellers in mergers, stock and asset purchases, joint ventures and related transactions. He can be reached at john.cleary@procopio.com or 619.515.3221.

[1] In many cases, stockholders may be able to use the more restrictive Section 4(1) general exemption, although such reliance involves more risk because it is not a safe harbor.

© 2016 Procopio, Cory, Hargreaves & Savitch LLP