A STUDY ON THE CONCEPT OF REVERSE MERGERS: AN ALTERNATIVE TO THE IPO IN INDIA

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ABSTRACT

In India, the procedure for a private company to go public is very lengthy, expensive, and time-consuming, which may be in the interest of the general public as it helps reduce fraud, but at the same time, might affect the company. The concept of Reverse Mergers is not very much in practice in India but it is a much simpler way for private companies to go public. The Tax laws in India promote this concept to some extent. The problem lies in the fact that it is not yet recognized by the Indian laws and is not even illegal but is less practiced and is also feared by the shareholders of the public companies as there are several challenges and disadvantages to it and is categorically a new and less practiced concept. They are also equally susceptible to fraud and abuse. This raises a question as to whether special rules and regulations should be introduced by the policymakers and the regulators governing backdoor listings. This article studies concepts like the prospects of IPO in India, and the concept of Reverse Mergers in the US analyzes the applicability of the concept of Reverse Mergers in India and attempts to figure out if Reverse Mergers are feasible within the basic Indian Laws and whether the concept of Reverse Mergers can be an alternative to the pre-existing IPO and suggest a few recommendations.

INTRODUCTION

An initial public offering (henceforth referred to as IPO) refers to the process of offering the shares of a private corporation to the public in a new stock issuance. An IPO allows a company to raise capital from public investors. The transition from a private to a public company can be an important time for private investors to fully realize gains from their investment as it typically includes a share premium for current private investors. Meanwhile, it also allows public investors to participate in the offering. But here, the companies may come across several disadvantages in the process of going public and potentially choose alternative strategies, e.g., the fact that IPOs are expensive, and the costs of maintaining a

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public company are ongoing and usually unrelated to the other costs of doing business. Fluctuations in a company's share price can be a distraction to the management, which may be compensated and evaluated based on stock performance rather than real financial results. Additionally, the company is required to disclose financial, accounting, tax, and other business information. During these disclosures, it may have to publicly reveal secrets and business methods that could give an advantage to competitors. Rigid leadership and governance by the board of directors can make it more difficult to retain good managers willing to take risks. Remaining private is always an option. Instead of going public, companies may also solicit bids for a buyout. Additionally, there can be some alternatives that companies may explore.

On the other hand, a Reverse Merger by way of a Reverse IPO is the process of acquisition of a public company by a private company. A large Private company may choose to go for a reverse merger with a smaller listed company and go public without an IPO. *The Private Company's shareholders exchange their shares for shares of the public company thereby making the private company a publicly traded company without undergoing a process of IPO and making it time and cost-effective.* The Private Company changes its status from Private to Public. Apart from having several disadvantages, it has some advantages over the IPO process. Reverse mergers allow a private company to become public without raising capital, which considerably simplifies the process. While conventional IPOs can take months to materialize, reverse mergers take only a few weeks. This saves a lot of time and effort for the management. Undergoing the conventional IPO process does not guarantee that the company will ultimately go public. Managers may end up spending hundreds of hours planning for a traditional IPO but if the Stock market conditions become unfavorable to the proposed offering, the IPO may have to be called off. Pursuing a reverse merger minimizes the risk. As the Reverse merger is solely a mechanism to merge a private company into a public entity or vice-versa, the process is less dependent on market conditions.

INITIAL PUBLIC OFFERING AND REVERSE MERGERS

The capital market primarily deals with the 'Primary' and also the 'Secondary' markets. New investors (primary market) and company stocks (secondary market) are two intertwined and integral parts of the capital market. Issuers utilize the main market to support more investments from financial investors by giving initial public offerings or offering to sell shares or obligations. Since these financial investors investing in the primary market are guaranteed a secondary market where they will exchange their inclinations, a robust secondary market energizes the extension of the primary market and raises capital. An initial public offering or private placement of shares is the most preferred way to raise capital from the market in the primary market. An IPO could be a fundamental achievement during an organization's turn of events. It permits a company to get funds from the overall population of the capital market. An IPO additionally supports an organization's authenticity and permeability. When a huge number of IPOs are given, it shows a durable and protected market as well as an economy.

When a company becomes public for the first time, the connection between the corporate and financial investors is immediate, and the fund streams to the corporate as "Share Capital." By supporting the IPO, shareholders become proprietors of the company and have possession and privileges over it. More often than not, this is an association's biggest wellspring of accounts, permitting the organization to create "Fixed Assets" that might be used throughout tasks. The Company's shareholders enjoy the option to sell their shares in the secondary market.[1]

Book building might be a strategy for productive value revelation used in IPOs. It's a cycle where financial investors submit offers at different costs that are precedent or satisfactory, the basic cost when the IPO is open. After the bid's conclusion, the selling cost is decided. The investing company can give securities to the overall population concerned following the SEBI rules:

1. The offerees get 100% of the web offer through the book-building process.

2. They get 75% of the web offer through the book-building cycle and 25% at the value chosen through the book-building process.

After the conclusion of the book-building process, during which the trouble cost is decided, the Fixed Price segment is done as an ordinary public issue. The idea of Book Building is new in India but it's a standard practice in most developed nations.

The main components of the IPO marketing process are:

[1]See National Stock Exchange, About Initial Public Offerings (IPO), (January 12, 2022) https://www.nseindia.com/products-services/about-initial-public-offerings

1. Announcement of Intention to Float ('AITF') is a public statement known as the AITF that is the first time a corporation provides precise confirmation of its IPO plans. The marketing effort begins in earnest at this point, with the dissemination of studies by analysts affiliated with the book-runner(s). Larger organizations are more likely to have a well-planned media PR (public relations) effort to increase media awareness of the company and its management.[2]

2. Draft offer document- Prospectus A draught prospectus is frequently made available to potential investors at this stage in the process. The prospectus is practically complete in this paper. It should include all important facts, aside from the exact size of the IPO and the subscription price of the new shares to be sold (which are unlikely to be decided at this stage). The offered paper in draught form is referred to as a "Draft Offer Document." The draught offer documents must be filed with SEBI at least 30 days before the red herring prospectus or prospectus is registered with the ROC. SEBI may stipulate revisions to the draught Offer Document, if any, and the issuer or the lead merchant banker must make those adjustments before filing the Offer Document with the ROC. For a period of 21 days following the submission of the Draft Offer Document with SEBI, the public can comment on it on the SEBI website.

3. Investor Education is the method by which the analyst(s) use their study to refer to the story on the market to investors. This happens in advance of the management roadshow on larger IPOs.

4. Management road map presentation is where a series of meetings with potential investors is called a management roadshow. It usually starts with the CEO and CFO giving a formal presentation about the company's business operations, financial results, performance, markets, and goods and services. The merchant banker/book runner(s) in this work stream, like the analyst presenter, assists a corporation in the preparation of the presentation and organizes rehearsals.

[2] Manjari Sharma, A Review of the IPO Process in India, Malé Business School, Maldives, (May-June 2013).

5. Completion and pricing meeting occurs following the management roadshow and the IPO pricing, all essential documents and paperwork are examined in their final form by both the directors and their advisers during a completion meeting.[3]

6. Announcement Day is usually the day after the completion meeting, and it is the day when the prospectus becomes available for purchase and the listing is officially disclosed to the market.

7. SEBI approval upon the submission of the prospectus to the SEBI in its finality, which will incorporate all important estimating and data. Any supporting documentation, for example, directors' administration contracts, inspected accounts, and different reports referred to in the plan, should likewise be provided upon the arrival of endorsement, as per the SEBI Act. The prospectus is endorsed by the SEBI just on the day it is dated and distributed.

8. Applications for listing and trading: The formal application for a listing is submitted to the SEBI at least 48 hours before admission. At the same time, SEBI receives a formal application for trading admission.

9. Listing and Trading: This is the time at which a company's stock is "accepted to listing" and openly traded on the Main Market. The SEBI formally grants the listing, which is in conjunction with the Bombay Stock Exchange and the National Stock Exchange granting entry to trading.[4]

10. Specialist companies are a range of enterprises, including investment firms, resource firms, and financial firms, subject to certain restrictions. Expert reports may be necessary for particular instances (e.g. to report on oil and gas reserves). Companies that do not meet the three-year restriction on financial statements, such as those seeking a Standard Listing are rarely eligible to IPO. Both the sponsor and the BSE & NSE or the SEBI should discuss the prerequisites for listing in advance.[5]

Reverse Mergers may be a singular type of merger since the target is trying to find the correct way to reach the public, which may be a shell company. A consultancy business could provide additional information for the suitable corporation during the RT process. Small

[3]Maria Kyfonidou, Reverse Takeover: an alternative mechanism to go public, International Hellenic University School of Economics and Business Administration, (October 2012).
[4]Supra note 2.
[5]David N. Feldman, Reverse Mergers: Taking a Company Public Without an IPO, 66 (2006).

investment banking firms or clearinghouses are sometimes employed to finalize the deal.[6] When the proper shell business is founded and a financial strategy is devised, the private firm contacts the shell company's shareholders to determine whether or not they are willing to interact with the takeover and to decide upon the new entity's ownership.[7] The two parties then sign the primary agreement, and therefore the auditors of both firms do due diligence to validate the precise ownership proportion that's prearranged for every company within the new entity.[8] Certainly, the private firm owns the bulk of the new entity, because in most RTs, the general public company uses a considerable number of shares to 'purchase' the private one, and so the private firm gets equity within the shell. As a result, after the event, the new entity generally goes past the old private company's management. In most circumstances, the new firm adopts the private company's name or gets a new one.[9]

In the past, across the globe, a variety of successful reverse mergers have resulted in great revenue for a large number of companies, particularly in China, the U.S., and Canada. This has piqued the curiosity of a big number of personal businesses attempting to find new ways to draw capital from the market.[10]

Occidental Petroleum: Armand Hammer invested in a shell firm in the mid-1950s and integrated Occidental Petroleum into it.

Ted Turner engineered a reverse merger with faltering Rice Broadcasting in 1970, parturition to Turner Broadcasting.

Medium Rare was one of Dot Com's fallen Angels, and it was acquired by a little refrigeration company. After the merger, its stock rose from $2 in 1998 to just about $90 in 2000.

[6]Gleason, K. C., Rosenthal, L. and Wiggins, R. A., 2005. Backing into being public: an exploratory analysis of reverse takeovers. Journal of Corporate Finance, Vol. 12, pp. 54-79
[7]Brenner, V. C. and Schroff, W. K., 2004. Reverse merger or IPO. Strategic Finance, Vol. 85, pp. 46-52.
[8]Floros, I. V. and Shastri, K., 2010. A Comparison of Penny Stock Initial Public Offerings and Reverse Mergers as Alternative mechanisms for Going public, Working Paper, Iowa State University
[9]Dasilas, A., Koulakiotis, A. and Vutirakis, P., 2009. Reverse takeovers: an alternative to IPO. International Journal of Financial Services Management, Vol 4, No 1, pp. 11-20.
[10]SamikshaOjha, RichaMaheshwari& Star Jain, Reverse Mergers: The Way Forward, IORS Journal of Business and Management, Volume 10, Issue 3 (May-June 2013).

In February 2007, CKX, previously Sports Entertainment, a 5-10 cent stock, announced a reverse merger with Presley Enterprises, which owned all of Elvis Presley's estate rights. Following the merger, the stock price skyrocketed.[11]

This mechanism is gaining relevance with each passing day, because of the success of several of the above-mentioned businesses. This is often supported by the facts: within the US alone, closed reverse mergers totaled 46 in 2003, 168 in 2004, and 179 in 2005, with an ever-increasing trend thereafter.[12] After Companies and investors witnessed the benefits of adopting these approaches to get funds from the general public in recent years, their enthusiasm for time-consuming IPOs has waned. According to bankers, raising capital through IPOs is difficult since it entails lengthy processes, high expenses, value mismatches owing to regulatory approval delays, and thorough due diligence by merchant bankers. As a result, businesses are trying to find faster ways to get funding.[13]

CASE STUDIES

Reverse Merger between Actinium Pharmaceuticals Inc. and Cactus Ventures Inc:-

Public Company: Cactus Ventures Inc. Private Company: Actinium Pharmaceuticals Inc., a York-based biopharmaceutical business, went public via a reverse merger with Cactus Ventures, Inc., a public company, with a share exchange agreement dated December 28, 2012. Former Actinium stockholders became the controlling shareholders of the general public company after the merger. Approximately 21% of Actinium's issued and existing shares were exchanged for 4,309,015 shares of the Company's common shares at the end of the share exchange.[14] Until the proposed name change to Actinium Pharmaceuticals, Inc. takes effect, the Company's stock would trade under the name Cactus Ventures, Inc.[15]The Company would still exchange its ordinary stock for Actinium shares held by remaining Actinium shareholders, and existing Actinium shareholders would be urged to try and do it soon. The corporate would continue the Offering on identical terms on a proforma basis after

[11]Sandeep Poddar , Europlus Capital Limited: A study on Reverse Merger, IORS Journal of Business and Management, Volume 4, Issue 5 (May-June 2002).
[12]William K. Sjostrom, JR., The Truth About Reverse Mergers, 2(2) Entrepreneurial Business Law Journal, 743- 759, (2008).
[13]Rajesh Mascarenhas& Ram Sahgal, Costly IPOs may lose out to hassle-free reverse mergers, The Economic Times, (January 9, 2013), https://economictimes.indiatimes.com/markets/ipos/fpos/costly-ipos-may-lose-out-tohasslefreereversemergers/articleshow/17946104.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst
[14]Ojha, Maheshwari& Jain Supra note 6.
[15] Id.

the share exchange, with the stock issued at $1.65 per share, the 120-day warrants selling price at $1.65 per share, and also the 5-year warrants exercise price at $2.47 per share.[16] The Business, a public company, would issue securities to the Offering's investors, not Actinium. within the Offering, the newly established Company is entitled to dispose of$15 million in gross proceeds.[17] The above example elucidates the results of a reverse merger further as a number of the actions that follow it in great detail.

In India, the reverse merger notion is gaining traction. By following the identical approach, existing international corporations and their subsidiaries try to introduce the notion of a reverse merger in India.

In India, a range of rules is changed to safeguard investors in reverse merger transactions. Minority shareholders of a publicly traded business can opt for a reverse merger under the Businesses Bill of 2011. The present legal framework isn't exclusive. "If the transferor company's shareholders want to choose of the transferee company, the provision shall be provided for payment of the worth of their shares and other benefits, by a predetermined price formula or following a valuation," the new Bill states.[18] All of those measures are intended to shut loopholes in reverse mergers and to help avoid fraud. It'd also encourage investment in reverse-merger companies.

McDonald's franchisee Hardcastle Went Public through Westlife Development Limited:-

Private Company: Hardcastle Restaurants Private Limited (HRPL) &Public Listed Company: Westlife Development Ltd. In December 2012, Hardcastle Restaurants Private Limited (HRPL), the master franchisee for McDonald's Corp's operations in South and West India, combined with its parent company, Westlife Development Ltd., which is listed on the Bombay Stock market. Westlife Development (Shell Company financial)'s performance for the year 2011-2012, which led to March 2012, is as follows:[19]

- Rs.12.2 million in revenue 4.36 million rupees in EBITDA;

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[16] Id.
[17] Id.
[18]8 N Sundaresha Subramanian, Reverse mergers: Exit option in New Cos Bill, Business Standards, (January 20, 2013), https://www.business-standard.com/article/markets/reverse-mergers-exit-option-in-new-cos-bill111122100059_1.html
[19]See Press Release, Westlife Development Ltd Proposes Merger To Make Hardcastle Restaurants a Direct Subsidiary, (December 7, 2012), https://www.moneycontrol.com/mccode/news/article/article_pdf.php?autono=792115&num=0

- Rs.9.94 million in net loss after tax. The company was losing money, and its stock was only traded seldom on the Bombay stock market. HRPL's financial performance for the twelve months of 2011-12, ended on March 31, 2012.[20]
- Revenue climbs 44 percent to $5444.6 million; EBITDA jumps 69 percent to 672.4 million; and net profits rise 126 percent to 425.1 million. Over the previous three years, the franchisee has grown at a compound annual rate of 22.3 percent, operating 148 locations across western and southern India. It has a customer base of roughly 165 million people in India.[21]

Following the transaction, HRPL became an owned subsidiary of Westlife Development, which is listed on the Bombay stock market, allowing investors to participate in McDonald's expansion in India. Westlife, which had been doing poorly, would merge with HRPL, and therefore the business would be listed as Westlife Developments Ltd. Its post-merger strategy has been to expand McDonald's retail network to boost its position in existing markets and expand into new ones. The procedure was straightforward and took little time to finish. After McDonald’s franchisee, Hardcastle Restaurants became its direct subsidiary, little-known WestlifeDevelopments soared up the stock exchange overnight, with its shares soaring 75% in mere three trading days. Westlife Developments' stock ended three days after the merger at Rs.153.90/- on the Bombay securities market, up from Rs.86.20/-on the day of the transaction.[22] It was a fairly straightforward process that took little time to finish. After McDonald's franchisee Hardcastle Restaurants became its direct subsidiary, little-known Westlife Developments soared up the securities market overnight, with its shares soaring 75% in precisely three trading days. On the Bombay stock market three days following the merger, Westlife Developments' shares ended at Rs.153.90/-, up from Rs.86.20/- on the day of the merger. It is important to notice that India has tougher market control standards and policies than other countries, making it a perfect place for Reverse Mergers, which could be dangerous if not completed with thorough audits.

The new Companies Act also ensures that shareholders' rights are fully protected. It can be predicted that mechanisms like reverse mergers would be adopted by Indians shortly owing to the inherent benefits and also the applicability of such procedures per the country's solid corporate law.

[20] Id.
[21] Id.
[22]Ojha, Maheshwari& Jain Supra note 6.

Advantages of using a Reverse Merger:-

This analysis assumes an organization has the choice between a reverse merger and an IPO. The subsequent benefits of a reverse merger over an IPO[23]:-

1. A reverse merger involves much lower costs. Assuming that the merger is done with a blank check or a no-trading shell, the costs are fundamentally lower. If the company's monetary accounts are evaluated consistently, costs likewise are brought down. Moreover, some law offices charge a flat fee expense to lead a Reverse Merger.

2. A reverse merger is faster. An IPO may take years while Reverse Merger may be concluded merely within weeks. Before the new SEC rule ordering extra diligence, Reverse Mergers regularly required two to a few months and presently require three to four months.

3. A Private company isn't subject to watching the IPO "window." In 2000, around 400 initial public offerings (IPOs) were finished; starting around 2002, there are less than 100 most years and somewhat under 200 in 2006. This doesn't indicate that strong IPO commercial centers for more small-scale companies are returning at any point shortly.

4. There's no risk of withdrawal. Indeed, even following an extended time of work and cost, an underwriter in an IPO may end an arrangement or significantly cut an offering cost almost too late according to the economic situation. Since Reverse mergers don't appear to be market-delicate, investors rarely alter or drop contracts.

5. Reverse mergers experience lower dilution of ownership control. During an IPO, a financier habitually proposes or maybe requests that the company look for more money than it requires. Lower sums are brought up in a Reverse Merger, permitting prior financial investors, owners, and executives to retain a greater share of the company's share capital.

6. Reverse mergers lack an underwriter. Organizations say that IPO underwriters endeavor to apply impact over numerous components of their activities. This represents a major danger of veering off from the organization's objective. An underwriter, for instance, may suggest selling an unproductive firm whether or not it's drawn out the potential in the long run, to set up the organization's financials before going public.

[23] David N. Feldman, Reverse Mergers + PIPEs: The New Small-Cap IPO, Business Law Review, Bloomberg Press, 34-44, 2005.

Disadvantages of using a Reverse Merger as opposed to an IPO:-

There are two perceived disadvantages of reverse mergers as compared to a standard IPO. There's less funding obtained in a reverse merger than in an IPO.[24]This is primarily because the additional assets gained through an IPO are superfluous. Secondly, a firm can continue with a greater IPO- offering flexibility in share purchase to the public through a Reverse Merger, which is likely more expensive than a straight IPO. Following an initial public offering, an endorsing company attempts to help the stock and keep it exchanging at a fitting level. If the corporate doesn't proceed as guaranteed, it'll quickly dissolve. It isn't how a solid securities market ought to develop, and deplorably, post-IPO market support will in general keep going just as long because the underwriters and their new financial investors need it.

CONCLUSION

Many companies have chosen to go public through procedures other than IPOs, such as reverse takeovers, in recent decades. A reverse takeover occurs when a private company is acquired by a public company to gain public status. Although it appears that the public firm is the bidder, the private corporation is the aggressor who initiates merger negotiations, which is why this process is known as the 'reverse'. Despite the rise in popularity of reverse takeovers in recent years, most companies still prefer to go public through an IPO. Reverse takeovers, on the other hand, are mostly understudied. The latest study adds to the continuing discussion on the wealth impacts of Reverse Mergers by presenting findings from Europe, a market that has been largely ignored so far. The findings are expected to reveal the drivers of such corporate initiatives as well as the economic significance of such processes. Our findings show that the reverse takeover is not a method for corporations to go public when the IPO market deteriorates, but that both markets exhibit comparable patterns and are influenced by the same events as the dot-com bubble. Many helpful conclusions were gained by examining various additional aspects of the participating firms more closely. Because private and public enterprises are usually in the same industry, we argue that growth is the primary motivation for both parties involved in the transaction. This appears to be an opportunity for the public body to enhance its financial performance, as the public sector had been performing rather in the substandard category before the occurrence. As a result, the company, the underwriter, and the syndicate members all have a complex set of tasks to complete during the initial public offering. The firm relies on the underwriter's competence to advertise, price, distribute,

[24] Id.

stabilize, and support the issue throughout the process, while the underwriter relies on the company's information and transparency. The process' completion offers the firm new capital as well as a new investment option for the general public and thus contributes to economic growth.