Does your client really want to avoid public reporting? If so, it’s better to go dark than go private.

WITH THE PASSAGE of the Sarbanes-Oxley Act of 2002 (SOX) by Congress in July 2002, government regulations of publicly held companies significantly expanded, thereby increasing the external costs and the internal personnel necessary for the new compliance and reporting requirements. The magnitude of the increased costs caused many companies to question whether continuing to be a public company was in the best interest of their shareholders and to consider going private. Particularly for many smaller companies that had not reaped the anticipated benefits of access to the public capital markets and use of their securities as currency for acquisitions, the financial and personnel burdens were no longer commensurate with the benefits. Sometimes, however, companies are unable to entirely give up their search for the grail by repudiating public status altogether and attempt to straddle the fence. Especially since it is possible to maintain some level of liquidity and public interest through trading on the “Pink Sheets” in the over-the-counter market, companies sometimes consider “going dark.”

Going dark means eliminating the public reporting requirements of the Securities Exchange Act of 1934 (the Exchange Act) while not shedding all of the company’s...
“public” shareholders. One reason some companies consider this approach is their lack of the financial resources necessary to completely eliminate all of their public shareholders. Many times, however, they do have the cash or borrowing capability to reduce the number of public shareholders to below 300 (or below 500 if the company had no more than $10 million in assets on the last day of each of its three most recent fiscal years). This is typically accomplished by a reverse stock split and the payment of cash to the holders of fractional shares created in the transaction. In going dark, through selection of a particular split ratio, the company is able to control to a certain extent the size and identity of its shareholder base.

After going dark, however, as a result of the passage of time and third-party actions, such as normal trading and transfers, the number of record shareholders may creep upward toward 300 and the company faces the possibility of the resumption of public reporting requirements. In these instances, a company may consider “going darker.” In going darker, a company attempts to maintain its status as a non-reporting company by ensuring that the number of its record shareholders remains below 300 by effectuating another reverse stock split.

SECURITIES LAW CONSIDERATIONS

• When a publicly held company has fewer than 300 shareholders of record, it may elect to file a Form 15 with the Securities and Exchange Commission (the SEC or the Commission), thereby relieving the company of its obligation to file further reports under the Exchange Act. Notwithstanding the lack of public reporting by the company, the common stock of such a company may continue to be traded through the Pink Sheets. This is not necessarily a desirable situation because, while liability under the “anti-fraud” provisions of the Exchange Act and SEC Rule 10b-5 is substantially reduced, it is not eliminated entirely. The company must still take measures to ensure that its ordinary business communications and selective dissemination of non-public, material information by its controlling persons do not create a market manipulation or fraud. This could result in liability for trading by officers or directors or larger shareholders and subject the company to negative publicity that would accompany alleged market manipulation or SEC investigations. In addition, the company could be required to make public disclosure of matters it otherwise would have desired to keep confidential and this, in turn, may lead to obligations in the future to correct or update prior disclosures. More importantly for purposes of this article, an active trading market contains the inherent risk that the number of shareholders may increase over time to more than 300 as a result of over-the-counter trading, which would require the company to resume publicly filing reports with the SEC.

Unfortunately, getting “off” the Pink Sheets is not a simple matter because the trading platform is not an issuer-based system similar to the exchanges. Rather, it is a largely unregulated, privately based trading system operated by Pink OTC Markets, Inc. A company’s stock is quoted on the Pink Sheets and sales result from transactions effected through market makers. Generally, before a market maker can quote a stock on the Pink Sheets, it must gather and review certain information about the issuer and file a Form 211 with the FINRA OTC Compliance Unit. Since a non-reporting company does not file an application and obtain approval to “list” its stock, the company cannot simply “delist” or require the Pink Sheets to terminate quotations and trading in its stock. Except in extremely limited circumstances, the only means whereby a company can ensure termination of trading is if the class of stock ceases to legally exist (which would be the result in a corporate merger or similar transaction). Only through such a transaction can the company take action to cause NASDAQ to eliminate the trading symbol for the stock.
Public Company Considerations

A company can take action to avoid the time, expense, and other associated burdens of public reporting under Section 15(d) of the Exchange Act if it has fewer than 300 shareholders of record (or 500 if the company’s total assets have not exceeded $10 million for the last three fiscal years) by filing a Form 15 with the SEC. However, the company’s reporting obligations are merely suspended, not terminated, by this action. The company must recommence its filings under the Exchange Act if the number of its shareholders does not remain below 300 on the first day of any fiscal year after it files a Form 15. If a non-reporting company becomes required to resume filing reports with the SEC, this will represent a significant and expensive development. The company must not only resume reporting during future periods; it must also file an annual report on Form 10-K for the fiscal year preceding the 10-K in which it resumes reporting, and make that filing within 120 days of the end of that fiscal year.

The board of directors and management will be required to spend significant time, effort and money to become familiar with the changes to the legal landscape for SEC reporting companies since the company ceased reporting. Many new accounting and corporate governance requirements have resulted from the promulgation of regulations by the SEC under SOX. Other regulations reflect the increasing influence of institutional investors, such as the extensive new executive compensation disclosures and access to the proxy statement by shareholders. The pendulum swing towards an emphasis on increased regulation and the importance of enforcement has increased as a result of recent scandals caused by investment industry “professionals” such as Bernie Madoff and Allen Stanford. The complexity of financial reporting also has increased, due to the internal control provisions of SOX, the establishment of the Public Company Accounting Oversight Board, and new accounting rules. These developments include changes to the periodic reporting requirements as well as substantive regulations governing the operations of public companies.

The broad reach and complexity of the current federal securities laws and regulations presents substantial risk of exposure to members of the board of directors and management of a company that has allowed the infrastructure, discipline, and personnel necessary for public company compliance to dissipate when it ceased filing public reports. The costs of gearing up to resume reporting and compliance through the engagement of qualified attorneys, accountants, compensation, and other consultants, and other professionals to assist in meeting the new reporting and operational regulations will be very large. Further, a newly reporting company must bear the costs of higher directors’ fees, meeting expenses, directors and officers liability insurance, and shareholder reports and meetings. In addition, the public disclosure of the company’s financial and business information in periodic reports filed with the SEC might be used by its competitors to its disadvantage.

Of course, a listing of its common stock by a previously non-reporting company on a registered securities exchange will also impose additional reporting, disclosure, and governance obligations on the company.

Going Darker: Alternatives For Business Strategy Planning

As discussed above, the increased regulation and attendant expense that would accompany the resumption of Exchange Act reporting are significant. Fortunately, there are several methods that a company might consider to avoid becoming obligated to re-enter the public arena involuntarily due to trading activity that results in an increase in the number of record shareholders to 300 or more.

The traditional methods for reducing the number of shareholders are a tender offer, open market
share purchases, a cash-out merger, and a reverse stock split. Each of these methods has certain advantages and disadvantages that must be carefully considered in light of the fiduciary duties owed by the board of directors to the company’s shareholders. These include the duties of good faith, due care, fair dealing, loyalty, and full and adequate disclosure.

If not properly effected, the transactions enumerated above can result in expensive and time-consuming class action lawsuits alleging breach of the directors’ fiduciary duties. Because this litigation involves close scrutiny of the process used by the board of directors to structure and approve such a transaction, special care must be taken by the directors, beginning with consideration of the appointment of a special committee of independent directors responsible for ensuring the fairness of the transaction. The use of a special committee is critical because it shifts the burden of proof in establishing the fairness of the transaction to the challenging plaintiffs and protects directors who have demonstrated, through proper process and their substantive actions, that they have met their fiduciary duties.

TENDER OFFER • Going darker through a tender offer contemplates the purchase of shares by a company from shareholders owning fewer than some specified number of shares. Usually, the offer is made to all shareholders who hold less than 100 shares (or some other threshold) to purchase their shares for a specific price. Alternatively, a company can offer to purchase up to a maximum number of shares from any and all shareholders at a specific price. If this method is used and more than the maximum number of shares are tendered, the company will buy from each tendering shareholder on a pro rata basis. Another alternative is a so called “Dutch auction tender offer,” in which a company offers to buy up to some maximum number of shares at prices within a specified range. For example, the company may offer to buy shares at prices between $2.00 and $3.00. Each interested shareholder must then indicate the number of shares he or she is willing to sell to the company at $2.00, $2.10, $2.20, and each $0.10 break point up to and including $3.00. Based upon the responses received by the termination date for the tender offer, the company decides what price it will pay within the range. It then purchases all shares offered by shareholders at or below that price, up to the maximum number of shares specified in its tender offer.

Here are the advantages:
• No shareholder meeting or approval required;
• No appraisal rights for shareholders;
• Lower litigation risk as each shareholder has a choice of whether to sell or retain his or her shares.

Here are the disadvantages:
• Requires extensive disclosures;
• Unpredictable results — requires shareholders to take action to tender shares;
• Shareholders may tender less than all shares they own, which will not reduce the number of record holders.

With respect to disclosure, shareholders must be provided with sufficient information to allow them to determine the fair value of their shares and whether they want to tender for the offered price(s). The disclosures must include a description of the company’s business, financial condition, management, properties and current shareholders — essentially the same basic information that would be included in a registration statement offering the company’s shares for sale to the public.

While the board of directors and officers do not have a fiduciary duty to offer to buy the shares at “fair value” when the shareholder has the choice to sell or retain his or her shares, they are prevented by federal and state securities laws from buying shares from shareholders on the basis of material
non-public information. Since a company knows everything material that there is to know about its business but does not report all (or any) material information to its shareholders through SEC filings or otherwise, any purchase from a shareholder by the company or one of its officers or directors would be subject to liability unless the company provides the shareholder with appropriate disclosure prior to the purchase.

**OPEN MARKET PURCHASES** • The open market method of going darker contemplates the purchase of shares on the open market by the company or by the company in conjunction with its affiliates. For all intents and purposes, open market purchases by the company or any of its directors, executive officers or controlling shareholders will have the same advantages and disadvantages as a tender offer. In contrast to the direct offer to purchase shares by the company, an open market purchase approach involves an indirect offer through the company’s broker.

Here are the advantages:
- No shareholder meeting or approval required;
- No appraisal rights for shareholders;
- Lower litigation risk as each shareholder has a choice of whether to sell or retain his shares.

Here are the disadvantages:
- Requires extensive disclosures;
- Disclosure document must be delivered to the company’s broker that executes the trades with instructions to deliver a copy to each seller’s broker with instructions to deliver to the selling shareholder;
- If purchases are made over an extended period of time, disclosures must be kept current and updated with material developments, financial statements and the like;
- Unpredictable results — shares may be purchased from shareholders owning larger numbers of shares, including sales of less than all shares owned, with no reduction on the number of record holders;
- Inability to acquire sufficient shares — if low volume and limited participation in the trading market, it may be difficult to acquire a large amount of shares or significantly reduce the number of shareholders;
- Unfavorable pricing — the company may have to pay increasing prices to acquire the number of shares it desires.

**CASH-OUT MERGER** • A cash-out merger to reduce the number of record shareholders involves a merger of the company into a newly formed corporation organized by management or a friendly third party, typically a financing partner. As a result of the merger, the shares owned by shareholders other than the controlling shareholder and management, or shareholders holding less than a predetermined minimum number of shares, are converted into a right to receive a cash payment. A cash-out merger would have the same pricing issues discussed below with respect to reverse stock splits.

Here is the advantage:
- Can eliminate all minority shareholders.

Here are the disadvantages:
- Extensive disclosures required;
- Appraisal rights for dissenting shareholders;
- Time and expense of shareholder approval — and risk of failure if majority of shareholders to not vote for approval;
- Litigation risk — since, under federal and state securities laws, a cash-out of shareholders is a “purchase” of stock by the company, a material misstatement or omission of material information constitutes the basis for shareholder claims against the company and its executive officers and directors;
- Additional documentation and expense due to formation of new corporation, negotiation of merger agreement, and related transactions.
**REVERSE STOCK SPLIT** • A reverse stock split is the most common method of going darker. The company files an amendment to its articles of incorporation to effect a reverse stock split of the company’s stock at a specified ratio designed to ensure a smaller number of shareholders, with all shareholders that own less than a whole share after the reverse split given the right to receive a cash payment in lieu of the fractional share created in the transaction.

Here are the advantages:

- Can be utilized to cash out fewer than all of the minority shareholders;
- Provides minority shareholders the choice to remain a shareholder by purchasing additional shares in the open market;
- Provides minority shareholders who otherwise would remain shareholders after the stock split the ability to sell shares in the open market to cause their remaining shares to be cashed out (which could also serve to reduce the number of shareholders).

Here are the disadvantages:

- Extensive disclosures required;
- Appraisal rights for dissenting shareholders;
- Time and expense of shareholder approval — and risk of failure if majority of shareholders to not vote for approval;
- Litigation risk similar to that in a cash-out merger.

As with the other methods of going darker, in a reverse stock split, shareholders must be given sufficient disclosure about the company, its business (including material changes in the business which have been approved, or are under consideration, by the board of directors or management), financial condition, management, properties, current shareholders, the board’s reasons for the transaction and the manner in which the price to be paid for the shares was determined, so the shareholders are able to determine whether to vote in favor of the transaction, and whether the amount that they would receive as a result of the reverse stock split approximates the “fair value” of their shares, so they can decide whether to exercise their available dissenter’s right of appraisal.

**Pricing**

The board of directors, to satisfy its fiduciary duties, must set the price to be paid for the shares to be cashed out at their “fair value.” If the price is set at less than fair value, shareholders who are cashed out may have a claim of breach of fiduciary duty by the board (and will be entitled to receive the actual “fair value” if they dissent). If the price to be paid is higher than fair value, shareholders who remain shareholders after the transaction may make a claim that paying more than “fair value” is a waste of corporate assets and a breach of the directors’ fiduciary duty to them.

The board of directors should consider appointing a special committee of independent directors to represent the shareholders to be cashed out through the reverse stock split. Ideally, the committee would be comprised of directors whose shares will be cashed out as a result of the split. If a properly constituted independent committee is used, then under Delaware law the committee and the board would be entitled to the protection of the “business judgment rule.” This means that the directors are presumed to have been motivated by a bona fide regard for the interests of the company and the court will refuse to review the actions of the directors unless there is some allegation that they were not acting in good faith. If a special committee is not used, in the event of a judicial challenge to the transaction, it is likely that the board will have the burden to prove that the price paid and the process by which the minority was cashed out was fair to such shareholders. While legal precedent varies, and the law of the state of incorporation will govern the duties of the board of directors, because
of Delaware’s well-developed case law other courts often look to Delaware corporate law decisions in the absence of local state case law on point.

The special committee, or the board of directors if a special committee is not used, should consider hiring a valuation expert to provide an estimate of the value of the company for use by the board in its evaluation of the transaction. The expert’s valuation of the company would then be divided by the number of outstanding shares of stock to determine the value of each share. Alternatively, if the committee or board members believe they have sufficient financial expertise, they could set the price and then engage an investment banking firm to render an opinion regarding the fairness of the proposed price. Of course, neither of these actions will prevent a shareholder from exercising its dissenter’s rights of appraisal. While the appraiser’s valuation or the fairness opinion can be introduced by the company as evidence in the appraisal proceeding, the court may determine that “fair value” is higher or lower than such price.

Fair value is an elusive concept, particularly in the current environment in which there may not be a great number of transactions to serve as “comparables” for purposes of valuation. A company’s stock price is often suspect, particularly where there is a dearth of trading, and particular caution must be used in giving much weight to the trading price of a company’s stock as reported in the Pink Sheets. The trading volume on the Pink Sheets is likely to be low and, of much greater significance, the trades are being made without the benefit of public disclosure by the company about its business and financial condition.

### Reasons For The Stock Split

In undertaking a reverse stock split to enable a company to go darker in order to maintain its status as a non-reporting public company by ensuring that the number of its record shareholders stays at less than 300, the reasons for the transaction must be clearly articulated and disclosed to the shareholders. In approving a reverse stock split to reduce the number of record shareholders to fewer than 300, the following reasons often are cited:

- The significant cost savings as a result of maintaining the suspension of the registration of the company’s common stock under the Exchange Act, including legal, accounting, financial printing and insurance costs;
- The continued savings in terms of management’s and employees’ time not spent preparing the periodic reports required of publicly traded companies under the Exchange Act;
- Ensuring compliance with applicable securities and possibly exchange regulations, and managing shareholder relations and communications;
- The reverse stock split will permit smaller shareholders (those holding less than a certain number of shares) to liquidate their investment in the company — which otherwise may not be possible because of the lack of liquidity in the trading market; and
- The stock split may permit smaller shareholders to receive a premium over prevailing market prices without incurring brokerage commissions (if minority shareholders will be cashed out at a price higher than current market price).

### Setting The Stock Ratio

The reverse stock ratio is calculated by the board of directors, in its discretion, based upon its objectives and resources. While a principal purpose of the transaction may be to ensure the company can maintain its non-reporting status, the actual number of shares (and number of shareholders) proposed to be eliminated often is based upon the amount of available capital to pay for the fractional shares created by the transaction. In some cases, the lack of available cash or additional borrowing capability, or the unfavorable leverage created, mandates the decision. In other cases, the board of directors may conclude that some larger sharehold-
ers might desire to remain as shareholders. Even in a controlled company, the board of directors sometimes may wish to consider establishing a ratio for the reverse stock split that does not eliminate all of the shareholders outside the management or control group. So long as the number of shareholders is reduced to significantly fewer than 300 so that the company’s reporting obligations remain suspended, the board may conclude that there is no reason to further reduce the number of shareholders.

By not eliminating entirely the unaffiliated shareholders, those shareholders, in effect, have a choice as to whether they wish to be cashed out. If they are satisfied with the buy-out price, which typically is at a premium to market prices prevailing at the time of the approval of the reverse stock split, they can terminate their share ownership without incurring brokerage commissions. If they have fewer than the number of shares required to remain a shareholder, as determined by the split ratio, they can purchase additional shares in the market and, thereby, remain a shareholder after the transaction. By not forcing out all of the non-affiliated shareholders, and providing them with the choice to remain a shareholder, some companies conclude they further enhance the procedural fairness aspect of the transaction and reduce their potential liability. Perhaps this is the case, but in determining the fair value of the shares, the board must walk a tightrope so as not to pay what might be considered “too much” by the unaffiliated shareholders who remain shareholders after the transaction or “too little” by those shareholders who will be cashed out in the transaction.

While the amount of available financing and other imperatives of the transaction may drive the final number in setting the reverse stock split ratio, it is important to remember that the purpose of the reverse stock split is to create enough cushion between the number of shareholders remaining after the transaction and the critical 300 or 500 maximum shareholder threshold. By going darker, the periodic reporting requirements merely remain suspended and not permanently eliminated. If the number of shareholders in the future does not remain below the 300 (or below 500, if the company has no more than $10 million in assets) threshold, the company again qualifies as a reporting company and must file an annual report on SEC Form 10-K for the preceding fiscal year, and make its filing within 120 days of the end of that fiscal year. Creeping over the threshold could occur in the ordinary course of shareholder split-ups for estate planning or other reasons. It also may arise as a result of broker “kick-out” where the securities broker no longer wishes to hold shares in street name and delivers shares previously held in its nominee name to the beneficial owners. This often occurs when companies undertake a transaction that suspends its periodic reporting or greatly reduces the number of shareholders and trading activity, such as going private and going darker.

**Issues Arising After Approval of The Reverse Stock Split**

The actions necessary to effect a reverse stock split — board approval of the proposed action, preparing and mailing the proxy statement, holding the special shareholders’ meeting to approve the reverse stock split, convening a special meeting of the board of directors after receiving the requisite shareholder vote to approve the filing of an amendment to the company’s articles of incorporation and filing such amendment — are just the beginning of what must occur to effect a reverse stock split to maintain the suspension of the company’s public reporting obligations. For the company and its counsel, there are many post-split issues, legal and otherwise, that require attention.

**Dissenters’ Rights**

As set forth in the particular law of the state of its incorporation, a company must notify its share-
holders of each action taken that would allow a shareholder to seek dissenters’ rights of appraisal, and inform them that they have such rights. Such notice must be accompanied by a copy of the dissenters’ rights statutes.

Under Delaware law, dissenters’ rights are only available to shareholders in connection with mergers and consolidations effected pursuant to specific enumerated sections of the Delaware General Corporate Law and are not triggered by a reverse stock split. However, under the laws of many states, such as Nevada and Florida, for example, a shareholder may exercise dissenters’ rights and receive “fair value” for those shares that will be cashed out as a result of a reverse stock split.

If a shareholder asserts dissenters’ rights of appraisal, under the laws of some states, such as Nevada, the company must pay the shareholder the company’s estimate of the fair value of the shares. The payment must usually be accompanied by a set of financial statements for the prior fiscal year, the most current set of financial statements, and a statement of the company’s estimate of the fair value of the shares.

The shareholder then has a specific time period, typically 30 days, to object to the amount paid and demand payment of an amount he or she estimates to be the fair value of the shares, or simply reject the company’s estimate and demand payment of the fair value. If the shareholder states his or her estimate of fair value, the company can pay the shareholder that amount and be done with it. If the demand for payment remains unsettled, the company must, within a statutorily enumerated number of days after receiving the shareholder’s rejection and demand for payment of fair value, commence a proceeding in state court asking the court to determine the fair value of the shares. The company has to make all dissenting shareholders who have not accepted the company’s payment parties in the proceeding. If the company does not initiate such a proceeding timely, it is required to pay each dissenting shareholder the amount he or she demanded.

Under many state statutes, the court will assess the costs of the proceeding, including the reasonable compensation and expenses of any appraisers appointed by the court, against the company. In some states, the court may assess costs against all or some of the dissenters, in amounts the court finds equitable, to the extent the court finds the dissenters acted arbitrarily, vexatiously, or not in good faith in demanding payment. The court may also assess the fees and expenses of the counsel and experts for the respective parties, in amounts the court finds equitable: against the company and in favor of all dissenters if the court finds the company did not substantially comply with the dissenters’ rights statutes; or against either the company or a dissenter in favor of any other party, if the court finds that the party against whom the fees and expenses are assessed acted arbitrarily, vexatiously, or not in good faith with respect to the rights provided by the dissenters’ rights statutes. If the court finds that the services of counsel for any dissenter were of substantial benefit to other dissenters similarly situated, and that the fees for those services should not be assessed against the company, the court may award to those counsel reasonable fees to be paid out of the amounts awarded to the dissenters who were benefited.

**New CUSIP Number**

The shares of each class of capital stock traded in the U.S. securities markets are identified through a “CUSIP number.” A CUSIP number is issued by the Committee on Uniform Securities Identification Procedures and consists of nine letters and numbers that identify a company or issuer and the type of security. When a company effectuates a reverse split, a new CUSIP number must be issued for the new post-split stock and the underlying stock’s CUSIP number is suspended. The issuer company can request a new CUSIP online and is typically
able to obtain a new CUSIP number within 24 hours. The issuance of a new CUSIP number is a mandatory pre-condition to the commencement of trading of the post-split shares. This is because the new CUSIP number must be obtained before the Financial Industry Regulatory Authority, Inc. (FINRA) will grant the company a new trading symbol and a market effective date (as discussed in further detail below) for trading. FINRA is the largest independent regulator for all securities firms doing business in the United States. Currently, FINRA oversees nearly 4,900 brokerage firms, about 173,000 branch offices and approximately 651,000 registered securities representatives. FINRA was created in July 2007 through the consolidation of National Association of Securities Dealers, Inc. and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange.

**FINRA Reporting Requirements**

Obtaining the issuance of a new trading symbol from FINRA is not a simple exercise. As of December 2008, any company the stock of which is traded on an over-the-counter bulletin board, such as the Pink Sheets, effectuating a major corporate action, including a reverse stock split, must make certain disclosures to FINRA before FINRA will issue a new trading symbol and permit trading thereunder. The company must submit to FINRA an Issuer Notification Form setting forth certain basic information about the company and the proposed action as well as a Reverse Stock Split Request Form. More significantly, because the submitting company has previously ceased public reporting when it “went dark,” no public information on the company is available to FINRA. FINRA, therefore, requires extensive disclosure about the company before it will approve the transaction.

Specifically, the company must submit to FINRA: the company’s articles of incorporation and bylaws, as amended; a list of all of the company’s past and current directors and officers; minutes of board of directors and shareholder meetings evidencing their election or appointment as well as the resignation or removal of any directors and officers; board and shareholder minutes and the corresponding governing documents reflecting action to approve and effect the reverse stock split; minutes of board of directors and shareholder meetings; and certified documents effectuating any major corporate action which took place before the reverse stock split, such as any prior mergers or name changes. Because the company has not been filing periodic reports with the SEC, it will take some time and effort on the part of management to locate and organize all of the required information. Further, some members of management may not have been with the company since its inception and may not be familiar with the complete history of the company’s organization and operation. The practitioner should communicate the need for this information to the company as early as possible to avoid any delay in obtaining FINRA approval due to gaps in the company’s corporate records.

The company’s transfer agent must also submit a Transfer Agent Notification Form to FINRA before FINRA will issue the new trading symbol. This is often the last step in the FINRA approval process and will involve some level of communication and coordination between the company and transfer agent to ensure that the form is properly and timely completed and submitted to FINRA.

It is important to emphasize that, regardless of the fact that the shareholders have approved an action, the board has subsequently authorized the action, and documents effectuating the action, such as the amendment to the corporate charter, have been filed and accepted by the Secretary of State of the company’s state of incorporation, the action cannot go effective on the market until FINRA has satisfied its due diligence inquiry and issued a new trading symbol. Depending on how long the company’s reporting requirements have been suspended, the familiarity of the FINRA rep-
resentative with the company and the process, and management’s familiarity with the company’s history, this process could take weeks or even months. Even though the company can begin submitting these materials before the legal effective date of the reverse stock split, some of the required information, such as the number of post-split shares and the new CUSIP number cannot be obtained, much less submitted, until after the legal effective date. Consequently, the practitioner should be diligent in helping the company achieve its desired market effective date by submitting all required FINRA information on a timely basis. When FINRA completes its inquiry, it will issue a notification to the company containing the new trading symbol and the market effective date, which date is typically the business day following the day of FINRA’s notice.

Press Release For The Transaction

Because the company’s public reporting requirements are suspended, the company has no obligation to publicly announce the effectuation of its reverse stock split. However, the company should consider issuing a press release for the benefit of its shareholders and potential investors. As a practical matter, the lack of public notice can cause havoc in the marketplace. If the details of the reverse stock split are not made public, the company’s transfer agent is likely to be bombarded with telephone calls from brokers on the market effective date of the stock split inquiring why trading of the pre-split shares has ceased.

Transfer agents for smaller issuers typically assign one particular staff member the responsibility for managing a company’s affairs, and this individual generally has other duties. It is important to provide as much support as possible to the transfer agent, who can be critical to a smooth transaction, especially if the transfer agent is also serving as paying agent to the shareholders. Anything that can be done to lighten the transfer agent’s workload during the process of canceling pre-split shares and issuing post-split shares, such as eliminating time needlessly spent on the telephone explaining the transaction to brokers, is time well spent. Therefore, as soon as FINRA announces the market effective date, the company should issue a simple press release announcing the reverse stock split.

Open Trades

When an order to buy or sell a security is placed with a customer’s broker, a “trade date” and a “settlement date” are recorded. The trade date is the date that the order was executed and the settlement date is the date (typically three days after the trade date) when the cash and securities from the transaction are received by the buyer and seller respectively. On the market effective date of a reverse stock split, there may be open trades. That is, the effective date of the reverse stock split may be after the trade date but before the settlement date of some active trades. In this situation, on the settlement date the seller of the company’s shares will still receive cash in an amount of the stock’s sales price. However, as a result of the split, the buyer may receive one of three things: fewer shares than he or she purchased as a result of the split; cash, if all of his or her shares result in fractional shares as a result of the split; or a combination of cash and stock. In most cases, when the proxy statement is received by shareholders, the stock’s trading price will rise to approximate or equal the fair value the corporation has set for its shares. Most of the subsequent trading occurs due to the purchase of additional shares by shareholders to avoid being cashed out as a result of the split or the sale of a small number of shares by shareholders in an effort to be cashed out as a result of the split.

Because all of the company’s pre-split shareholders will have received a proxy statement, those shareholders will have had ample notice and opportunity to sell or purchase shares before the split and their transactions, hopefully, will have settled before the effective date. A new investor in the
company purchasing on the market, however, may have had no notice of the split and, even if a press release is issued upon the company’s receipt of the FINRA notice one day before the split’s effective date, may not get what he or she bargained for. If the shareholder has paid less than “fair value” for his or her shares, the split may work to the investor’s benefit, and he or she may make an immediate profit if the trade results in receiving cash in lieu of a fractional share. However, depending on the size of the reverse stock-split ratio, there could be a decrease in liquidity of the shares due to a larger post-split share price.

Any cash in lieu of a fractional share that has to be paid to a purchaser on the settlement date must be paid by the broker, who will then look to the paying agent to satisfy its obligation. Consequently, the company should be prepared to transfer funds to the paying agent on the market effective date to satisfy these obligations.

**Engaging The Paying Agent**

Due to the large amount of work and record-keeping involved in reviewing tendered shares, issuing new shares and paying fractional cash in lieu of fractional shares to shareholders, many companies engage a third-party paying agent to perform these tasks. Often, a company will engage its own transfer agent to serve as paying agent because of the transfer agent’s familiarity with the company and the pre-existing rapport between the company and the transfer agent. Regardless of who the company chooses, engaging the paying agent will involve negotiating the terms of engagement. The company must consider whether it will put the aggregate amount of fractional cash to be paid into the paying agent’s account at the beginning of the engagement or if it will distribute cash to the paying agent as shareholders tender their shares. Also, the company will need to decide when it will make its first payment to shareholders and ensure not only that the funds will be in place before that date, but that the paying agent will have printed checks and new certificates and that FINRA will have issued the new trading symbol before the date set for an initial payout. The company should also consider whether it will engage the paying agent for a fixed term, for example two years, after which it will serve at its own paying agent, or if it will have the option to terminate the paying agent’s services as soon as the tendering of shares diminishes to the point where the company is comfortable taking over the obligations of the paying agent.

**Escheat Laws**

Inevitably with the passage of a few years, there will still be a few shareholders who have not tendered their certificates to receive cash in lieu of their fractional shares. State escheat or “unclaimed property” statutes require companies to report and deliver unclaimed funds of its residents to the state. Typically, funds are deemed to be unclaimed if there has been no activity by the owner for a specified number of years, often between three and seven, although this varies from state to state. When unclaimed funds are delivered to the state, they are held in trust by the state and can be claimed by the rightful owner from the state at any time. Consequently, at some point the company may choose to deliver the cash reserved for payment in lieu of fractional shares that has not been claimed by shareholders to the states of residence of the unclaiming shareholders. Thereafter, the shareholders entitled to receive the fractional cash may have to obtain the funds directly from the state to which they were paid.

Companies that timely report and deliver unclaimed funds to the state are by law indemnified against, and relieved from liability for, any claims by the owner of the funds. Therefore, after a period of 18 to 24 months after the transaction, the company should research the escheat laws of the states of residence of those shareholders who have not tendered their shares and prepare to tender the cash
reserved for payment in lieu of fractional shares to those states before the statutory deadlines.

**Suspension Of Quotations On The Pink Sheets**

After effectuating the reverse stock split, the Pink Sheets may discontinue displaying quotes for the company’s stock for 30 days and attach a “caveat emptor” label to the company’s stock. The Pink Sheets may block quotes in the company’s shares because it views the reverse stock split as a “disruptive corporate action” due to the fact that it was effectuated without making current information available to the public. After the 30-day suspension period, the company can have the caveat emptor label removed by submitting “adequate current information” to the Pink Sheets in the form of an Initial Company Disclosure Statement. To accomplish this, the company must provide all “material” information — the information necessary for an investor to make a sound decision. The disclosure must also be accompanied by a letter from the company’s counsel stating that the disclosure constitutes “adequate current public information.”

Because the company’s reason for the reverse stock split was to avoid the expense of reporting requirements in the first place, the company is unlikely to be motivated to engage counsel to assemble the disclosure and opine as to its adequacy. Further, because the company does not provide information to the public, any trades reflected on the Pink Sheets are necessarily based on incomplete or inaccurate information about the company and, therefore, speculative. Since there is no advantage to the company in supplying “half a loaf” of disclosure or meeting speculation with anything other than full disclosure, a trading suspension or caveat emptor designation on the Pink Sheets is not entirely unwelcome. Further, following delisting from the Pink Sheets, the number of company’s shareholders is less likely to increase and the likelihood that the company will have to go darker in the future may be significantly reduced. Consequently, the company may prefer that its stock be delisted from the Pink Sheets and the refusal of the Pink Sheets to publish quotes for its stock may be an unplanned but desirable result of the reverse stock split.

**CONCLUSION** • Under the right circumstances, and sometimes as a result of practical considerations, a company will find it more desirable to go dark than to go completely private. As discussed above, this is a complex, time-consuming, and expensive proposition. There are risks throughout the process that require the board of directors, management, and their legal advisors to act carefully and cautiously. Nevertheless, as described, there are substantive benefits to going dark rather than exiting the public system entirely.

Accomplishing a going private transaction, as illustrated in this article, is not the end of the story. If, after going dark, the number of a company’s shareholders is again nearing 300, a properly effected going darker transaction can serve the company and its shareholders well. While the process of “going darker” is fundamentally no less complicated than the initial going dark transaction, the substantial — and avoidable — costs, management time, and potential liability attendant to the resumption of public reporting requirements all militate in favor of monitoring the number of record shareholders and considering, at the appropriate time, going darker through a reverse stock split.
Since it is possible to maintain some level of liquidity and public interest through trading on the “Pink Sheets” in the over-the-counter market, companies sometimes consider “going dark,” eliminating the public reporting requirements of the Securities Exchange Act of 1934 (the Exchange Act) while not shedding all of the company’s “public” shareholders.

A company can take action to avoid the time, expense, and other burdens of public reporting under Section 15(d) of the Exchange Act if it has no more than 300 shareholders of record (or 500 if the company’s total assets have not exceeded $10 million for the last three fiscal years) by filing a Form 15 with the SEC.

In normal trading and transfers, the number of record shareholders may creep upward toward 300 and the company faces the possibility of the resumption of public reporting requirements. In these instances, a company may consider “going darker.” The traditional methods for reducing the number of shareholders are a tender offer, open market share purchases, a cash-out merger, and a reverse stock split.

Going darker through a tender offer contemplates the purchase of shares by a company from shareholders owning fewer than some specific number of shares. Usually, the offer is made to all shareholders who hold less than 100 shares (or some other threshold) to purchase their shares for a specific price. The advantages are that no shareholder meeting or approval is required, there are no appraisal rights for shareholders, and the litigation risk is lower because each shareholder has a choice of whether to sell or retain his or her shares. The disadvantages are that it requires extensive disclosures, has unpredictable results, and shareholders may tender less than all shares they own, which will not reduce the number of record holders.

The open market method of going darker contemplates the purchase of shares on the open market by the company or by the company in conjunction with its affiliates. The advantages are that no shareholder meeting or approval is required, there are no appraisal rights for shareholders, and the litigation risk is lower because each shareholder has a choice of whether to sell or retain his or her shares. The disadvantages are that extensive disclosures are required, results are unpredictable, there is no ability to acquire sufficient shares, and pricing is unfavorable.

A cash-out merger to reduce the number of record shareholders involves a merger of the company into a newly formed corporation organized by management or a friendly third party, typically a financing partner. The advantage is that this can eliminate all minority shareholders. The disadvantages are that extensive disclosures are required, dissenting shareholders have appraisal rights, getting shareholder approval can be expensive and time-consuming, and there is a risk of failure if majority of shareholders do not vote for approval;
In a reverse stock split, the company files an amendment to its articles of incorporation to effect a reverse stock split of the company’s stock at a specified ratio designed to ensure a smaller number of shareholders, with all shareholders that own less than a whole share after the reverse split given the right to receive a cash payment in lieu of the fractional share created in the transaction. The advantages are that it can be utilized to cash out fewer than all of the minority shareholders, it provides minority shareholders the choice to remain a shareholder by purchasing additional shares in the open market, and permits minority shareholders to sell shares in the open market to cause their remaining shares to be cashed out. The disadvantages are the need for extensive disclosures, that dissenting shareholders have appraisal rights, and that shareholder approval can be expensive and time-consuming.