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DAILY REPORT

A SMART READ FOR SMART READERS

Paul Hastings securities lawyer Elizabeth Noe says reverse mergers are "the worst idea on the face of the earth." FILE PHOTO

Analysts warn of reverse mergers' dangers

BUT SOME SAY smaller companies can benefit from alternative to IPO

ANDY PETERS | apeters@alm.com

ATLANTA-BASED BIOSTEM Inc. has spent the last few years searching for its mission in life.

Since November 2001, the company has described itself in federal securities filings as an Internet developer, a copper miner, a valet-car parking company and a service that stores stem cells.

Such rapid shifts in business strategy are a result of multiple reverse mergers conducted by BioStem's owners. Reverse mergers—in which a private company merges with a public shell company—are touted by some lawyers and bankers as a way to gain access to public markets cheaper and faster than a traditional initial public offering.

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Find a copy of BioStem Inc.'s recent quarterly report by clicking on this story at dailyreportonline.com.

DLA Piper merger at crossroads

ANNA PALMER | apalmer@alm.com

LAW FIRMS TYPICALLY advise Fortune 500 companies, not emulate them. But that's exactly what DLA Piper Rudnick Gray Cary did last November, when 47 lawyers on its leadership team met for a weeklong seminar at Harvard Business School.

Just 10 months after creating a massive, 3,100-lawyer worldwide operation, the firm reassessed its undertaking by using case studies of investment giant Morgan Stanley and advertising behemoth Ogilvy & Mather to examine the daunting issues

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Finance, law analysts warn of dangers of reverse mergers

Reverse, from page 1

Recent changes on Wall Street have prompted reverse mergers to become more popular. So far in 2006 a total of 69 reverse mergers have been performed in the U.S., according to DealFlow Media Inc.'s Reverse Merger Report. Through the first quarter of 2005, 43 reverse mergers were done in the U.S.

One common reverse-merger procedure involves a special-purpose acquisition vehicle, or SPAC. In this process, the SPAC, a publicly traded shell company with no assets and no operations, acquires a private company. The SPAC then changes its name to the private company's name and adopts the private company's business.

SPACs appear in several forms. One is a dormant shell company, with no remaining assets, where the controlling shareholders hunt for a private business to merge into their public shell. Another is a so-called "blank check" company formed by investment banks or hedge funds expressly for the purpose of acquiring a private business.

Blank-check companies tend to be more legitimate vehicles for reverse mergers, said Raymond L. Moss, a partner at Atlanta securities-law boutique Sims Moss Kline & Davis.

But some Atlanta securities attorneys say reverse mergers are fraught with problems and they routinely advise their clients to eschew them.

"It's the worst idea on the face of the earth," said Paul, Hastings, Janofsky & Walker partner Elizabeth H. Noe. "The companies that are doing reverse mergers really are companies that should not be public. They're too small for the financial burdens of the public filing system."

While SPACs offer a cheaper alternative to initial public offerings, they involve too many drawbacks, Noe said. One flaw is that a company conducting a reverse merger through a SPAC draws little interest to itself from Wall Street or institutional investors. With few interested buyers, the stock is subject to the whims of day traders, causing the stock price to be highly volatile. Or, she added, no one buys the stock, and its price drops to a very low level and stays there.

"A reverse merger certainly avoids the cost of an IPO, but it also avoids all the benefits," Noe said.

Reverse mergers don't always work out well for the investors, either.

One Atlanta-area company was the target of recent litigation stemming from its reverse merger. SmartVideo Technologies Inc., of Duluth, reverse-merged into a public shell company, OVT Inc., in November 2002. In April, two federal suits were filed against SmartVideo by investors that claim the company violated the terms of its reverse merger. *Smith v. SmartVideo*, No. 06-CV-0849MHS (U.S. N.D. Ga., filed Apr. 10, 2006) and *Breit v. SmartVideo*, No. 06-CV-0850MHS (U.S. N.D. Ga., filed Apr. 10, 2006).

BioStem's repeated reverse mergers do not appear to have landed the company a stable source of funding.

When it was known as Web Views Corp., BioStem seemed to make no money from the Internet, according to its U.S. Securities and Exchange Commission filings. BioStem, when known as Cascade Mountain Mining Co., did own gold and copper reserves in Washington state, but it does not appear that the company ever mined those reserves. One of BioStem's predecessors seems to have owned a facility in Altamonte Springs, Fla., where it stored stem cells taken from umbilical cord blood. Another predecessor, National Parking Systems Inc., conducts valet-parking services in Atlanta. BioStem Chief Executive Marc Ebersole and General Counsel Scott A. Schweber did not return calls seeking comment.

The company trades on NASDAQ as BTEM.

Good alternative?

Despite the problems of reverse mergers, some smaller companies should consider them, Moss said.

"They're not for everyone, but in special situations reverse mergers can be beneficial," said Moss, a former Holland & Knight attorney.

Demand for SPACs increased after New York Attorney General Eliot Spitzer cracked down on investment-bank analysts' conflicts of interest in the 1990s, said Brett Goetschius, publisher of Reverse Merger Report. Spitzer charged that Wall Street firms used their equity research to unethically promote companies that were their clients.

"Absent the research promotion machine, investment banks found it very difficult to round up buyers for the stock offerings of these smaller, unknown companies," Goetschius said. "The small cap IPO, raising less than $100 million, pretty much disappeared."

Some larger companies are using SPACs successfully.

A recent successful blank-check reverse merger was that of Jamba Juice Co., a San Francisco chain of juice-and-snacks outlets. Jamba Juice went public through a $265 million reverse merger into Services Acquisition Corp. International.

NYSE Group Inc., parent of the New York Stock Exchange, went public through a reverse merger with Archipelago Holdings Inc. But Archipelago, of Chicago, was a legitimate business, not a shell company.

A number of Chinese companies are exploring going public in the U.S. through SPACs, largely because of the difficulties inherent in a public offering in the Chinese markets, said Kilpatrick Stockton partner Wayne H. Elowe. In the past year about 20 percent of all reverse mergers have been conducted by foreign companies looking to get into the U.S. market, according to Reverse Merger Report. Of those, more than half were Chinese companies.

One of Elowe's clients, TLC Beatrice (China) Ltd., was recently approached by an investment bank that proposed the food-service company and food retailer conduct a reverse merger with a U.S. shell company. But because the bank's fees were too expensive, TLC Beatrice is exploring other options, Elowe said.

If smaller companies can't stage a successful IPO, they probably shouldn't pursue a reverse merger, either, Noe said.

"If a smaller company thinks it can't afford the real process," Noe said, "that should be a sign it's not big enough to go public."