



GOING PUBLIC: Initial Public Offerings vs Reverse Take-overs

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CASSELS BROCK
LAWYERS

TABLE OF CONTENTS	INTRODUCTION.....	1
	INITIAL PUBLIC OFFERING.....	2
	Advantages	2
	Dilution	2
	Stronger Retail Distribution	2
	Limits Liability	2
	Potentially Quicker	2
	No Stigma	2
	Disadvantages	3
	No Market or Marketing until IPO is Filed	3
	Prospectus Liability	3
	REVERSE TAKEOVER.....	4
	Advantages	4
	Can Limit Distribution of the Financing	4
	Other Commercial Advantages	4
	Market and Close Financing Sooner	4
	Disadvantages	5
	Dilution and Legacy Shareholders	5
	Requirement for Shareholder Meeting	5
	Additional Advisors and More Complex Financial Statements	5
	Additional Liabilities	5
	Stigma	5
	CONCLUSION.....	6
	SCHEDULE A: TIMELINE FOR AN IPO IN CANADA	7
	SCHEDULE B: TIMELINE FOR AN RTO IN CANADA	9

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INTRODUCTION

The purpose of this memorandum is to provide an overview of the advantages and disadvantages of proceeding with a going public transaction in Canada by way of an initial public offering (“**IPO**”) or a reverse takeover (“**RTO**”) with an existing Canadian public company. We generally advise clients that when weighing the advantages and disadvantages of an IPO versus RTO, unless there is a real commercial reason for proceeding by way of an RTO, an IPO is the better method of going public in Canada. However, if there is a marketing reason for proceeding with an RTO, or a target listed shell company that has cash, compatible assets or a shareholder base which would assist a company in meeting the relevant exchange distribution requirements, the commercial advantages of an RTO may outweigh those of an IPO. If it appears that an underwriter or agent would prefer an RTO in connection with its fundraising activities, or it appears unlikely that an underwriter or agent will be in a position to place shares with a sufficient number of shareholders to meet the minimum shareholder distribution requirements, then an RTO with a publicly listed shell company may be a desirable route to go.

The following should not be considered to be an exhaustive list of all of the advantages and disadvantages of an IPO and an RTO, but the list is illustrative.

INITIAL PUBLIC OFFERING

An IPO is the traditional method for going public. In an IPO, a company obtains its exchange listing concurrently with the distribution of its securities in a public offering. The securities are qualified by a prospectus filed with the relevant securities commissions.

A sample timeline and associated documentation for going public by way of an IPO has been attached hereto as Schedule A (see page 7).

ADVANTAGES

Dilution

In the event that a company was to proceed with an RTO transaction, it would be required to give up some percentage of the company to the existing shareholders of the shell company in addition to the stake given up on the equity financing. The only dilution in an IPO is with respect to the financing itself.

Stronger Retail Distribution

In an RTO transaction, the operating company inherits the existing retail distribution of the shell company. There would be less additional retail distribution required on the financing. Unfortunately, the legacy retail shareholders of the shell company are often only interested in recovering their original investment and are therefore sellers rather than long term investors. In an IPO, the underwriters or agents would market directly to new retail investors who would be buying into the IPO because they are interested in the company's story. This usually provides for a much stronger retail base for the Canadian public company going forward.

Limits Liability

In an IPO, the operating company carries out the transaction itself. Accordingly, it would have no unknown prior history and would not acquire any new liabilities. In an RTO, the acquiring company inherits the prior history and existing commitments (including contractual and regulatory restrictions on operations) and liabilities of the shell company, including all contingent and currently unknown liabilities. Although due diligence would be conducted on the shell, there would be no guarantee that the shell will not have "surprises."

Potentially Quicker

An IPO can be completed just as quick, if not quicker, than an RTO transaction and will likely cost less than an RTO. An RTO entails a shareholder meeting of the shell company, an additional set of legal advisors and auditors for the shell being involved in the transaction, a due diligence review of the shell company and potentially separate shareholder meeting materials for the operating company and the shell company, and listing application. All of these steps require additional time and expense.

No Stigma

There have been some notorious RTO transactions in Canada, which may have resulted from the fact that RTO transactions are not required to be cleared through the securities commissions across Canada (e.g., Sino-Forest). As a result, there is a certain stigma that exists with an RTO transaction. An IPO is generally considered a more legitimate and more professional way of going public.

DISADVANTAGES

No Market or Marketing until IPO is Filed

In an RTO, the financing transaction can be announced and marketed without any filing requirements or regulatory approvals in Canada. The shares of the shell company may be able to continue to trade from the time of the announcement of the RTO, although the exchange that the shell is listed on will often require a halt in trading of the shares of the RTO vehicle until certain information required to be filed is filed and/or approved. This effectively provides a market for the acquiring company's shares, which may or may not be a good thing. In an IPO, there can be no announcement and no marketing until the preliminary prospectus for the IPO is filed and a receipt obtained. Once the preliminary prospectus is filed, only it and certain prescribed derivative documents may be used as marketing documents. An RTO provides more flexibility in how the financing is marketed, both from a timing and document perspective.

Prospectus Liability

Under Canadian securities laws, there is statutory liability for misrepresentations in a prospectus. That liability extends to the issuer, the underwriters or agents and each of the directors of the issuer personally. In an RTO, liability can extend to the marketing materials, which are typically quite limited, and to the shell company's circular, which may or may not have target company disclosure. Liability under these documents is rare and does not extend to the underwriter in the typical case. The fact that there is underwriter liability on the IPO prospectus means that the underwriters or agents tend to complete a more thorough due diligence review on the operating company and the relevant documents can take longer to prepare.

REVERSE TAKEOVER

An RTO occurs when a publicly listed “shell” company acquires a private company, where the owners of the private company become the majority owners of the shares of the publicly listed company. The shell company will not have an operating business and will typically have few, if any, assets. The owners of the private company obtain control of the shell company by selling the existing private company assets to the shell company (the “**Acquisition**”), which may be achieved through a number of means, including by merger of the two companies, an asset acquisition or a share acquisition. The Acquisition generally requires the preparation of materials for a meeting of shareholders of each company to approve these transactions or related matters required to complete the Acquisition. Materials for the shell company will often contain prospectus level disclosure on both the company resulting from the RTO.

The time required to complete an RTO varies, but it usually takes a minimum of three months to a maximum of six months from the time the owners of the private company identify or acquire the shell company. The key determining factors with respect to timelines include the complexity of the structure of the Acquisition and the resulting company (with U.S. target companies often requiring more complex structures), statutory requirements for the holding of shareholder meetings, the time required by regulators for review of materials and the receptiveness of the market to any proposed financing.

The issuer which results from the Acquisition must meet the original listing requirements of the CSE and the certain aspects of the Acquisition may be subject to the approval of the CSE.

A sample timeline and associated documentation for going public by way of an RTO has been attached hereto as Schedule B (see page 9).

ADVANTAGES

Can Limit Distribution of the Financing

Although an IPO provides stronger retail distribution, the RTO enables the transaction to be completed without the requirement to market to retail investors.

Other Commercial Advantages

In certain circumstances, if the ideal shell can be secured, the shell company can provide the acquiring company with commercial advantages such as cash, qualified resident Canadian directors, a strategic shareholder base or a compatible asset.

Market and Close Financing Sooner

As mentioned above, traditionally an RTO could be announced as soon as an agreement between the Company and the shell is reached. The shell could continue to trade which will provide an immediate valuation of the transaction (based on limited liquidity although the exchange the shell is listed on will typically halt trading of the shares of the RTO vehicle until all filings are made). If only a private placement was required, it could then be marketed and closed. In an RTO transaction there isn't the same restriction on the materials that can be distributed during marketing as compared to an IPO transaction because the financing is completed as a private placement rather than as a public offering. Unlike the IPO, it is customary to close the financing on the RTO and hold the funds in escrow pending completion of the RTO. Once the RTO is closed, the funds are released and the company is listed for trading.

DISADVANTAGES

Dilution and Legacy Shareholders

As indicated above, an RTO results in additional dilution, the impact of which can be greater for smaller operating companies. The result is a percentage of the issuer being owned by legacy shareholders of the shell who, if not strategic, could end up being more of a nuisance than anything else.

Requirement for Shareholder Meeting

An RTO usually requires a shareholder meeting of the shell, which adds uncertainty, delay and additional expense. Separate shareholder meeting materials are usually required, which can include prospectus-level disclosure on the target company. A listing application must also be prepared and filed.

Additional Advisors and More Complex Financial Statements

The shell company will have separate legal and accounting advisors, which adds delay and expense. While both the prospectus for the IPO and the meeting materials for an RTO would include financial statements, the pro forma financial statements are required for an RTO, which can be more complex because the shell actually has historical operations.

Additional Liabilities

As indicated above, the shell company would have some prior operating history which means that there is greater potential for actual or contingent liabilities that would be inherited by the operating company.

Stigma

As indicated above, an RTO is not generally considered the more professional way of proceeding with a going public transaction.

CONCLUSION

For all of the reasons enumerated above including the likely requirement for a shareholder meeting, the additional advisors and the separate meeting materials and listing application, we believe that an RTO would often be more time consuming and more costly than the IPO.

For more information regarding the foregoing, please contact a member of Cassels Brock & Blackwell LLP's Securities Group.

SCHEDULE A: TIMELINE FOR AN IPO IN CANADA

Week	Task
Weeks 1-2	<ul style="list-style-type: none"> • Management and key shareholders confirm the current board of directors and management team will meet the regulatory requirements of a public company and are otherwise acceptable for a public company • Management chooses and engages professional advisors: agent/sponsor (underwriter/agent); securities lawyers; external auditor; investor relations professionals • Meeting with auditors and other advisors to discuss financials, MD&A, prospectus drafting, governance documents, and to commence preparation of same • Internal documentation organized to ensure due diligence and prospectus preparation are completed efficiently • Underwriters begins due diligence review • Drafting of preliminary prospectus commences • Engage with translators, if necessary • Pre-filing meeting with CSE
Weeks 3-4	<ul style="list-style-type: none"> • Preparation of CSE listing application • Attend to CSE listing requirements (i.e., application for CUSIP number, distribution of personal information forms to directors and officers) • Legal and business due diligence to continue • Commence preparation of marketing materials • Arrange for financial printers
Week 5	<ul style="list-style-type: none"> • Oral due diligence session with the company's management, auditors and legal counsel • Finalize preliminary prospectus • Board meeting to approve preliminary prospectus (including financial statements and technical reports) • Preliminary prospectus and supporting documents, including financial statements, filed with CSE and applicable provincial securities regulators
Weeks 6-9	<ul style="list-style-type: none"> • "Waiting period" begins: issuer permitted to solicit interest in securities by forwarding copies of preliminary prospectus to prospective investors • Underwriters' counsel distributes draft underwriting/agency agreement • CSE and provincial securities regulators review preliminary prospectus and advise applicant issuer and professional advisors of any deficiencies • Applicant issuer (with aid of securities counsel) to address deficiencies and file necessary amendments to prospectus with securities regulators • Underwriters to begin marketing efforts once initial comments reviewed and addressed if necessary • File CSE listing application
Weeks 10-11	<ul style="list-style-type: none"> • Marketing completed • Hold bring-down due diligence session with company's management, auditors and legal counsel • Resolve any outstanding comments from the securities commissions on the preliminary prospectus • Finalize terms of offering (i.e., price, size, etc.) • Finalize prospectus • Hold board meeting to approve final prospectus and any other ancillary matters • File final prospectus with relevant securities commissions • Issue press release • Print commercial copies of final prospectus for distribution to subscribers

Week	Task
Weeks 12-13	<ul style="list-style-type: none"><li data-bbox="573 247 1105 279">• Expiry of statutory withdrawal rights in Canada<li data-bbox="573 279 1295 310">• Pre-closing meeting to settle and sign all closing documentation<li data-bbox="573 310 760 342">• Closing occurs<li data-bbox="573 342 987 373">• Securities begin trading on the CSE

SCHEDULE B: TIMELINE FOR AN RTO IN CANADA

Week	Task
Weeks 1-2	<ul style="list-style-type: none"> • Identify and commence negotiations with shell company • Select management and board of directors of resulting issuer • Parties to commence due diligence process on each other • Determine stock consideration ratio or range • Select management and board of directors of resulting issuer • Commence negotiations with an underwriter/agent when a financing is required in connection with the RTO • Prepare financial statements for inclusion in information circular
Weeks 3-5	<ul style="list-style-type: none"> • Announce proposed financing and transaction with shell company • Underwriters begin marketing of private placement • Commence preparation of shareholder meeting materials • Continue preparation of financial statements and prospectus disclosure for shareholder meeting and listing application • Legal and business due diligence to continue
Week 6	<ul style="list-style-type: none"> • Pre-filing conference with CSE • Deliver initial draft documentation to the CSE (i.e., information circular, financial statements, listing application, personal information forms) • Publish record date for shareholders meeting (at least 7 days prior to the record date)
Week 7-11	<ul style="list-style-type: none"> • Record date for shareholders meeting • Private placement closes – funds held in escrow • Obtain CSE conditional listing approval • Printing and mailing of meeting materials for shareholders meeting (must be at least 21 days prior to the meeting date)
Week 12-13	<ul style="list-style-type: none"> • Hold shareholder meetings and obtain necessary shareholder approvals • Closing of RTO – private placement funds released from escrow • Common shares of the resulting issuer to commence trading on the CSE • CSE to issue final exchange bulletin (evidencing final CSE approval)