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CHINA AUTOMOTIVE SYSTEMS, INC.: THE CASE FOR REVERSE MERGERS

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CASE DESCRIPTION

This case concerns a" reverse merger" by which a Chinese corporation obtains publicly traded status in the United States. The objective is to familiarize students with this alternative to an initial public offering, the more widely known method by which a company can become publicly traded, and to sharpen their analytical and research capabilities as they access the SEC website and EDGAR database as well as websites that provide other financial information for the answers to specific questions.

This case is appropriate for use in an advanced corporate finance class, an entrepreneurship or new business formation class, or an international finance class. Some aspects of the case may also be of interest to a business law or securities class. The case has a difficulty level of four, and should take from one to two hours of class discussion. Students will require three to four hours of preparation time.

CASE SYNOPSIS

The "reverse merger" is an alternative to the initial public offering (IPO) method of "going public". This back-door SEC registration technique is relatively common in practice, but is entirely ignored in finance textbooks as well as the academic literature.

The case considers China Automotive Systems, Inc., formed when Visions-In-Glass, Inc., a US non-operating, public "shell" company, acquires Great Genesis Holdings Limited, a closely held Hong Kong company that indirectly owns joint venture interests in mainland China. After the merger, Great Genesis stockholders own most of the stock of Visions-In-Glass, Inc., thus controlling the corporation and Visions-In-Glass retains its publicly trading status. The privately traded Hong Kong company becomes a publicly traded U.S. company.

In addition to focusing on the process of the reverse merger and the financial returns to various investor groups, this case examines how recent SEC actions may affect future reverse mergers. These actions include the suspension of trading in 26 shell companies for delinquent reporting, and the promulgation of regulations adding reporting requirements for shell companies

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or reverse mergers. These actions may reduce the advantages of a reverse merger in the future. Students gather information and render an opinion as to whether the China Automotive reverse merger presents evidence of a fraudulent "pump and dump" scheme, as well as whether reverse mergers remain advisable in the future. A further unique aspect of this case involves restrictions on investment and/or currency exchange that a foreign country may impose on its residents. The case demonstrates how transactions may avoid or circumvent such restrictions. Finally, the case illustrates the layering of funding common in a start-up business, and how firms use exemptions from SEC registration (for private placements and the Reg S exemption) in connection with funding.

INSTRUCTORS' NOTES

RECOMMENDATIONS FOR TEACHING APPROACH

Students should be encouraged to read the case, access the SEC's EDGAR database to obtain additional information about the companies and the reverse merger transaction, and respond to the questions listed in the case.

DISCUSSION OF CASE QUESTIONS

1. **Briefly describe the purposes and process of a reverse merger. Compare and contrast a reverse merger with an IPO, a private placement and an ADR. What are some advantages and disadvantages of each?**

Initial Public Offering

In an Initial Public Offering (IPO) a corporation sells or issues shares of its common stock to the public. In order for a corporation to legally sell stock to the public, it must first register the stock issue with the Securities and Exchange Commission (SEC). Registration requires full disclosure to potential investors of all relevant information about the stock issue as well as the company's management, the nature of its business, and its financial condition.

Companies meet the disclosure requirement by preparing a legal document called a prospectus, which contains all relevant information about the company. A prospectus must be filed with and approved by the SEC before the securities may be sold to the public.

When the proposed public offering has been approved by the SEC, the process of selling the securities to the public may begin. This process, called underwriting, is normally carried out by an investment bank, which contacts its clients to see if they may have interest in purchasing the securities. In each case the potential purchaser of the securities must be given a copy of the prospectus prior to the completion of a sale.

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The initial sale of securities to investors is referred to as the primary market. Once securities have been sold by the corporation to the public, secondary market trading in these securities may begin. The issuing corporation is not a party to transactions in the secondary market. Investors that previously purchased securities from a corporation in the primary market, may enter the secondary market and sell to another investor. Such trades are normally facilitated by securities brokerage firms and may be executed on an exchange or other organized market.

The effective cost of an IPO can be quite high. <<costs>> Accountants and attorneys work with management to prepare the prospectus and other registration materials. These costs along with the costs of printing the prospectus will usually be in the range of $150,000 to $200,000. Fees collected by the investment bank that underwrites the sale to the public are substantial. These fees may exceed ten percent of the sales price of the issue. See, for example, "Considerations of an IPO" at http://library.lp.findlaw.com/articles/file/00446/002605/title/Subject/topic/Science,%20Computers,%20and%20Technology_Initial%20Public%20Offerings/filename/science,computers,andtechnology_1_990. Management time is spent meeting with advisors, preparing documentation and attending sales presentations where prospective investors learn about the offering.

In addition to the financial costs of an IPO there may be significant delays in the process. The time required to prepare the registration materials and secure SEC approval may extend for months. For these and other reasons some corporations have sought other means of "going public."

Reverse Merger

A reverse merger is an alternate way of going public. In a reverse merger a private corporation merges with another corporation which has already "gone public." In the typical reverse merger case, the public corporation has few or no assets and little or no ongoing business. Such corporations are sometimes referred to as corporate "shells." Notwithstanding their lack of assets or business activity, the shares of such corporate shells may still be bought and sold by members of the public in the secondary market.

In the reverse merger, the shell corporation acquires the private operating corporation by issuing stock to the owners of the private corporation. The number of shares the shell corporation is required to issue for this acquisition is normally quite large in relation to the number of shares previously outstanding. The result is that the majority of the post-merger stock of the shell corporation is owned by the stockholders of the private corporation, who have transferred the assets and business activity of the private corporation to the shell. The

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new majority stockholders from the private corporation will normally elect new officers and change the name of the corporation.

Of course those members of the public who previously held stock in the shell corporation, still own stock in the corporation and may continue to trade their shares in the secondary market. The value of the shares will likely increase after the reverse merger because they now represent ownership of an operating company rather than a corporate shell.

Like an IPO, the reverse merger results in the shares of a corporation being traded publicly in the secondary securities market. Unlike the IPO, the reverse merger does not usually result in an immediate inflow of cash to the corporation.

The Costs associated with a reverse merger involve purchasing enough of the outstanding shares of the public shell to have clear control of the corporation. Typically these shares are purchased from someone who already has purchased most of the outstanding stock and is offering to sell control of the shell corporation. Such a transaction will usually cost from $300,000 to $400,000 for a shell which is current in its reporting obligation to the SEC. For a shell which is not current it may only cost $150,000. See for example, "Reverse Merger Offers Alternative to the Traditional IPO" Dallas Business Journal May 2000.

Private Placement with Secondary Trading Under Rule 144 or Rule 144A

An exemption in the Securities Act of 1933 allows corporations, both public and private, to make private placements of their stock. Under certain limited circumstances corporations may sell stock without registering the issue with the SEC. Such sales must be limited to only a few investors. Additionally the corporation must provide evidence that such investors are knowledgeable, sophisticated investors.

Those who purchase stock on a private placement receive restricted shares which may not be freely sold in the secondary market for two years (under Rule 144) or earlier if sold to "qualified institutional buyers" (under Rule 144a).

Although private placements may be made by either public or private corporations, in general they will be much more successful for public corporations. This is so because the secondary market for the public corporation establishes the value of the stock, which may be used as a guide in the private placement.

The costs associated with a private placement are normally much less than either an IPO or a reverse merger. Typically prospective investors will require financial statements as well as a legal opinion regarding the status of the company and the status of the shares being offered in the private placement. There are no brokerage fees or printing costs, and there is no lengthy approval process from a governmental agency.

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China offering coupled with a sponsored ADR

An American Depository Receipt is created when a depository (frequently the London- based subsidiary of a US commercial bank) purchases stock of a foreign firm trading on a foreign stock exchange, holds that stock in a trust account, and offers shares that represent an interest in the trust account to investors in the United States. The shares offered to US investors, known as American depository receipts, represent a proportional interest in the foreign company stock held by the depository. The ADRs are denominated in dollars rather than the foreign currency and, when the foreign stock pays a dividend, the depository handles currency exchange and distribution to the ADR holders. ADRs may be privately held or trade publicly on an exchange; secondary market trading of ADRs is similar to that for a domestic company's stock. When ADRs trade publicly, the reporting requirements for a US public company apply to the foreign company.

In a sponsored ADR, the foreign company cooperates with the depository in order to create the ADR. The stock purchased by the depository may be newly issued stock making this a vehicle to raise additional capital from US rather than the foreign company's domestic capital market.

Costs for a sponsored ADR include the cost of issuing stock in the foreign capital market (which may be greater or less than issuance costs in the United States), the cost to arrange the depository relationship and create the trust, and the cost of issuing the ADR in the US (which are likely to be comparable to costs associated with a US domestic stock issue).

The discussion on this topic will require the students to draw some conclusions regarding the intentions of the Great Genesis owners. Clearly if they wanted to raise additional funds immediately, they would have selected an IPO (although the IPO market in 2003 may not have been receptive to such an offering) or a private placement. The 2003 annual report filed by China Automotive indicates a desire to expand with strategic acquisitions. As a result of the reverse merger, the company has publicly traded stock available as acquisition currency which may facilitate such plans.

2. Why did Yarek Bartosz pay $100,000 to acquire 94.5% ownership of a firm with no assets and no apparent business prospects?

The public registration of Visions-In-Glass, Inc. has value. Bartosz determined that it was worth $100,000. As a dealer in public "shell" corporations, Bartosz acquired the company and then looked for a private company that was interested in going public without the necessity of filing a registration statement with the SEC. Assuming such a company

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could be found, Bartosz expected either cash or stock to compensate for the amount paid and the risk assumed.

Some students may find other transactions involving Yarek Bartosz on the SEC website. (Searching for "Bartosz" as the "company name" in the "EDGAR company search" page generates a Form 3 and a Form 4 indicating the ownership of stock in Parallax Entertainment, Inc. by Yarek Bartosz.) In August 2002, Bartosz purchased a controlling interest in Parallax Entertainment, Inc. which he later sold to a corporation incorporated in the Republic of China.

3.a. What return (total and annualized) did the founder of Visions-In-Glass, Inc. realize in the sale of stock to Bartosz?

Investment of $1000; receipt of $100,000 3.16 years later. Return is 9900%; 328.5% per year.

b. What return (total and annualized) did Bartosz realize on the investment in Visions-In-Glass stock?

Investment of $100,000; receipt of $250,000 and stock worth $233,275 (using $3.10 initial trade as per share value and 75,250 shares not cancelled) 0.55 year. Return is 383% (1698.6% annualized).

c. What return (total and annualized) did the seven private placement shareholders realize on their investment in Visions-In-Glass, Inc.?

Investment of $0.01 per share grew to $10.85 (3.5 post-split shares at $3.10 per share). Return is 108400% (557.8% per year).

d. What return (total and annualized) did the 48 Reg. S offering shareholders realize on their investment in Visions-In-Glass?

Investment of $0.10 per share grew to $10.85 (3.5 post-split shares at $3.10 per share). Return is 10750% (356.7% per year).

The calculations in these questions should be in the nature of review for most students. However, the return levels are higher than they will typically have seen. Some students may struggle with calculating annualized returns, so it may be appropriate to spend some time on this topic. For the returns involving stock prices, the answers provided above

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use the first price at which stock traded after the reverse merger. Students may elect to use other prices, e.g., the $18.50 maximum post-merger price, in which case their results will differ. Obviously, the actual return realized by an investor will depend on the price at which the stock is actually sold.

In connection with the calculation of these returns, it may be appropriate to discuss the fact that early-stage investors frequently demand higher returns than those realized on investments in established companies. The additional risk borne by those funding a development stage business justifies the additional return.

4. Why did Great Genesis Holdings Limited select a reverse merger rather than an IPO, a US private placement, or a China offering together with a sponsored ADR to enter the US capital markets?

Considerations common to all reverse merger decisions

The advantages of a reverse merger over an IPO are that it may cost significantly less and take much less time to accomplish. Once the reverse merger has been completed, the corporation will find it much easier to acquire new assets or subsidiary companies in exchange for its stock, and consultants and key management personnel will be more likely to accept stock or options on the company's stock in lieu of cash for services rendered. Of course such transactions by private corporations are also possible, but in the absence of an ongoing secondary market for the shares of the corporation, the value of such transactions is difficult to determine.

Another advantage of the reverse merger is that the operating company can become a publicly traded company without having to pass the scrutiny of the SEC. Foreign corporations may find this appealing since the SEC is not likely to approve an IPO for a foreign company whose financial statements were prepared by foreign accountants who are not bound by the same accounting standards and procedures as those required in this country, and therefore its financial statements may be incomplete or misleading. Note however that after the reverse merger, the company’s financial statements will have to comply with SEC standards in order for the company to retain its publicly traded status.

A foreign or domestic corporation that goes public in the United States through a reverse merger may establish a track record for several years and then file a registration statement with the SEC and, provided it is approved, sell additional shares of stock or other securities to the public in order to raise needed funds.

The principal advantage of a reverse merger over a US private placement is the publicly traded status a company obtains in the reverse merger. However, a private

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placement would generate additional capital for the company while a reverse merger does not.

A sponsored ADR requires that the depository be able to acquire the company's stock in the foreign market, presupposing sufficient liquidity in the foreign market and availability of a block of shares, or that new shares be issued specifically for the purpose of creating an ADR. In addition to market characteristics that may make an ADR more difficult, it is possible that regulatory requirements attaching to shares issued in a non-US market conflict with the company's objectives making a sponsored ADR less attractive.

Considerations that arise from China's restrictions on investment and currency exchange

Additional reasons favoring a reverse merger may lie in the limitations Chinese nationals face in making investments outside of China. The reverse merger allows the owners of Ji Long to effectively export their investment capital outside of China and into the United States. They have exchanged their interests in joint ventures in China for shares in a publicly traded US corporation. Although these shares are restricted and may not be immediately sold in the US secondary market, over time it may be possible (pursuant to Rule 144) that some of these shares could be sold for cash. This cash could then be used to invest in other US-based assets.

Essentially the same result can be obtained immediately without actually selling China Automotive stock. The corporation can acquire other investment assets or subsidiary companies in the US or other countries and pay for the acquisition by issuing additional shares. Such acquisitions will reduce the portion of China Automotive that the Chinese investors own, but their investment will have changed in character from an investment in strictly Chinese businesses to include businesses in other countries. The Chinese investors can thus diversify their country-specific investment risk.

In addition, the market value of the Chinese investors' holdings may significantly increase simply as a result of this reverse merger. It is possible that valuation of the company in the US equities markets will be greater than it would be in Chinese equity markets. This difference in valuation may reflect the diversification such an investment offers to US investors, which may be fundamentally different than the diversification such an investment provides to an investor in China. Disparities in the valuation of securities would not be expected to persist in efficient markets. However, the current situation is characterized by inefficiency arising from investment restrictions and currency controls imposed by the Chinese government. Valuation differences may well persist for extended periods due to the resulting segmentation of international capital markets. If inefficiencies exist also in the US market, valuation of China Automotive stock may reflect limited information about actual operations in China together with publicity about the size and

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growth of the Chinese economy. This may lead US investors to overvalue an investment such as China Automotive during times that direct investment in comparable Chinese entities is not available.

5. What proportion of Great Genesis did each of the 5 Chinese investors in the Ji Long Holding Company own before the merger? What proportion did each receive of the shares issued by Visions-in-Glass to acquire Great Genesis? Comment on your findings.

	Great Genesis Shares Owned	% GG Owned	Visions in Glass Shares Received	% VIG Received
Guofu Dong	2,340	3	627,429	3
Liping Xie	3,900	5	2,091,425	10
Qizhou Wu	3,900	5	2,195,996	10.5
Tse Yiu (Andy) Wong	3,900	5	1,359,426	6.5
Hanlin Chen	63,960	82	13,280,547	63.5
Shaobo Wang		0	731,998	3.5
Shengbin Yu		0	627,429	3
Total	78,000	100	20,914,250	100

There is a substantial difference between the percentage that some investors owned of Great Genesis and the proportion of the Visions-in-Glass shares they receive in exchange for their shares. Clearly the differences must be due to private agreements among the investors. They may be designed to adjust differences in the parties investments in the Ji Long Enterprise Investment Limited, ownership of which is not reported and may differ from ownership of Great Genesis, or in the individuals' various managerial roles in Ji Long or Great Genesis, or they may represent compensation for services or other consideration provided. From a disclosure point of view, since the differences are well documented in the merger transaction, they present no real reason for concern.

6. Were the warrants issued at the time of the reverse merger ever exercised? If so, on what terms? Who do you think may have exercised them?

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The warrants were issued to the designees of the Great Genesis stockholders. In the 2003 annual report of China Automotive Systems, Inc. available on the EDGAR database at http://www.sec.gov/Archives/edgar/data/1157762/000101054904000267/china10ksb123103.txt, we find that they were issued to consultants and that 509,856 of the warrants issued were exercised on a "cashless basis" in December 2003, despite the fact that they were originally issued with the understanding that each warrant would require the payment of $1.36 in exchange for one share of common stock. It is likely that at least some of the warrants were given as payment for services from the law firm of Loeb and Loeb where closing of the reverse merger occurred and which likely advised Great Genesis in connection with the transaction, to the investment bank that located the shell company and provided advise regarding the financial aspects of the reverse merger, or to the public relations firm retained by China Automotive. Payment for services with stock or stock equivalents is not uncommon.

To the extent exercise of the warrants dilutes the value of the Great Genesis stockholders' interest in China Automotive, there is no difficulty assuming they contracted for the services for which warrants were issued as compensation. These shareholders bear the cost of those services in dilution of their stock value.

To the extent exercise of the warrants dilutes the interests of the original Visions-In-Glass shareholders who did not contract for the consulting services but have the value of their interest in China Automotive diminished by dilution of their proportional ownership, there may be reason for concern.

It should be noted however that when shares of stock are received in lieu of payment for services, the stock is restricted and may not be sold for an extended period. See discussion of restricted stock below.

7.a. Describe the "pump and dump" scheme and the concerns of the SEC regarding shell corporations and their role in the reverse merger process.

Historically shell corporations have not enjoyed a high degree of popularity with the SEC. This apparently stems from the presumed opportunity for manipulation and fraud. There is concern that unscrupulous promoters may acquire control of a publicly traded "shell" corporation and then manipulate its stock price by disseminating false or misleading information about new assets being merged into the corporation. Once the stock price has been pumped up by these rumors, the promoter then dumps the stock on the market, selling it to unsuspecting investors.

The SEC's action to halt trading of the stock of 26 shell corporations which had not filed timely reports reflects this concern. Without timely reporting, investors have difficulty

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valuing a company and the risk of manipulation or fraud increases. When the stock of the shell company ceases to trade in the secondary market, it becomes more difficult to use it in a pump and dump scheme, and also is much less desirable as a merge partner for a reverse merger. The proposed regulations that would require enhanced disclosure after a reverse merger also reflects the SEC's concern that investors have adequate information to evaluate stock value prior to allowing the stock to trade publicly.

b. Is there any evidence of "pump and dump" in the reverse merger which resulted in the formation of China Automotive Systems?

In the case of China Automotive Systems there appears to be no evidence of a "pump and dump" scheme. The company reported the reverse merger transaction promptly on Form 8-K, and provided financial statements reflecting the Great Genesis assets and operations. The 2003 annual report indicates that none of the shares received by the Chinese investors in exchange for Great Genesis stock had been sold as of December 2003. Nor have any been sold since. Such sales must be reported to the SEC since the stockholders are officers and directors of China Automotive. Students should be encouraged to scan China Automotive's SEC filings to verify this. Purchases and sales of stock by corporate insiders are reported on Form 4.

c. Given the negative view the SEC appears to hold of reverse mergers, what would you advise a private corporation today which is considering the use of a reverse merger in order to "go public"?

Although not widely publicized, some well-known companies have used the reverse merger process to go public. These include, e.g., Turner Broadcasting and Travelocity.com. The technique is a valid and appropriate business transaction that can be misused in ways that create a risk to uninformed members of the public. Similar risks exist in connection with other business transactions regulated by the SEC. However, the SEC has selected the reverse merger process for increased regulation, making it more costly and possibly less desirable. Students will need to determine whether the objectives advanced through a reverse merger

The discussion may extend to whether additional regulation that affects only "shell" companies is appropriate. After any merger between a public and private company, investors have incomplete information about the surviving company. The information they do have may not be adequate to accurately judge stock value whether the public company is a "shell" or not.

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ADDITIONAL TOPICS THAT MAY ARISE IN DISCUSSION OF THE CASE

Layered financing

The case provides a limited illustration of the layered financing of development stage firms. Founders and a few private investors provided the initial funding. A second stage of funding came from a small offering that was exempt from SEC registration. The company registered its stock and began reporting perhaps in anticipation of future funding needs that could not be satisfied from private or exempt sources.

Offerings that are exempt from SEC registration

Two different types of exempt offerings appear in this case. The section 4(2), private offering exemption, is likely to be familiar to students. The Reg S offering is not as well known. This regulation exempts stock issues that are sold entirely outside the US from registration with the SEC. More information about the Reg S offering is available from the SEC at http://www.sec.gov/divisions/corpfin/forms/regs.htm. (Other exemptions from registration exist but are not used by the companies in this case. Students may be familiar with, e.g., the Reg A, small issue, or Reg D, limited offer, exemptions).

Restricted stock

The Visions-In-Glass stock involved in the China Automotive reverse merger is specifically recognized as restricted stock in the Share Exchange Agreement. This limits the ability of the Great Genesis stockholders to sell the stock in the secondary market. Although not widely understood, shares of stock received from a corporation, even a public corporation, in exchange for assets or services, may be restricted, and not be immediately tradable. This is the case when the shares are not issued in connection with a public offering (accompanied by an SEC approved prospectus), e.g., stock issued under an exemption from registration. When restricted shares are sold, the seller has the burden to establish that the sale is not part of an unlawful issuance or distribution of stock (that is, an issuance or distribution that is subject to registration with the SEC but has not been duly registered). Safe harbors exist under which sale or restricted shares by non-affiliated investors after a two-year holding period (Rule 144) or to a “Qualified Institutional Buyer” (Rule 144A) may be presumed to be not in connection with an unlawful issue or distribution.

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Uncertainty of cash flow from China joint ventures

The regulation of currency exchange by China raises additional issues that affect the value of China Automotive stock. China Automotive's income consists of distributions by joint ventures in China. Foreign exchange rules require Central Bank of China approval of transfer of currency out of China. Even if there is income, it is not certain when or whether that income can ever be distributed to China Automotive and thus to its stockholders.

The dividend discount model suggests that the value of a stock is the present value of all futures expected dividends. All businesses are subject to some uncertainty regarding the timing and amount of future cash flows. That uncertainty is magnified in this case by the uncertainties associated with the location of the operating business of China Automotive and the regulation of foreign exchange by China. Restriction on currency flowing out of China may interfere with China Automotive's ability to pay dividends to its stockholders even if the joint ventures interests it owns do generate profits.

If the market expects that no dividends will ever be paid on a stock, the stock value should be zero. Clearly the market has assigned positive value to China Automotive stock. Apparently, the market anticipates forecasting an easing of currency controls in China. In that event cash dividends paid by the Chinese joint ventures Ji Long would flow to Great Genesis and ultimately to China Automotive. For a reference to the problems stemming from currency controls in China, see the Wall Street Journal article, "Snowed in Beijing" Sept. 3, 2003.

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