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Reverse Mergers vs. an IPO: Market Trends, Transaction Structure, Benefits, Drawbacks

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Reverse Mergers vs. an IPO: Market Trends, Transaction Structure, Benefits, Drawbacks

Perrie Weiner and Michelle Heisner, Baker McKenzie | June 11, 2024

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01 History

What Is a Reverse Merger?

Generally, term can be used to refer to any time a private company effectively attains a public listing via a business combination with an already listed company.

Reverse Merger ≠ Reverse Triangular Merger

In a reverse triangular merger, a subsidiary entity formed by the acquiror merges with and into the target company, with the target company as the surviving corporation.

Different Flavors of Listed Vehicles

- Blank Check/SPACs: Shell companies formed for the specific purpose of effecting a reverse merger are known as blank check shell companies.
- Development Stage: Companies that have previously filed a registration statement under the Securities Act and may have a business plan but only have nominal operations. May or may not be "shell companies".
- Fallen Angels: Companies that previously conducted operations that were either disposed of, otherwise terminated or simply failing. May or may not be "shell companies".

Key Question: Is the vehicle Nasdaq/NYSE-listed or trading on OTC?

Evolution

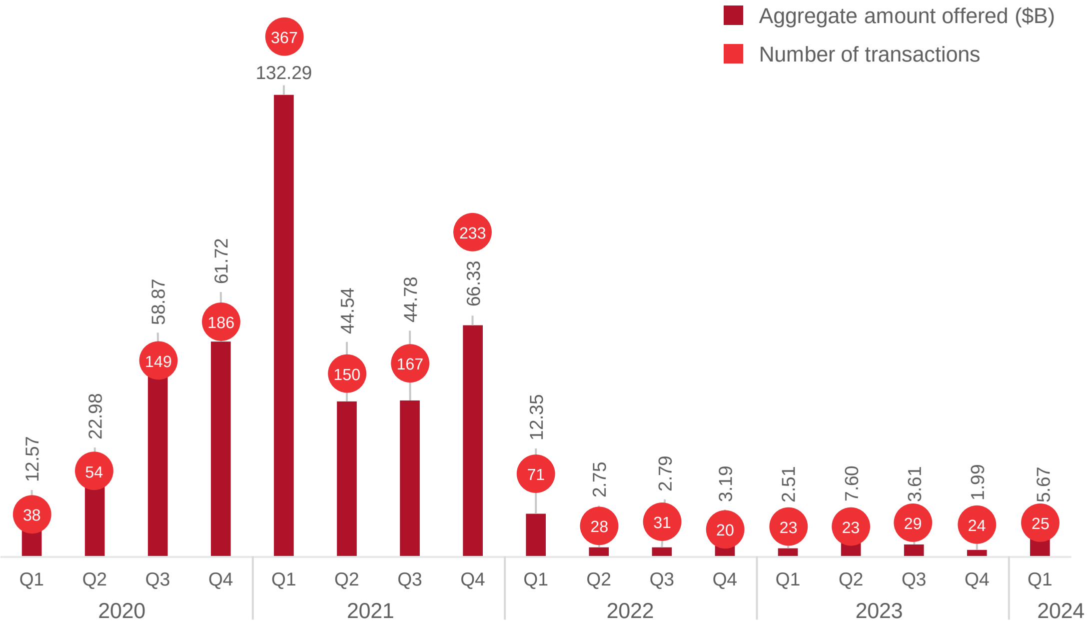
- After 2001: After the tech market crash of the late 90’s, hedge funds seeking to invest in private operating companies used the reverse merger to gain immediate liquidity.
- 2007-2010: Private companies in emerging markets went public in the U.S. through reverse mergers. Foreign companies, notably those in China, sought to gain access to U.S. capital markets.
- 2011: The SEC brought enforcement actions against a variety of Chinese companies taken public through reverse mergers.
- 2018: Around 5 years ago, SPACs (a variation on a theme of reverse mergers), exceeded the IPO market.
- Now: SPACs and IPOs have declined, while reverse mergers have resurged, specifically in the life sciences sector. Foreign countries continue to seek access to U.S. capital markets, reminiscent of the Chinese reverse mergers prior to 2011.

Takeaways from the History of Reverse Mergers

- Chinese Reverse Mergers: Assure that proper accounting and auditing practices are in place. Once the company goes public, ensure compliance with all public filings. These were the bases of SEC enforcement actions against Chinese reverse mergers in 2011.
- SPACs: In the last few years, securities class actions against SPACs have centered on breach of fiduciary duty claims arising from potential misalignment of interests between SPAC sponsors and their shareholders. Another recent development is that SPACs are no longer afforded safe harbor protection for forward-looking statements.
- Now: The benefits of reverse mergers that drew many Chinese companies to seek U.S. investment 15 years ago hold true today. But it is also critical to learn from the pitfalls of the past.

02 Today's Market

IPO Window Closed

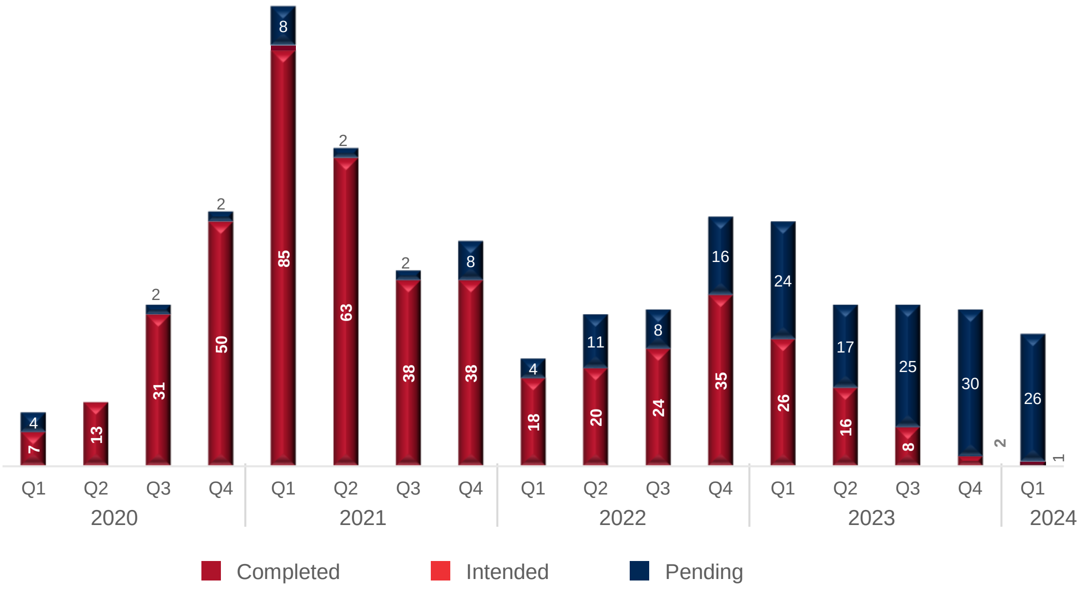


Source: Stock Analysis - IPO Statistics/S&P Global Markets Intelligence
Data compiled April 4, 2024.
Analysis includes global initial public offerings completed between Jan. 1 2020, and March 31, 2024, by companies headquartered in the US.
Excludes private placements
Aggregate amount offered includes overallotments

In the US, in 2023, there were only 26 IPOs launched by US companies in the fourth quarter. This was up from 20 launched in the same quarter in 2022 but well below the 232 launched in the fourth quarter of 2021.

The cumulative value of securities sold through IPOs in 2023 was $15.71 billion in 2023, down from $21.08 billion in 2022 and well below the $287.94 billion sold in 2021

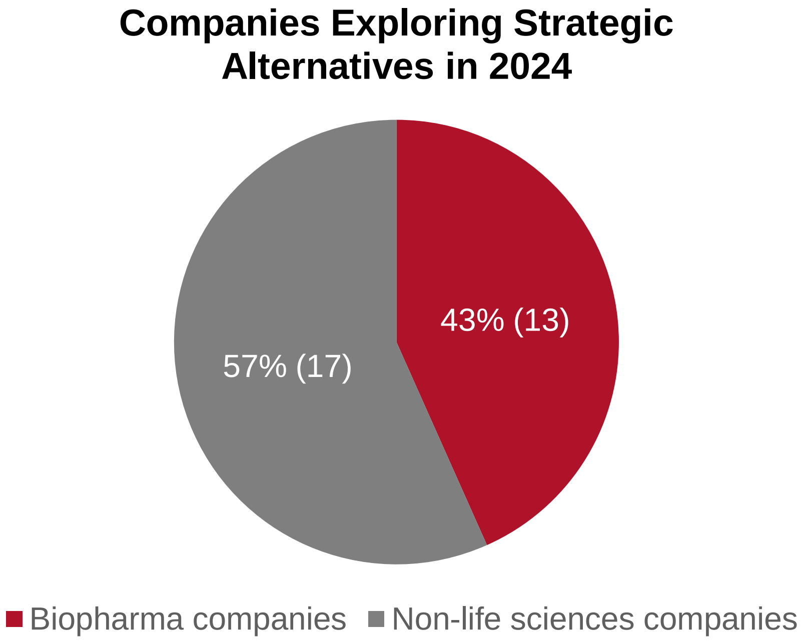
De-SPAC Decline



Source: LSEG
Data compiled May 24, 2024.
Date Announced de-SPACs

- In late 2020 and early 2021, SPACs experienced explosive growth. They became the IPO vehicle of choice for many private companies, especially in high-growth sectors like electric vehicles, tech, fintech, space travel, and biotech.
- Several factors led to a decline in popularity in 2022 and the first half of 2023:
  - Increased interest rates
  - Poor trading performance
  - Shareholder redemptions and difficulty in raising PIPEs
  - Regulatory scrutiny
  - Shift in investor preference

Life Science Fallen Angel Candidates



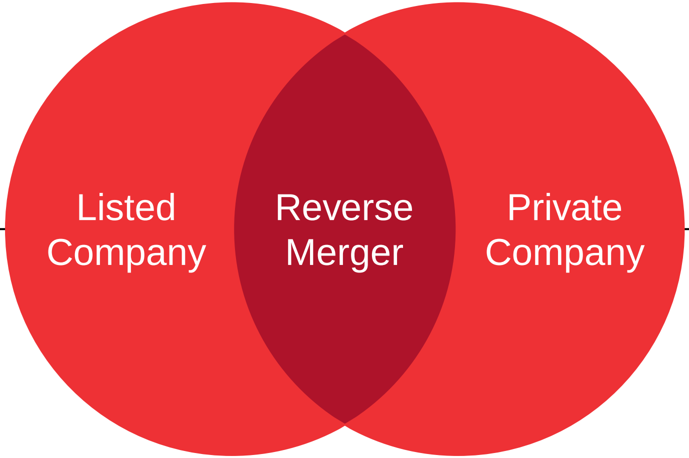
Source: 8K Intelligize Search - Announcement Analysis
Data compiled May 28, 2024
Analysis Includes companies exploring strategic alternatives between Jan. 1, 2024 – May 28, 2024

- In 2024, life sciences companies are the leading industry in announcing their intent to explore strategic alternatives.
- The majority of life sciences companies exploring strategic alternatives have encountered clinical setbacks, prompting them to reduce operating costs as they evaluate their options.
- Out of the total number of companies exploring strategic alternatives, 10% (3) were in bankruptcy. 2 of those were life sciences companies.

Case for a Fallen Angel

Listed Company

A public company has a material cash balance, but due to adverse business events (e.g., a failed clinical trial), there are limited go-forward business prospects.
A bankruptcy would be unduly expensive and/or the company lacks creditors, a dissolution would take years to complete, and issuing a large dividend and "going dark" is not feasible, including because it doesn't address business or D&O risks.



Private Company

A private company has a limited cash runway (e.g., 12 months). There are some existing investors who would be willing to fund a public company, but not to further finance a private company with its limited liquidity. The private company would do an IPO to raise funds, but the IPO window is closed and a de-SPAC isn't likely to bring cash.

03 Benefits & Drawbacks

Comparison

	Reverse Merger: Non-Shell	Reverse Merger: Shell – Non-SPAC	Reverse Merger: Shell - SPAC	Traditional IPO
Benefits	▪ Access to cash ▪ Public attention of a listing ▪ Ability to set your "starting" public valuation (e.g., merger exchange ratio) ▪ Access the public markets at an earlier point in time than a traditional IPO process ▪ Will not be subject to Securities Act burdens of being a shell company ▪ Existing listing on Nasdaq/NYSE will inherently make it easier for the combined company's securities to be admitted to trading ▪ Because the company is already an SEC reporting company, diligence should be easier than on an OTC-listed shell (but not easier than a SPAC) ▪ If companies are in similar industries, established sector analysts may be providing coverage for the business combination	▪ Public attention of a listing ▪ Ability to set your "starting" public valuation (e.g., merger exchange ratio) ▪ Access the public markets at an earlier point in time than a traditional IPO process ▪ Mechanically faster route to listing – at least theoretically	▪ Public attention of a listing ▪ Ability to set your "starting" public valuation (e.g., merger exchange ratio) ▪ Access the public markets at an earlier point in time than a traditional IPO process ▪ If your shell is a SPAC, then because SPAC has never had business operations, diligence is relatively simple ▪ May have more flexibility in terms of choosing an ex-US listed entity ▪ Business combination itself less likely to be litigated, though risks post-closing associated with performance and targeting of de-SPACs could be greater	▪ Public attention of a listing ▪ "Clean" operating history ▪ Greater control of timing (subject to IPO window being open) ▪ Greater certainty of funds ▪ Brand visibility/higher profile ▪ Potentially broader base of investors (e.g., institutional investors may be wary of former OTC shells and SPACs)
Drawbacks	▪ Opportunistic – requires conditions of listed company and private target to align ▪ Need to navigate legacy issues associated with operations (e.g., employee matters like reductions in force and severance arrangements, board transitions)	▪ Many non-SPAC shells are OTC-listed, which would mean clean up to get back into Nasdaq/NYSE listing plus liabilities which may or may not be written off. ▪ Subject to onerous requirements under the Securities Act of 1933 ▪ May not have cash ▪ Operating company combined with lack of Securities Act reporting leads to more diligence work	▪ Often formed by sponsors or promoters that have financial interests that may be in conflict with the interests of other stockholders. Potentially different type of litigation risk ▪ Contingent liabilities (e.g., warrants, convertible notes, fees ▪ Subject to onerous requirements under the Securities Act of 1933 ▪ For SPACs, high redemption rates mean limited trust account cash post-closing combined with a challenging PIPE market ▪ Redemption also subject to 1% excise tax for US SPACs	▪ IPO window needs to be open ▪ Pricing pop immediately upon listing/perception of leaving money on the table ▪ No projections/may not be as attractive for non-traditional candidates

04 Structure

Give-Get Framework

Public Company

Estimated net cash at close

- Primary value driver
- Ability to maximize cash preservation via operational streamlining

+

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Listing value

- Can drive further valuation
- But, dependent on equity capital market conditions

Other Assets

- Potential for right partner to ascribe value
- Can give public company stockholders a CVR for the value of sold legacy assets

Legacy Liabilities

- Value reduced for liabilities, including liabilities created through wind down of unnecessary legacy operations

Private Company

Post-money valuation of last private financing

- Value may be adjusted based on market conditions
- Meaningful events since last financing could justify a value adjustment

Valuation supported by:

Intrinsic valuation

- Inherent value of future cash flows
- Sensitive to changes in assumptions
- Less reliable for earlier-stage companies

Market based valuation

- Crossover to IPO step-up, comparable companies analysis

PIPE

- Valuation used by financing source as reflected in a PIPE lends credibility

Exchange Ratio = relative value ascribed to the two companies through negotiation

05 Transaction Considerations (Spotlighting a Fallen Angel Reverse Merger)

Mutual Operational and Financial Diligence (and Planning)

Conducted by Public Company (Focus on fiduciary duties in exercise)	Conducted by Private Company (Diligence is key because unlikely to get protection via indemnification)
▪ Attractiveness of target's business (e.g., lead asset, pipeline, technology)	▪ Understanding of public company's net cash position (Will there be sufficient cash on balance sheet to fund activities through key value-driving catalysts?)
▪ Near-term, value-driving catalysts within pro forma cash runway	▪ Quality of public company investor base – overlap with private company is often helpful
▪ Management, board and existing investor quality	▪ Concentration of public investors/ease of securing support for the reverse merger
▪ Readiness to be a US publicly traded company	▪ Material litigation, liabilities or sustained operational commitments
▪ Need for additional financing and commitment from private company investors to provide such	▪ Personnel with complementary domain expertise (e.g., scientific, development, or commercial) vs. personnel that will be made redundant
▪ Fit and value assigned to public company's programs	▪ Change of control diligence on public company (e.g., leases, financing arrangements, warrants and convertible securities, existing employment agreements and equity incentives, D&O tail)
▪ Speed to close (e.g., when PCAOB audited financials are ready)	▪ Contractual impacts of "IPO" on private company (e.g., are convertible securities triggered?)
▪ All the normal traps run by a public company, with a board subject to fiduciary duties, in a transformative business combination	▪ Net operating loss utilization analysis
	▪ IPO readiness drills (e.g., PCAOB audited financials, public company compensation planning, D&O insurance)

Securities Laws Traps

A "shell company" under the Securities Act is any company with:

1. No or nominal operations; and
2. Either: (a) no or nominal assets; (b) assets consisting solely of cash and cash equivalents; or (c) assets consisting of any amount of cash and cash equivalents and nominal other assets.

But SEC policy has evolved to include consideration of:

i. Whether the primary purpose of the reverse merger is to provide cash and a stock exchange listing to a private company;
ii. Whether the transaction is accounted for as a reverse capitalization;
iii. Whether the prior operations of the public company will continue post business combination and to what extent;
iv. Whether the combined company will maintain employees, offices, or other operational aspects of the pre-merger public company for a meaningful period of time post business combination;
v. Whether the pre-closing public company assets will be sold or otherwise divested; and
vi. Whether the pre-closing public company stockholders receive a contingent value right (CVR) entitling them to the value of legacy assets of the public company to be sold following the closing of the business combination.

Securities Laws Traps

Merging into a shell company can impose limitations –

a. **Employee Share Plans (delay in ability to file Form S-8):** The combined company will not be eligible to use Form S-8 for the registration of compensatory securities offerings until at least 60 calendar days after the combined company has filed current Form 10 information.

b. **Short Form Registration Statement (delay in ability to use Form S-3):** The combined company will not be eligible to use a Form S-3 registration statement until 12 calendar months have passed per SEC CD&I.

c. **Ineligible Issuer:** The combined company will be an ineligible issuer for three years following the closing of the reverse merger (e.g., no free writing prospectus, no WKSI status despite public float, etc.).

d. **No Incorporation by Reference:** Although Form S-1 is available for offerings (including for a resale shelf registration statement), the combined company will be ineligible to use incorporation by reference until Form S-3 becomes available (i.e., manual updates will be required to keep a resale shelf prospectus current).

e. **Limitations on Availability of the Form S-1 Resale Shelf:** Investors who were affiliates of the private company and receive securities of the public company in the reverse merger (i.e., Rule 145(c) securities) are statutory underwriters with respect to resales of those securities and, as such, their securities not be included in the Form S-1 resale shelf and instead can only be sold in a fixed price offering in which such investors are named as underwriters in the prospectus.

f. **Unregistered Resales:** The combined company's securities cannot rely on Rule 144 for resales until one year after it ceased to be a shell company and has filed with the SEC information that would satisfy the requirements of Form 10 or, for foreign issuers, Form 20-F. Must also be a timely filer of periodic reporting etc.

And… consider whether combined company (whether result of combination with shell or non-shell) will be an Emerging Growth Company or Smaller Reporting Company.

Exchange Ratio (and Net Cash)

Stock held by **PubCo Stockholders** + Stock held by **PrivateCo Stockholders** = **Combined Company Stock**

A ratio is used to compare relative quantities

Should a shortfall in anticipated net cash allow the private company to refuse to close?

Should such a shortfall result in an adjustment to the exchange ratio?

Exchange Ratio (and Net Cash)

Common negotiated items in the net cash definition:

1. transaction expenses
2. stockholder claims
3. amounts paid to employees
4. prepaid expenses

PIPEs

Cash Needed (e.g., to reach clinical test) **-** **Net Cash of PubCo** **-** **Anticipated Closing Cash of PrivateCo** **=** **PIPE** Amount

… or, wait and try capital raising post-listing.

Public Company Stockholder Vote

Public company will need to obtain any stockholder votes required by the law of its jurisdiction of formation, governance documents and stock exchange rules (e.g., Nasdaq/NYSE 20% rule).

- Typical structure requires stockholder vote because it involves issuance of 20% or more of a company's common stock or voting power and/or a change of control.
- Easier to obtain necessary vote if ownership of the public company is concentrated and significant investors are wall crossed and agree to support agreements.
- It may be theoretically possible to simultaneously sign and close the reverse merger and then seek the stockholder vote after closing, but it requires careful deal structuring. For example, typically involves issuance of non-voting preferred stock in a private placement that converts to common stock upon stockholder approval, subject to a redemption right if vote fails.

Termination

As a public company M&A transaction, you can expect normal negotiations around termination.

- Go Shops
- Fiduciary Outs (i.e., which permits the target's board of directors to change its recommendation and terminate the initial merger agreement should a higher price come along prior to the stockholder vote)
- Reverse Termination Fees

CVRs

CVRs can be used to get value to the public company's shareholders for assets from legacy operations.

- Mechanism: Special dividend to public company stockholders of record prior to the reverse merger becoming effective
- Duration: 10-15 years, defined auction period for asset on the block, periods that make sense based on facts (e.g., milestone triggers where assets held as separate operating business)
- Tradeable: No, if you don’t want to register it with the SEC

Can make a bid by a private company more attractive and assist the public company board's analysis of releasing its fiduciary duties under Revlon.

SEC Filings

A merger proxy statement and/or a Form S-4/F-4 registration statement is typically required.

While reverse mergers are touted as a faster method to IPO, these filings are arguably more complicated and can be more time intensive than the Form S-1 for a traditional IPO.

	Reverse Merger (Exchange Listed/SEC Registered)	Traditional IPO
Financials and Related Analysis	Separate audited financial statements for each company, plus pro forma combined financial statements reflecting the combination of the two companies	Audited financials of private company only
Background and Reasons	Detailed descriptions of each company's process leading up to execution of the merger agreement and its board's reasons for recommending approval of the merger	N/A
SEC Review	SEC scrutiny of merger proxy/Form S-4 filings for reverse mergers has been increasing	N/A
Litigation	Merger proxy/Form S-4 filings often attract strike lawsuits claiming deficient disclosures and/or an inadequate board process	Lawsuits generally occur post-listing

06 Regulatory and Litigation Risks

Regulatory and Litigation Risks

- **Auditing:** The SEC in a June 2011 Investor Bulletin noted that some of the foreign companies that access the U.S. markets through the reverse merger process use small U.S. auditing firms, some of which may not have the resources to meet their auditing obligations when all or substantially all of the private company's operations are in another country. As a result, litigation may arise where such auditing firms fail to identify circumstances where these companies are not in compliance with the relevant accounting standards.
- **Disclosure of risks unique to reverse mergers:** Item 105 (formerly Item 503) of Regulation S-K5 requires a discussion of the most significant factors that make an offering speculative or risky. Risks such as lack of history of compliance with U.S. laws and accounting principles should be disclosed.
- **Short-and-distort attacks:** Certain "analysts" have taken advantage of the reverse merger market by shorting the stock of thinly traded companies, then putting out an intentionally or recklessly false negative report about the company, then drawing in other short sellers to assure a profit, causing the stock to drop sharply. The sharp sell-off that results may give rise to an SEC investigation or securities shareholder class action litigation Naked short.
- **Whistleblowers:** Companies should have internal reporting channels to share information about possible wrongdoing to evaluate complaints and investigate those that warrant further investigation. Simply firing a whistleblower typically will result in their going to the SEC, sparking an SEC investigation.

Recent legal developments to be aware of

	Case	Development
Data Breaches	Complaint, *SEC v. SolarWinds Corp.*, et al., Case No. 1:23-cv-09518-PA (S.D.N.Y. October 30, 2023).	The SEC brought an enforcement action suing a company for scienter-based fraud involving a cybersecurity breach for the first time. It also marks the first time the SEC has sued any individual for their role in cybersecurity failures, as the action was also brought against the company's Chief Information Security Office (CISO).
Shadow Trading	*Securities and Exchange Commission v. Matthew Panuwat,* 4:21-cv-06322 (N.D. Cal. filed Aug. 17, 2021).	Shadow trading is a newly recognized form of insider trading, where material nonpublic information (MNPI) is leveraged to trade securities of a different but economically linked company. Even if you don't trade shares of the company you have MNPI from, if you trade shares of a competitor or otherwise "economically linked" company, you may be held liable for insider trading.
Pure Omissions	*Macquarie Infrastructure Corp. v. Moab Partners, L.P.,* No. 22-1165, 2024 U.S. LEXIS 1575, 601 U.S. ___ (Apr. 12, 2024).	Once the company is publicly traded, they will need to think about their disclosures in light of the U.S. Supreme Court's recent ruling in *Macquarie Infrastructure v. Moab Partners*, holding that there is no liability for pure omissions (failure to disclose future trends), under Rule 10b-5(b).

Data Breaches

- The SEC in Oct. 2023 brought an action against SolarWinds and its CISO **for scienter-based fraud in connection with a cybersecurity incident**.
- Following this action, public companies will need to be careful about what their disclosures say about cybersecurity, and assuming there is a data breach, they will need to **disclose within 4 days** of a materiality determination that there has been a data breach. This has the potential to drive the price of the stock down, which will likely trigger securities class actions, shareholder derivative actions, and an SEC investigation/enforcement action.
- When a private operating company goes public quicky through the reverse merger process, they need to be cognizant of these new exposure risks and have processes in place for reporting and disclosure of cybersecurity compliance and breaches.
- With more than 80% of organizations experiencing more than one data breach annually, it is not a matter of whether a public company will be the subject of a data breach, but when.

Shadow Trading

- Newly formed publicly traded companies will need to be careful how they draft their internal insider trading policies to account for the trading of stock in economically linked companies.
- **Shadow trading** is a new form of insider trading, **where material nonpublic information** (MNPI) of one company **is leveraged to trade stock of a different but economically linked company**.
- The more common insider trading case involves a person who purchases stock while having MNPI about that issuer of that stock. But Rule 10b-5 is not limited by its language to the purchase or sale of stock of an issuer for which the party has MNPI.
- A person commits fraud "in connection with" a securities transaction, and violates Section 10(b) and Rule 10b-5, when they misappropriate confidential information for securities trading purposes, in breach of a duty owed to the source of the information.
- Insider trading policies, after *Panuwat*, likely should prohibit trading in the equities of any issuer based on the receipt of MNPI gained through a position of confidence or trust.
- Companies may also be wise to consider expanding blackout periods, at least as to those insiders presumptively in the possession of MNPI, to apply not only to the company but also to competitors and other issuers for which such nonpublic information could be considered material.

What omissions are actionable?

- Once the company is publicly traded, they will also need to think about their disclosures considering the U.S. Supreme Court's recent ruling in *Macquarie Infrastructure v. Moab Partners*, holding that **there is no liability for pure omissions** (failure to disclose future trends), under Rule 10b-5(b).
- This ruling suggests that this is the case even where there are world events—such as proposed legislation, new regulations, natural disasters, war or even court rulings—that could lead to a change in industry trends that impacts the outlook of the company or causes a material decline in profit for the business.
- Although the court held that the failure to disclose these events cannot, by itself, support a claim for securities fraud under Rule 10b-5(b), **half-truths remain actionable in private securities cases.** This is where a company makes an affirmative statement that makes an omission misleading.
- The dilemma, especially for newly-formed public companies focused on ESG, AI, or cybersecurity, will be how to strategize as to the disclosure, or lack of, about future trends? If they make a statement on a topic, they can be punished for "half-truths.”

Questions

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Q&A

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