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The Current Landscape of Reverse Mergers: An In-Depth Analysis and Q&A

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SUMMARY

SEC rulemaking and newly expansive interpretations of long-standing rules has impacted the recently popular reverse merger structure[2] by (i) eliminating the ability to complete the so-called "sign and close" reverse merger (with limited exceptions discussed below) and (ii) adding incremental execution aspects to the "traditional" reverse merger structure. Despite these developments, reverse mergers remain attractive to both private targets and the stockholders of public companies considering a business combination transaction and which support a strategic pivot toward a private company's assets and operations. While the SEC rules that became effective July 1, 2024[3] may have initially cast a pall over the transaction structure, we continue to believe it remains viable, despite some challenges relative to prior practice.

DISCUSSION

A Disturbance in the Force in 2023

For nearly two decades, the laws around reverse mergers were clear and predictable providing regulatory certainty for M&A participants and their legal and financial advisors. Public companies that were "shell companies" (i.e., no/nominal assets and no/nominal operations) were subject to more stringent regulations in business combination transactions, while operating companies that had suffered a setback, but nonetheless maintained more-than-nominal assets and/or operations, would not be classified as a "shell company" and thus would be able to enter into business combination transactions (including reverse mergers) where the merged company emerged from the transaction as a "seasoned issuer"[4].

Beginning in the second half of 2023, the SEC began advancing through issuer comment letters a new interpretative position with respect to the 2005 shell-company rules, seemingly abandoned the assets/operations analysis embodied in Rule 12b-2 and imputed a new "degree-of-continuity" test to determine whether a public company was a "shell company" (or not). This new test, which was articulated as the "totality of the transactions" test, looks at various factors such as a sale of legacy public company assets (pre- or post-closing, including pursuant to a CVR[5]), retention of ongoing drug development programs and management/board turnover. The SEC Staff based its new interpretation, in part, on an expansion of the principle articulated in footnote 32 of the Shell Company Adopting Release (33-8587) (the "2005 Release") and asserted that acquirers issuing CVRs as partial consideration for the public company's legacy asset sales were effectively deemed shell companies by virtue of engaging in the "inverse" of the practice described in Footnote 32 of the 2005 Release.[6]

Building on this position, the SEC Staff then concluded that any merged company meeting this "totality of the transactions" test for shell company status (i) would be ineligible to use Form S-3 until it has been a reporting company for a complete 12

months, (ii) Rule 144 would be unavailable for an equivalent one-year period, and (iii) affiliates of the target company at the time of the stockholder vote would (effectively) be ineligible to have shares they receive in connection with the business combination registered until Form S-3 eligibility is achieved (i.e., a minimum one-year holding period for affiliates post-closing).

Background -- A Landscape Shift in 2024

In January 2024, the Commission voted to approve new rules regulating SPACs and Shell Companies (Release No. 33-11265) (the "2024 Release"). While most of the 2024 Release related to the SEC's efforts to regulate de-SPAC mergers, this release also contained terms that expanded the scope of the SEC's shell company rules and thereby made reverse mergers more difficult to consummate. More specifically, the 2024 Release expanded the scope of the definition of a "shell company" without amending the definition of a "shell company" in Rule 12b-2. For example, in the context of adopting Rule 145a (discussed below), Footnote 943 of the 2024 Release memorializes the SEC Staff's "inverse of Footnote 32" interpretation of the 2005 Release by expanding the scope of what constitutes a shell company for purposes of Rule 145a, citing evasive practices identified in 2005 where transactions were allegedly structured to avoid shell company status.[8] The Staff viewed operating companies looking to acquire new assets and provide legacy stockholders with the value of the legacy assets via a CVR as the functional equivalent of a scheme to evade shell company status.[9]

The impact of Footnote 943 on reverse merger transactions is hard to overstate. This language invoking Rule 145a allows the Staff to disregard the objective rules-based approach of the shell company test embodied in the 2005 Release (which focused on the book value of assets on the most recent balance sheet) and instead seeks to apply a subjective test where "in substance" a business combination "is used to convert a private company into a public company." The footnote goes on to provide an example applying the Rule 145a shell company rules to transactions where the public company disposes of historical assets or operations before or after the business combination.[10]

Implications for the Traditional Reverse Merger Structure

Having swept in a broad swathe of business combination transactions as potential shell company transactions (even where the public company does not meet the definition of a shell company under Rule 12b-1), Rule 145a provides that the business combination will be deemed to be an offer of the target's securities to the public company stockholders. As a deemed offer of securities by the target company, the offering must either be registered under the Securities Act of 1933 (the "1933 Act") or exempt from registration. The exemption for a private placement of securities typically used in capital formation transactions would not be possible in the context of being acquired by a publicly traded corporation where the target would be deemed an offeror of its securities to thousands of anonymous stockholders. Thus, lacking an obvious exemption from registration, the business combination must be registered under the 1933 Act, presumably on Form S-4.

The Commission amended Form S-4 in the 2024 Release to allow for the concept of a co-registrant in the context of a deemed offering of securities by a target company in a de-SPAC merger. However, this instruction is limited to business combinations involving SPACs. The Commission considered the scope of the definition of a "SPAC" and elected to not include shell companies in the SPAC definition. Thus, the instruction in Form S-4 that allows for a co-registrant in the context of a de-SPAC transaction (as required by Rule 145a) does not, on its face, seem to allow for the use of co-registration in the context of a shell company business combination. Practice to date has reflected the omission of co-registrants (without objection by the SEC Staff) from the cover page and signature pages of the Form S-4, although presumably the "deemed offering" pursuant to Rule 145a by the private company to public company stockholders is nonetheless being made pursuant to the Form S-4.

The "deemed offering" construct created by Rule 145a without a commensurate path on Form S-4 for the company that is deemed to be making the offering (i.e., the private target) to file as a registrant remains a gap in the rules as adopted by the SEC.

Impact on the "Sign and Close" Reverse Merger Structure

One significant consequence of Rule 145a is that acquisitions by deemed shell companies of targets in private placements can no longer be consummated (with a potential limited exception in the first Q&A below). Historically, many public companies that may be deemed to be a shell company under the SEC's new rules have acquired target companies with concurrent stock issuances that have been exempt as a private placement under Section 4(a)(2). These so-called "sign and close" transactions can no longer be consummated under Rule 145a, as the deemed offering by the target company to the public company stockholders would need to be registered. Thus, all business combination transactions involving companies deemed to be a shell company will require registration on Form S-4. Thus, the shell company status of the public company is critical to analyzing the viability of the sign-and-close transaction structure.

Legal and Market Impact and Analysis

As a result of the SEC's newly expanded interpretation of shell company status, companies that may have previously been deemed not a shell company will, after the closing of the business combination: (i) operate as an "ineligible issuer" for three years after closing,[12] (ii) require a full 12-month reporting history prior to gaining eligibility to use Form S-3 to register securities, and (iii) not be able to register for resale shares issued to the target's former affiliates at the time of the stockholder vote in connection with the business combination transaction until eligible to use Form S-3.[13]

The combination of the Staff's expansive interpretation of the shell company rules, fueled by the subjective standard articulated in Footnote 943, as well as the expansion of the 1933 Act to cover "deemed offerings" of securities under Rule 145a have combined to impact the longstanding cost-benefit analysis of potential reverse merger transactions. Gone are the so-called "sign-and-close" transactions that once allowed for a private placement of securities by the public company.[14]

While reverse mergers registered on Form S-4 are still permitted under Rule 145a, the Staff's position on imposing shell company status and related penalties for reporting companies that in actuality do not meet the definition of a shell company under Rule 12b-2 serves to make these transactions less attractive to private companies and their investors. Despite these challenges, we expect that many companies will continue to find the reverse merger path to be a viable alternative to the traditional IPO process, which entails a significant investment of time and capital before knowing whether an offering is ultimately possible and the terms that would allow an offering to be completed. In contrast, a reverse merger (like a de-SPAC transaction) allows the private company to have certainty as to the size and price terms of an offering (subject to approval by the public company stockholders) before investing substantial sums and time associated with SEC review of a registration statement. The total cost and time required for an IPO and a reverse merger on Form S-4 are roughly comparable given that the working group and associated gatekeepers will undertake similar drafting and diligence exercises; however, the reverse merger provides greater certainty of the outcome at the start of the process (e.g., an agreed valuation and funding commitments from a concurrent private placement in lieu of IPO investors), while an IPO only provides that certainty at the end of the registration and roadshow process. Given this dynamic, we expect that reverse mergers will continue to remain viable and attractive for certain issuers.

Questions and Perspectives

Q: Where a company with a failed business (e.g., a biopharma primary-asset company with an unsuccessful clinical trial) that has some ongoing operations (e.g., a nascent pre-clinical program) acquires a new lead program, is that company a "shell company" under the SEC's new interpretation?

A. Historically speaking, no. However, based on our recent conversations with the SEC Staff (prior to the new Administration), we understand the intended or actual disposal of the remaining ongoing operations either through a sale/out-license or the distribution of a contingent value right to stockholders may cross a line that would cause the company to be deemed a shell company along with the attendant burdens and limitations described above.

Q: What if an unsuccessful company (one or more failed drug programs) enters into a reverse merger to acquire a new drug development program from a third party and the target intends to continue at least one primary program of the public company? Is the public company still a "shell company"?

A: Perhaps not. Consistent with the 2005 shell company rules regarding "nominal assets and/or operations" and the new "totality of the circumstances" test, the continuation of a legacy program by the new company would appear to allow the go-forward company to avoid shell company status. Based on recent conversations with the SEC staff (prior to the new Administration), we understand the important criteria to focus on is the continuation of a drug program where the parties don't have an intent to dispose of that program, but instead the intention to continue further development of the drug program.

Q: Do the "shell company" rules apply to the acquisition of an "asset" by a public company? Or do they only apply to the acquisition of a "business"?

A: In discussing the financial statement requirements in connection with shell company business combinations, the Staff noted "[a]fter a business combination involving a shell company, the financial statements of a business that will be a predecessor to the shell company registrant become those of the registrant for financial reporting purposes." In doing so, the Staff introduced uncertainty as to what constitutes a "business" in the context of a reverse merger under Footnote 984.[15]

The ambiguity of Footnote 984 raises a few questions. It is unclear whether the phrase "that is not an asset acquisition" modifies both "private operating company" and "target company" or only the latter. If the phrase only applies to the latter, then presumably the Staff is intending to exclude from the definition of a "business" target companies which are not operating companies (and are accounted for as asset acquisitions). However, if the Staff interprets a "business" as any target company (operating or non-operating) that is not accounted for as an asset acquisition, then several additional questions arise.[16]

It is possible that the Staff included the language "includes but is not limited to" in Footnote 984 to make clear that a transaction that is not an asset acquisition is not the only situation in which a target company is considered a "business."

Q: When does an entity become a shell?

A: Given the expansiveness of Footnote 943, the Staff's guidance with respect to when an entity becomes classified as a shell in the reverse merger context is sparse. The footnote indicates the shell company requirements apply to any reporting company that sells or disposes of its legacy assets or operations in connection with a transaction with a private operating company which results in the private company becoming public, and that the requirements

apply regardless of whether such a sale or disposal occurs before, at or after closing. It is unclear whether other factors such as management and board turnover are also relevant to the analysis from the SEC's perspective.

This nuance poses several challenging questions with respect to sales of legacy assets. What are the sale thresholds that trigger the classification of a reporting company as a shell? If the reporting company disposes of some of its legacy assets, but not all or perhaps not even a majority, in connection with the transaction, what is the tipping point? The footnote presents timing questions as well. Is there a timeframe in which a sale of assets must occur to be considered part of the transaction, triggering shell company status? What if assets are disposed of over a year after the transaction closes, or several months before (perhaps even in a sale that was being planned prior to engaging with a reverse merger target)? If the transaction includes a contingent value right which would provide consideration to the reporting company's legacy stockholders in connection with an asset sale post-closing, what happens if the public company never consummates a sale which would trigger that payment? In that event, the public company would retain the legacy assets, which would seem to invalidate the classification of the company as a shell company from the outset.

Similar questions arise in the context of disposition of operations. Will the Staff's analysis be informed by considerations of which party engages in the disposition, the quantum of operations being disposed of, the timing of the disposition or the reasons the operations are being disposed of? Footnote 943 (and the text of the 2024 Release more broadly) do not provide answers to any of these questions.

Q: When shares issued to the target's affiliates at the time of the stockholder vote in connection with the business combination transaction are excluded form the Form S-4 (as required) and are only eligible for inclusion on a subsequent resale registration statement as a deemed underwriting with the shares offered at a fixed price, when are those shares eligible for inclusion on a resale registration statement?

A: Based on recent conversations with the SEC Staff (prior to the new Administration), we understand the Staff would not object to including those shares on a Form S-1 or Form S-3 after twelve full months have elapsed from the date the company exits "shell company" status (e.g., the company's filing of the "Super Form 8-K" following the closing of the reverse merger).

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2 A reverse merger is when a private company becomes publicly traded by acquiring a publicly listed company, often a company that is or is close to becoming a shell. Instead of going through an initial public offering, the private company takes control of the public company, as an alternative to the traditional IPO process. A key advantage of the reverse merger is that the private company is able to determine its valuation at the beginning of the transaction process rather than the end.

3 https://www.sec.gov/files/rules/final/2024/33-11265.pdf

4 A seasoned issuer, as defined by the SEC, is a company that meets the eligibility criteria to use Form S-3 or Form F-3, as applicable, to register securities under the Securities Act of 1933.

5 A Contingent Value Right (CVR) is a financial instrument that gives stockholders the right to receive additional payments if certain future events or performance targets are met, such as a company's achieving certain sales targets or a drug receiving regulatory approval, or in the case of a reverse merger, if the legacy assets are monetized.

6 Footnote 32 of the 2005 Release provides as follows: “We have become aware of a practice in which a promoter of a company and/or affiliates of the promoter appear to place assets or operations within an entity with the intent of causing that entity to fall outside of the definition of ‘blank check company’ in Securities Act Rule 419. The promoter will then seek a business combination transaction for the company, with the assets or operations being returned to the promoter or affiliate upon the completion of that business combination transaction. It is likely that similar schemes will be undertaken with the intention of evading the definition of shell company that we are adopting today. In our view, where promoters (or their affiliates) of a company that would otherwise be a shell company place assets or operations in that company and those assets or operations are returned to the promoter or its affiliates (or an agreement is made to return those assets or operations to the promoter or its affiliates) before, upon completion of, or shortly after a business combination transaction by that company, those assets or operations would be considered ‘nominal’ for purposes of the definition of shell company.”

7 SEC Commissioner Hester Peirce characterized the 2024 Release as seeking to kill SPAC mergers while ignoring the regulatory inefficiencies that made these transactions popular, noting “The regulatory reaper came for SPACs and seems to have won. That outcome is disheartening. Not only is the Commission removing a potential avenue for bringing small companies into the public market, but it also fails to acknowledge, let alone grapple with, real issues around the public markets’ accessibility for small companies. The popularity of SPACs with certain types of companies was an indicator that the traditional IPO process was not working for these kinds of companies. Imposing additional regulatory obstacles on SPACs only compounds the underlying problem by further impeding these companies’ preferred pathway to the public markets. While killing the canary in the coal mine might make us regulators feel better, silencing the songbird will not improve the suffocating atmosphere that is burdening small companies’ access to our public markets.”

8 For example, a promoter temporarily transferring assets to a shell company to avoid shell company status, with the expectation that the assets would be returned at a later time.

9 To that end, Footnote 943 provides the following “We reiterate the Commission’s previous position on structuring transactions to avoid shell company status in adopting the 2005 shell company limitations . . . Rule 145a as well as any other requirements applicable to reporting shell company business combinations apply in situations where, in substance, a shell company business combination is used to convert a private company into a public company. For example, the requirements applicable to reporting shell company business combinations adopted herein will apply to any company that sells or otherwise disposes of its historical assets or operations in connection with or as part of a plan to combine with a non-shell private company in order to convert the private company into a public one. This is true regardless of whether such sale or disposal of the legacy assets or operations occurs prior to or after the consummation of the business combination.”

10 Of note, this test does not consider the magnitude or timing of the disposition. For example, a business combination with no planned disposition of legacy assets at closing could be determined to be a shell company reverse merger subject to Rule 145a if the public company elects to dispose of legacy assets at some time post-closing. The relative size of the disposition that causes this determination is not specified in the 2024 Release. The release also refers to disposition of historical operations, which raises the same question about shuttering prior operations post-closing.

11 We note Commissioner Peirce’s dissent to the 2024 Release and the SEC’s lack of statutory authority to regulate a “deemed” offer of a security by the target company where no offering and sale is actually occurring. Similar comments were made by the American Bar Association in its comments to the proposed Rule 145a.

12 This status imposes more restrictive rules on certain communications, the use of Rule 144 and the ability of the public company to utilize the “well-known seasoned issuer” (WKSI) abbreviated registration requirements for follow-on offerings.

13 Rule 145c limits the availability of registration of former affiliates’ shares received in connection with the business combination on Form S-1 unless the offering is at a fixed price and the selling security holders are identified as affiliates. Practically speaking, this requires waiting one year and registration on Form S-3.

14 In the case of a public company that is listed on either NYSE or Nasdaq, the transaction must also not involve a “change of control”, as defined by such exchanges.

15 Footnote 984 reads, in pertinent part (emphasis added): “In connection with the adoption of final Rule 15-01(b) in this release, we reiterate that, in a business combination transaction involving a shell company, a ‘business’ includes but is not limited to a private operating company or a target company that is not an asset acquisition.”

16 Many sign-and-close reverse mergers are accounted for as asset acquisitions under both GAAP (per ASC 805-50) and Regulation S-X. Take, for example, a formerly operating pre-revenue public life sciences company which was met with unfavorable data, has significantly reduced operations and plans to consummate a reverse merger with an operating pre-revenue private life sciences company. This transaction could be classified as an asset acquisition under GAAP if, for example, the target is at an early enough stage where it does not yet have any revenue-producing outputs (as is the case in many pre-revenue life sciences companies) and there is not yet an organized workforce that is sophisticated enough to turn the inputs into outputs (e.g., a commercial-stage pharmaceutical product). This same transaction could similarly be considered an asset acquisition under SEC rules (per Regulation S-X Rule 11-01(d)) if this very early-stage target were to undergo transformative operational change as a result of the reverse merger transaction, which would result in a failure of the continuity of operations test. If Footnote 984 is read to exclude this asset acquisition from the definition of a "business," that would imply that the financial statements of the target would not become the financial statements of the public company, which does not seem to be the Staff's intended result.

This is complicated further where a transaction is legally structured as an asset acquisition and where the analyses under GAAP and Regulation S-X become moot. In this scenario, the transaction is literally an "asset acquisition," and Footnote 984 appears to indicate that the target in any transaction structured in this way would not be a "business." As such, this language in Footnote 984 is in tension with Footnote 943, which deems any transaction that is used to convert a private company into a public company to involve a sale of the target's securities to the reporting company's shareholders which necessitates broad disclosure, including target financial statements. The exclusion of asset acquisitions from the definition of a "business" contemplated by Footnote 984 is not aligned with the expansive scope set forth in Footnote 943.

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