Reverse Merger Tips For Biotechs After SEC's Recent Actions

By **Stephen Thau, Albert Vanderlaan and George Pothoulakis** (January 29, 2024)

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On Jan. 24, the U.S. Securities and Exchange Commission approved final rules that raise new challenges for special-purpose acquisition company and de-SPAC transactions — but that's not the only sector the SEC is approaching with more skepticism.

Recent SEC positions relating to reverse mergers are also threatening that path to go public.

This article discusses these new SEC developments and provides steps that companies contemplating a reverse merger should consider in order to avoid shell company status, including continuing product development for legacy programs or acquiring new programs as part of a structured transaction.

Reverse mergers have been an effective tool for biotech companies to access public markets in recent years, as a merger into an already public biotech company historically created timing and cost efficiencies for private — or foreign — biotechs relative to a traditional initial public offering process.

Examples of recent acquisitions in the biotech industry structured as reverse mergers into public companies include:

- Angion Biomedica Corp.'s merger with Elicio Therapeutics Inc., combining entity trading on Nasdaq under the ticker ELTX;
- Immunome Inc.'s acquisition of Morphimmune, combining entity trading on Nasdaq under the ticker IMNM;
- Kineta Inc.'s merger with Yumanity Therapeutics, combining entity trading on Nasdaq under the ticker KA; and
- PHAXIAM Therapeutics' merger with Erytech Pharma SA, combining entity trading on Nasdaq under the ticker PHXM.

One of the benefits of engaging in a reverse merger, compared to an IPO or de-SPAC transaction, was the post-closing ability of the combined company to use Form S-3 for fundraising activities, bypassing the more intensive Form S-1 used for IPOs and follow-on

offerings.

However, the SEC has started to take a hard look at what constitutes a shell company in these transactions, jeopardizing this benefit and risking more biotech companies falling into shell company status.

This new SEC approach, coupled with new rules that increase liability and disclosure obligations for shell companies, puts reverse merger transactions at risk of no longer being a viable "path to public" for the biotech industry.

Under current SEC rules, a company that is or has been a shell company is not eligible to use Form S-3 to register securities for public offerings until 12 months after it has ceased being a shell company. Additionally, a shell company loses the ability to use Rule 144 for a period of 12 months from the time the company ceases to be a shell company and is unable to attain well-known seasoned issuer status for a period of three years from such time as well.

Rule 405 under the Securities Act defines a shell company as a registrant that has both: "(1) No or nominal operations; and (2) Either: (i) No or nominal assets; (ii) Assets consisting solely of cash and cash equivalents; or (iii) Assets consisting of any amount of cash and cash equivalents and nominal other assets."

For shell companies seeking a transaction, it will cease to be a shell company by filing the necessary Form 10 information following the closing of the applicable transaction with an operating company, which is typically handled through the filing of a Super 8-K that includes or incorporates by reference the information required by Form 10 — equivalent in most respects to a Form 10-K level of disclosure.

Historically, the SEC had not taken an aggressive view of what constitutes a shell company under the Rule 405 definition in the context of reverse mergers, so that a public biotech company that had ceased development of its programs and was selling off legacy assets was not necessarily deemed a shell company.

To the extent the public company retained some employees and had operations such as licensing non-core products, such a public company was generally understood to fall outside shell company classification.

Further, oftentimes such a public company would cease work on legacy programs and/or distribute any potential upside from legacy programs to its stockholders prior to the completion of the reverse merger through a contingent value right — though typically only at the time of the completion of the transaction in order to align the relative valuations of the companies in connection with the transaction terms.

Based on a review of recent SEC correspondence with a number of issuers that recently completed reverse mergers, the SEC is taking a more aggressive look at public companies involved in reverse mergers to determine whether the preclosing public company was a shell company prior to engaging in the reverse merger.

The SEC is nearly universally finding that pretransaction issuers were shell companies, even in the face of evidence of assets and business activities that many would have previously thought were sufficient to avoid falling into shell company status.

Interestingly, the SEC has been raising the issue not during the review of the Form S-4 or

proxy review process prior to closing, but instead when the post-closing issuer files a Form S-3 after the reverse merger has closed.

This approach raises several concerns, including potential issues relating to the ability of the parties to the transaction to give or rely on representations in merger agreements relating to shell company status — an underpinning to many of the transactions as to the value of the public company engaging in the reverse merger.

Consistent with the SEC's new direction on shell companies, on Jan. 24, the SEC also adopted new Rule 145a under the Securities Act, which imposes increased disclosure and liability burdens on the private company in a reverse merger when the public company in the transaction is a shell company.

Rule 145a deems mergers and acquisitions transactions between a reporting shell company and an entity that is not a shell company to involve a sale of securities under the Securities Act to the reporting shell company's shareholders. Under the recently adopted rule, these deemed sales will need to be registered under the Securities Act unless there is an applicable exemption.

To avoid the pitfalls of shell company status, public companies should consider the impact of quickly winding down legacy programs in advance of a potential reverse merger transaction. Issuers considering a reverse merger should make sure to evaluate the potential of falling into shell company status and how such a status could affect negotiations and outcomes.

There may be opportunities to structure a transaction to include an asset purchase within the transaction, for example, to ensure that the public company has more than nominal assets and operations during the time between signing and closing of the transaction.

Fiduciary obligations must also be taken into account, and some public companies facing a failed drug development program may want to give greater consideration to a liquidation of assets and distribution to stockholders, instead of a reverse merger, particularly in situations where keeping programs and employees may lead to a depleted cash position that would reduce stockholder returns and make the company a less attractive target for private companies in a reverse merger.

Regardless, potential parties to either side of a potential reverse merger transaction should consider engagement early in the transaction with the SEC to avoid an unexpected outcome as to shell company status.

Ultimately, the SEC's evolving position on shell companies could limit the availability of reverse mergers for private companies looking to go public and will require additional creativity and analysis for companies looking to go down this path.

It is clear that the SEC continues to focus on reducing non-IPO paths to the public markets, even in non-SPAC segments that have otherwise not raised the same concerns relating to investor protection.

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