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Report from the Transactions Affinity Group

Business Law Update

Reverse Mergers and Small, Privately Held Healthcare Companies: The Perfect Match or a Case of Fatal Attraction

By Michel Marcoux*

In the healthcare arena, many lawyers, executives, private equity firms, and venture capitalists view reverse merger transactions as an attractive way to make a small, privately held company into a public one. The acquirer in a typical reverse merger in the healthcare context is a small, growing, privately held company that purchases a publicly traded company, commonly referred to as a "shell company," "special purpose acquisition company," or a "SPAC," which are companies with little or no assets or operations, but that have value to the acquirer because of its publicly traded status.¹

The mechanics of a reverse merger are relatively straight forward--an acquirer merges with and into a target company, with the shareholders of the target receiving cash or securities of the acquirer or a combination of both.² The documents required to effect a reverse merger include an agreement and plan of merger between the parties as well as, in most cases, the affirmative votes of the parties' respective boards of directors (or managers) and equity holders. Following a reverse merger, the newly merged company usually takes the name of the private company, installs a new board of directors and corporate officers, and files any necessary forms (typically a Form S-4 registration statement) with securities regulators that are required as a result of the transaction.³

The benefits to a company of going public through a reverse merger are numerous and can include: (1) garnering the company easier access to capital from a wider range of investors; (2) providing investors with a simple exit strategy of selling stock on the open market; (3) resulting in a higher valuation for the company due to the ability to trade its securities on a public market; (4) avoiding some of the expenses associated with an initial

public offering, which can entail paying large fees to investment bankers to act as underwriters and provide other services; and (5) achieving public status in a faster time frame than might be accomplished through an initial public offering (IPO).⁴

However, several disadvantages exist for a company that chooses to go public through a reverse merger instead of an IPO. For example, a reverse merger does not raise additional capital in conjunction with the company going public and typically results in more limited sponsorship of the equity securities being offered due to the lack of involvement of investment bankers.⁵ Further, the equity securities offered in a reverse merger generally trade on a lower exposure exchange, such as the Pink Sheets or the OTC Bulletin Board, instead of a more prominent exchange like the New York Stock Exchange or the NASDAQ.⁶

The first of these disadvantages--not raising additional capital in conjunction with going public--may be avoided if a company couples its reverse merger with a private investment in public equity (PIPE) offering in which certain accredited investors are given an opportunity to purchase unregistered stock in the newly formed company, combined with registration rights, immediately upon closing of the merger.⁷

Additionally, reverse mergers involve the same risks that a company faces in buying any business, such as pending litigation, hidden debts, and inaccurate reporting by the shell company. Due diligence by the acquirer is vital prior to consummation of a reverse merger. This risk can also be mitigated through post-closing indemnities paid in the form of cash or stock.

One notable example of a reverse merger/PIPE transaction took place with Los Angeles, CA-based pharmaceutical company Cougar Biotechnology Inc., which closed a \$47.5 million (27.5 million unit) private placement to institutional and other investors in conjunction with its reverse merger into public shell company SRKP 4 Inc. in 2006.⁸ Prior to the merger, SRKP 4 was a non-operating shell created primarily to merge with a private company. Post-merger, the combined company, in which Cougar stockholders held 100% of the equity, operated under Cougar's name and business plan. On July 10, 2009, Cougar was acquired by Johnson & Johnson for approximately \$1 billion in a cash-tender offer.⁹ Cougar now operates as a wholly owned subsidiary of Johnson & Johnson and works with Ortho Biotech Oncology Research & Development, a unit of Centocor Research & Development, a Johnson & Johnson company.

Separately, in 2008, Cardiovascular Systems Inc., a St. Paul, MN-based medical device company that manufactures and sells the Diamondback 360 minimally invasive catheter system for the treatment of peripheral arterial disease, creatively used a reverse merger to go public and simultaneously raise working capital by merging into Replidyne, a biotechnology company that had \$40 million in cash.¹⁰ At the time, Replidyne and its investors had just had their hopes dashed due to the Phase III clinical failure of its primary pharmaceutical compound. Rather than push forward with earlier-stage development projects or liquidating and giving the \$40 million back to its shareholders, Replidyne decided to look for a merger partner and found Cardiovascular Systems. In that case, Cardiovascular Systems investors controlled 83% of the combined company post-merger, while Replidyne investors received the other 17%.

While many highly successful companies have gone public through reverse mergers, some data suggests that there is a higher failure rate among public companies that achieved their public status through a reverse merger versus ones that did so through a

traditional IPO.¹¹ Further, in the past, the term "reverse merger" has had an unsavory air associated with it due to crooked promoters employing various types of "pump and dump" strategies where they: (1) used shell companies to bring public companies with no real business or prospects; (2) touted (or pumped up) those companies' potential to investors; and then (3) sold (or dumped) their equity interests in those companies for a tidy profit once the deal was complete.¹² Investors were left with worthless stock in such situations.

Still, with the IPO market experiencing difficulty over the past couple years, the reverse merger deserves consideration as a potentially viable and prudent alternative path for a small, privately held healthcare company to use in going public.

**We would like to thank Michel Marcoux, Esquire (Balch & Bingham LLP, Birmingham, AL), for writing this alert and sharing his expertise with other colleagues.*

¹ [The Smallcap Digest, Stocks--Reverse Mergers, The Investment FAQ](#) (last visited Mar. 29, 2010).

² Peter V. Letsou, *Corporate Mergers and Acquisitions*, 9-12 (2006).

³ [Going Public Through a Reverse Merger](#), Gaebler.com Resources for Entrepreneurs.

⁴ [The Smallcap Digest, Stocks--Reverse Mergers, The Investment FAQ](#) (last visited Mar. 29, 2010).

⁵ *Id.* See also Serena Ng, *Small Companies Gobble Up Already-Public Concerns As Cheap Way to Get Listed*, WALL ST. J., June 29, 2005, at C3.

⁶ *Id.*

⁷ *Id.*

⁸ Staff Writer, *Cougar Goes Public Through Reverse Merger, Raises \$47M*, Bioworld Today, Nov. 3, 2009.

⁹ Johnson & Johnson Investor Relations Website, [Johnson & Johnson Announces Definitive Agreement to Acquire Cougar Biotechnology, Inc.](#)

¹⁰ Chris Morrison, [CSI-Replidyne: A Reverse Merger Mystery Maybe Grissom Can Solve](#), The In Vivo Blog, Nov. 7, 2008.

¹¹ [The Smallcap Digest, Stocks--Reverse Mergers, The Investment FAQ](#) (last visited Mar. 29, 2010).

¹² Serena Ng, *Small Companies Gobble Up Already-Public Concerns As Cheap Way to Get Listed*, WALL ST. J., June 29, 2005, at C3.

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