REVERSE MERGERS BETWEEN GERMAN AND US BIOTECH COMPANIES

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Introduction

Many private German biotech companies are facing difficulties in raising capital. In Germany, venture capital is increasingly only available to a small number of companies which receive relatively large funding. An IPO is an option to very few German late-stage companies; however, many difficulties and uncertainties are associated with such IPOs in Germany where low valuations and lack of oversubscription have been common problems. Follow-on financings also prove more difficult in Germany than in countries with more developed capital markets like the United States or the United Kingdom. As a result, German biotechs are finding public listings in more established markets increasingly attractive. GPC Biotech AG, for instance, is not only listed in Germany, but also on NASDAQ. Other German biotech companies have explored creative transaction structures like the ‘reverse merger’ into a publicly held US company as a way of accessing US capital markets. Over the past year, this transaction model commonly found in the US biotech sector has presented itself as an attractive model for German biotechs seeking to go public in the United States.

The Model: The Reverse Merger between Micromet and CancerVax

On 9 January 2006, the private German biotech company Micromet AG and the publicly held US biotech company CancerVax Corporation announced the signing of a merger agreement. Micromet will be formally taken over by CancerVax by way of a reverse merger to create a new transatlantic, NASDAQ-listed biotech company with a drug development pipeline focusing on oncology, auto-immune and inflammatory diseases. Based on a valuation of both companies, stockholders of the legal target Micromet (primarily venture capital firms) will own approximately 67.5 per cent of the combined company, while CancerVax stockholders will own the remaining 32.5 per cent. The combined company will be renamed Micromet, Inc. and be led by Micromet’s CEO. While the new company’s formal headquarters will be in Carlsbad, California, research and development activities will be consolidated at the German headquarters in Munich, where most of the company’s employees will work. Although Micromet will legally be taken over by CancerVax, its shareholders and management will actually control the new combined company. This opportunity presented itself to Micromet because the shares of CancerVax had dramatically lost value over the last year, and the company had to reduce the number of employees significantly after phase III trials had to be discontinued following unfavourable results.

The Advantages of Reverse Mergers for German Biotech Companies

There are several potential advantages of a reverse merger for a German biotech company.

Access to US Capital Markets Facilitates Raising Capital

As a US-listed company, the German biotech will gain access to the US public capital markets for follow-on financings. In the current climate, large market capitalisation companies in Europe typically have sufficient liquidity on their home-country stock exchanges (such as the Deutsche Börse) to satisfy their needs. In contrast, growth companies (such as in the biotech sector) rely more heavily on (1) liquid markets (that is, stocks with high average daily trading volumes), (2) a strong technology-focused investor base, and (3) a well-established legal and regulatory framework to support their growth and permit smooth exits for their investors. Unfortunately, the German stock market currently lacks the critical mass to meet these needs of a growing biotech company.

Reduced Time and Costs to Secure Public Listing in the United States

A reverse merger can achieve a US listing with time and costs substantially reduced compared with a straight listing of shares or American Depositary Receipts by a German biotech company. A first-time direct listing in an underwritten US public share offering may require several months, perhaps a year, to achieve at costs of up to $5.0 million or more (not even including the substantial underwriting fees payable to brokers to the transaction). In contrast, a reverse merger may be concluded within a shorter period and with significantly reduced costs. Accordingly, a reverse merger can be a very efficient way of accessing the US market.
Enhanced Share Liquidity and Potentially Higher Valuation

Although a German biotech company may list its shares as a foreign private issuer in the United States, many financial advisors believe the public flotation of a US entity, as opposed to a straight flotation of shares (or ADRs) of the non-US entity, will enhance valuation and US investor acceptance. Furthermore, some large US institutional investors are prohibited by their organisational documents or regulatory restrictions from investing in non-US companies. Allowing access to these investors may result in greatly improved demand for the company's shares and potentially enhanced valuation.

Cash Balance May Add Fresh Capital to the Company

A reverse merger is particularly attractive for a German biotech company interested in a US public listing if the US partner brings a considerable amount of fresh capital to the combined company. In the Micromet/CancerVax case, for instance, CancerVax had a cash balance of approximately $40 to $50 million, which the company can now use to accelerate the development of its drug candidates and to expand its drug pipeline.

Additional Product Candidates May Expand the Existing Portfolio

Similarly, the attractiveness of reverse mergers for German biotechs may further be increased if the US partner brings in additional product candidates which broaden the product portfolio. In the case of the Micromet/CancerVax merger, CancerVax provided the combined company with an additional pre-clinical antibody program which strengthened Micromet’s existing pipeline of drug candidates.

An Exit Opportunity for Old Investors

For shareholders in German biotech companies, particularly venture capital houses, the reverse merger is a new way to reach an exit. This point should not be underestimated, as other exit routes like IPOs and trade sales have become increasingly difficult in the German market. It is not surprising that discussions about a possible reverse merger are often initiated by venture capital firms with shareholdings in German biotech companies. They are particularly attracted by the prospect of getting the valuation of their portfolio companies to a level which rewards them for their investments and opens the way to a profitable exit.

US corporate law, and the State of Delaware in particular (for historical reasons, many of the largest companies in the United States have been incorporated under the laws of the State of Delaware), has developed a comprehensive and highly regarded body of statutory and case law that provides guidance and predictability for a company and its directors in considering a trade sale exit. Assuming investment documentation is properly structured, Delaware law allows for the approval of trade sales and mergers by a simple majority vote of stockholders, rather than super-majority provisions often found in many European jurisdictions (such as the German law requirement of a 75 per cent majority of the votes cast to approve the sale of an entire business and mergers). The ability to easily 'squeeze out' minority investors not desiring to sell is a significant selling point to any potential acquirer. Furthermore, the buyer's familiarity with the legal issues, documentation and due diligence of a US target company will certainly enhance the likelihood of concluding a successful exit with a would-be US purchaser.

Legal Structure

The following is an outline of the legal structure and steps to achieve a reverse merger of a German biotech with a US NASDAQ-listed company.

(a) German Biotech reorganisation
(b) Establishment of new US company (‘Acquiror Parent’).
(c) Share exchange: Acquiror Parent issues new shares in exchange for all shares of German Biotech.
(d) As a result of the reorganisation, German Biotech becomes a wholly owned subsidiary of Acquiror Parent and shareholders of German Biotech become shareholders of Acquiror Parent.
(e) Merger with US target
(f) Newco Subsidiary merges with and into Acquiror Parent in a statutory merger under US (Delaware) law.
(g) As a result of the merger, Acquiror Parent is the surviving corporation, becoming a subsidiary of US target.
(h) US target issues new shares as merger consideration to shareholders of Acquiror Parent receiving a majority of US target's then outstanding shares.
Merger and issuance of new shares by US target requires approval of both shareholders of US target and of German Biotech.

Shareholders

U.S. Target

Acquiror Parent

Newco Subsidiary (U.S.)

German Biotech

Result of the reverse merger

(a) Shareholders of German Biotech become majority shareholders in combined group.

(b) US target renames itself, either taking the name of German Biotech or a new name to reflect combined companies.

(c) US target (renamed) maintains NASDAQ listing.

(d) New shareholders in US target (former shareholders of German Biotech) receive freely tradeable shares in the US market (except for affiliates, who are subject to certain trading restrictions).

Follow-on Financings

A US listing can offer several attractive options for obtaining follow-on financings, which can be critically important to fund product development and clinical trials. These options, some of which are briefly outlined below, would in most cases not be as readily available on the German market.

Avoidance of Pre-emption Rights and Shareholder Approvals

The board of directors of a US company generally can issue new shares, either in a follow-on public offering or in a private placement, without having to first obtain shareholder approval or accommodate or seek waivers of shareholder pre-emption rights. As a result, a US company can complete a follow-on equity fundraising quickly to take advantage of favourable market opportunities.

PIPEs (private investments in public equity)

In a US PIPE offering, investors commit to purchase from a company a certain number of its shares at a specified price, which is often below the market price. The company agrees, in turn, to file a resale registration statement so that the investors can resell the shares in the public market. PIPEs can often be executed quickly and privately (without advance publicity). German law, in contrast, does not provide comparable special rules on the issuance of shares to institutional investors and a share issuance significantly below the market price would be particularly problematic.

Convertible Bonds

Although convertible bonds are available under both US and German law, the United States has a well developed market for them, with US investors having a deep understanding of these instruments. In contrast, complicated German legal procedures (such as creating contingent share capital) have restricted the market, and therefore the attractiveness of convertible bonds, in Germany.