Paul|Weiss

Private Equity Digest

April 2016, Issue 16

Key Considerations for Private Equity Investors in the Growing PIPEs Market

Overview

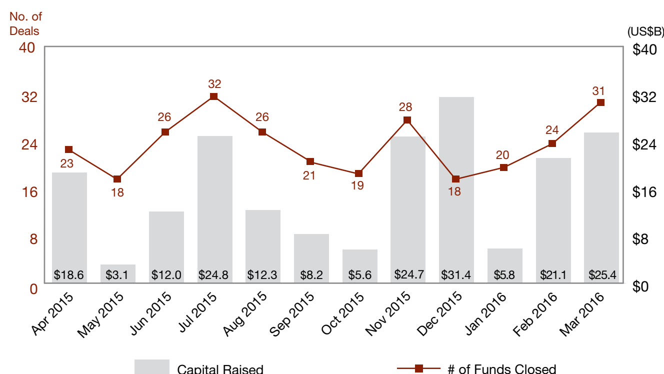
As access to capital through the credit markets continues to tighten, public company issuers have begun to seek alternative methods of financing, and private equity investors have begun to seek alternatives to the typical M&A investment. One option that has seen a recent, and possibly continued, revival is private investments in public equity, commonly referred to as PIPEs. In a typical PIPE transaction, one or more investors purchase securities directly from a public company in a private transaction, rather than through the public markets or in a registered transaction. The type of securities issued and purchased varies, but could include anything from common or preferred stock to convertible debt or warrants. We discuss below some key considerations for private equity investors looking to enter the PIPE market in 2016.

Discussion

Historically, private equity investors were not active participants in the PIPE market – PIPEs were viewed as instruments of short-term trade, and cut against the traditional leveraged buyout model. However, when certain market conditions are present, such as a lack of available acquisition financing (*see* our February 2016 issue here) and increased pricing competition from strategic buyers, PIPEs can provide private equity investors an alternative avenue to put their fund capital to work while simultaneously offering issuers an opportunity for unlevered capital and to add savvy investors to their executive teams.

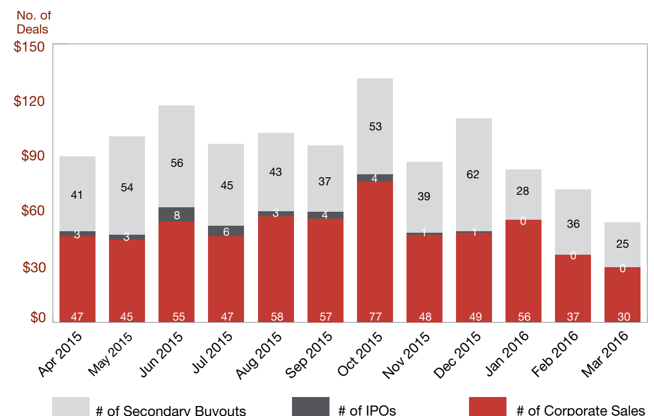
2015 was a particularly active year for the PIPE market, especially in comparison to PIPE activity in the prior three years. Based on statistics from PrivateRaise, a data service of *The Deal*, in 2015, private equity and venture capital investors either closed (or signed definitive agreements to close), 79 unregistered PIPE transactions valued at $10 million or greater. This represented a 36% increase in these transactions from 2014 (58 transactions) and similar, though smaller, increases in these transactions from 2013 (67 transactions) and 2012 (62 transactions). More importantly, and perhaps more illustrative of the underlying trends currently present in the marketplace, the issuance amount of PIPE transactions in 2015 was $10.7 billion, over a 100% increase when compared to 2014's $5.3 billion, and an amount that was greater than the aggregate issuance amounts of 2012 and 2013 ($4.5 billion and $2.8 billion, respectively).

U.S. Private Equity Fundraising



Source: Pitchbook

U.S. Sponsor Backed Exits by Number

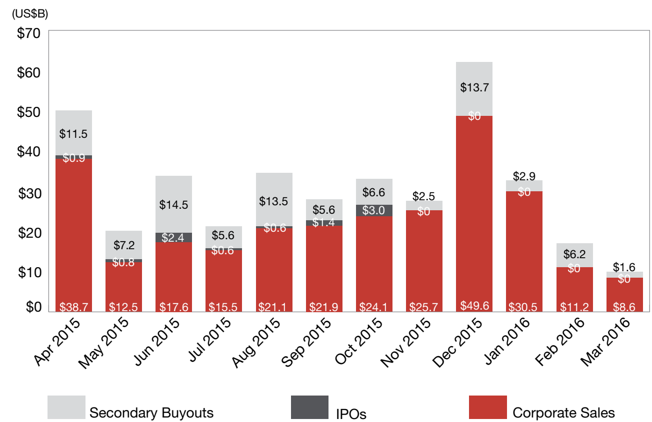


Source: Pitchbook

Key considerations for private equity investors investigating PIPEs transactions include the following:

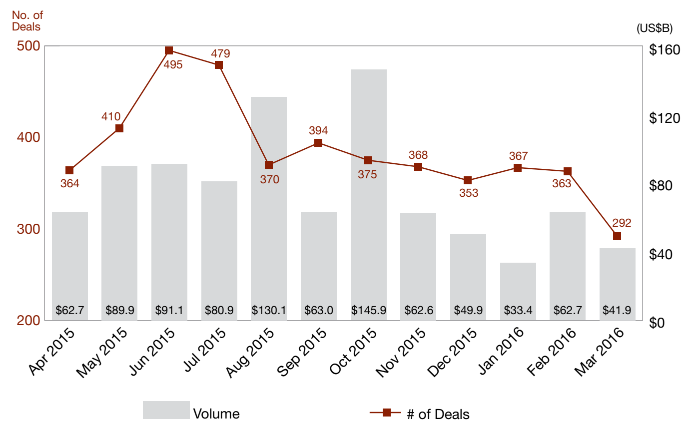
- *Pricing and Other Terms*. The terms of PIPE deals vary widely and can involve a number of different types of securities, including common stock, preferred stock, convertible debt, warrants or any combination thereof. Also, with respect to pricing itself, typically PIPE securities are sold at a discount to the trailing average market price for some period prior to closing. However, sometimes PIPE securities, particularly where the security sold is convertible or includes warrant coverage, are actually sold at a premium to market to account for certain rights that attach to such securities. Finally, because PIPE deals are highly negotiated, private equity investors can expect deal terms to include provisions for dividend options (such as PIK vs. cash dividends), conversion rights, voting rights, board or observer rights, liquidation preferences or "waterfalls", change-of-control premiums, puts, calls, redemption rights and pre-emptive rights. If, future, longer term growth in the subject company is of more interest to the private equity investor, some rights, such as dividend payments, should take a back seat to governance rights, such as board appointments and voting control. However, if a private equity investor is looking to make a return on capital in the short term, dividends and change-of-control or other premiums (and favorable liquidation preference rights to manage downside risk) should drive negotiations with issuers.
- *Authority to Issue Securities*. If an investor and an issuer strike a PIPE deal in which the underlying security issued is common or preferred stock, shareholder approval can become a roadblock, either because there is not enough authorized capital stock or because the board is not authorized to issue preferred stock without shareholder approval. Investors must diligence the issuer to ensure that the issuer's charter has sufficient authorized capital and permits the issuance of blank check preferred stock as appropriate. Blank check preferred stock authorizes the board of directors to provide for one or more series of preferred stock and fix the price, control rights and other rights applicable to such designated stock. Assuming the issuer is already authorized to issue the number of shares contemplated by the PIPE, blank-check preferred will allow the board (subject to its fiduciary duties) to negotiate and execute a preferred stock PIPE without shareholder approval (unless otherwise subject to the applicable stock exchange requirements discussed below).

U.S. Sponsor Backed Exits by Dollar Volume



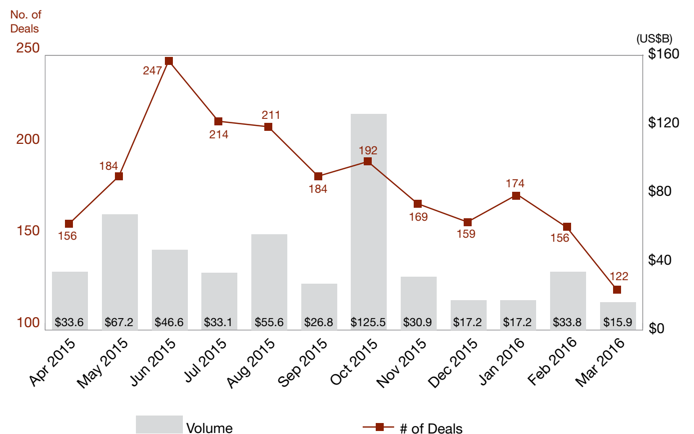
Source: Pitchbook

Global Sponsor-Related M&A Activity



Source: Dealogic

U.S. Sponsor-Related M&A Activity



Source: Dealogic

- *Exchange Requirements*. Exchange listing requirements may restrict the ability of issuers to issue voting securities in a PIPE without shareholder approval.
  - *Stockholder Approval Requirements*.
    - *Exchange Rules*. The NYSE and NASDAQ impose stockholder approval requirements on certain significant issuances of voting securities. For issuers whose common stock is traded on the NYSE, shareholder approval is required prior to the issuance of common stock or convertible securities (i) to any related party, subsidiary or affiliate of a related party, or any entity in which a related party has a substantial interest if the number of shares of common stock to be issued exceeds 1% of outstanding or voting power prior to the issuance or (ii) if the common stock to be sold has or will have voting power equal to or greater than 20% of the voting power outstanding prior to the issuance or the number of shares of common stock to be issued is or will upon issuance be equal to or in excess of 20% of the number of outstanding shares prior to issuance (NYSE Rule 312.03). Under NASDAQ's rules, shareholder approval is required in connection with the issuance or potential issuance by the issuer of common stock (or securities convertible into or exercisable for common stock) at a price less than the greater of book or market value, which together with sales by officers, directors and substantial security holders equals 20% or more of the common stock or voting power outstanding prior to issuance (NASDAQ Rule 5635). These primarily exist to protect stockholders from significant dilution and disenfranchisement.
    - *Share Caps and Alternative Outcomes*. Typically, in contemplation of the exchanges' shareholder approval requirements, issuers and investors strike deals where the number of voting securities issued remains a hair under 20%, known as a "share cap". The remainder of the contemplated investment, to the extent it exceeds the share cap, is issued in another non-voting, but convertible security. The exchanges generally permit issuers to issue securities in an amount greater than the share cap so long as those securities are not entitled to vote prior to obtaining shareholder approval. Often such securities are in the form of convertible preferred stock that, upon shareholder approval, converts into voting common stock or some other voting security. Additionally, issuers and investors often consider what will happen if shareholder approval is not obtained. For example, under NASDAQ's "alternative outcome" interpretative material regarding the use of share caps, "penalties" or "sweeteners" such as a coupon or conversion ratio increases or a specific monetary penalties imposed on the issuer, are not permitted. In fact, if the alternative outcome rules are triggered, NASDAQ may determine that the cap is defective and, moreover, that no common shares may be issued prior to the approval of the shareholders, including those common shares issued below the 20% threshold. The NYSE does permit some alternative outcomes, such as changes to a coupon rate, but will reject any measures that are determined coercive to the shareholders' vote.
    - *Recent NASDAQ Solicitation of Comments*. Though these shareholder approval listing rules remain in place, there has been some indication by NASDAQ that these requirements are burdensome for issuers and overprotective for shareholders. In a recently distributed Solicitation of Comments (found here), NASDAQ is considering whether there is room to amend its voting requirements in favor of issuers and investors. For example, NASDAQ is seeking comment on (i) whether the 20% threshold is too burdensome, especially for smaller companies; (ii) whether to require shareholder approval at all on an issuance below book value; (iii) whether to adopt a "sliding scale" approach that adjusts the 20% threshold based on the size of the discount to market price (i.e., a greater number of shares can be issued when the discount is nominal and vice versa); and (iv) whether an issuer should be allowed to obtain pre-approval to issue shares on a periodic basis and what terms should be included in the pre-approval.
  - *Voting Rights Rules*. Both the NYSE and NASDAQ prohibit issuers from taking actions that adversely alter the relative economic rights of its stockholders. Under NYSE Rule 313 and NASDAQ Rule 5640, voting rights of existing shareholders of publicly traded common stock cannot be disparately reduced or restricted through any corporation action or issuance. If the securities issued are a type of convertible securities that permit its holders to vote on an "as-converted" basis, investors must pay close attention to the applicable exchange's voting rights rules. Convertible securities that convert at a discount to market can run afoul of the exchanges' voting rights rules because the economic interest and voting power of the stockholders on a fully diluted basis before the issuance will differ from the same after the issuance.
- *Third Party Consents*. As part of the diligence process, investors should pay close attention to the issuer's debt financing documents, such as credit agreements or indentures. For example, a change-of-control of the issuer is a standard circumstance that may trigger a default under an issuer's debt documents, and it is not uncommon that the ownership percentage required to trigger a change-of-control provision in indentures is as low as 30%. Additionally, debt documents typically contain restrictive

covenants on the use of proceeds from an equity raise, limiting how an issuer can use such proceeds after the closing of the PIPE. Investors and issuers need to develop a strategy to strike a delicate balance between staying within the limits of an issuer's debt documents and staying on course with regards to the intended purposes of the PIPE deal, and consider the effects of seeking and obtaining third-party consents from lenders or debtholders.

- *Hart-Scott-Rodino Filings*. PIPEs could trigger an HSR filing if the deal and the parties thereto meet both the respective "size-of-transaction" and "size-of-person" tests. The size-of-transaction test is met if the buyer will acquire voting securities of the seller valued in excess of $78.2 million. The size-of-person test is met if one party to the transaction has $156.3 million or more in annual sales or total assets and the other has $15.6 million or more in annual sales or total assets.
  - *Filing Upon Conversion*. Generally, acquisitions of nonvoting securities, such as convertible notes or nonvoting convertible preferred are exempt from filing under the HSR Act. However, in a PIPE transaction where the securities sold are nonvoting securities that are convertible into voting securities, although no HSR filing may be required at the time of sale, the parties may be obligated to make an HSR filing at the time of conversion (assuming the conversion exceeds the thresholds noted above). Penalties for failure to file are not uncommon.
  - *HSR Waiting Period*. If a notification is required, the transaction cannot close during the statutory waiting period (30 days from filing). The 30-day waiting period can cause some uneasiness in private equity buyers looking to invest in an issuer in a volatile marketplace. Investors wishing to close the PIPE transaction in a shorter time frame can reduce the waiting period (assuming HSR is the gating item to closing) in or up to half if they request "early termination" and the FTC approves. To avoid notification altogether, a private equity investor could rely on the investment-only exception and acquire up to 10% of the voting shares in a company. However, federal regulations require that the investment be made "solely for investment purposes", i.e., the purchaser "has no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer." If the private equity investor negotiates for any of the above-mentioned control rights, it is unlikely they will be able to rely on this exemption.
- *Other Transaction Documents*. In the transaction documents of a PIPE deal – primarily a securities purchase agreement or subscription agreement (and, in the case of preferred stock or convertible debt, documents setting forth the terms of the security) and a stockholders' agreement – investors and issuers often discuss whether to enter into any provisions to govern matters such as standstills, lock-ups and registration rights.
  - *Standstills*. Issuers seeking to preserve pre-PIPE control of the company should think about whether standstills are an appropriate measure. Standstill agreements would typically restrict the ability of the stock purchaser to purchase additional securities of the issuer and take control (whether through a proxy contest, tender offer or otherwise) of the issuer without prior board approval. Issuers and investors should consider the substance and duration of the standstill restrictions placed on the investor (typically ranging from 1 to 4 years).
  - *Lock-ups*. Lock-up agreements are another protective measure for issuers, ensuring that the PIPE investor cannot exert downward pressure on the company's stock in a block sale of the PIPE securities. Durational limits on such restrictions, holding percentages and caps under these agreements can become significant areas of discussion for deal teams.
  - *Registration Rights*. In PIPE transactions where an investor purchases unregistered restricted securities, assuming no exemptions apply, the securities cannot be resold to the public market. Therefore, registration rights become an essential tool for investors to obtain liquidity. Registration rights generally come in one of two types: demand or piggyback. Demand registration rights give investors the ability to force the issuer to register the investor's securities under the Securities Act. Piggyback registration rights allow investors to include their securities in any other registration of securities being effected by the issuer. If an investor negotiates for piggyback rights only, the investor will be unable to trigger the registration process, severely limiting the investor's ability to access liquidity. Investors and issuers will also have to reach agreement on matters such as the durational period and number of times in which an investor can demand registration or exercise its piggyback rights as well as notice requirements and underwriter feasibility restraints.

This publication is not intended to provide legal advice, and no legal or business decisions should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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