Raising Equity Capital in Uncertain Times, PIPEs: A Primer for Public Companies

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In the midst of what we have come to know as the “global economic crisis,” credit markets continue to be frozen and, in understatement, equity markets continue to be volatile. Failing a substantial near-term recovery, any meaningful window for underwritten public offerings will remain closed. The question that many public companies are asking is what, if any, alternatives are there to raise cash?

Private investments in public equity, commonly referred to as PIPEs, are one option. Once used almost exclusively by small cap issuers or issuers who historically had not been able to sell securities to the public, today large, well-seasoned issuers are turning to the PIPEs market. Indeed, both General Electric Company and the Goldman Sachs Group issued a combined total of $8.0 billion to Berkshire Hathaway Inc. in the fourth quarter of 2008 in PIPEs transactions.¹ Mainstream hedge funds and private equity funds are now opportunistically looking at PIPE investments in distressed companies. Competition in these markets is increasing. Depressed valuations are offering investors attractive opportunities to invest in companies with the potential for future growth.

PIPEs, Deconstructed

What is a PIPE? A typical PIPE is a transaction where one or more investors purchase securities directly from a public company in a private placement rather than in a transaction registered with the Securities and Exchange Commission (SEC). Often, these transactions are conducted through an investment bank or other placement agent, but more recently a greater volume of PIPEs are being sold without an intermediary to one or few large investors. Since PIPE securities are purchased in a private transaction, they are considered “restricted securities” and cannot be immediately resold into the public market. In the transaction, the issuer agrees to file a resale registration statement with the SEC promptly after the closing of the financing. In this way, illiquidity is mitigated—once the resale registration statement becomes effective, the investor may immediately sell the securities purchased in the transaction (or issuable upon conversion in the case of convertible preferred stock or debt) in the public markets. This structure allows for speedy access to capital, a key attraction of a PIPEs transaction to issuers. PIPEs also provide issuers with lower transaction costs as compared to a traditional public offering.

Specifically, in a PIPE transaction, an issuer is contractually required to prepare and file a resale registration statement with the SEC promptly following the completion of the private placement. Typically, a registration rights agreement requires that the issuer use its best efforts to have the registration statement filed with the SEC within 30 to 45 days of closing and declared effective within 90 to 120 days of filing. Registration rights agreements typically contain penalty payments of 1% to 2% of the principal amount of proceeds per month if the issuer fails to meet the filing deadlines. Once the SEC declares the resale registration statement effective, investors may sell the PIPE securities in the public market. The registration statement must remain effective, and the issuer is required to update the registration statement for any material changes, during the period in which the investors are reselling the securities.
Registered Direct PIPEs

Issuers with existing effective shelf registration statements may find PIPEs transactions even more attractive. In a “registered direct” PIPE, an issuer sells securities directly from its shelf registration statement to one or more private investors in a transaction not involving a public offering. As in typical PIPEs, the time to closing may be quick. However, in a registered direct PIPE, investors do not receive “restricted securities” as they are purchasing the PIPE securities in a registered transaction. Unless the investor would be deemed an affiliate of the issuer, there is no need to file a resale registration statement with the SEC following the closing of the transaction. Indeed, this is an attractive option for issuers as not only are transaction costs even lower, the elimination of liquidity risk allows for more attractive pricing. Note, however, that the existing shelf registration statement must already cover the PIPE securities being offered (including any warrants) and the plan of distribution in the base prospectus must contemplate such private sales. In addition, as in all PIPE transactions that utilize the resources of an investment bank to place the securities, the investment bank does not act as an underwriter in an offering. Even though the PIPE securities are offered and sold from an issuer’s existing shelf registration statement, the investment bank acts merely as a placement agent and the transaction is not a firm underwriting.

PIPE Terms

The terms of PIPEs deals vary widely from deal to deal and can involve the offering of a number of different types of securities such as common stock, preferred stock, convertible preferred stock, convertible debt and warrants or any combination of these securities. Typically, PIPE securities are sold at a discount to the trailing average market price for some period prior to closing. However, this is highly negotiated and convertible PIPEs have been priced higher than current market value, especially if there is a conversion premium attached to a convertible security or the security includes warrant coverage.

In the early 2000s, PIPE transactions were structured to provide price protection for investors. The key feature in these transactions was a security with a variable conversion price which automatically adjusted the conversion price downward if the market price of the reference common stock fell below the then conversion or reset price. There was no floor or limit on the downward adjustment of the conversion price, resulting in a so-called “death spiral” of unlimited dilution to existing stockholders. Investors often shorted the issuer’s stock, creating downward pressure on the stock price and, correspondingly, more dilution. After a series of enforcement actions brought by the SEC, these “toxic” PIPEs are no longer permitted without the use of a floor or a cap on the conversion feature. Today, the vast majority of convertible PIPEs are structured with a fixed conversion price. In addition, warrants are increasingly being used to sweeten the terms of PIPEs transactions. Warrant terms can also vary, but in general the warrant exercise price exceeds the issuer’s current stock price.

PIPE transactions also contain a variety of highly negotiated terms. For example, in many PIPEs transactions that contain a conversion premium, investors have successfully negotiated for a higher coupon. In addition, anti-dilution protection, veto rights on certain significant corporate actions (such as issuances of additional equity, incurrence of indebtedness in excess of a specified threshold and significant acquisitions or dispositions), and optional conversion features have become common terms. Many recent cases, notably those transactions with one or few investors, contain additional rights and protections for the investor that more closely mirror protections found in investments made in private companies by private equity investors. Here, a significant investor may successfully negotiate for board representation or observer rights, payment
priorities in liquidation, payments upon a change of control transaction (e.g., at the investor’s option, the greater of liquidation preference plus accumulated dividends or an amount that would have been received on an as converted basis), puts, calls, redemption features, and pre-emptive rights.

For their part, issuers are also negotiating for additional protections. For example, standstills that prohibit investors from taking actions to exert control over the issuer have become more common. In addition, investors are often subject to prohibitions on hedging activities for a specified time period, typically one year.

**Exchange Rules Applicable to PIPEs**

The size of PIPEs transactions is subject to the rules imposed by Nasdaq Stock Exchange or the exchange on which the issuer’s common stock is traded. As more specifically discussed below, issuers may be required to seek shareholder approval for PIPE transactions that involve an issuance of greater than 20% of common stock or voting power outstanding, a change of control or the sale of stock by officers, directors, related parties or substantial stockholders. When a vote is required, the issuer may need to file a proxy statement with the SEC and hold a meeting of its shareholders to receive approval of the PIPE transaction, which could significantly delay closing.

Subject to certain exceptions and qualifications, for issuers whose common stock is traded on the New York Stock Exchange (NYSE), shareholder approval is required prior to the issuance of common stock or convertible securities (i) to any related party; a 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 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 issuance or the number of shares of common stock to be issued is or will be upon issuance, equal to or in excess of 20% of the number of outstanding shares prior to issuance. Shareholder approval is not required, however, if the transaction qualifies as a “bona fide private financing” and the price of the common stock to be sold (or the conversion price in the case of convertible securities) is at least as great as each of the book and market value of the issuer’s common stock. A “bona fide private financing” is any transaction where (i) a registered broker-dealer purchases the securities from the issuer with a view to the private sale of such securities to one or more purchasers or (ii) the issuer sells directly to multiple purchasers and no one purchaser or group acquires or has the right to acquire upon exercise or conversion, more than 5% of the common stock or voting power prior to the consummation of the transaction. It should be noted that in order to qualify as a bona fide private financing under clause (i) above, the broker-dealer must take full economic ownership and risk with respect to the securities purchased from the issuer. It is not sufficient to have conditionality or privity between the ultimate purchasers directly with the issuer.

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. Under both NYSE and Nasdaq rules, true public offerings for cash are not subject to shareholder approval under this test. Neither the NYSE nor Nasdaq considers a “registered direct” PIPE a public offering and therefore such transactions are subject to these limitations. Both NYSE and Nasdaq also require shareholder approval prior to a change of control transaction. Both will scrutinize any transaction where an issuer is selling securities representing 20% or more of its common stock or voting power.
outstanding, irrespective of the price at which it is sold, to determine if the transaction in fact constitutes a change of control.

It is worth noting that both the NYSE and Nasdaq look to the “potential issuance” of securities in the future to determine whether shareholder approval is required prior to issuance of common stock or convertible securities. This becomes particularly important in the case of convertible PIPEs transactions where the securities issued may be convertible into greater than 20% of the issuer's current outstanding common stock at some point in the future. Features in PIPEs transactions that avoid triggering the shareholder approval requirement for Nasdaq purposes include the implementation of share caps and floors on the conversion price of the issued security. In the case of a share cap, the number of shares issuable upon conversion is capped at just under 20% so that no securities may be converted into common stock prior to the receipt of shareholder approval. In this way, an issuer may close the transaction subject to obtaining shareholder approval at a later date for the shares issuable in excess of the cap. Shares issuable under the cap in the first part of the transaction may not vote to approve the remainder of the transaction and the cap must apply for the entire life of the transaction until the vote is obtained (in other words, caps that no longer apply if the issuer is no longer listed on Nasdaq are not permissible). In addition, transactions utilizing a share cap for Nasdaq purposes may not include penalties or sweeteners (for example, changes in the coupon or defaults) that provide for an alternate outcome based on whether shareholder approval is obtained.

The NYSE allows issuers somewhat more flexibility in structuring PIPEs transactions for purposes of the 20% test, however, coercive measures, such as defaults if the shareholders do not approve the deal are not permitted. The NYSE has permitted issuers to issue securities in an amount greater than 20% so long as those shares are not entitled to vote prior to obtaining shareholder approval. In addition, the NYSE has also permitted changes in the coupon or springing covenants in the event of a failed vote.

Warrants have gained increased popularity in recent transactions as a way to sweeten transactions for investors. In calculating whether a transaction requires shareholder approval for purposes of the 20% test, one must consider both the primary security (common or convertible) as well as the warrants that are being issued. Nasdaq will look at the total “unit” issuance and attribute to each warrant $0.125 for each share that could be purchased. In cases where the warrant exercise price is less than the closing bid price at the time of the transaction, the amount that the warrant is in the money is added to the $0.125 to determine the attributed warrant value. In each case, the remainder of the consideration to be received by the issuer is then allocated for the common stock (or other security) and is compared to the book value and closing bid price at the time of the transaction. For example, let’s assume an issuer is selling 1,500,000 units which represent more than 20% of outstanding shares for $2.00 per unit. Let’s also assume that this price is equal to the closing bid price of the issuer’s common stock on the date of the transaction which is also higher than its book value. Each unit consists of one share of common stock and one warrant which an exercise price of $2.50 (so, out of the money). To avoid the need for shareholder approval, the units must be priced at $2.125 per unit or more, since $.125 is attributable to each warrant.

Conclusion

As credit markets remain frozen and equity markets continue to be volatile, PIPEs transactions may represent an attractive alternative to public offerings for issuers needing to raise equity capital. This may also prove to be an increasingly attractive market for opportunistic investors in an age of low valuations where they may be able to receive common stock at a discount to market with warrant coverage. However, as experience
has proven, PIPEs transactions are highly negotiated with widely differing terms. PIPEs may be a welcome source of bespoke financing to weather the perfect storm.

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1 Buffet Uses Credit Crunch to Take Cheap Stakes in GE, by Erik Holm, BLOOMBERG NEWS, (Oct. 2, 2008).