Client Alert

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PIPE Transactions: A Customized Financing Option in Challenging Markets

During uncertain economic times, registered securities offerings may not be a viable source of much-needed capital for public companies due to increased market volatility and uncertainty. Private Investment in Public Equity (PIPE) transactions can provide a quick, customizable financing source for issuers seeking to raise capital despite unfavorable public market conditions. PIPE transactions involve a variety of legal and practical issues that the parties to the transaction may not have encountered in registered offerings. We highlight several of the most prominent issues below.

The Basics

A PIPE transaction involves a public company's private sale of securities of the same class, or convertible into the same class, as the company's securities traded on a national securities exchange (typically common stock). The transaction is considered private because the securities are sold to a limited number of investors (often institutional investors) without registration under the Securities Act of 1933 in reliance on an exemption from such registration requirements. A company may sell common equity, notes, preferred equity, warrants or other equity-like securities through a PIPE. Securities sold in a PIPE often contain conversion, redemption and anti-dilution features to protect both the issuer and the investor.

Convertible preferred equity is commonly sold in PIPE transactions because the terms of preferred equity securities can be customized to satisfy the goals of both the issuer and investors. For example, in addition to dividend and voting rights, convertible preferred equity securities can include downside protection features such as a liquidation preference that is senior in priority to the liquidation rights of the issuer's common equity, while, depending on the terms, enabling the issuer to potentially treat the preferred security as equity rather than debt from a ratings or accounting perspective. Convertible notes and warrants exercisable for shares of common stock are also often sold in PIPE transactions as a mechanism to allow the investors to capture additional upside potential of the issuer's common stock.

Nasdaq and NYSE Rules

The desired size of a PIPE transaction can drive the characteristics of the offered securities in an effort to comply with stock exchange listing requirements. Both Nasdaq and the NYSE require a listed company to obtain shareholder approval when issuing 20% or more of its common stock or voting power except in limited circumstances. This requirement is often referred to as the "20% Rule." In response to the COVID-19 pandemic, both exchanges have issued orders allowing conditional exemptions to their respective 20% Rules through June 30, 2020 for companies that must raise capital due to conditions caused by COVID-19.

PIPEs are often structured to avoid violating the 20% Rule and, consequently, to avoid the lengthy and costly process of having to seek shareholder approval before the issuance of the common equity or other voting securities. Despite the inherent offering size restrictions imposed by the 20% Rule, the size of a PIPE transaction can be expanded by offering a convertible security that cannot convert into common stock until the requisite shareholder approval is obtained. Issuers can also offer warrants exercisable for common stock to entice investors. In light of the complexities and variation in the terms of PIPE transactions, issuers engaging in PIPE transactions should communicate with their stock exchange representatives regarding the application of the 20% Rule as far in advance of the transaction as feasible.

Nasdaq and the NYSE also require shareholder approval for any transaction constituting a change of control. Guidance indicates that the NYSE may presume a change of control has occurred upon an investor's or group of investors' acquisition of securities representing 20% or more of a company's voting interests or the right to acquire such interests, and Nasdaq may presume a change of control has occurred upon such an acquisition if the acquiring investor or investors will hold the largest ownership position in the company as a result of the acquisition. Additionally, the NYSE requires shareholder approval of certain issuances to directors, officers and 5% shareholders of the issuer, as well affiliates of and entities directly and indirectly owned by such insiders. Under certain circumstances, Nasdaq may also view issuances to insiders as equity compensation arrangements requiring shareholder approval.

Registration Rights

The securities sold in a PIPE transaction are restricted securities because the offer and sale of the securities are unregistered. Consequently, PIPE investors usually require the issuer to grant the investors registration rights requiring the issuer to register the resale of the securities under the Securities Act of 1933 in order to increase the liquidity of the investment. Investors may receive demand registration rights (i.e., the right of the investor to require the issuer to register a public offering of the securities) and/or piggyback rights (i.e., the right of the investor to have its securities included in a future registered offering by the issuer or other investors).

Registration rights negotiations typically focus on the type of registration rights being granted to the investor. Issuers should consider the details of any registration rights, such as the length of time the issuer has to comply with registration requirements, the number of registrations an investor is permitted to request, the rights of the issuer to defer a demand right and the agreed upon potential damages that result from any failure to meet a registration deadline. Carefully negotiating these features can mitigate the expenses and complexities of the issuer's registration process down the road. Issuers should also avoid granting registration rights that require the registration of a large number of securities immediately following the closing of the PIPE. In such a circumstance, the SEC may consider the PIPE transaction to be a scheme to evade the requirements of a public offering.

Board and Observation Rights

Many PIPE investors receive governance rights in the form of either representation on the issuer's board of directors or board observation rights. Governance rights are typically proportional to the investment being made and are often conditioned on the maintenance of a minimum level of investment. The terms of the security offered in the PIPE may also grant the investor voting or veto rights over certain types of transactions, which often include actions that affect the security's right of payment. Issuers must consider how any governance rights may affect their ability to conduct future capital markets offerings, among other things.

Investor Restrictions

PIPE investors are often subject to a lock-up period during which they cannot transfer the securities purchased through the PIPE. If the amount of voting securities purchased in a PIPE is sufficiently large, the transaction may include standstill provisions that prevent the investor from purchasing additional securities of the issuer, entering into voting arrangements or seeking to propose a change of control or join in a proxy solicitation. These restrictions prevent the investor from seeking increased control over the issuer and can be tailored to fit the size of the investment and the relationship between the issuer and the investor.

Other Considerations:

- **Charter and Third-Party Agreements –** Prior to undertaking a PIPE transaction, the issuer should confirm the contemplated issuance of securities is authorized under the issuer's charter and governance documents. The issuer should also analyze its debt instruments and other relevant third-party agreements to confirm whether the PIPE transaction is permitted under such agreements.

- **Timing –** PIPEs may require either shareholder approval (as discussed above) or regulatory approval, such as antitrust or CFIUS approval. Obtaining these approvals often takes time and can delay the closing of a PIPE.

- **Filing Requirements** – While a PIPE is not a registered offering, several of the agreements underlying the PIPE will be required to be filed with the SEC. Investors may also be required to make ownership filings, such as a Form 3 or Schedule 13D/G, if the investment increases an investor's ownership of the class of the issuer's securities above certain threshold levels. Generally speaking, for purposes of these ownership filings, the holder of a security convertible into common stock is deemed to beneficially own the underlying common stock at such time as the security becomes convertible into or exercisable for common stock within 60 days.

A PIPE transaction can provide an issuer with a creative source of financing in times when raising capital may be challenging. While the flexibility offered by a PIPE can be attractive to both issuers and investors, the parties must be aware of a multitude of legal issues that naturally may arise from a customized transaction. Our team is available to help issuers and investors navigate these issues and ensure their goals are met through a swift and successful execution.

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