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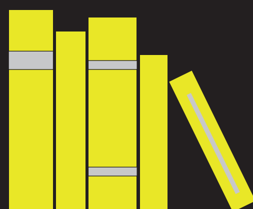

Raising Capital Through a PIPE Transaction

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In a difficult public market environment, many smallcap and microcap public companies engage in PIPE transactions (Private Investment/Public Equity) to raise capital. With more than 1,800 PIPE transactions raising over $30 billion closing in 2006 alone, PIPEs have become a common capital raising technique that public companies seeking immediate cash infusions should consider. While PIPEs represent an attractive means for a company to quickly raise new money, there are several issues for companies and placement agents to consider as they evaluate the utility of this increasingly popular financing technique.

The difficult public market environment of the past several years has left many smallcap and microcap public companies in an unenviable position: they need additional funding to weather tough times or otherwise execute on their business plans, but traditional financing alternatives may not be available to them. While banks maintain strict lending policies, the market for underwritten registered offerings has become less accessible for such companies. Even when a public offering is an option, the delay that may occur if a company's registration statement is reviewed by the Securities and Exchange Commission (SEC) makes that alternative considerably more risky for companies in immediate need of cash.

Accordingly, an increasing number of companies have turned to PIPEs as a means to raise much needed funds. The term PIPE is short for "Private Investment/Public Equity." In a PIPE transaction, a public company sells equity or equity-linked securities to a limited group of investors in a private transaction, and then immediately registers the shares for resale into the public markets by those investors. If a convertible security is sold, the underlying common stock is registered for resale.

In this issue of the Snell & Wilmer Corporate Handbook Series 2007, we provide an overview of the PIPE transaction process and its advantages and

disadvantages to companies seeking to raise capital. We also cover the impact that exchange rules on shareholder voting may have on a PIPE transaction. Finally, we discuss certain issues that placement agents face when handling PIPE transactions.

The Primary Advantage of a PIPE: No Pre-Closing SEC Review

Under the Securities Act of 1933 (the "Securities Act"), companies that qualify as "well known seasoned issuers," or WKSIs, are able to file shelf registration statements that become effective automatically without SEC review. However, to qualify as a WKSI, a company must, among other things, have a market cap (the float of shares held by non-affiliates) of $700 million or more, or have issued $1 billion or more in debt via public offerings.[1] The filing of a registration statement by all other companies will continue to be subject to SEC review, and the need for the SEC to affirmatively declare the registration statement to be effective.

In a PIPE transaction, the front end of the transaction is a private offering to a limited number of institutional investors that is not subject to SEC review and clearance. Because the capital raising segment of the transaction can be accomplished on a predetermined time frame, without the threat of an SEC review that could radically change that timetable, PIPEs can be an important financing option for many public companies.

A registration statement is typically filed promptly following the closing of a PIPE transaction, on behalf of the investors, to facilitate their resale of the stock acquired. In order to protect their expectation of relatively immediate liquidity, investors will generally insist on penalty provisions that require the company to make payments if the resale registration statement is not filed or does not become effective within prescribed time periods (typically 30 days for filing and 90-120 days for effectiveness) or if effectiveness of the registration statement is not maintained for a specified period (each of the foregoing are sometimes referred to as "registration defaults"). These penalty payments, which generally range from 1% to 2% of the aggregate proceeds received by the company (and are generally capped at between 10% and 25% of the aggregate proceeds received), typically are due upon the registration default and upon each 30 day anniversary thereafter (or pro rated portion thereof) until the registration default is cured.

Process and Timing

Typically, an investment banker, serving as a placement agent, will sell the securities to a limited group of accredited investors. The placement agent acts as an intermediary, putting the buyers and the seller (the company) together. Generally, it does not buy the securities for its own account and immediately resell them, as it would in a firm commitment underwriting or Rule 144A offering. However, there is little practical difference in these processes since ready buyers are often lined up in advance of closing.

PIPEs can take as little as a few days to execute, or up to several weeks. Timing is often governed by the manner in which the PIPE is marketed. Some placement agents treat them as they would a public offering, structuring a specific deal, working with the company to prepare a formal confidential private placement memorandum and requiring a placement agency agreement (which resembles a traditional underwriting agreement), together with accountants' comfort letters and an extensive legal opinion. Other placement agents operate in a more informal fashion and place the securities using the company's already prepared public reports, sometimes accompanied by a "teaser" document that summarizes the company and the offering.

In many cases, deals are based upon term sheets submitted by investors following a limited roadshow focused primarily on the company and not specific deal terms. Typically, a lead investor emerges, and all purchasers acquire securities on the terms negotiated by the company

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and this investor. In this regard, unlike a public offering, PIPES are characterized by the use of a formal purchase or subscription agreement, a registration rights agreement and, in the case of a convertible preferred stock or convertible debt security, instruments setting forth the terms of the security (i.e. a certificate of designations or an indenture).

Types of Securities Sold in PIPE Transactions

Companies can offer a variety of securities in a PIPE transaction, including convertible debt, preferred stock, common stock and warrants, and any combination of these securities. Issuers should take care in negotiating the security to be issued. In selected cases, especially in turnaround situations, prospective investors may seek, for a fixed period of time, protective provisions such as:

- "Re-set" provisions to protect against a price drop;
- Veto rights on major transactions (such as a sale of the company) or preemptive or anti-dilution rights on sales of new equity; and
- "Bonus" provisions on liquidity events (such as repayment of their money plus participation on an as converted basis on a sale).

On the other hand, an issuer should seek specific protections against manipulation of its stock price, such as limitations on the volume of resales and representations and warranties by the purchasers that they have not engaged in any short-selling or other transactions in the company's securities between the time the deal was disclosed to them and the closing of the transaction.

Amount and Pricing Considerations; Shareholder Approval

There is no legal limit on the amount of money that a company can raise through a PIPE transaction. However, the exchanges do have rules that generally restrict a listed company from selling 20% or more of its outstanding common stock (whether directly or through convertible or derivative instruments), unless the company sells the shares at the greater of market value or book value, or the company obtains prior stockholder approval of the deal.[2] (This requirement can be waived by Nasdaq in the event of an issuer's financial distress, but in order to rely on this exception the company must, at least 10 days prior to the issuance of the securities, mail to all shareholders a letter alerting them to its failure to seek shareholder approval and indicating that its audit committee has expressly approved reliance its on the exception).[3] Market value for this purpose typically means the closing bid price on the date that the purchase price is established and purchase commitments made.

Companies should also keep in mind that transactions that would result in a change of control (generally, where a single investor or group of investors acquires 20% or more of a company's common stock or voting power), involve an acquisition, or involve the sale of stock by officers, directors or substantial stockholders may also require stockholder approval under exchange rules.[4] Accordingly, depending on the size and purpose of, and parties to, a PIPE transaction, these provisions may need to be evaluated as well. Indeed, it is recommended that a company consult its exchange representative in advance of a transaction to address any issues that the proposed structure may raise.

The price at which a company sells its securities in a PIPE transaction is highly dependent upon the company's financial position, market conditions and similar factors. Although securities sold in a PIPE transaction are generally priced at a discount from current market price (generally 10-15%, although sometimes higher), they can be priced at or even above fair market value (in the form of a conversion premium on a convertible instrument or accompanying warrant). As indicated above, exchange

rules do not preclude a company from issuing shares at below market value; they merely limit the amount of shares that can be sold in this manner without stockholder approval.[5]

Accounting Considerations

There are several accounting issues that companies need to be cognizant of when considering a PIPE, and which they should carefully address with their accountants prior to closing. They include:

- Transactions with a beneficial conversion feature (e.g., the sale of securities with a below fair market value conversion price) may produce a noncash charge to earnings;
- In unit transactions, where warrants are issued, a portion of the purchase price needs to be allocated to the warrants;
- In the case of preferred stock, if it can be redeemed by the holders, or if it has a fixed redemption date, it generally will not be treated as equity. This latter issue can have important consequences for companies seeking to comply with borrowing ratios, regulatory requirements or the listing standards of the exchanges; and
- If a registration rights agreement provides for liquidated damages to be paid upon a registration default, a contingent liability must be separately recognized and measured at the time the issuer concludes that payment of such liquidated damages is probable (whether at closing or later). The amount to be recognized and measured is governed by EITF 00-19-2, which was issued by the Financial Accounting Standards Board on December 21, 2006.

Other Issues To Consider at the Outset

Other issues that a company should explore before proceeding with a PIPE transaction include:

- Obtaining any required consents (such as from lenders, in the case of a dividend paying preferred stock), or waivers of existing registration or preemptive rights;
- Confirming that the company has sufficient authorized capital stock to execute the PIPE;
- Evaluating the potential dilutive effect to existing stockholders;
- Evaluating whether antidilution adjustments under existing convertible instruments will be triggered;
- Considering the possible integration of the PIPE transaction with other recent or planned offerings in a manner that would violate the securities laws or that would violate the shareholder voting rules of the exchanges; and
- Exploring any unusual tax consequences to the company or the investors. As to tax consequences, for example, investors may want to purchase a preferred stock that accrues but does not pay dividends, in an effort to avoid ordinary income taxation on the "dividends."[6]

Disclosure Requirements and Securities Law Filings

Public companies should consider issuing a press release, providing specific, limited information, to alert the market that the company is in the process of conducting a private placement.[7] Indeed, exchange rules arguably require a company, immediately following board action with respect to a private placement of a listed security, to issue a press release disclosing known terms and details of the transaction. In addition, the existence of a PIPE may constitute material, undisclosed information, and discussions with prospective investors without such a disclosure raises potential Regulation FD issues. On the other hand, public disclosure, or even limited disclosure through private road show presentations, oftentimes results

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in arbitrageurs shorting the stock on the anticipation that the potential dilution from the transaction will cause a price drop. And, the shorting itself tends to cause a price decrease.

As prospective investors in a PIPE transaction generally do not sign written confidentiality agreements, companies usually address these issues in one of two ways. Some companies issue a press release disclosing the fact that they are conducting a private offering as soon as is reasonably practicable. Any such press release should comply with the conditions of the "safe harbor" found in Rule 135c of the Securities Act. Other companies elect to wait until the transaction closes to issue a press release. Sometimes these companies or, more likely, their placement agent will, as a condition to bringing a prospective investor "over the wall" on the transaction, obtain verbal assurance that the prospective investor will hold the information it receives regarding the transaction (including the fact of the transaction itself) in confidence and that it will not effect trades in the company's securities until the transaction is publicly announced (or abandoned). Such assurances are often confirmed by email and then supported by representations, warranties and/or covenants made by the prospective investor in the purchase agreement.

Upon the closing of a PIPE transaction, companies typically issue a press release, and then file a Form 8-K describing the transaction, which includes the press release and deal documents as exhibits. Indeed, investors generally will require that information regarding the transaction, and any other material, nonpublic information that they have been provided, be disclosed promptly following the closing so that the investors are not precluded from trading in the company's securities after closing.

As to the transaction itself, companies generally rely on the exemption from registration provided by Regulation D, the SEC's private placement "safe harbor," to effect the transaction, and thus will file a Form D once the transaction has closed.

Immediately following the closing of the PIPE transaction (and occasionally as a pre-condition to the closing), the company will need to file and cause to become effective a registration statement permitting resale of the securities sold. Form S-3, a highly simplified form of registration statement, is available for a company to register resales of securities by selling securityholders as long as the company has been current in its SEC filings for the past year,[8] and has not suffered material payment defaults on its debt, preferred stock or leases.[9] An issuer does not need to meet the requirements for a primary offering (such as the $75 million dollar public float test), since it is viewed as a resale registration statement.[10] Issuers that do not meet the requirements for use of Form S-3 for the resale registration statement must be mindful of the impact that may have on their ability to file a registration statement (which would need to be on Form S-1 or Form SB-2) and to achieve effectiveness within the applicable time periods.

Resale registration statements are filed pursuant to Rule 415, which allows for the "shelf" registration of shares that will be sold on a delayed or continuous basis in the future. In recent months, the SEC has prevented small PIPE issuers from utilizing Rule 415, arguing that, in certain cases, the selling securityholders have acquired such a large percentage of the company's securities that they are in fact affiliates of the company and that, therefore, the Rule 415 provision allowing for the shelf registration of shares to be sold by selling securityholders is not applicable. The effect of this position on such companies is that, if they cannot meet the $75 million public float test for use of Form S-3 on a primary basis, then they will not be able to avail themselves of Rule 415 at all, raising significant issues under their registration rights agreements (or preventing some deals from closing in the first place). While the SEC's enforcement of this position has been inconsistent to date, with the result that PIPE investors are now very cautious when reviewing potential transactions involving

microcap companies, in late January 2007, the SEC staff publicly announced certain items that guide its review in this area. In particular, the staff noted that comments on a resale registration statement could be expected where an issuer that is not S-3 eligible on a primary basis seeks to register more than 1/3 of the outstanding common stock held by non-affiliates prior to the transaction, which comments, among other things, will seek an analysis of why the offering is a secondary resale rather than a primary offering and significant disclosure about the economics of the transaction and its impact on existing stockholders. Issuers should consult with counsel in connection with a transaction to determine whether the transaction is likely to trigger the Rule 415 issues and, if so, what changes might be made to the transaction structure to avoid such issues.

Under the Securities Act reform amendments that became effective on December 1, 2005, Form S-3 has become even simpler for qualified issuers to use. Under the new rules, seasoned issuers (generally, issuers that are eligible to use Form S-3 for a primary offering) can file their resale registration statement without including any of the information on selling shareholders, so long as the PIPE transaction is closed and the securities are issued and outstanding. Selling shareholder information can be added later by prospectus supplement.

Under Section 18 of the Securities Act, offerings by companies listed on the New York Stock Exchange ("NYSE"), the American Stock Exchange ("AMEX"), or the Nasdaq Global Market, or pursuant to Rule 506, the private placement safe harbor under Regulation D, are generally exempt from further regulation under state blue sky laws.[11] Accordingly, state blue sky laws typically have little impact on PIPE transactions. However, if an issuer is not listed on one of the foregoing exchanges, its resale registration statement may be subject to review, including merit review, by blue sky authorities. Therefore, in the case of a company listed on the Nasdaq Capital Market or quoted on the over-the-counter bulletin board or in the Pink Sheets, potential blue sky issues should be carefully analyzed at the outset of a PIPE transaction. If it appears that blue sky issues could significantly delay the investors' goal of relatively immediate liquidity, a PIPE may not be a viable alternative.

Filings with the Exchanges

If an issuer is listed on the Nasdaq and the private placement will result in the issuance (or potential issuance) of more than 10 percent of the shares or voting power outstanding prior to the transaction, the issuer should file a listing of additional shares notification form at least 15 days prior to the closing (although this requirement is often waived in connection with deals that move more quickly than this requirement would permit).[12] In addition, Nasdaq-listed issuers must file, within 10 days of closing, a notification form if the number of securities issued in the PIPE transaction results in an increase of more than 5 percent in the number of shares outstanding.[13]

If the issuer is listed on the NYSE, it must file a listing application and obtain prior authorization of the listing.[14] NYSE rules provide that the listing application should be submitted at least two weeks in advance of the date approval of listing is desired.

If the issuer is listed on the AMEX, it is not permitted to issue additional shares of common stock (or securities convertible into common stock) until it has first filed a listing application with AMEX and received notification from AMEX that the additional shares of common stock have been approved for listing.[15] The AMEX rules provide that the issuer should submit the listing application to AMEX one to two weeks in advance of the anticipated closing date of the private placement.[16]

Special Considerations For Placement Agents

As with any offering that involves "special selling efforts," placement agents need to comply with Regulation M. In general, this regulation precludes persons involved in an

offering from making a market in the securities to be sold (or related securities) for a period beginning on the later of one or five business days (depending on the size of the issuer and trading volume of the securities) prior to the time pricing is established or the time at which they become "participants" in the deal, and ending on the completion of their participation in the deal. These restrictions do not apply to "actively-traded" securities of a very large issuer.[17]

Placement agents should consider suspending the issuance of research reports on any issuer for which it is considering executing a PIPE, as well as restricting the issuer's participation in investor conferences. In this regard, although "gun-jumping" restrictions surrounding these activities have been loosened for public offerings,[18] by definition the front end of a PIPE transaction is a "private offering" and investors cannot be solicited (or deemed to be solicited) by any advertising or general solicitation.[19] Moreover, the SEC has taken the position in comment letters that the issuance of an analyst report may constitute unlawful "gun-jumping" in the situation where the report is issued prior to effectiveness of the resale registration statement by an investment banker who received securities, generally warrants, as compensation for the PIPE transaction and who intends to include those securities in the registration statement. It remains to be seen whether the loosening of restrictions on gun-jumping under the recent amendments to the Securities Act will impact the SEC's view of this situation. A placement agent should also be aware that, under NASD Rule 2711, its role in connection with a PIPE constitutes "investment banking services."[20] As such, acting as placement agent in a PIPE transaction would trigger certain disclosure obligations in research reports concerning the issuer.[21]

The compensation paid by a company to a placement agent in a PIPE transaction does not need to be pre-cleared by the NASD as it does in most public deals. However, as with an underwritten transaction, the terms of the placement agent's participation should be set forth in an engagement letter or placement agency agreement. If a simple engagement letter is preferred, it can be amplified by incorporating the representations and warranties made directly to investors in their purchase or subscription agreement. In addition, placement agents should obtain the same indemnification as they would in any other securities offering, and should conduct a sufficient level of due diligence to be comfortable with the company's disclosures.

Although a placement agent's compensation on the front end (private offering) segment of a PIPE transaction is not subject to review and approval by the NASD, participation by the banker in the back end resale of securities for investors pursuant to the selling stockholder registration statement is subject to regulatory approval, unless the issuer has been subject to the reporting requirements of the Exchange Act for at least 36 calendar months, is current in its reporting obligations, has registered the offering with the SEC on a Form S-3 and (i) has an aggregate market value for its voting securities held by non-affiliates of at least $150 million, or (ii) has an aggregate market value for its voting securities held by non-affiliates of at least $100 million and has an annual trading volume for its stock of at least three million shares.[22] Note that compensation received in the PIPE transaction may be reviewed by the NASD in this context.

For several years, the NASD has had outstanding a proposed amendment to Rule 2710, which would clarify the manner in which the underwriter compensation rules apply in the context of sales by selling securityholders pursuant to the selling stockholder registration statement. While currently Rule 2710 operates to require a compensation filing if an underwriter is involved in the sale of even one share off a registration statement, the modified rule would allow for, among other things, a "market transactions" exemption to the filing requirements. This rule proposal remains outstanding as of the date of this memorandum.

Conclusion

Under current economic and market conditions, PIPE transactions oftentimes represent one of the few viable alternatives for a company in need of additional, and immediate, funding. However, there are a number of issues that a company should consider before proceeding with a PIPE transaction. In particular, a company contemplating a PIPE should analyze and comply with exchange rules with regard to transactions for which prior shareholder approval is required and carefully review and negotiate the terms of the transaction documents to ensure that the best possible deal is obtained for the company and its shareholders.

NOTES

1 Under the rules, a WKSI is an issuer that is required to file reports under Section 13 or Section 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act") and that, as of the date of determination, (i) meets the registrant requirements of Form S-3/F-3, (ii) has a worldwide market value of its common equity held by non-affiliates of at least $700 million or has issued at least $1 billion aggregate principal amount of non-convertible securities (other than common equity) in primary, registered offerings for cash during the past three years, and (iii) is not an ineligible issuer (as defined).

2 See Nasdaq Rule 4350(i)(1)(D), NYSE Rule 312.03(c), and AMEX Rule 713(a).

3 See Nasdaq Rule 4350(i)(2).

4 For shareholder approval requirements in connection with a change of control, see Nasdaq Rule 4350(i)(1)(B) and NYSE Rule 312.03(d). For shareholder approval requirements in connection with transactions involving an acquisition, see Nasdaq Rule 4350(i)(1(C) and AMEX Rule 712. For shareholder approval requirements in connection with transactions that involve insiders, see Nasdaq Rule 4350(i)(1)(A), NYSE Rule 312.03(b) and AMEX Rule 711.

5 See Nasdaq Rule 4350(i)(1)(D), NYSE Rule 312.03(c), and AMEX Rule 713(a).

6 See Treas. Reg. sec. 1.301-1(b), which provides that a distribution made by a corporation to its shareholders shall be included in their gross income when the cash or other property is unqualifiedly made subject to their demands.

7 The content of any such release is governed by Rule 135c under the Securities Act of 1933, as amended.

8 See General Instruction I.A.3. to Form S-3.

9 See General Instruction I.A.5 to Form S-3.

10 See General Instruction I.B.3. to Form S-3.

11 See Section 18 of the Securities Act of 1933, as amended.

12 See Nasdaq Rule 4310(c)(17)(D).

13 See Nasdaq Rule 4310(c)(24).

14 See NYSE Rule 703.01.

15 See AMEX Rules 303 and 331.

16 See AMEX Rule 303(b) and 331.

17 See Regulation M, Rule 101(c)(1), which defines securities with an average daily trading volume of at least $1 million issued by an issuer whose common equity securities have a public float value of at least $150 million as "actively-traded securities".

18 See Rules 163A and 168 under the Securities Act.

19 See Rule 502(c) of Regulation D under the Securities Act.

20 See NASD Rule 2711(a)(2).
21 See NASD Rule 2711(h)(2).

22 See NASD Rule 2710(b).

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