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PIPEline: Sponsor-Led PIPE Transactions in Volatile Markets

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We created PIPE (private investment in public equity) transactions in 1984 to address unmet financing needs.[1] While a lot has changed since the first PIPE transaction, much remains the same. PIPE transactions were created to be an effective approach to capital raising for public companies when there were few, if any, other satisfactory financing alternatives. Then, it was very difficult to predict whether the

[1] One of the authors, James R. Tanenbaum, developed this financing methodology for Bear, Stearns & Co. Inc. It executed the first PIPE transaction in 1984 for New Jersey National Corporation, a regional bank holding company. Together, the authors have executed over 300 PIPE transactions.

public offering window would be open, stay open at least a crack, or close with little notice. PIPE transactions proved to be particularly useful when the equity markets were quite volatile. The first PIPE transactions were executed by regional bank holding companies, but the PIPE offering methodology rapidly became industry agnostic.

In the ensuing 36 years, both the relevant federal securities regulation, and the major sources of capital, have evolved. Today, securities regulations permit considerable flexibility in the use of shelf registration statements, as well as in the kind and character of confidential investor discussions that may be conducted with potential investors prior to the public announcement of the launch of a transaction. Unlike in 1984, now private equity and venture capital firms (referred to as financial sponsors below) are key players in the capital markets ecosystem. Today, as a result of the global pandemic, we are watching capital markets volatility that is, essentially, unprecedented in most of our lifetimes. This suggests that issuers across a broad spectrum of industries will be looking to PIPE transactions in order to ensure that they have a future.

While there are now a number of other confidentially marketed securities offering methodologies, for the reasons we discuss below, for many issuers, PIPE transactions may be the most efficient or only alternative. In light of the importance of private equity and venture capital market participants, we are likely to see much more activity in sponsor-led PIPEs. The following discussion is intended to answer some basic questions to which practitioners who may have limited familiarity with PIPE transactions, or more precisely, sponsor-led PIPEs, will want straightforward answers.

What Is a PIPE Transaction?

A PIPE transaction refers to any private placement of equity or equity-linked securities of an already public company. This broad definition encompasses many different types of financings, including everything from a venture-style private placement for a public company to a change of control transaction, to a private placement of highly structured securities. In a typical PIPE transaction, the issuer will engage a placement agent to introduce the issuer principally to institutional accredited investors. These investors will purchase newly issued shares of common stock or securities convertible into, or exchangeable for, shares of common stock at a fixed price in a private placement. Given that the securities are sold in an offering exempt from the registration requirements of Section 5 of the Securities Act of 1933, as amended (the "Securities Act"), the securities will be considered "restricted securities."[2] In order for investors to be able to obtain greater liquidity, as a condition of the transaction, the issuer will covenant to file a registration statement with the Securities and Exchange Commission (the "SEC") that will cover the resale from time to time of the securities purchased by the PIPE investors. The PIPE securities purchase agreement, or sometimes a separate registration rights agreement, will specify certain time periods within which the issuer must file the resale registration statement and in which the issuer must have the registration statement declared effective. Again, to minimize impediments to any resale of the securities by the PIPE investors, the issuer will covenant to limit the number, and the duration, of any suspension (or "blackout") periods during which the resale registration statement will not be available to the PIPE investors. If the resale registration statement were not available, the PIPE investors may nevertheless resell their securities by complying with the Rule 144 sale requirements.

The issuer and investors in a PIPE transaction enter into a securities purchase agreement pursuant to which the investors commit to purchase a specified number of shares at a fixed price. Accordingly, the investor bears the market risk of its investment from the time the transaction is priced (upon entry into the purchase agreement) until closing (when the investor funds its purchase of securities). There are no purchase price adjustments for subsequent events, such as changes in the issuer's stock price. The conditions to closing of the transaction are limited and are outside of the investor's control. As a result, from a securities law perspective, the PIPE transaction is considered "completed" at the time at which the definitive securities purchase agreements are executed.

A PIPE transaction is actually a combination of two separate components. First, the issuer (or one or more selling security holders, if secondary shares are part of the transaction) sells shares of common stock to investors in a private transaction. Second, the issuer files a resale registration statement covering the possible resale from time to time by the investors of the securities purchased in the PIPE transaction. Since the PIPE transaction is a private offering, the issuer and the placement agent must comply with all of the conditions for the applicable exemption from registration. Generally, a PIPE transaction will be structured to comply with the section 4(a)(2) exemption

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[2] *See* 17 C.F.R. § 230.144(a)(3) definition of "restricted securities."

under the Securities Act and the Regulation D safe harbor. Typically, the issuer will rely on Rule 506 of Regulation D.

Why Would a Public Company Consider a PIPE Transaction Instead of Another Capital-Raising Alternative?

In a traditional, fully marketed underwritten public offering, the issuer often discloses the transaction at the launch. For many follow-on public offerings by public issuers, the issuer will file a registration statement (assuming it does not have a shelf registration statement available). The filing of the registration statement alerts the market to a possible offering. In the case of a fully marketed underwritten takedown from the issuer's shelf registration statement, the issuer may file a preliminary prospectus supplement, which has the same effect of alerting the market to an upcoming offering. A public announcement will often have a negative effect on the issuer's stock price. However, an issuer publicly discloses a PIPE transaction only after definitive securities purchase agreements have been executed. Investors are approached by the placement agent on a confidential, or "wall crossed," basis, as discussed below. This allows the issuer to gauge interest in the transaction. If the issuer does not receive sufficient interest or does not like the proposed purchase price discussion, it does not have to proceed with the PIPE transaction. The issuer can elect not to proceed without any negative publicity.

When the PIPE transaction format was developed in the mid-1980s, there were fewer issuers that were eligible to file a shelf registration statement. The confidential and targeted marketing process that is central to a PIPE transaction was, therefore, quite important as a way of minimizing investor front-running. Over time, the SEC has amended the eligibility criteria for use of a primary shelf registration statement, and more issuers, including smaller issuers, may now file a shelf registration statement. While this has expanded the range of offering alternatives available to issuers, PIPE transactions remain an important capital-raising approach. In a number of special situations, a PIPE transaction will be the most efficient, or sometimes the only, financing approach. This is especially true during periods of heightened market volatility and disruption.[3]

[3] For example, in this article, we discuss a PIPE transaction that involves financial sponsor investors. An issuer also may use a PIPE transaction as a means of raising proceeds to fund an

Only an issuer that is already public may issue securities in a PIPE transaction. With few exceptions, the issuer will be current in its periodic filings under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). As a result, most PIPE issuers are eligible to use a Form S-3, or a short form, registration statement to register the resale of the PIPE shares. Most disclosure requirements of the Form S-3 may be satisfied through incorporation by reference from the issuer's Exchange Act filings. This means that it will be less time-consuming for an issuer to prepare the resale registration statement and, barring unusual occurrences, there should be little work required in order to keep the registration statement current. A PIPE transaction may be completed relatively quickly, and the costs associated with a PIPE transaction generally will be significantly lower than the costs that can be expected in connection with a public offering.

The PIPE market has experienced substantial growth. According to data provider Private Raise, in 1995, 114 PIPE transactions were executed, raising a total of approximately $1.3 billion in proceeds. By 2007, 1,448 PIPE transactions were executed, raising a total of approximately $83.6 billion in proceeds. As we discuss below, in 2008, in a difficult economy, 1,029 deals were executed, raising a total of approximately $121.4 billion in proceeds. During the financial crisis, large financial institutions that were unable to effectively or efficiently access the public equity and debt capital markets made use of the PIPE structure. By 2019, the number of transactions executed increased to 1,063 deals, but the proceeds declined to an aggregate of approximately $39.5 billion. For the first quarter of 2020 ended on March 31, 2020, 269 deals were completed, raising a total of approximately $15.0 billion in proceeds. In April and May 2020, 206 deals were completed, raising a total of approximately $11.8 billion in proceeds.

What Are the Typical Terms of a PIPE Transaction?

Most PIPE transactions involve only the sale of common stock or common stock and warrants. The issuer makes few, if any, covenants to the investors. Typically, the

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acquisition. To the extent that the acquisition may be material, the issuer may not have available to it an effective shelf registration statement because necessary historical target financial information may be required to be filed in order for the registration statement to be current.

only covenant made relates to the issuer's undertaking to file the resale registration statement within a specified period of time following closing.

What Information Is Shared with the PIPE Investors?

It is presumed that the fact that the issuer is contemplating a proposed financing may (on its own) constitute material nonpublic information. In order to ensure that the issuer does not violate Regulation FD (Fair Disclosure)[4] and is not required to make a premature announcement regarding the proposed transaction, the issuer and the placement agent will ensure that each potential investor understands the confidential nature of the proposed transaction. The issuer and the placement agent will agree to a process by which the placement agent will obtain confidentiality undertakings from the potential purchasers before the name of the proposed issuer is disclosed, and any details regarding the possible financing are shared. More often than not, the issuer will not use any marketing materials in connection with the PIPE transaction. It will rely on its Exchange Act filings. However, on occasion, an issuer may wish to conduct a PIPE transaction in connection with a particular plan of financing that may involve an acquisition, a recapitalization or restructuring, or another material event. Under these circumstances, it may be necessary to share with investors information about these material developments. This is likely to be the case when market conditions are challenging, and the issuer's Exchange Act reports, which discuss historical results, may be less relevant, and prior earnings guidance may no longer be accurate. If the issuer intends to share other material nonpublic information, such as anticipated financial results for the most recently completed quarter, with potential investors, a confidentiality agreement may be negotiated that contains express provisions pursuant to which the investor acknowledges that it will not be able to transact in the issuer's securities until the confidential information that has been shared becomes public or becomes stale.

[4] 17 C.F.R. Part 43, Regulation FD. Regulation FD was adopted in order to prevent selective disclosure by SEC-reporting companies to securities market professionals and certain other individuals. The regulation was intended to promote full and fair disclosure and market integrity.

How Do Venture Capital-Led or Private Equity-Led PIPE Transactions Differ from Typical PIPE Transactions?

In volatile markets, such as those associated with periods of economic stress, an issuer, even one with an effective shelf registration statement, may choose to undertake a PIPE transaction in order to augment its capital. Raising funds in a PIPE transaction may allow the issuer to continue to meet financial covenants in its credit facilities or other debt securities or instill more confidence in the issuer's creditworthiness. A PIPE transaction under these circumstances also may be part of a broader recapitalization that might entail, among other things, paying down or renegotiating credit facilities, paring back the issuer's expenses or other downsizing measures. During a market downturn, an issuer may not want to undertake a public offering, even on a confidentially marketed basis, as the public markets may be too uncertain. In a period of rapid, unpredictable, and extraordinary change, the issuer's Exchange Act filings may not be current, and the issuer may be reluctant to make certain disclosures, which would be required in connection with a public offering. As a result, a PIPE transaction may be the preferred financing alternative.

Venture funds, private equity funds and distressed debt funds may be interested in participating in financing transactions during volatile periods. Their investments may be opportunistic (they may take the view that certain assets are undervalued), may present the opportunity to leverage their existing investment strategy and industry expertise, or may be a means of maintaining or defending an existing ownership interest in a company. To the extent that a financial sponsor would like to invest in a public company, the best approach may be to structure the capital injection as a PIPE transaction. Typically, a financial sponsor will want to make its investment in the form of a more highly-structured security, and likely will want contractual protections in the form of affirmative and negative operating and financial covenants. Occasionally, as we discuss below, an investor may also want certain governance rights. It will be most efficient to address all of these rights and preferences in a private placement rather than in a public offering.

What Are the Principal Terms of These Financial Sponsor-Led PIPE Transactions and How Are These Transactions Documented?

As discussed above, a placement agent will obtain certain confidentiality undertakings from prospective investors before discussing specific PIPE transaction terms. A financial sponsor may want to receive certain specific financial information from the issuer that will constitute material nonpublic information. In other cases, a financial sponsor will want to undertake its own business diligence before making an investment. In this event, the financial sponsor may be restricted from trading in the issuer's securities for some period of time following completion (or abandonment) of the transaction. As with the typical PIPE transaction, the issuer and financial sponsor investor will negotiate a securities purchase agreement and certain registration rights relating to the resale of the securities sold in the PIPE transaction. However, the similarities between a typical PIPE transaction and a financial sponsor PIPE transaction end there.

More often than not, a financial sponsor will negotiate with the issuer the terms of a more structured security, such as a series of preferred stock or convertible preferred stock and/or a warrant. In the case of debt funds, the investment may be structured as a senior or secured debt instrument with accompanying warrants. The preferred stock may be cumulative or non-cumulative and will bear a specified dividend rate. The terms of the preferred stock may be structured in a way that is intended to yield the investor a specified targeted rate of return that is consistent with the fund's investment strategy. Typically, for so long as the preferred stock remains outstanding, the holders of the series will have certain investor protections. For example, without the favorable vote of all of, or a majority of, the holders of the preferred stock, the issuer may be prohibited from incurring additional debt, or debt in excess of certain permitted amounts, incurring liens, granting guarantees, paying dividends or distributions other than to the preferred stock, entering into transactions with affiliates, undertaking asset sales, entering into sale and leaseback transactions, effecting a merger, or filing for bankruptcy. The sponsor also may negotiate certain affirmative covenants, such as the maintenance of a specified minimum net worth, or certain unencumbered cash or certain leverage ratios.

A financial sponsor may want board representation in order to take an active role in the oversight of the issuer's business and affairs. Of course, to the extent that a sponsor takes a board seat, the sponsor will be considered an affiliate of the issuer and a control person, which will limit the fund's flexibility with respect to transactions in the issuer's securities. For that reason, the sponsor may prefer not to take a board seat. However, even if the sponsor chooses to forego a board seat, the issuer's failure to make required dividend payments on the series of preferred stock may give the holders of the preferred stock the right to elect a director during the nonpayment period.

The financial sponsor also may negotiate other contractual rights including, but not limited to, rights of first offer (triggered if the issuer proposes to raise additional equity capital), preemptive rights, and information rights. If the issuance of warrants is also contemplated, the terms of the warrants will often be highly negotiated. The warrants usually will have an exercise price that represents a premium to the market price of the issuer's common stock on the execution date. Most warrants will be exercisable for the issuer's common stock through payment of the exercise price or on a cashless basis beginning on the date when the resale registration statement is declared effective, or six months from the closing date. The warrants also will contain standard antidilution rights, as well as fundamental change provisions that protect the warrant holder in the event of a merger of the issuer. The affirmative and negative covenants discussed above in connection with the preferred stock may be included in the terms of the warrant as well.

Does the Transaction Constitute a Change of Control?

The issuer and the sponsor may want to avoid having the transaction constitute a change of control and the sponsor may want to avoid being considered an affiliate of the issuer. Nonetheless, the voting power of the sponsor, any board representation, and the presence of certain contractual rights may suggest that the sponsor may, in fact, be able to exercise control. Under Rule 405 of the Securities Act, "control" is understood to be "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract or otherwise."[5] State law also may provide some guidance regarding the meaning of "control." Under Section 203(c)(4) of Delaware General Corporation Law, "[a] person who is the owner of 20% or more of the outstanding voting stock of any corporation, partnership or unincorporated association or other entity shall be presumed to have control of such entity, in the absence of proof by a preponderance of the evidence to the contrary."[6] Any determination regarding control will depend on the facts and circumstances and will have to take into account, among other things, whether there are preexisting holders of the issuer's voting stock that have board designees or that hold a higher percentage equity or voting interest than that of the new sponsor investor.

[5] 17 C.F.R. § 230.405.

[6] Del. Code Ann. tit. 8, § 203(c)(4).

What Are Some of the Considerations if the Transaction Might Constitute a Change of Control?

If a transaction may be deemed to constitute a change of control, the issuer, its board of directors and its advisers will have to consider a number of matters. For example, if the issuer has not opted out of any state business combination or anti-takeover statute, it may need to follow a prescribed procedure. Additional concerns may arise if the sponsor is an existing security holder or if an insider is investing alongside the sponsor. For instance, Delaware, the issuer's board of directors has particular duties with respect to evaluating and approving a transaction that constitutes the sale of control of the corporation. The duties are heightened in the case of a transaction that involves a related party. While less common in recent years, an issuer may have a poison pill or rights plan in place that may be triggered by the sale of a significant percentage of the issuer's voting stock. Waiving the application of such a plan also may require that the issuer's board of directors undertake additional diligence in order to discharge its duties. In addition, the issuer also may be a party to material agreements that contain change of control triggers. For example, often debt securities and lending facilities contain change of control provisions.

The issuer and its board of directors may consider including, in connection with the negotiation of the PIPE transaction, a standstill provision that would limit the percentage of voting stock that could be acquired by the sponsor and its affiliates. This might help to mitigate concerns regarding a change of control and serve to preserve the issuer's future strategic alternatives.

What Securities Exchange Rules Should Be Analyzed in Connection with These Transactions?

All three securities exchanges, the New York Stock Exchange ("NYSE"), the NYSE Amex, and Nasdaq, impose shareholder vote requirements if a listed company undertakes certain transactions that may be dilutive to existing stockholders or as to which existing stockholders should have a vote.

NYSE Listed Company Manual Section 312 and Nasdaq Rule 5635 require an issuer to obtain shareholder approval prior to the issuance of common stock, or securities convertible into or exercisable for common stock in any transaction or series of related transactions not involving a public offering, if the common stock has or will have, upon issuance, voting power equal to, or in excess of, 20% of the voting power outstanding prior to the issuance of such securities.[7] A shareholder vote also is required if the number of shares of common stock issued or issuable in such a transaction will be equal to or be in excess of 20% of the pre-transaction total shares outstanding if the shares are sold at a price less than the minimum price (a price that is the lower of the closing price immediately preceding the date of the definitive purchase agreement, or the average closing price for the five trading days immediately preceding the date of such agreement).[8] The securities exchanges also require shareholder approval in connection with a transaction that results in a "change of control."[9] While the securities exchanges do not have a definition of the term, the exchanges generally consider a transaction that involves the sale of a 20% (in the case of the Nasdaq)[10] or 20% to 30% (in the case of the NYSE)[11] interest in the issuer's voting stock to be a presumptive change of control. The presumption may be refuted, and the exchanges will consider a number of subjective factors, including voting rights, board rights, and whether preexisting control positions are displaced by the transaction.

The exchanges also impose limitations on transactions involving related parties that, in the case of the NYSE, exceed certain specified percentage interests of voting stock,[12] or, in the case of the Nasdaq, involve sales to insiders that are made at less than the minimum price.[13]

Following the global pandemic, both the NYSE and the Nasdaq have provided listed companies with limited and temporary relief from the application of certain of the rules discussed above.

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[7] NYSE Listed Company Manual § 312.03(c); *see also* the Nasdaq Stock Market Rule 5635 (hereinafter, Nasdaq Rule).

[8] NYSE Listed Company Manual § 312.04; *see also* Nasdaq Rule 5635(d).

[9] NYSE § 312.03(d); *see also* Nasdaq Rule 5635(b).

[10] *Id.*

[11] *Id.*

[12] NYSE § 312.03(b).

[13] Nasdaq Rule 5635(c).

What Other Securities Law Considerations Should Be Taken into Account in Connection with a Sponsor-Led PIPE Transaction?

Depending on the nature of the investment (whether it is "passive" or "active" for example), such a transaction may be subject to the Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR" or the "Act").[14] Generally, the HSR is thought to apply to mergers and acquisitions, but a private placement of substantial size may be subject to the Act's reporting requirements. If no party acquires more than 10% of the issuer's voting stock and the stock is acquired for investment purposes, the transaction should be exempt from the HSR requirements. However, the parties should consider the application of the HSR if a party acquires more than 10% of the voting stock, and the total value of the transaction exceeds the then applicable HSR thresholds.

Following completion of such a transaction, the sponsor may become subject to certain ownership reporting requirements under Section 13 or Section 16 of the Exchange Act. Under Section 13d-1 of the Exchange Act, a person or group that becomes a beneficial owner of 5% or more of a class of equity securities registered under the Exchange Act must file a Schedule 13D with the SEC.[15] Institutional investors that hold securities in the ordinary course of business or holders whose investment is passive may file a Schedule 13G.[16] The Schedule 13D filing requirements are more extensive and more burdensome than those associated with Schedule 13G. Section 16(a) requires disclosure of equity ownership by directors, officers and holders of more than 10% of any class of registered equity securities.[17] A Section 16 person also becomes subject to certain "short swing" profits issues, which may be challenging to monitor.

Conclusion

It may be the case that elevated levels of volatility in our capital markets will be a fact of life for some time. If that turns out to be the case, we would expect that PIPE transactions, generally, and sponsor-led PIPE transactions, in particular, will assume

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[14] Pub. L. No. 94-435, Stat. 1390 (codified as 15 U.S.C. § 18a (1976)).

[15] 17 C.F.R. § 240.13d-1.

[16] *Id.*

[17] 17 C.F.R. § 240.16a-2.

even greater importance in capital formation. That said, a few cautionary observations may be helpful. Management and boards of directors would be well-advised to evaluate thoroughly and carefully, and discuss at length, the terms and conditions of PIPE financing proposals and alternatives. These discussions should be memorialized. In addition, management and the board should be fully conversant with the company's governance, regulatory and disclosure obligations that will arise by virtue of completing the PIPE transaction.

If one were to look back to the financial crisis in 2008, one would observe that PIPE transactions proved to be a key component of the financing packages that enabled some of the nation's largest financial institutions to recover and thrive. So, while much has changed, do not be surprised if PIPE transactions end up, once again, playing a critical role in enabling companies of varying size in diverse industries to obtain the capital necessary to recover and prosper.

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