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To Our Clients and Friends

Memorandum

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Possible Expanded Utility of PIPE Transactions for Companies to Raise Funds in the Current Environment

As a result of the economic crisis arising from the global Coronavirus pandemic, many companies are seeking creative fundraising solutions to meet their cash flow requirements. Private investments in public equity (so-called "PIPE" transactions) are one strategy for companies to raise cash quickly when more traditional forms of equity or debt financing are not feasible. PIPEs traditionally have been used most often for share repurchases, acquisition financing, to refinance debt or to fund specific capex projects. In the wake of the current crisis, companies may turn to PIPEs for these purposes and potentially, in some cases, as an appropriate vehicle to fund regular cash flow needs if alternative financing sources are not available on a timely basis. PIPEs also have the corollary benefit to issuers of placing a large block of stock in the hands of "friendly" investors, which may serve as a deterrent to either activist investors or competitors seeking to take advantage of depressed stock prices.

PIPE transactions. A PIPE transaction is a private placement of securities of a public company to selected accredited investors (often, private equity firms or institutional investors). The investor enters into a purchase agreement that commits it to purchase securities; and the company agrees to file a separate registration statement covering the resale from time to time by the investors of the privately purchased securities. The securities typically are either (a) common stock or (b) preferred stock or debt securities that are convertible into common stock at a specified price or exchange rate. There have also been PIPE issuances of non-convertible preferred and non-convertible debt "stapled" together with warrants to purchase common stock (with, in these cases, customary lender protections provided to the investor). In each case, the terms of a PIPE must be tailored for the specific facts and circumstances.

Key advantages of PIPEs for the issuing company. The critical advantage that PIPEs provide is their availability when traditional financing sources are not available. While an expensive source of capital to issuers in certain respects, PIPE funding may be a necessary alternative in the current environment given the obstacles to public equity issuances in light of the extreme uncertainty and volatility in the stock markets, as well as potential difficulties relating to obtaining bank financing. Also, funds can be obtained quickly under a PIPE transaction as compared to the process required for a public issuance of securities (although, depending on the investor, the negotiation of the transaction can take some time). In addition, a PIPE transaction sometimes can lead to a more expansive business partnership between the company and the investor and/or more generally serve as a catalyst for stock price appreciation. (At the same time, however, depending on the circumstances, if effective standstill provisions are not included, the arrangement could raise defensive concerns for the company.) In general, the use of convertible preferred stock and/or debt, rather than common stock, in a PIPE transaction is preferred by the company due to the need, typically, to issue common stock at a discount to market price, as well as the differentiation of the investment from other public market investments.

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Key disadvantages of PIPEs for the issuing company. The key disadvantage of a PIPE is that the issuance may be at a discount to the market price--or it may be at the current market price which the issuing company views as significantly impaired on a short-term basis because of the current crisis--and as a result is dilutive of the existing shareholders' interests. In addition, the investor's right to resell the stock can create an "overhang" issue for the company's stock price. In some agreements, in the event of specified levels of decline in the stock price, the company must issue additional shares to the investor at a significantly reduced price. In this situation, with short-sellers potentially also taking advantage of, and thus accelerating, the market price decline, the PIPE investor's equity stake can increase--as a result of which many agreements set a minimum share price below which no compensatory stock is issued. (At the same time, some agreements include a forced or automatic conversion of the issued convertible securities into common stock, at the discretion of the company, if the stock price increases above a specified price for a specified period of time.)

A company also will have to keep in mind that, under NYSE and NASDAQ rules, shareholder approval may be required for a PIPE transaction if the share issuance: involves more than 20% of the company's outstanding shares or voting power being issued (at the time of issuance or in the future under the agreement provisions); is to a more than 5% shareholder; constitutes a "change of control"; or requires a charter amendment due to insufficient authorized stock or the need to create a new type of security. As the rules of the exchanges are different in several key respects, care should be taken to consider the specific rules applicable to the issuer. Of note, the NYSE recently adopted temporary waivers of certain of its shareholder approval requirements relating to share issuances to "Related Parties" (including more than 5% shareholders) or involving more than 20% of the outstanding common stock or voting power. These waivers (which are effective through June 30, 2020) make the NYSE rules more (but still not entirely) consistent with the NASDAQ rules. The waivers, which will facilitate PIPEs, reflect the NYSE's appreciation of the urgent liquidity needs many listed companies are facing.

Key considerations for the investor. A PIPE investor cannot resell the purchased securities until any non-public price-sensitive information that it received in its due diligence process has been made public by the company or becomes stale. In addition, as the securities are unregistered and the investor may be deemed an affiliate of the issuer, the investor may need registration rights to resell its entire block of shares. Also, compared to a situation where a significant investment is made in a private company, a PIPE investor may be afforded more limited control rights (although this is a negotiated term that will vary widely depending on the circumstances). The key considerations for the investor relating to the terms of the PIPE will be: in the case of convertible securities or debt, pricing terms (including the amount of the conversion premium); the dividend rate or coupon (which is typically cash-pay or cumulative); the "liquidation preference" (typically, the issue price plus accrued and unpaid dividends)--which is the key value of the convertible instrument and provides the investor with downside protection (stronger in the case of convertible debt); board representation (which has become more common and, under exchange rules, can be commensurate with the investor's equity ownership in the company); any specific negative control rights; investor conversion rights (typically optional but may include a non-conversion period after issuance--and consideration should be given to potential Hart-Scott-Rodino Antitrust Improvements Act of 1976 pre-conversion filings); impact of a change of control (including a potential make-whole or change of control premium); anti-dilution protections (with adjustment to the conversion price); standstill provisions restricting the investor from increasing its ownership in the company (subject to preemptive rights); restrictions on resale of the purchased securities; and restrictions on hedging or shorting the company's securities.

Importantly, the timing and pricing of the investor's exit will be uncertain--and the larger the investor's stake, the more difficult an exit may be. In addition, private funds may be restricted in their organizational documents from making investments in public securities. The investor will also need to take into consideration the impact of the rules under Section 13(d) and Section 16(a) of the Securities Exchange Act of 1934 (*e.g.*, potential "group" status if there is more than one investor participating in the PIPE).

Further, there will be important tax considerations for both the investor and the issuer. Finally, the impact of potential pre-closing regulatory approvals should be given careful consideration from the outset, since a protracted period before being able to close on a PIPE and receive liquidity may be a significant deterrent to an issuer's willingness to engage in discussions, particularly in the current climate.

Impact of the Coronavirus pandemic on PIPEs. Whether a PIPE will be a preferred alternative as compared to other financing sources will depend on a company's individual circumstances, including the extent of its need and the availability and timing of other sources. Clearly, we may see more PIPE fundings for acquisitions under existing merger agreements without a financing condition or an ability to invoke a no-material adverse change or other condition. We have already begun to see some companies exploring PIPEs in the current environment to fund their near-term cash needs. It remains to be seen whether, in light of the potential of extreme financial difficulties for companies in the months ahead, the terms of PIPEs may become generally more favorable to investors than previously (such as by providing a deeper discount on the price, a shorter time period for restrictions on resale, and stapled warrants that provide the investor with an option to increase its equity position following consummation of the PIPE).

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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