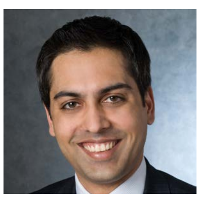
Market Trends 2019/20: PIPEs

A Lexis Practice Advisor® Practice Note by
Ari B. Blaut, Krishna Veeraraghavan and Lindsey C. Meyer, Sullivan & Cromwell LLP


Ari B. Blaut
Sullivan & Cromwell LLP


Krishna Veeraraghavan
Sullivan & Cromwell LLP


Lindsey C. Meyer
Sullivan & Cromwell LLP

This article explores trends in the private investments in public equity (PIPE) market in 2019 and the market outlook for 2020. The market for PIPEs in the United States saw an increase in both the number of deals and total dollar volume of deals that closed in 2019 compared to 2018. According to PlacementTracker, the leading source for data and analysis to institutions in the PIPE and private placement markets, in 2019, there were 1,033 PIPE transactions with a total dollar volume of $48.8 billion, as compared to 875 PIPE transactions with total dollar volume of $44.6 billion in 2018. This represents an 18% increase in number of deals and a 10% increase in dollar volume from 2018. How Covid-19 impacts issuers in 2020 will be a fluid situation.

For additional information on PIPEs, see PIPEs and Raising Capital and PIPE Transactions. For further information on private placements in general, see Private Placements Resource Kit.

Notable Events

On September 26, 2018, the Securities and Exchange Commission approved amendments to the price tests in Nasdaq's private placement shareholder approval rule (Nasdaq Rule 5635(d)). The amendments were intended to enhance capital formation by providing greater flexibility and certainty for Nasdaq-listed companies entering into PIPE transactions and other private offerings, while maintaining dilution protection for existing shareholders.

As discussed below under Deal Timing – Shareholder Approval, the 20% rule, as it is commonly known, is often implicated in PIPE transactions and other private offerings. The 20% rule requires Nasdaq-listed companies receive shareholder approval before they can issue 20% or more of their outstanding common stock or voting power in a private offering at discounted prices. The purpose of the 20% rule was to protect existing shareholders against the dilutive effects of such follow-on offerings.

Prior to the amendments, the 20% rule for Nasdaq-listed companies exempted from shareholder approval offerings priced at or above the greater of book or market value per share. Companies and market participants, however, expressed dissatisfaction with market value and book value, as previously defined. Market value was based on the closing bid price, which is not necessarily clear and does not always reflect actual trading prices. Book value is an accounting measure based on historic asset costs, and does not necessarily reflect the current value of the issuer. The amendments modified the market value measure to reference the "minimum price," defined as the lesser of (1) the closing price of the issuer's common stock on Nasdaq immediately prior to signing or (2) the average closing price of the common stock on Nasdaq for the five trading days prior to closing, instead of the closing bid price. They also eliminated the book value test.

Under the amended rule, the issuance of 20% or more of common stock or voting power of a company will not require shareholder approval if the offer price is greater than or equal to the lesser of (1) the last closing price immediately preceding the signing of a binding agreement and (2) the average closing price of the common stock on Nasdaq for the five trading days immediately preceding the signing of the binding agreement.

Companies listed on the New York Stock Exchange (NYSE) are subject to a similar shareholder approval listing rule regarding 20% share issuances that contains certain differences from the Nasdaq rule. Please see below for further information and certain deal timing and structure considerations for PIPE transactions.

Deal Structure and Process

PIPE transactions tend to be tailored to the particular situation and often arise when issuers are distressed or for acquisition financings. Issuers may opt for PIPE transactions over a registered public offering when their stock is undervalued or they encounter a short-term liquidity crunch, as PIPEs are a good way to signal to the market that smart money, in the form of sophisticated investors, is backing the issuer or a transformative transaction. For more information on PIPE deal timing and documentation, see PIPE Transactions — Steps for Conducting a PIPE.

Deal Timing

Given the need for quick execution in many PIPE transactions, it is important to be mindful of timing considerations. Highlighted below are some key timing considerations.

- **Shareholder approval.** Both NYSE and Nasdaq require shareholder approval prior to the issuance of common stock (or securities convertible into or exercisable for common stock) in excess of 20% of common stock or voting stock outstanding prior to the issuance. Given the potential delays in obtaining shareholder approval, parties may structure around the exchange requirements by opting for share caps, where there are multiple classes of securities, one of which is voting up to just below the 20% threshold and the other of which is either nonvoting or convertible into voting stock only upon shareholder approval. In instances where shareholder approval is necessary, PIPE investors often impose punitive economic consequences if issuers fails to obtain shareholder approval in a timely manner. In addition to structuring the transaction to avoid or delay shareholder approval the parties may take advantage of exceptions to these exchange requirements. Under NYSE rules, shareholder approval is not required if the issuance is a bona fide private financing and the price paid or the conversion price 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 a sale to either a registered broker-dealer that intends to sell the securities in private resales or to multiple purchasers where no single purchaser or group acquires more than 5% of the issuer's common or voting stock outstanding prior to the sale. Under Nasdaq rules, shareholder approval is not required if the offer price is greater than or equal to the lesser of (1) the last closing price immediately preceding the signing of a binding agreement and (2) the average closing price of the common stock on Nasdaq for the five trading days immediately preceding the signing of the binding agreement. Only a few of the PIPE transactions surveyed in 2018 and 2019 required shareholder approval. Further, in 2018, some of the convertible debt deals surveyed included a cash-out option as an alternative to conversion to common stock in the event conversion would result in a requirement to obtain shareholder approval. For further information, see 20% Rule and Other NYSE and Nasdaq Shareholder Approval Requirements.
- **HSR filings.** In certain circumstances, filings under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (HSR), may be necessary if the parties meet the size-of-transaction and size-of-person tests. If an HSR filing is required, parties cannot consummate the transaction during the 30-day statutory waiting period, unless early termination is granted. The Federal Trade Commission (FTC) may grant early termination before the expiration of the statutory waiting period if the FTC and the Department of Justice decide that an in-depth second request review of the transaction is unnecessary. Parties may choose to seek early termination by filing a term sheet (prior to the finalization of definitive documents) with the request. However, parties wishing to

keep the transaction entirely confidential should be aware that the FTC is required to publish notice of the early termination in the Federal Register and on the FTC's website.

- **Constraints in existing debt arrangements.** There may be requirements under the issuer's existing debt documents, including indentures, credit agreements, and security agreements, that may restrict the incurrence of debt and use of proceeds in subsequent equity offerings. Issuers should evaluate their existing obligations and determine whether any third-party consents are necessary.

Transaction Documentation

- **Key deal documentation.** Deal documentation in a PIPE transaction is specific to the type of instrument being purchased. In PIPE transactions for equity securities, the principal documents are typically a purchase agreement (or subscription agreement) governing the terms of the purchase of securities, a governance agreement (or shareholders' agreement) setting forth the purchasers' governance rights (such terms may also be included in the purchase agreement), a certificate of designations or amendment to the issuer's charter (in cases where a new class of securities is being issued), and a registration rights agreement (sometimes covered together with governance rights in a shareholders' agreement), which allows investors to resell securities in the public market. The latter three documents are usually filed or entered into at closing. For equity issuances, there will be a listing application, if listing is required, and agreements with agents for transfer, conversion, and dividend disbursement, as applicable. In the case of a sale of debt securities, the principal documents are a note purchase agreement, an indenture governing the terms of the notes, and a registration rights agreement. In negotiating the terms of these documents, it is important to ascertain early on the objectives of the investor. If the investor is focused on longer term growth, governance rights and voting rights will be highly negotiated, and if the investor is focused on shorter term returns, dividends, conversion, redemption, and registration features will be more important. For more information and forms of certain documents, see PIPE Transactions — Drafting Key Documents, Purchase Agreement (PIPE Offering), Registration Rights Agreement (PIPE Offering), Common Stock Warrant (PIPE Offering), and Officer's Certificate (PIPE Offering).

- **Material nonpublic information.** In the event the issuer discloses to the investor material nonpublic information (MNPI), a nondisclosure agreement may need to be executed prior to disclosure. Regulation Fair Disclosure prohibits companies from disclosing MNPI selectively without making a prior or simultaneous public disclosure, unless the recipient of MNPI agrees to maintain confidentiality of the information provided. For more information on Regulation Fair Disclosure, see Regulation FD. For further information on materiality, see Materiality Determination for Disclosure Checklist, and Materiality: Relevant Laws, Guidance, and Determination Guidelines.

Deal Terms

Based on 20 PIPE transactions with deal values of over $100 million in 2019 and 2018, below is a summary of material deal terms and trends in 2019 as compared to 2018 for these larger transactions. The data set includes some of the largest PIPE transactions in 2019 and 2018, and despite the relatively small size of the sample, it should generally be representative of the trends in larger transactions because of the relative dearth of large PIPE transactions vis-à-vis smaller transactions. Nonetheless, readers should exercise caution in drawing conclusions based on the below analysis given the size of the sample.

Type of Security

PIPE transactions involve different types of securities, the most common being common equity, convertible preferred equity, and convertible debt. Preferred equity is particularly attractive for PIPE investors because it retains the upside of equity while the liquidation preference gives investors the downside protection of being senior to common equity in the event of a bankruptcy. In both the 2019 and 2018, common stock and convertible preferred equity transactions were equally represented, and convertible notes represented only a small portion of the surveyed PIPE deals. In terms of dollar volume, the largest deals slightly favored common equity over preferred equity in 2019, whereas in 2018 the largest deals favored convertible preferred equity.

- In both 2019 and 2018, 40% of the transactions in the data set involved the sale of common equity, 40% involved the sale of convertible preferred equity, and 20% involved convertible notes.

- In terms of dollar volume, in 2019, the 28% of the dollar volume of the transactions in the data set consisted of common equity, 57% consisted of preferred equity, and 14% consisted of convertible notes. In contrast, in 2018, 43% of the dollar volume of the transactions in the dataset consisted of common stock, 39% consisted of preferred equity, and 16% consisted of convertible notes.

Dividends/Coupons

The preferred security issuances surveyed for 2019 provided for dividend payments ranging from 1.75% to 9.00% per annum, with some deals providing for step-ups in the dividend payments after specified periods. Coupons on the convertible notes issuances for 2019 ranged from 1.75% per annum to 5.00% per annum. A small minority of the preferred securities and 50% of the convertible notes issuances surveyed for 2019 included payment-in-kind (PIK) interest or dividends, whereas a large majority of the preferred securities and 50% of the convertible notes issuances included PIK interest or dividends in 2018. PIK allows the issuer to pay interest or dividends in additional securities or by increasing the stated value or principal amount of the security, as applicable. If a security includes a PIK feature, the issuer typically has the right to decide whether cash or PIK interest or dividends will be paid. Sometimes the right to pay PIK interest or dividends is only available for a limited period of time.

- In 2019, 33% of the preferred equity and convertible notes issuances surveyed provided for a combination of cash and PIK interest or dividend payments, compared to 83% of the issuances in 2018.
- All of the preferred equity and convertible notes issuances in 2019 that provided for a combination of cash and PIK interest or dividend payments permitted the issuer to determine the proportion of cash vs. PIK payments. In contrast, in 2018, 40% of such issuances included a right to PIK interest or dividends only for a limited period of time, and in some cases the rate for PIK interest or dividends was higher than the rate for cash interest or dividends.

Governance Rights

Governance rights tend to be one of the most highly negotiated provisions in PIPE transactions as they govern the ongoing relationship of the issuer and investor. The most common forms of governance rights are the appointment or nomination of a director or board observer (i.e., an individual who may attend company board meetings but is not a member of the board) and voting rights. On the former, board representation is usually proportional to the equity ownership of the investors and is often conditioned on the investors maintaining ownership above a certain threshold.

Director and/or board observer appointment/nomination rights were granted in 60% of the 2019 transactions surveyed and 90% of the 2018 transactions surveyed. This is driven by the data set involving PIPES as an increasing part of acquisition financing. In both years, the majority of appointment/nomination rights were conditioned on ownership of a threshold percentage of securities purchased or outstanding common stock of the issuer.

Standstill and Lock-Up

Many investors in PIPE deals agree to standstill provisions prohibiting them from, among other things, acquiring additional securities, entering into voting agreements, or waging proxy fights for a specified period of time or until their ownership drops under a threshold level. Also, investors often agree to lock-up arrangements restricting them from transferring securities to third parties for a period typically ranging from one to three years. Given the importance of the particular PIPE investor to the issuer, this is an important feature for issuers in PIPE transactions.

- In 2019, 40% of the deals surveyed included standstill provisions and 80% included lock-up agreements. In 2018, 81% of deals surveyed included standstill provisions and 100% included lock-up arrangements. The survey for 2018 demonstrated a stronger trend in the inclusion of both forms of issuer protective measures.

For a form of lock-up agreement in another context, see Lock-Up Agreement (IPO).

Registration Rights

As PIPE transactions are by their nature private investments, investors generally require registration of the securities to resell in the public market and obtain liquidity on their investments. Based on publicly available documents, 90% of the transactions surveyed in 2019 and 81% of the transactions surveyed in 2018 included registration rights for investors, which typically contain highly negotiated provisions on the timing of filing the registration statements, number of demand rights (the investors' right to demand registration of their securities), and piggyback registration rights (the investors' right to add their securities in other registrations of securities by the issuer).

- **Demand rights.** In 2019, the trend toward fewer demand rights continued. Of the deals that included registration rights, none included demand registration rights in 2019, compared to 10% in 2018. However, a number of the deals surveyed in both 2019 and 2018 that included registration rights included a minimum offering amount threshold (ranging from $1 million to $175 million) to demand an underwritten offering using the shelf and/or limitations on the number of shelf takedowns that the investor can do in a given period of time.

- **Blackout period.** All of the deals surveyed in 2019 and 2018 that included registration rights included a blackout period in which the issuer may delay filing of a registration statement or suspend sales under a registration statement for certain events, with the blackout periods ranging from 30 to 120 days in aggregate per year.

Deal Terms Specific to Convertible Instruments

Conversion

PIPE transactions often involve the issuance of convertible equity or debt. Of the deals surveyed in 2019, 60% involved the issuance of convertible equity or debt. When conversion is triggered, the securities usually convert into common equity. In both 2019 and 2018, convertibility at the option of issuers and investors is prevalent, with the latter being more frequent. Consistent with 2018, automatic conversion features were less common in 2019.

- **Conversion at option of issuer.** In both 2019 and 2018, 66% of convertible security issuances surveyed provided for a conversion feature at the option of the issuer, usually exercisable starting two to five years after closing and triggered when the common stock trades above a certain price over a certain period of time. In determining the reference conversion price of common stock, in 2019 all of such convertible issuances tied the reference conversion price to the closing prices of the common equity or volume-weighted average price (VWAP) of the common equity, which averages trading prices throughout the trading day and is weighted by total volume traded that day, over a look-back period. In 2018, 50% of such convertible issuances tied the reference conversion price to the closing prices or VWAPs of the common equity over a look-back period, and 50% used an agreed amount. While the look-back period varies by deal, most deals had look-back periods of around 20 to 30 trading days.
- **Conversion at option of investor.** All of the convertible security issuances surveyed for 2019 and 2018 provided for conversion at the option of the investor, exercisable immediately or after a fixed period of time, ranging from six months to five years.
- **Automatic conversion.** In 2019, only one of the surveyed transactions that involved convertible securities provided for automatic conversion into common equity in connection with change of control events of the issuer. In that transaction, automatic conversion applied only for change of control events in which 90% or more of the consideration was cash. In 2018, none of the surveyed transactions that involved convertible securities provided for automatic conversion into common stock in connection with change of control events of the issuer. Although automatic conversion in connection with change of control events was not common in 2019 and 2018, most deals provided for optional conversion by the holders in this respect, and a number of deals included an increased conversion rate if the securities were converted by the holders thereof in connection with a change of control event. In addition, in 2019, none of the surveyed transactions that involved convertible instruments provided for automatic conversion into common equity in connection with certain bankruptcy or litigation events of the issuer. In 2018, 16% of the surveyed transactions that involved convertible instruments included this feature.

Redemption

Convertible securities offered in a PIPE transaction can either be perpetual or redeemable, with redemption at the option of the issuer or investor or upon the occurrence of certain extraordinary events.

- In 2019, 83% of the surveyed transactions that involved convertible securities provided for redemption at the option of the issuer and 83% at the option of the investor. In comparison, in 2018, 83% of the surveyed transactions provided for redemption at the option of the issuer and 50% at the option of the investor. The triggers for redemption included the passage of time, change of control of the issuer, and other fundamental events. In 2019, none of the surveyed transactions that involved convertible securities included automatic redemption upon a change of control of the issuer, whereas 16% of such transactions in 2018 included such automatic redemption.

Anti-dilution Adjustments and Preemptive Rights

Because future issuances of securities at lower prices, stock splits, and reclassifications have dilutive effects on the ownership of investors in PIPE transactions, investors will usually include anti-dilution protections. Along the same lines, some PIPE transactions give investors preemptive rights to participate in future issuances of securities to maintain their relative ownership.

- Consistent with 2018, in 2019, 100% of the surveyed transactions that involved convertible securities contained anti-dilution provisions, with the most prevalent being based on broad-based weighted averages, which take into account the weighted average dilutive effect based on the size of the future offering. Also, 33% of the convertible security issuances in 2019 included either preemptive rights or right of first offer (providing the investor with the right to purchase securities of the issuer prior to the issuer offering to sell to third parties), compared to 66% of the convertible security issuances in 2018. In all of the transactions surveyed, none provided for full-ratchet anti-dilution protection, which resets the conversion price to the price for the new issuance irrespective of the size of the new issuance. This aggressive form of investor protection appears to have lost ground in the market.

For additional information on anti-dilution, see Anti-dilution Adjustment Formulas in Convertible Bonds and Antidilution Provisions in Warrants Checklist.

Industry Insights

As in 2018, two of the most active industries for PIPE deals in 2019 were technology and healthcare. The following is an analysis of the trends in PIPE transactions in these two industries.

Technology

The technology industry is a high activity space for PIPE deals, as many issuers have constant financing needs to fund research and development and/or acquisition activity, and investors find the industry attractive due to its growth prospects and revenue models.

Healthcare and Biotechnology

Consistent with 2018, PIPE deals in the healthcare industry remained prevalent. The healthcare industry lends itself to PIPE transactions because of the significant economic challenge driven by high research and development costs and the innovative nature of the industry. This results in increased funding needs with respect to which companies in the industry turn to PIPE investors.

Market Outlook

PIPE transactions continue to be attractive financing alternatives to registered public offerings. PIPEs often allow for relatively quick execution and flexibility compared to public issuances and provide parties with the ability to maintain confidentiality until execution, allowing issuers to avoid risks associated with an unsuccessful public issuance. Increased volatility and uncertainty from recent macro level developments (including the global efforts to limit spread of the novel coronavirus, the oil price war following disintegration of the OPEC+ alliance, the trade war with China, Brexit, and other geopolitical frictions) will impact this market in 2020, but it is still too early to determine the net impact. While you would expect distressed PIPEs to increase, the impact on investor liquidity could be a significant counter trend.

Ari B. Blaut, Partner, Sullivan & Cromwell LLP

Ari Blaut is a partner in the firm's leveraged finance, restructuring and capital markets groups. Ari maintains a broad corporate practice advising clients on a wide range of financing transactions, including bank financings, high yield bond issuances, "PIPE" transactions, debt restructurings, liability management, creditor representations and joint ventures. Ari has particular expertise in leveraged finance, acquisition finance and strategic credit transactions. Ari regularly acts for clients in connection with arranging committed debt financing (both bank and bond) for mergers and acquisitions.

Some of Ari's significant representations in the past year include, among others, advising (i) AT&T on its $40 billion debt financing for its pending acquisition of Time Warner, (ii) Tesoro on its $4.1 billion debt financing for its pending acquisition of Western Refining, (iii) Eastman Kodak in connection with its "PIPE" transaction with Southeastern Asset Management and (iv) the ad hoc committee of Key Energy's unsecured note holders in connection with financing matters related to the acquisition of Key Energy through its prepackaged Chapter 11.

Krishna Veeraraghavan, Partner, Sullivan & Cromwell LLP

Recognized twice as "Dealmaker of the Week" by The American Lawyer, for his work on M&A mega-deals by The Legal 500 and as Leading Lawyer by the IFLR 1000, Krishna Veeraraghavan is a partner and member of S&C's Mergers and Acquisitions Group, focusing his practice on M&A, corporate governance and private equity matters. He has represented U.S. and non-U.S. companies, special committees, boards of directors and financial advisers in public company transactions, leveraged buyouts and private company sales of subsidiaries and divisions. He is an adjunct professor at Columbia Law School.

His recent representations are from a wide range of industries including: AB InBev, Amgen, AT&T, Concordia, Cyberonics, Dyax, Eastman Kodak, Heyman Family, Highgate Hotels, Idenix, Impax, LabCorp, Lion Capital, Perrigo, Pharmasset, Synageva BioPharma and Teva Pharmaceuticals.