PIPEs

Private investments in public equity (PIPE) transactions, once considered an unattractive investment for many types of financial investors, have become increasingly popular, especially among private equity investors. It is no longer the case that only the most troubled companies are willing to raise capital through a PIPE transaction. A recent survey undertaken by Latham & Watkins LLP examined the terms and features of 50 major recent PIPE transactions. David S. Allinson, Thomas J. Malone and Alexandra H. Croswell review the results.

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SCOPE OF SURVEY

This survey of private investments in public equity (PIPE) transactions analyzed 50 PIPE transactions completed between 2007 and August of 2009 (the sample period).

Most of the PIPEs surveyed were among the 50 largest PIPE transactions during the sample period. The sample covers 50 separate issuances of securities that were issued in connection with 45 transactions. Generally, where an issuer issued two or more securities at the same time on substantially the same terms (for example, two series of preferred, one of which required shareholder approval to authorize the voting/conversion feature), these were grouped together and were considered to be one issuance. There are five transactions where we did not combine an issuer's securities issued on the same day because the securities were substantially different from one another.

To take into account the uncharacteristically high number of PIPE transactions involving financial institution issuers during the sample period, we adjusted the sample by including other "representative" PIPE transactions from the sample period.

For a breakdown of the sample survey, see *Box, The Sample*. The full list of the PIPE transactions surveyed is included in the online version of this article.

For more information on PIPEs, see the following resources on practicallaw.com
>> Simply search the title OR resource number
PIPEs: A Lasting Trend? or 4-422-4792
PIPE Offerings: Overview or 5-383-4576

The global credit crisis and the recession have had a dramatic impact on the PIPE market. Grim equity markets and weak balance sheets made PIPE investments a lifeline for many issuers.

As a result, the size and diversity of PIPEs soared, particularly in the period 2007 to 2008. Based on the PrivateRaise database of PIPE transactions (available at *privateraise.com*), the aggregate proceeds of the 50 largest PIPE transactions were:

- $11,917,454,599 in 2006.
- $39,843,487,897 in 2007.
- $66,914,772,635 in 2008.
- $15,156,287,376 in 2009.

During the 2007–2008 spike the average issuance amount per PIPE investment also increased dramatically (from $238,349,091 in 2006 to $796,869,758 in 2007 and $1,338,295,453 in 2008). In addition to the increase in the overall number and size of PIPEs in 2007 and 2008, financial institutions became the dominant PIPE issuers during this period. In 2006, only five of the 50 largest PIPE transactions involved financial institution issuers. In 2007 that number rose to nine and in 2008 increased to 24, as PIPE transactions involving financial institution issuers, such as Berkshire Hathaway's $5 billion PIPE in Goldman Sachs and Mitsubishi UFJ Financial Group's $9 billion PIPE in Morgan Stanley, became front-page news.

In the survey, 19 of the 50 PIPE issuers during the sample period were financial institutions. In addition, financial institution PIPEs completed in this period were typically larger-sized deals. The average issuance size of financial institution PIPE transactions in the survey was significantly larger ($3,037,977,525) than the average issuance size of non-financial institution issuers ($757,615,599).

We examined the use of the following terms and features in 50 PIPEs undertaken during the sample period:

- Types of securities.
- Dividends/coupons.
- Conversion.
- Redemption.
- Shareholder approval.
- Governance.
- Standstills and lock-ups.
- Anti-dilution and preemptive rights.
- Registration rights.

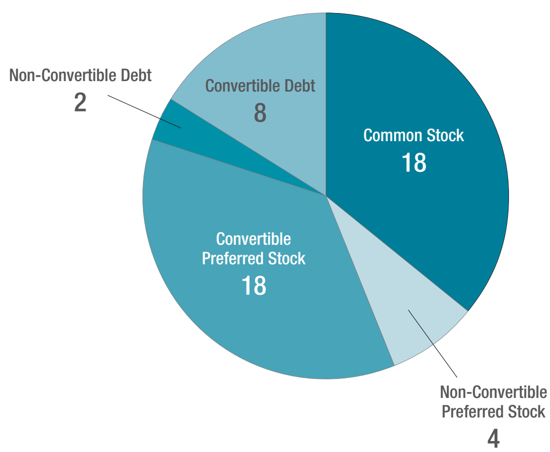
TYPES OF SECURITIES

The survey sample consisted of a variety of types of securities purchased in the PIPE transactions, including:

- Common stock.
- Non-convertible preferred stock.
- Convertible preferred stock.
- Non-convertible debt (issued with warrants).
- Convertible debt.

Most of the PIPE investments in the survey involved the purchase of either common stock (18 of 50 investments) or convertible preferred stock (18 of 50 investments).

Type of Securities



DIVIDENDS/COUPONS

Most of the preferred equity securities in the sample provided for a dividend or coupon. However, the size, form and features of these dividends and coupons often differed greatly from one transaction to another.

While most of the non-convertible preferred stock and debt securities contained a coupon or dividend that was payable in cash, a majority of the convertible preferred stock in the sample contained a "pay-in-kind" (PIK) dividend, which pays the holder of a security additional securities (or other property) rather than a cash payment. While a PIK dividend can be paid in the form of additional shares of the same security or shares of other classes (for example, preferred stock paying dividends in shares of common stock), the most prevalent form of the PIK dividend in the sample was one in which the original "liquidation preference" (or original issue price) of the preferred stock increased each quarter based on the dividend percentage.

The majority of the securities containing PIK dividends in the sample had a built-in mechanism that caused the dividend to have a compounding effect. Typically, the PIK dividend would operate to increase the liquidation preference each dividend period (commonly each quarterly period) by applying a fixed percentage (the dividend rate) to the then-existing liquidation preference. A higher liquidation preference also causes more shares to be issued on a conversion into common stock and results in the preferred holder receiving a higher pay out on a proportional basis as compared to common security holders on redemption or liquidation.

Many of the securities in the sample contained protections against the non-payment of dividends by the issuer, although these took different forms. A typical protection feature was a springing board appointment right such that if dividends were not paid for a certain number of quarters, the holders of the securities were entitled to appoint additional directors to the issuer's board.

CONVERSION

Many PIPEs have conversion features so that the security initially issued to the investor may convert into another security, either on the occurrence of a certain event or at the option of the issuer or holder. In some cases, a debt security is convertible into equity, while in other cases preferred equity is convertible into common equity.

Of the convertible securities in the sample (18 convertible preferred stock securities and eight convertible debt securities), approximately one-third were subject to a mandatory conversion feature, meaning that those securities would convert upon the occurrence of a certain event (which included the passage of time). Of those convertible securities in the sample subject to optional conversion, one-third were convertible at the issuer's option and two-thirds were convertible at the investor's option. However, some securities in the sample were convertible at the option of the issuer or the investor and in some transactions the same security subject to optional conversion was also subject to mandatory conversion.

The triggering events for mandatory conversion varied among deals. Examples of triggering events in the sample included:

- The issuer's share price hitting certain benchmarks (usually after the passage of time).
- Shareholder approval.
- Obtaining certain regulatory approvals.
- Violating transfer restrictions.
- A change of control of the issuer.

Many PIPE transactions involving convertible securities provide a feature so that upon a change of control of the issuer, the holder of the convertible security receives both:

- Shares of common stock of the issuer based on a conversion formula.
- Additional bonus shares commonly referred to as "make-whole" shares.

The number of make-whole shares payable to the holder generally depends on both the:

- Length of time between the PIPE closing date and the change of control triggering event.
- Price at which the change of control transaction takes place.

PIPEs are often structured so that as time passes post-issuance, fewer make-whole shares are awarded to the holder. The make-whole share mechanism was particularly prevalent in the convertible debt PIPE transactions in the sample, as seven of the eight transactions surveyed contained provisions entitling the holder to receive additional make-whole shares upon a change of control.

REDEMPTION

While some PIPEs contemplate a perpetual security that will remain outstanding indefinitely, others provide for mechanisms for the security to be redeemed by the issuer (or converted, as explained above).

Approximately half of the securities in the sample were redeemable at the issuer's option and approximately one-third were redeemable at the investor's option (although as the case with optional conversion, some securities were redeemable at the option of either party). Less than one-third contained a mandatory redemption feature.

The key features with respect to redemption are:

- When the security will be redeemed (including whether it is automatic or at the option of the holder or the issuer).
- At what price the security will be redeemed.

Similar to the conversion features discussed above, there are a number of triggers that may permit or require redemption, including the passage of time, the stock price of the issuer and a change of control. All of these mechanisms allow the investors and the issuer to allocate the economic risk and/or benefit of the occurrence of certain events.

The consideration for redemption varies from deal to deal, and may change depending on what "trigger" is pulled to give rise to the redemption. The consideration to be paid for redemption can range from par, to a premium based on the common stock price in a change of control transaction, to a range of declining premium to the liquidation preference after a no-call period. As a corollary to the make-whole shares discussed above, many of the securities in the sample were redeemable for a 1% premium upon a change of control.

SHAREHOLDER APPROVAL

PIPEs may require shareholder approval for a variety of reasons. PIPEs requiring the issuance of more than 20% of the issuer's outstanding shares of common stock or voting power (including on an as-converted basis) require shareholder approval under NYSE or NASDAQ listing requirements. Shareholder approval may also be required if the issuer's constituting documents require amendment before certain features of the PIPE can operate (such as if additional shares must be authorized).

Shareholder approvals are usually time consuming for issuers and conflict with the need to obtain financing quickly. As a result, and as the survey shows, in many cases the issuer will close the PIPE transaction in a manner that does not initially require shareholder approval. After the closing, the issuer then seeks shareholder approval for certain features of the PIPE (such as a voting right or a conversion right) to become effective. If shareholder approval is not obtained by a certain date, certain features of the investment may adjust, such as an increase of the coupon or dividend on the PIPE security. Of the 17 transactions in the sample that required shareholder approval, 15 were structured in a manner that did not require the issuer to seek shareholder approval until after the closing of the transaction.

The penalties for an issuer's failure to receive shareholder approval also varied among the PIPE transactions in the sample. Typically, the dividend of the security increased (often incrementally based on the number of days that passed since the date on which shareholder approval should have been obtained). Other times, the failure to receive shareholder approval triggered the mandatory conversion or redemption feature in the security, thereby entitling the holder to convert into another security with superior economic rights or to force the issuer to redeem the security at a premium.

The survey also revealed that a number of changes to the PIPE terms resulted from the receipt of shareholder approval (in other words, the penalty for failure to receive shareholder approval was initially part of the PIPE security). In some cases, the dividend on a particular class of stock decreased and voting rights sprang into existence. In other cases, the stock converted into a completely different class of stock (with voting rights) after stockholder approval was obtained.

GOVERNANCE

There is a dramatic range in the level and type of control and governance features that PIPEs afford investors. The level of control sometimes changes over time based on certain events, such as providing investors:

- Additional voting rights on the receipt of shareholder approval.
- More or fewer board appointment rights based on the holder's ownership percentage.
- Additional board appointment rights if dividends are not paid for a period of time.

The governance rights in a PIPE depend in some cases on the business of the issuer. For example, granting governance rights in a retail company has quite different implications than granting governance rights in a financial institution because investors deemed to "control" a bank under the Bank Holding Company Act, by virtue of holding 25% or more of an institution's securities or exercising a "controlling influence," would subject those investors to regulations as a bank holding company. Investors were granted board representation in just under half of the PIPE transactions in the sample, which likely was partly the result of the high number of financial institutions in the survey.

STANDSTILLS AND LOCK-UPS

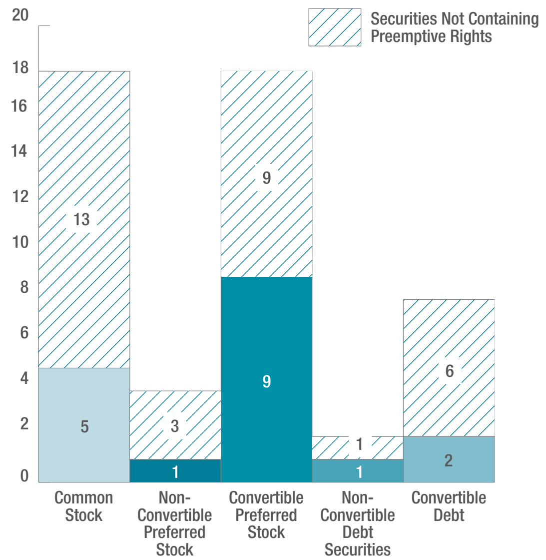
Many investors agree to some form of a standstill as part of the PIPE. The standstill often consists of a laundry list of actions that the investors will not take, ranging from acquiring additional securities to waging proxy fights. These standstills either last for a specified period of time and then terminate or lapse when the percentage of securities held by the investor drops below a threshold ownership level. 19 of the 50 PIPEs in the sample contained standstill provisions.

Approximately half (24 out of 50) of the PIPE transactions in the sample contained lock-up provisions. In contrast to standstill provisions, lock-up provisions restrict investors from selling securities to third parties. Although it is common to include contractual prohibitions on the transfer of securities received in a PIPE, the securities laws may also restrict investors from transferring securities without prior registration.

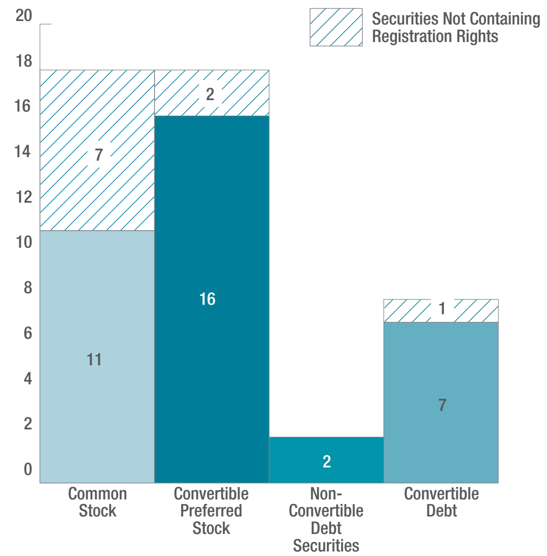
ANTI-DILUTION AND PREEMPTIVE RIGHTS

PIPE investors are often concerned about the dilutive effect of future issuances of new securities on more favorable terms than the PIPE investment as well as stock splits and similar corporate actions by the issuer. Typically, price anti-dilution protection covers issuances of common stock or convertible securities at prices below market value or below the price granted to the PIPE investor (directly or implied by the conversion price on convertible preferred stock). This anti-dilution protection usually lasts for a specified

Securities Containing Preemptive Rights by Type of Security



Securities Containing Registration Rights by Type of Security



period of time after closing and may also require that the new issuance exceed a certain minimum threshold.

The most aggressive form of price anti-dilution protection is called "full ratchet" which essentially resets the PIPE issuance or conversion price to the level of the new dilutive issuance regardless of the size of the new issuance. The more common form of protection is called "broad based weighted average" which adjusts the investor's purchase or conversion price by taking into account the weighted average dilutive impact of the new issuance based on the size and aggregated value of the new offering.

Virtually all of the PIPEs in the sample contained provisions that adjusted the conversion rates (and, by extension, the voting rights of the holder) if the issuer splits its stock or takes other similar corporate actions. In addition, a majority of the conversion rates in the sample would undergo a broad based weighted average adjustment in the event an issuer issued rights, options or warrants to all holders of its common stock that entitled those holders to subscribe to the issuer's common stock at a price per share that was less than a certain threshold amount (typically the current market price of the issuer's common stock).

In addition to anti-dilution rights, preemptive rights give PIPE investors the right to participate in certain additional security issuances by the issuer, subject to customary exceptions for issuances of incentive-based securities to employees. In exercising preemptive rights, an investor purchases the new securities as part of the issuance to maintain that investor's relative ownership in the company.

In the sample, preemptive rights were not as prevalent as anti-dilution rights, in part because the issuance of new securities for value would not cause the same economic harm to a PIPE as the types of transactions that price anti-dilution provisions protect against. In addition, an investor may have the same protections as would be afforded through preemptive rights if the investor has a consent right with respect to new security issuances. 18 of the 50 PIPES in the sample contained preemptive rights (see *Chart, Securities Containing Preemptive Rights by Type of Security*).

REGISTRATION RIGHTS

By virtue of a PIPE issuance being a private investment, investors hold unregistered securities of the issuer at closing. As a result, investors typically need to have their shares registered to sell without limitation in the public market. 36 of the 50 transactions in the sample contained registration rights (see *Chart, Securities Containing Registration Rights by Type of Security*). Registration rights are an important feature that allows PIPE investors to obtain liquidity for their investment. The registration rights in the sample typically contained restrictions regarding the number of demand registrations (requiring the issuer to register an investor's shares) granted to the investors and/or requirements that investors register enough shares to receive a minimum threshold amount of expected proceeds from the sale.

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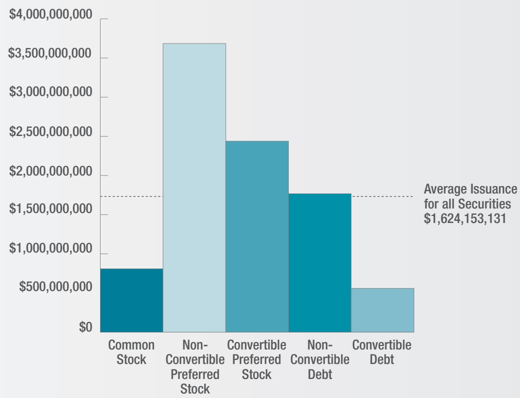
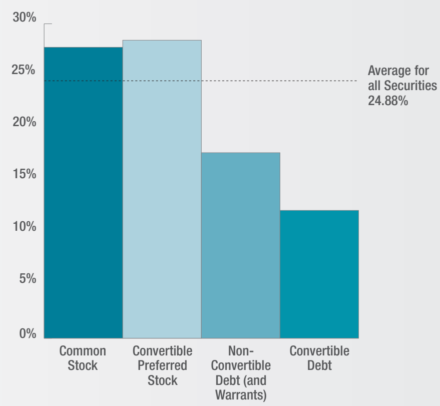
THE SAMPLE

The following information conveys the features of the 50 PIPE transactions surveyed. These characteristics are not necessarily indicative of trends applicable to all PIPE transactions.

Average Issuance by Type of Security

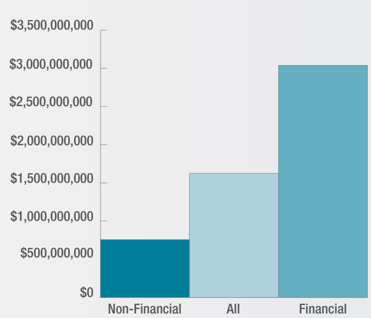


Average Percent of Issuer Acquired



19 of the 50 PIPEs issuers in the sample were financial institutions. The average issuance size of these PIPE transactions was significantly larger than the size of the average issuance of non-financial institution issuers.

Average Issuance by Type of Issuer

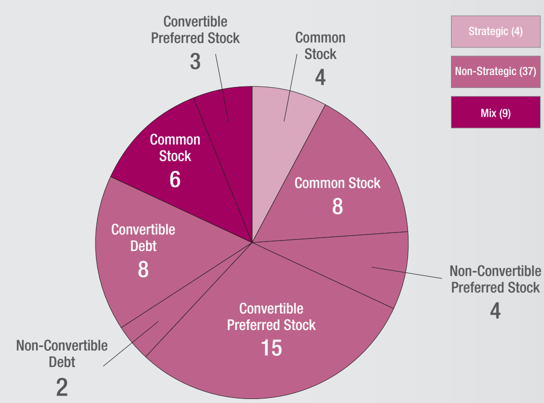


The investors in the PIPE transactions in the sample were generally non-strategic investors. Approximately half of the PIPE transactions involved investments from private equity firms. In some cases it is difficult to characterize an investment by a financial issuer as being for strategic or investment purposes.

These difficulties are apparent in Bank of America's investment in Countrywide Financial Corporation, Mizuho Financial Group's investment in Merrill Lynch & Co. and Mitsubishi UFJ Financial Group's investment in Morgan Stanley.

For purposes of consistency, this survey coded these types of investments as non-strategic. This survey also coded the PIPEs in which the investors are unknown but the publicly available information indicated that the securities were sold to institutional buyers as non-strategic (for example, Deutsche Bank AG, VeriFone Holdings, Inc. and Horizon Lines Inc.).

Type of Investors



The trends in the large transactions covered by this survey may not apply to PIPEs of less established or less regulated issuers. Reviews of smaller transactions illustrate that in a number of cases, investors receive enhanced economic terms and greater protections as compared to PIPEs of financial institutions.