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PIPE Transactions: Key Considerations for Issuers and Investors

During uncertain times, public companies may find themselves in need of additional capital, but a traditional follow-on underwritten public offering may be out of reach or considered too risky. Alternative ways to access the capital markets and increase liquidity through equity financing include, among others, "at-the-market" (ATM) offerings, registered direct offerings, and private investments in public equity (PIPEs). This update describes considerations for issuers and investors contemplating a PIPE offering as an increasingly used method of equity financing in the current market environment.

Potential Benefits All Around

PIPEs: Transactions in which public companies issue securities in a private placement, or PIPEs, have been steadily rising in recent years and are trending to increase significantly for 2020, both in number of transactions and total dollar volume, based on data and estimates from [PlacementTracker](#). PIPEs involve the issuance in a private placement of publicly traded equity securities, typically common stock, or equity-linked securities such as convertible preferred stock, warrants, or convertible notes. In a PIPE, the issuer sells a fixed number of securities directly to the investor(s) at a fixed price, usually at a discount to market price, pursuant to a purchase agreement. The transaction usually includes a registration rights agreement requiring the issuer to register the issued securities (or underlying securities) following closing so the investor may eventually sell them freely in the public markets.

The Upside for Issuers

A PIPE may be attractive to issuers for several reasons:

- **Availability.** If a volatile market presents obstacles to a traditional public offering and traditional bank financing is unavailable, a PIPE may be readily available, whether for issuance to existing investors or new accredited or institutional investors.
- **Speed.** An issuer may obtain funds quickly in a PIPE. Investors typically receive fairly light transaction-specific disclosure, instead relying on publicly available information. Depending on the negotiation of terms, a PIPE may come together in a matter of days.
- **Privacy and Control.** Because a PIPE is not publicly disclosed until after a purchase agreement is signed, the issuer has flexibility to confidentially explore possible terms with an investor (whether directly or on a no-names basis through a placement agent prior to an investor's wall-cross). This process may also allow the issuer more control over the strategic direction of a PIPE offering—for example, placing a block of equity with a "white squire" or other friendly investor (particularly with an appropriate standstill agreement in place) to deter opportunistic activists from taking advantage of market volatility.
- **Cost-Effective.** Depending on the terms, PIPEs may be considered cost-effective alternatives to traditional underwritten offerings, usually with lower transaction expenses, although the negotiated pricing discount may be higher.

Investor Motivations: Potential investors may find a PIPE appealing for several reasons. During volatile times, private equity and hedge fund sponsors may find that the uncertainty around private company valuations makes private company investments more difficult to execute. A PIPE offers an opportunity to obtain what could be a sizeable stake in a public company at a negotiated and discounted price. In addition, investors have an increasing ability—especially in the current market environment and for larger investments—to negotiate minority investor

protections in some PIPEs similar to those they could obtain in private company investments, including the possibility of a seat at the (board) table.

Unique Challenges

While PIPEs offer potential benefits to both issuers and investors, particularly during volatile market conditions, these transactions include unique challenges and issues on both sides of a deal.

Shareholder Approval

Both Nasdaq and the NYSE require listed companies to obtain shareholder approval prior to certain issuances of common stock or securities convertible into common stock. A shareholder approval requirement could delay a company's plans to raise capital, but listed companies may face delisting by the applicable exchange for noncompliance with the shareholder approval rules discussed below.

The 20% Rule: Most notably, both exchanges require shareholder approval if a company issues securities representing 20% or more of the issuer's pre-transaction outstanding common stock or voting power, subject to certain exceptions (collectively, the 20% Rule). These exceptions include (1) "public offerings" and (2) private placements so long as the price is not at a discount to the issuer's market price. The NYSE and Nasdaq each use a facts-and-circumstances analysis to determine whether an issuance qualifies as a public offering. Companies offer securities in a PIPE transaction on a private placement basis and also typically at a discount to the market price, which means they are typically subject to the 20% Rule. Issuers should consult with counsel early in the process if a PIPE may trigger the 20% Rule, including to assess potential workarounds:

- One common workaround permitted by both Nasdaq and the NYSE is for the issuer to structure the issuance as a two-step transaction, in which a company issues less than 20% of its pre-transaction common stock outstanding, together with the issuance of convertible securities or warrants that are non-voting and non-convertible or non-exercisable (or with a cap on the number of common shares that may be issued upon conversion or exercise) until shareholder approval is obtained. This "share cap" allows the issuer to either avoid or delay shareholder approval.
- Additionally, deal terms for convertible securities may include "sweeteners" (or penalties) triggered upon the outcome of a shareholder vote, to encourage shareholder approval. Examples of sweeteners include monetary penalties, an increase in the interest rate for convertible notes, an increase in the conversion ratio, or a reduction in the exercise price. The exchanges may, however, view the use of sweeteners in conjunction with share caps as coercive because, at least according to Nasdaq, this combination could deprive shareholders of their ability to freely exercise their vote on the transaction. In fact, Nasdaq guidance provides that if the terms of a transaction can change based upon the outcome of the shareholder vote, no shares may be issued prior to shareholder approval.

When determining the timing and structure of the PIPE transaction, the issuer and its counsel should carefully consider not only the effect of the proposed issuance, but also other issuances in the recent six-month period. Under applicable rules, the exchanges may aggregate non-public offerings made at less than a market price during the preceding six-month period to analyze whether the combined issuances exceed 20% in determining whether shareholder approval is required under the 20% Rule.

Other Rules: Even if the 20% Rule does not apply, the company must still consider whether shareholder approval is required because the issuance of securities may result in a "change of control" of the company, as defined by the applicable exchange (collectively, the *Change of Control Rule*), or because related parties are participating in the issuance (collectively, the *Related Party Transactions Rule*).

- **The Change of Control Rule.** Nasdaq and the NYSE will consider several factors in determining whether a change of control may occur as a result of a transaction, which notably includes transactions with less than a 51% change in ownership. Although a primary factor for both exchanges is whether an investor's post-transaction stock ownership crosses the 20% threshold, Nasdaq will also consider whether the largest ownership position in the issuer has changed as a result of the transaction, and the NYSE will consider, in addition to stock ownership, the issuer's corporate governance structure, such as board representation, management rights, and other control rights such as veto rights. Notably, a significantly dilutive transaction, especially with a single investor, will also require careful consideration and advice of counsel to the board regarding directors' fiduciary duties.
- **The Related Party Transactions Rule.** The NYSE requires shareholder approval for issuances to an issuer's directors, officers, and 5% shareholders, as well as their affiliates and entities in which related parties have a substantial direct or indirect interest, if the number of shares of common stock to be issued, or the number of shares of common stock into which the securities may be convertible or exercisable, exceeds 1% of the number of shares of common stock or the voting power outstanding prior to the issuance. There is an exception for issuances of up to 5% of a company's shares to a shareholder that is a related party only because it is a 5% shareholder. Nasdaq does not have a similar related party transactions rule, but both Nasdaq and the NYSE view issuances to employees, officers, or directors priced at a discount as equity compensation, which requires shareholder approval.

Shareholder Approval Exceptions: If an issuer faces financial hardships that require prompt access to capital, both exchanges provide a "financial viability" exception to the shareholder approval requirement. An issuer must demonstrate upon application to the relevant exchange that a delay in securing shareholder approval would "seriously jeopardize the financial viability" of the issuer and that the issuer's audit committee or other comparable body of the board of directors has expressly approved reliance on the financial viability exception. Issuers often find it difficult to obtain approval from the applicable exchange, so issuers should not necessarily rely on the financial viability exception being available. In addition, foreign private issuers are often exempt from the shareholder approval requirements.

Minority Investor Considerations

As noted above, private equity and hedge funds are increasingly interested in PIPE transactions, which include common features these investors may not be accustomed to in their typical private deals.

Deal Process: These investors may need to reset their expectations for the deal process, even if they anticipate negotiating strong minority investor protections in the deal terms.

- **Due Diligence.** Because the public company issuer files periodic reports with the SEC, including financial information and material developments in the business, PIPE due diligence is typically limited. While financial sponsors would generally expect to conduct comprehensive due diligence when acquiring a significant interest in a private deal, access to material non-public information of a public company may be limited for a minority investor.
- **Standstills, Lock-Ups.** A PIPE investor may be required to receive its interests subject to standstill restrictions limiting, among other things, the investor's acquisition of additional securities of the issuer and/or specifying lock-up periods during which the acquired securities cannot be transferred.
- **Documentation.** As PIPE transactions are designed to move quickly, the primary transaction documentation may be limited or rolled up into fewer definitive agreements. These typically include a securities purchase agreement with representations and warranties of the issuer and the investor, a registration rights agreement, and additional documents that describe investor rights and terms of the securities, such as an investor rights agreement and a certificate of designation, indenture, or warrant

agreement, as applicable.

Investor Protections: Investors are increasingly negotiating minority investor protections in PIPEs, which may include board representation, voting rights, anti-dilution protections, or registration rights.

- **Board Representation.** More significant rights, such as a board seat, are generally tied to a large investment and given only to a particular investor in the PIPE, rather than to all investors. A PIPE investor's board representation rights are limited by the relevant exchange rules, which require that board rights not be greater than the economic interest of the investor. A company may grant additional rights in the case of a default under the transaction terms, however. Depending upon the investment vehicle (e.g., convertible debt, preferred stock, or common stock), such board rights are contractual or applicable to the whole class.
- **Voting Rights.** The applicable exchange rules will also govern voting rights and generally provide that the voting rights of existing public shareholders cannot be disparately reduced or restricted. Further, the exchange rules generally require that voting rights not be greater than the holder's economic interest.
- **Anti-dilution Protections.** PIPE investors typically require anti-dilution protections to protect against future issuances, stock splits, and reclassifications. Investors may also require preemptive rights to participate in future issuances of securities to maintain their relative ownership interests.
- **Registration Rights.** As PIPE transactions are private offerings, investors generally require registration of the securities to ensure the ability to resell in the public market. Many PIPE investors negotiate the timing of the filing of registration statements, the number of demand rights, and piggyback registration rights, permitting the investor to add its securities in other registrations of securities by the issuer. They may also negotiate penalties for delayed registrations.

Fiduciary Duties: While there are many practical concerns for investors, PIPE issuers and investors should also consider the effect of the transaction and its structure in the context of fiduciary duties owed by directors to the company's shareholders. In some instances, directors may experience tension from the competing interests of and duties owed to preferred and common shareholders, particularly if a PIPE investor receives shares of a newly created preferred class. The Delaware Court of Chancery has applied the entire fairness standard of review, rather than the business judgment standard, to determine whether directors have complied with their fiduciary duty in taking actions for the benefit of preferred shareholders. Recent court decisions show the primacy of general director fiduciary duties over contractual obligations owed by the company pursuant to preferred stock.

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