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How To Raise Capital Using a PIPE

Law360, New York (September 05, 2013, 1:10 PM ET) -- A private investment in public equity, or PIPE, is an alternative financing option for public companies from traditional capital markets transactions. A PIPE is a private offering of unregistered securities exempt from the registration requirements of Section 5 (15 USCS § 77e) of the Securities Act of 1933, as amended (the "Securities Act").

Typically a PIPE is structured as a private placement under Rule 506 (17 CFR 230.506) of Regulation D, which is a safe harbor from the registration requirements of Section 5 under Section 4(a)(2) (15 USCS § 77d) of the Securities Act. (Effective April 5, 2012, what was formerly Section 4(2) of the Securities Act is currently Section 4(a)(2) of the Securities Act.)

Under Rule 506, an offering can include an unlimited number of accredited investors and up to 35 nonaccredited investors. Rule 506 currently prohibits any form of general solicitation or general advertising.

When Title II of the Jumpstart Our Business Startups (JOBS) Act (112 P.L. 106) becomes effective, it may permit issuers to engage in general solicitation and general advertising in connection with a Rule 506 offering if the securities are sold exclusively to accredited investors.

There are two basic PIPE structures. A "traditional" or "delayed" PIPE is a transaction in which a resale registration statement is filed after signing, and closing does not occur until the registration statement is declared effective by the U.S. Securities and Exchange Commission.

In order for the registration statement to be filed after signing, the private placement must be considered to be a completed private placement with the investors bearing the market risk of their investment. This requires that there are no closing conditions that are within the control of the investors.

The disadvantages of this structure are that the issuer does not gain fast access to capital since it must wait until effectiveness of the registration statement and the investors must bear market risk during that period.

While “traditional” PIPEs were once popular, this structure is rarely used in practice anymore. Instead, "standard" PIPEs are much more prevalent today.

In a "standard" PIPE, the closing typically occurs simultaneously or shortly after signing, and the issuer agrees to register the securities after the closing. Since this structure is far more common than the "traditional" or "delayed" PIPE, the discussion below addresses only "standard" PIPEs.

The securities issued in a PIPE transaction are restricted securities under securities laws, which means that they cannot be resold unless registered under the Securities Act or an exemption from registration is available for the resale of the securities.

Accordingly, investors in PIPE transactions may negotiate for registration rights, which generally take the form of resale shelf registration rights, but may include underwritten demand registration rights and/or piggyback registration rights.

Where resale shelf registration rights are included, the issuer is typically required to file a registration statement within 30 days after closing and cause it to be declared effective by the SEC within 90 days after closing (or 120 days after closing if it is reviewed by the SEC). Once declared effective, the resale registration statement will give the investors liquidity for their investment (subject to any blackout periods).

In lieu of registration, the resale exemption most commonly relied on is Rule 144 (17 CFR 230.144). For nonaffiliates of the issuer, Rule 144 requires only that the securities have been held for at least six months (or 12 months if the issuer was ever a shell company as defined in Rule 144(i)) and that the issuer is current in its public filings under the Securities Exchange Act of 1934, as amended.

The current public information requirement goes away once the securities have been held for 12 months, assuming the issuer was never a shell company as defined in Rule 144(i); otherwise this requirement remains indefinitely.

PIPEs offer issuers a number of advantages over other types of financing, such as quick access to capital on a relatively short and certain time frame. Compared to raising funds through traditional capital markets, PIPEs generally involve lower transaction costs.

For investors, PIPEs are advantageous because the securities issued in a PIPE transaction are often issued at a discount to the market price of the security. This discount compensates for the lack of immediate liquidity of the securities. A PIPE can allow an investor to purchase a sizable portion of securities at a negotiated price without driving the price up through open market purchases.

The securities issued in a PIPE can include anything from common stock, to convertible notes, convertible preferred stock and/or warrants to purchase common stock.

As compared with investments in common stock alone, investments in convertible preferred stock or convertible notes and investments, which include warrants, are more complex and take more time to negotiate because they typically include added provisions, such as anti-dilution protection, change of control provisions, negative covenants of the issuer and ranking or liquidation provisions.

Warrants to purchase common stock are typically issued as an equity "kicker" to an investment in common stock or convertible securities.

There are certain gating items that issuers, investors and their respective advisors should consider when structuring a PIPE transaction. Issuers need to confirm that they have a sufficient number of authorized but unissued and unreserved shares of common stock to cover all shares of common stock issued and issuable in the transaction.

If the equity-linked securities (such as convertible preferred) issued in a PIPE include potential increases to the number of shares underlying such securities (e.g., through the payment of interest or dividends or through economic anti-dilution provisions), the issuer will often be required to reserve additional shares.

The transaction must comply with the rules of the applicable trading market or exchange on which the issuer’s securities are listed. Most exchanges require an issuer to obtain the approval of its stockholders prior to any discounted issuance of 20 percent or more of its outstanding shares (on a pre-deal basis) and prior to any issuance that would constitute a change of control under the rules of the exchange.

It is important to identify whether there have been any past transactions that could be integrated with the proposed PIPE for purposes of any applicable shareholder approval rules and for purposes of analyzing the available exemptions from registration under securities laws.

If integrated under securities laws, one or more purportedly discrete valid exempt offerings could cease to qualify for an exemption, or an otherwise exempt private offering could be deemed to be part of a registered public offering that was not validly registered.

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