NON-TRADITIONAL OFFERING STRUCTURES: PIPES, EQUITY LINES AND SPACS

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Overview of PIPEs and Equity Lines of Credit

PIPEs, an acronym for Private Investment in Public Equity, have become an increasingly popular vehicle for public companies to raise money. PIPEs offer a relatively quick way to raise capital and often are used when more traditional sources of capital (such as bank debt or public offerings) are not available or cannot address immediate needs for capital. PIPE transactions are most frequently used by small-cap and micro-cap companies that have limited access to the public markets and may not meet the underwriting criteria required by traditional lenders. Historically, the largest single group of PIPE investors are hedge funds. However, an increasing number of large companies are turning to PIPEs to raise capital. Additionally, more private equity groups and other types of investors are purchasing securities in PIPE transactions. For example, in January 2007, Sun Microsystems announced a PIPE transaction in which it sold $700 million of convertible notes to Kohlberg Kravis Roberts. In June 2006, Sovereign Bancorp announced a PIPE transaction in which it sold a 19.9% equity stake to Grupo Santander, a large Spanish bank, for a purchase price of approximately $2.4 billion.

Although PIPEs have been around for many years, they began to emerge as a significant source of capital beginning in the mid-1990s. During the early period of PIPEs, the issuers often were struggling or distressed public companies that used a PIPE as a last chance to raise capital.

As such, the transactions sometimes were structured PIPEs that became known as "death spiral" or "toxic" PIPEs. The structured PIPEs utilized convertible preferred stock or convertible debt with floating or adjustable conversion prices that tracked the issuer's underlying common stock. Pursuant to the terms of the convertible security, if the issuer's stock price decreased, so did the conversion price, thus resulting in significant dilution upon conversion. During the market turbulence in the period from 2000 to 2003, PIPEs received bad publicity resulting in large part from the impact of death spiral structures on a number of relatively high profile companies that failed within a year of closing their PIPE transactions. Additionally, the Securities and Exchange Commission ("SEC") conducted well publicized fraud based investigations into certain hedge funds and their affiliates that invested in PIPE transactions and engaged in improper short sales of the underlying common stock prior to the announcement of the PIPE transaction.

Although structured PIPEs remain a substantial factor in the market, "traditional" PIPEs with fixed prices and conversion ratios have become more common. As a result of the more issuer friendly terms, PIPEs have attracted more companies and a larger variety of investors. According to PlacementTraker.com, 2006 was a record year with more than 1,300 PIPEs transactions that raised over $28 billion.[1] PlacementTracker.com also notes that the PIPEs market continues at an exceptionally strong pace.

[1] "PlacementTracker Stats: General Market Stats - All PIPEs", Sagient Research Systems (accessed March 9, 2006). http://www.sagientresearch.com/pt/GStats.cfm?Type=6. See also a report issued by PrivateRaise.com indicating that there were 1,842 PIPE transactions raising more than $33.5 billion in 1996. https://www.privateraise.com/home.php3?SID=76475b5d99a92f6e7b7a6cd189cba90f&datelimit=pipe_2006

Types of PIPEs

In light of the popularity of PIPEs, the large number of deals and the numerous players in the industry, there are many different types of PIPEs. Transactions can include common stock, convertible preferred stock, convertible debt, warrants, or any combination of the foregoing. The following are the basic types of PIPEs:

- Common Stock: In a typical common stock PIPE, the company issues common stock in a private placement under Regulation D. Because the shares are issued in a private placement, the investors cannot resell the shares until they are registered for resale or until they are available for sale under Rule 144. As a result, the investors assume the liquidity risk until the shares can be resold. Simultaneous with the sale of the common stock, the company enters into a registration rights agreement with the investors pursuant to which it agrees to register the shares for resale as soon as possible after the closing. Typically the registration rights agreement requires the company to file the registration statement within 30 to 60 days after the closing and cause the registration statement to be declared effective within 90 to 120 days from closing. The company usually sells the shares to the investors at a discount to the then current market price of the common stock in light of the liquidity risk assumed by the investor pending the registration of the shares.
- Convertible Preferred Stock or Convertible Debt: In this type of PIPE, the company issues convertible securities in the form of either preferred stock or debt that is convertible into the company's public equity (typically its common stock). Like a common stock PIPE, the convertible security is issued in a private placement under Regulation D with a registration rights agreement that requires the company to register the underlying public equity as soon as possible after the transaction closes. The

convertible security is more favorable to the investor in that the security is senior to the common stock and provides current income in the form of a dividend or coupon. In return, the conversion price of the preferred stock or debt often is at a premium to the market price of the underlying common stock at the time of closing. In a "traditional" PIPE, the conversion price of the convertible security is fixed at the time of closing. In a "structured" PIPE the conversion price is variable or includes price reset provisions that are triggered upon certain events typically tied to the market price of the underlying common stock. Structured PIPEs can include a floor that sets a minimum conversion price for the security. "Death spiral" and "toxic" PIPEs often are structured using convertible securities with either floating conversion prices or provisions that reset the conversion price upon the occurrence of specified events. In these deals, the conversion price of the convertible security changes based on how the underlying common stock performs after the closing of the transaction with no floor (or a very low floor). If the stock price falls, the conversion price adjusts downward pursuant to an agreed upon formula. The variable conversion price offers the investors price protection against declines in the stock price but it comes at the expense of greater, and potentially substantial, dilution to the common shareholders. Additionally, the market overhang resulting from the anticipated issuance of the shares underlying the convertible security can cause downward pressure on the market for the company's public equity.

- Equity Lines of Credit: An equity line of credit is a contractual agreement between a public company and investors that provide that the investors will purchase at set intervals of time or at the request of the company a quantity of stock determined based on a formula set forth in the agreement. The purchase price of the stock is not preset but

instead is based on the market price for the underlying security at the time of the individual purchases. The parties also enter into a registration rights agreement pursuant to which the company agrees to register the common stock issued in the transaction.

Advantages of PIPEs

Perhaps the most significant advantage of a PIPE is the fact that a transaction can be completed very quickly and without pre-closing scrutiny of an SEC review. A registered public offering often takes four to nine months from initial planning to the closing. On the other hand, an issuer can complete a PIPE in as few as three or four days to up to only a few weeks. The timing of a PIPE transaction is dictated by the amount of time the placement agent requires to locate buyers, conduct the road shows and negotiate the final terms. The timing of a public offering is dictated to a large extent by the timing of the SEC's review of the registration statement, particularly if the company is not a well know seasoned issuer, or WKSI, eligible for the use of automatically effective shelf registration statements.[2] In effect, a PIPE reverses the order of the SEC review by delaying the filing of a registration statement until after the closing. Further, because the registration statement filed after closing the PIPE relates to the resale of the common stock, the company may be able to register the shares on Form S-3 even if the aggregate market value of its common equity held by non-affiliates is less than $75 million.[3] Additionally, a public offering often is not a viable option for small-cap and micro-cap public companies

[2] In order to qualify as a "well known seasoned issuer", the company must, among other things, have a worldwide market capitalization (based on the public float of shares held by non-affiliates) of $700 million or more, or have issued $1 billion or more of debt in public offerings. The vast majority of PIPE issuers do not meet this requirement.

[3] Pursuant to Form S-3, the aggregate market value of an issuer's voting and non-voting common equity held by non-affiliates must be $75 million or more in order to use Form S-3 for the purpose of registering shares to be issued by the issuer in a primary offering. This minimum public float requirement does not apply if the registration relates to secondary offerings for the account of persons other than the issuer.

regardless of timing and the form of registration statement. As a result, a PIPE may be the only vehicle available to the issuer.

Certain advantages are outlined below:

- Time to market;
- No pre-closing SEC review of the offering;
- Use of Form S-3;
- Limited road shows and use of management time;
- Limited disclosure documents, including possible use of publicly filed reports rather than a detailed private placement memorandum;[4]
- Limited or no public announcement of the PIPE until closing;[5] and
- Substantial market for PIPEs.

Disadvantages of PIPEs

A company should carefully consider any adverse impact the PIPE may have on its business and shareholders. Following are certain disadvantages that should be considered:

- The shares often are sold a discount to market;

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[4] The placement agent typically determines the level and type of disclosure. Some placement agents will use a copy of the company's most recent SEC reports, including the Annual Report to Shareholders, Form 10-K and Form 10-Q, with a short "teaser" document describing the company and the offering. Other placement agents require a detailed confidential private placement memorandum.

[5] The issue of when and how to disclose the transaction depends on the facts and circumstances of the particular issuer and transaction. The issuer should consult with counsel in connection with the disclosure required in connection with a PIPE under applicable securities law, including Regulation FD, and Nasdaq or exchange rules. Some companies issue a press release and/or file a Form 8-K announcing the intent to conduct a PIPE. In that event, issuers should be careful to comply with the safe harbor provisions of Rule 135c under the Securities Act of 1933 (the "Securities Act") with respect to notices of proposed unregistered offerings. Other issuers do not disclose the PIPE until closing. In that event, the issuer or placement agent should obtain a non-disclosure agreement from the prospective investors. If prospective investors are not willing to execute a non-disclosure agreement, the issuer or placement agent should obtain

- Dilution to existing shareholders, particularly if the terms include variable conversion prices or reset provisions;
- The company will be subject to monetary penalties if it fails to file a registration statement, or fails cause the registration statement to be declared effective, within a relatively short period of time;
- The existence of the PIPE shares causes an overhang on the market;
- The PIPE may require shareholder approval under applicable Nasdaq or exchange rules; and
- Short-sales by the PIPE investors can cause downward pressure on the price of the company's stock.[6]

Recent Developments: Availability of Rule 415 and Form S-3

As discussed above, one of the key terms to investors in PIPE transactions is the requirement that the company register the shares of common stock issued in the PIPE (or the shares of common stock underlying the convertible securities issued in the PIPE) for resale soon after the closing of the transaction. Historically, companies have relied on the requirements of Form S-3 and Rule 415 of Regulation C promulgated by the SEC under the Securities Act to register the shares for resale as a secondary offering by the selling shareholders rather than a primary offering by the company.

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verbal assurances from the prospective investors that they will keep confidential the existence and terms of the PIPE and will not engage in any trades in the company's securities until the PIPE is announced.

[6] PIPE investors, particularly hedge funds that tend to invest on a short-term basis, often engage in short-sales of the company's stock with the intent of filling the short positions with the shares issued in the PIPE (once the shares are registered). The company may be able to obtain agreements from the investors in which they agree to refrain from, or limit, short-selling of the company's shares.

Beginning in 2006 and continuing into 2007, the SEC's Division of Corporation Finance announced in a series of speeches by deputy directors and the Chief Counsel that it will apply a more narrow interpretation to the question of whether the proposed resale of PIPE shares qualifies as a secondary offering under Rule 415, particularly if the number of shares being registered represents a substantial percentage of the issuer's outstanding shares prior to the PIPE. The Staff has expressed concern about the increase of PIPE transactions, and in particular, structured PIPEs transactions, utilizing convertible securities in which the issuer registers for resale a substantial number of shares in relation to the total number of shares outstanding prior to the PIPE. Accordingly, the Staff is taking the position that if the total number of shares being registered exceeds one-third of the issuer's outstanding common stock held by non-affiliates (i.e., the public float) prior to the PIPE, the Staff will issue a comment or series of comments requesting an analysis of whether the proposed offering is properly characterized as a secondary offering and not a primary offering.[7] If the Staff does not allow the offering to be a secondary offering then it is deemed to be a primary offering. It is important to note that the one-third threshold is not a bright line test for determining whether or not the offering qualifies as a

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[7] The Staff has stated that it has not changed its historical position and is relying on the analysis set forth in interpretations D.29 and H.76 of the 1997 Telephone Interpretations Manual. Interpretations D. 29 and H.76 are identical and state as follows:

> It is important to identify whether a purported secondary offering is really a primary offering, i.e., the selling shareholders are actually underwriters selling on behalf of an issuer. Underwriter status may involve additional disclosure, including an acknowledgment of the seller's prospectus delivery requirements. In an offering involving Rule 415 or Form S-3, if the offering is deemed to be on behalf of the issuer, the Rule and Form in some cases will be unavailable (e.g., because of the Form S-3 "public float" test for a primary offering, or because Rule 415 (a)(l)(i) is available for secondary offerings, but primary offerings must meet the requirements of one of the other subsections of Rule 415). <u>The question of whether an offering styled a secondary one is really on behalf of the issuer is a difficult factual one, not merely a question of who receives the proceeds. Consideration should be given to how long the selling shareholders have held the shares, the circumstances under which they received them, their relationship to the issuer, the amount of shares involved, whether the sellers are in the business of underwriting securities, and finally, whether under all the circumstances it appears that the seller is acting as a conduit for the issuer.</u> (emphasis added)

secondary offering. As a result, it is possible that offerings that exceed the one-third threshold can still qualify as a secondary offering. Likewise, it is possible that offerings that are below the one-third threshold do not qualify as secondary offerings. The Staff has stressed that it will use a facts and circumstances analysis on a case by case basis.[8]

If the proposed offering is characterized as a primary offering, in order to use Form S-3, the company must meet the eligibility requirements for use of Form S-3 on a primary offering basis. Among other things, in order to use Form S-3 for a primary offering, the aggregate market value of the company's voting and non-voting common equity held by non-affiliates must be $75 million or more. If the company is not eligible for use of Form S-3 for primary offerings, it must use a different form for registering the shares (usually a Form S-1).

The availability of Form S-3 can significantly affect the offering in several other ways. For example, because delayed primary offerings may be made only on Form S-3, the use of a different form will require that the offering of the shares be commenced promptly upon the effective date and that it be made on a continuous basis. In other words, the selling shareholders cannot conduct the offering on a delayed basis as is customary with secondary registrations on Form S-3. Further, Form S-3 is required for primary offerings with variable "at-the-market"

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[8] The Staff has said that it will consider multiple factors in its analysis, including the following:

- The factors set forth in interpretations D.29 and H.76 of the 1997 Telephone Interpretations Manual;
- The number of selling shareholders and the percentage of shares being sold by each;
- The relationship between the company and the selling shareholders, including whether or not the shareholders are affiliates of the company;
- The fees and discounts paid in the PIPE transaction and the amount the company actually received or will receive for the securities sold in the PIPE; and
- Whether or not there have been recent changes in the company's public float.

pricing.[9] If Form S-3 is not available because it is a primary offering, the use of a different form will require that the shares be sold at a fixed price to the public.

Finally, if the proposed offering is characterized as a primary offering, each selling shareholder must be identified in the registration statement as an underwriter. This is a particularly important factor in that it exposes the selling shareholders to underwriter liability for any misstatements or omissions in the registration statement. PIPE investors likely will be unwilling to accept potential underwriter liability.

The Staff has taken the position that it will not provide written guidance on the Rule 415 issue. Instead, the Staff will rely on the review and comment letter process that follows the filing of individual registration statements. As a result, PIPEs market participants will be forced to rely on informal pronouncements and accumulated comments in order to fully understand the impact and scope of the Staff's recent discussions.

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[9] See Rule 415(a)(4).

Overview of SPACs

During the last few years, special purpose acquisition companies, or SPACs, have enjoyed increased popularity as a vehicle for experienced management teams and, increasingly, private equity professionals to finance acquisitions through public offerings. A SPAC is a newly-formed, development stage company with no business plan or purpose other than a plan to engage in a merger or acquisition with an unidentified company or companies. As such, upon its formation and through the completion of its initial public offering, a SPAC has no business, revenue, assets, operations, operating history or plan of operations. It is a form of blank check company, also know as a blind pool company.

SPACs seek to raise capital to fund future acquisitions through an initial public offering. In light of the fact that a SPAC cannot engage in discussions with potential targets prior to completion of the offering, the investors essentially make their investment decisions based on the quality and experience of the SPAC's management team. As a result, key components that investors consider include the prior experience and success of the management team in buying and selling companies and management's access to potential deals. In effect, the investors are buying into the management team.

Structure and Issues

SPACs are incorporated as corporations by a management group or other group of founders that initially hold 100% of the outstanding equity. The founders typically purchase their initial equity stake in the form of common stock for which they pay nominal consideration. The SPAC, with the assistance of one or more underwriters, then files a registration statement

with respect to an underwritten initial public offering. Due to the fact that the SPAC has no business or operations and has not identified possible targets for acquisition at the time of the offering, the registration statement contains relatively little information about the company's business and no information about specific acquisition targets. Instead, the disclosure provides detailed information about the SPAC's acquisition strategy and targeted industries (if the SPAC has an industry focus), biographies of the management team, the terms of the securities offered, the structure of the offering, fees and expenses and the conditions and limitations relating to the use, and possible return, of the offering proceeds.

A substantial portion of the proceeds of the public offering (typically 80% to 85%) are required to be held in trust pending consummation of the SPAC's first acquisition. If the SPAC does not complete its first acquisition within a predetermined period of time, it is required to return the proceeds held in trust to the investors in the offering. The period of time allotted to close the first acquisition generally is either 12 or 18 months with an extension of up to one additional six month period if the SPAC enters into a letter of intent with respect to a qualifying acquisition prior to the end of the 12 to 18 month period. Additionally, the SPAC is required to use at least 80% of the offering proceeds to fund the purchase price in the first acquisition.[10]

There are variations in structures among different SPACs. However, the overall structure is driven to a large extent by the market. As a result, certain terms appear consistently from one offering to the next. For example, the following are certain common elements:

[10] Although the SPACs do not issue "penny stock" as defined in Rule 3a51-1 of the Securities Exchange Act of 1934, SPACs voluntarily comply with the basic concepts of Rule 419 of Regulation C promulgated by the SEC under the Securities Act. See Rule 419 for additional information relating to the escrow of the proceeds pending the initial acquisition as well as other information that impacts the offering.

- The SPAC typically offers units consisting of one share of common stock and warrants to purchase one or two additional shares;
- After closing, and in some deals only after the underwriters exercise their over-allotment options, the common stock and warrants will separate. As a result, three markets for the SPAC's securities may develop - a market for the units, a market for the common stock and a market for the warrants;
- The units, common stock and warrants likely will be listed for trading on the OTC Bulletin Board. However, a number of recent SPACs are listed on the American Stock Exchange. Further, the AIM market in London is an alternative market for SPACs;
- The founders may be required to invest additional capital in the SPAC and/or provide guarantees for the payment of expenses in the event the SPAC fails to complete the required acquisition within the allotted period of time;
- The founders' equity ownership is reduced to approximately 20% of the outstanding common stock after the offering but excluding the shares issuable upon exercise of the warrant; and
- The proceeds held in trust cannot be used to pay the expenses of the SPAC, provided that some SPACs use a portion of the interest earned on the trust funds to pay expenses.

The structure of the SPAC presents numerous issues. For example, the fact that the SPAC must complete its first acquisition within the prescribed time period and use at least 80% of the proceeds of the offering in the acquisition puts significant pressure on management to complete a qualifying acquisition relatively quickly. Further, the shareholders of the SPAC must approve the acquisition by majority vote. As a result, the

SPAC must negotiate the terms of the acquisition, prepare detailed proxy materials for filing with, and review by, the SEC and obtain the requisite shareholder approval prior to the expiration of the allotted time. Management must carefully consider all of these factors when negotiating the terms of the acquisition. The target companies are very much aware of the deadlines faced by the SPACs and can use the deadlines as leverage to increase the purchase price.

When seeking shareholder approval of a proposed acquisition, the SPAC also must offer each shareholder the opportunity to demand a refund of the shareholder's pro rata portion of the proceeds held in trust. If the holders of more than 20% of the outstanding shares of the SPAC demand a refund, the SPAC cannot complete the acquisition.

The growing popularity of SPACs has drawn the attention of the SEC's Staff. As a result, a SPAC should anticipate a full review of its registration statement and any proxy statement filed in connection with acquisitions. The SEC's Office of Emerging Growth Companies is tasked with responsibility for reviewing SPAC registration statements and other filings. The Staff frequently comments on the following areas:

- The nature and extent of the industry research before the initial public offering;
- The criteria used, or proposed to be used, in evaluating acquisition targets;
- Any conflicts of interest between management, other affiliates and potential targets;

- The procedures to be used in connection with acquisitions, including the method of calculating value for purposes of determining whether the acquisition meets the minimum 80% of proceeds requirement;
- Whether management has the authority to extend the time period for completing the first acquisition;
- The background of the transaction;[11] and
- The timing of the transaction in relation to the offering.

[11] As noted above, the SPAC should not identify, or engage in discussions with, potential targets prior to the closing of the initial public offering. If it does identify a target, or engage in discussions, the SPAC will be required to add significant disclosure in the registration statement with respect to the target company and any potential transaction. Pursuant to the proxy rules, the SPAC will be required to provide a detailed description of the background of the acquisition transaction in the proxy statement used in connection with shareholder approval of an acquisition. As a result, if the SPAC discloses discussions with the target that occurred prior to the closing of the public offering, the Staff will raise significant comment. If those discussions were not disclosed in the registration statement, the SPAC should be prepared to explain why such disclosure was not required.

About the Author

David Calhoun is a partner in the firm 's corporate group. He practices in the areas of corporate finance, securities, mergers and acquisitions, and real estate capital markets. He has significant experience in public and private securities and corporate finance, including representation of issuers, underwriters, and investors. Representative transactions include debt and equity offerings (public and private), going private transactions, venture capital financings, IPOs, secondary offerings of common and preferred securities, PIPEs (private investments in public equity), and tender offers. Mr. Calhoun has been active in mergers and acquisitions for public and private companies, including acting as counsel in transactions ranging in size from less than $100,000 to over $1 billion. Representative M&A transactions include representation of both buyers and sellers in mergers, asset sales, stock sales, international and cross-border transactions, and leveraged buy-outs. Mr. Calhoun received his bachelor's degree from the University of Tennessee at Knoxville and his law degree, *cum laude*, from Mercer University. He is a member of the State Bar of Georgia and the American Bar Association. He can be reached at (404) 504-7613 or dcalhoun@mmmlaw.com.