THE INVESTMENT LAWYER™
covering legal and regulatory issues of asset management

ASPEN PUBLISHERS   Vol. 16, No. 6 • June 2009

Structured PIPEs Offer Flexible Capital-Raising Approach

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Private investments in public equity (PIPEs) attracted substantial press attention in 2008 as prominent companies, including General Electric, Goldman Sachs, Legg Mason, Morgan Stanley, Washington Mutual, Whole Foods Market, and XO Holdings, completed successful PIPE offerings. These transactions, and the high profile issuers and investors that executed them, contrasted sharply with PIPE offerings that closed before the current market downturn. Traditional PIPE issuers had relatively small

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Structured PIPEs

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market capitalizations and frequent fundraising needs, such as early-stage biotechnology companies, and the PIPE offerings they completed were characterized by few, if any, control rights for investors. Partly as a result of this shift, the aggregate value of completed PIPE deals increased from $66 billion in 2007 to $123 billion in 2008. Moreover, many of the high-profile PIPE transactions completed in 2008 included control and other provisions characteristic of private equity investments, leading practitioners to refer to them as "structured" PIPEs. As these structured PIPEs gain prevalence, we believe that the rights, preferences, and privileges featured in such transactions will increase in complexity. In anticipation of this trend, we believe that PIPE issuers and investors should consider carefully several issues that arise in structuring PIPE transactions.

Traditional PIPEs

Traditional PIPEs generally are structured as sales of newly issued common stock or other publicly traded securities to a small group of investors by means of private placements. Due to the initial illiquidity of these securities in the absence of registration with the Securities and Exchange Commission (the SEC), these offerings typically are priced at a 5 to 15 percent discount (excluding any placement or commitment fees) to the then-current market price for freely tradeable securities, a slightly larger discount than would apply to a traditional follow-on primary offering of equity securities. Such PIPE offerings also may include warrants to purchase additional common stock so as to enhance the attractiveness of the offering, from an economic perspective, to investors. The issuance of securities through a traditional PIPE typically represents 10 to 15 percent of an issuer's outstanding share capital. This avoids the need for prior approval of such issuances by existing shareholders that are required by US national securities exchanges. In addition, the issuing company also typically undertakes to register the offered securities with the SEC shortly after the closing to render them freely tradeable in the public markets.

Issuers of traditional PIPEs generally have had less than $1 billion in market capitalization. Indeed, so-called micro-cap issuers, whose securities trade on the over-the-counter markets rather than on a national securities exchange, have relied most heavily on PIPE financings to meet their financing needs. Because many of these issuers are cash-strapped, closing speed and certainty of execution are critical. A traditional PIPE offering can close as soon as three days after the signing of a purchase agreement with investors, and, although these agreements often include a "material adverse change" clause, the closing conditions generally exclude any actions that are within the investors' control.

In addition, investors in traditional PIPE offerings generally do not expect to receive governance or other rights associated with the securities they hold. Such governance rights, such as representation on the issuer's board of directors, veto rights over certain fundamental corporate decisions, preemptive rights to participate in future securities issuances, and rights to obtain non-public corporate information, are relatively uncommon in traditional PIPE offerings. In exchange, investors obtain securities that become freely tradeable shortly after closing and that are not subject to standstill arrangements, voting agreements, or lengthy transfer restrictions.

Structured PIPEs

In contrast to a traditional common stock PIPE offering, a structured PIPE results in the issuance of a newly created class of securities. These securities, which may be debt or equity instruments, usually are convertible, at the election of the holder, into the issuer's common stock. The conversion terms may provide for mandatory conversion upon the occurrence of certain specified events, such as obtaining shareholder approval, and/or conversion at the option of the holder at a fixed conversion rate. This conversion rate often is subject to customary anti-dilution adjustments, which provide protection to the holders against subsequent discounted issuances of securities by the issuer. In addition, some structured PIPE securities are redeemable by the issuer at par upon the achievement of certain performance milestones, such as the attainment of specified closing prices for the issuer's common stock. PIPE securities also may be redeemable by the issuer at a specified premium on or after specified future dates. As with a traditional PIPE offering, the issuer agrees to ensure that the securities are or will become freely tradeable shortly after closing through the filing of a registration statement covering the securities with the SEC.

Investors in recent structured PIPEs typically consist of one or a small group of investors, which

may be affiliated funds advised by a common limited partner. By and large, these investors are larger and more focused on control-type investments than traditional PIPE investors and have included, in recent deals, Berkshire Hathaway and Mitsubishi UFJ Financial Group, Inc., as well as affiliates of Carl Icahn, Corsair Capital LLC, Goldman Sachs, Kohlberg Kravis Roberts, and Leonard Green & Partners. Significant terms from three of these recent transactions are summarized in Exhibit 1.

Due in part to the large aggregate dollar amounts invested in structured PIPE offerings and to the substantial ownership levels obtained thereby, these investors have insisted on a broad array of rights, preferences, and privileges as compared to traditional PIPE investors. These provisions raise five important legal and business considerations.

1. Control

Unlike traditional PIPE investors, structured PIPE investors typically seek some degree of control over the management and board of directors of the issuer. Observation rights at meetings of the board of directors or dedicated seats on the board of directors and its various committees have become relatively common. Under the listing rules of the national securities exchanges, unless a structured PIPE security represents a separate class of security from the issuer's voting stock, an investor's board representation generally cannot exceed, in any significant respect, the percentage ownership interest held by such an investor in the issuer.

Thus, the documents governing the terms of the structured PIPE must provide for decreases in board representation if and when an investor's percentage ownership interest in the issuer declines. Moreover, although an investor's director designees may satisfy stock exchange independence criteria, issuers should consider whether any of the investors' nominees will be deemed "affiliated outside directors" under the rules of Institutional Shareholder Services, a subsidiary of RiskMetrics Group, Inc. (ISS). Such a determination would result in a recommendation by ISS to withhold votes with respect to the election of such nominees. These standards, which are more stringent than those imposed by the national securities exchanges, may lead issuers to create a separate class of directors to be elected only by holders of the PIPE securities.

Finally, in connection with committee appointments, issuers and investors should consider the ability of nominees to serve on the audit committee of the issuer, particularly given the requirements imposed under Rule 10A-3 under the Securities Exchange Act of 1934, as amended (the Exchange Act). This rule includes in the definition of "affiliate," among other individuals, executive officers, general partners, and managing members of affiliates for purposes of determining audit committee independence.

In addition to board representation, structured PIPE investors often successfully negotiate veto, information, and preemptive rights in connection with their purchases of securities. Veto rights typically include requirements to seek the consent of the investor prior to taking certain specified corporate actions, including the payment of dividends on securities ranking junior to the structured PIPE securities, amendments to the terms of the structured PIPE securities that would have an adverse effect on holders and issuances of securities ranking senior to the structured PIPE securities.

We believe that most issuers find the granting of information rights to structured PIPE investors acceptable, particularly when the investor also gains board representation as a result of the offering. As a general matter, however, we do not believe that such information rights should require an issuer to prepare any incremental materials

Exhibit 1

	Goldman Sachs	General Electric	Whole Foods Market
Investment Type	Preferred Stock with Warrants	Preferred Stock with Warrants	Convertible Preferred Stock
Investment Size	$5.0 billion	$3.0 billion	$425 million
Dividend Rate	10.0 percent	10.0 percent	8.0 percent
Maturity	Perpetual	Perpetual	12 years
Call Price	110 percent	110 percent	104 percent declining ratably to par
Call Protection	None	3 years	5 years

that the issuer is not already required to prepare either for its management, board of directors or existing creditors. We note that access to material non-public information will limit the ability of a PIPE investor to trade in the issuer's securities and, accordingly, should not be sought if trading limitations would impair the investor's trading strategy. At a minimum, investors should consider terminating this information access right at such time as they lose board representation.

Finally, issuers may wish to include any pre-emptive rights (with appropriate exclusions for public underwritten offerings, options granted to employees, and securities issued in connection with a stock split, dividend, or reorganization) in the purchase agreement for the structured PIPE rather than the certificate of designations or other charter amendment of the issuer. This would prevent such rights from being transferred to third parties and also may avoid corporate and governance issues under state law, which may limit or prohibit grants of preemptive rights to a single class of security holders through an issuer's charter.

2. Limitations on Investor Activities

In consideration of the control rights described above, structured PIPE issuers generally seek some limitations on an investor's actions with respect to the issuer's securities. As a threshold matter, limited standstill arrangements may be appropriate, and the existence of an issuer's shareholder rights plan and the threshold at which such rights are triggered will impact standstill negotiations. A standstill can prevent, among other things, triggering a change of control provision under an issuer's debt obligations or other contractual arrangements. In the current constrained credit environment, any such triggering event could have a material adverse effect on an issuer because it would require the issuer either to refinance the affected obligation or contract or seek to negotiate a waiver or amendment to the provision. Standstill agreements also can be helpful in formalizing the understanding between investors and the issuer in terms of the investors' standing relative to other shareholders and the board of directors.

In addition to standstill arrangements, voting agreements between the investors and the issuer also are a common provision of structured PIPEs. The scope of such arrangements varies, and many include an agreement by the investor to support director candidates nominated by the board of directors in any shareholder vote or agreements to vote in accordance with the recommendation of the board of directors in connection with specified corporate events, such as business combinations.

Transfer restrictions, if included in structured PIPE offerings, generally range between one and three years, and tend to parallel the tenure of any standstill and voting arrangements. The registration rights agreement, however, may require the issuer to register the PIPE securities and any underlying securities into which conversion is possible in advance of lapsing of such transfer restrictions, so as to permit investors to hedge their position. It should be noted that hedging activity by investors, if any, must be done in compliance with applicable SEC regulations, including Regulation FD and Section 16 under the Exchange Act. Issuers as well as investors bear responsibility for structuring the terms of PIPE securities so as to ensure that any hedging activities comply with the applicable regulations. Increasingly, issuers also are being asked to facilitate the hedging activities of structured PIPE investors, including through stock borrow and other facilities, which can require the issuer to incur significant expenses.

3. Equity Classification

Prospective PIPE issuers seeking capital infusions often have structured these investments in the form of dividend-paying preferred stock. The selection of an equity offering rather than a convertible debt offering, in many cases, reflects the fact that such issuers are constrained in their ability to issue additional debt that complies with the covenants of their existing credit arrangements or due to a general lack of debt financing available in the current market. Given the careful scrutiny that many lenders are applying to covenant compliance today, issuers must take care to ensure that their lenders will not be able to re-classify a preferred stock issuance as indebtedness. As a threshold matter, we recommend that issuers and their advisors review carefully the Statement of Financial Accounting Standards No. 150 and relevant case law to ensure that a preferred stock instrument will be classified as equity upon issuance. The relevant authorities spell out several criteria in assessing whether an instrument should be classified as debt or equity, with one leading case considering 11 separate factors. Of critical importance is the nature of any mandatory redemption feature. To ensure that a preferred equity security will not be recharacterized as debt, redemption features, if any, should make clear that:

1. Redemption is dependent on the occurrence of a conditional event; and

2. Such condition is not certain to occur at the time of issuance and that such condition does not in the future become certain to occur.

Issuers also should review the definition of "indebtedness" in their credit facility and other debt documents, particularly when that term's definition does not track the definition used in the relevant accounting literature, to confirm that the contemplated security, by its terms, does not constitute indebtedness (or alternatively, if it were to be "indebtedness" when incurred, that such incurrence would be permitted). Finally, we encourage issuers to discuss any proposed preferred stock issuance with their independent auditors and lenders as promptly as possible to avoid conflicting interpretations of the debt/equity classification post-issuance.

We note, in addition, that fixed dividend payments on preferred stock may, on first glance, appear to resemble the quarterly interest payments characteristic of a debt instrument. Such dividend payments, however, are not deductible for federal income tax purposes. As a result, issuers may wish to negotiate with the investors to provide for an ability to exchange its newly issued preferred stock for debt securities having similar economic terms, particularly the coupon rate and redemption provisions. This can allow the issuer some flexibility to swap the equity securities for debt securities (and to achieve the tax deductibility of the interest payments) at a time when it is able to incur additional debt under the terms of its then-existing indebtedness.

4. Closing Conditions and Regulatory Considerations

Closing conditions for structured PIPE transactions are relatively minimal but nevertheless remain one of the most heavily negotiated components of the transaction. From an issuer's perspective, it is usually unacceptable to assume meaningful risk that a structured PIPE transaction will not close after it has been announced publicly.

However, a typical structured PIPE will exceed the relevant filing thresholds under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (HSR), which is approximately $65 million as of February 15, 2009. Therefore, the transaction parties should provide sufficient time or adjustment mechanisms to accommodate a filing and receipt of prior approval under HSR. In certain instances it may be possible to impose springing voting rights to allow for closing pending receipt of such approval. If investors do not wish to assume the risk of holding securities with limited voting rights for an indefinite period (for example, if there is a second request under HSR from the relevant regulator), closing and funding may be delayed 30 or more days from the date of signing the purchase agreement to accommodate the HSR filing and expected early termination. This settlement delay will postpone the infusion of funds to the issuer and also remove some of the speed and execution certainty that is a key advantage of the traditional PIPE.

To minimize such uncertainty and prevent changes in the issuer's financial position between signing and closing from becoming problematic to the closing of a transaction, some issuers, including Washington Mutual and Whole Foods Market, negotiated purchase agreements that did not include a "material adverse change" clause in the closing conditions. From the investors' perspective, the decision whether to proceed without such a closing condition will depend on the level of due diligence on the issuer that they can conduct prior to signing and their understanding of the short-term financial outlook of the issuer.

5. Shareholder Approval

Similar to traditional PIPEs, structured PIPEs typically are designed not to require shareholder approval prior to the initial issuance of securities. With respect to an issuance below the greater of the book or market value of the issuer's shares of common stock, shareholder approval generally is required only if such issuance could represent more than 20 percent of an issuer's voting securities (computed *prior* to giving effect to the transaction). Due to the small number of investors typically participating in a structured PIPE offering, issuers and investors also must consider whether the transaction will trigger a change of control under the relevant stock exchange's listing rules. These regulations may apply regardless of the pricing of the transaction. For example, Nasdaq's interpretive guidance provides that shareholder approval is required if, as a result of the issuance, a single entity would hold 20 percent or more of the issuer's voting securities (computed *after* giving effect to the transaction). Several recent transactions, such as Washington Mutual and Whole Foods Market, however, have imposed mechanisms to prevent triggering of the relevant 20 percent threshold through either:

1. The inability of holders to convert securities acquired in the structured PIPE into voting

securities prior to receipt of shareholder approval; or
2. A blocking mechanism that directly or indirectly prevents an investor from exercising voting rights with respect to 20 percent or more of the issuer's voting securities.

Another alternative would be to limit the issuance of such securities to less than 20 percent of the issuer's voting securities pending the receipt of shareholder approval. However, given the possible adverse reaction of existing shareholders to such an arrangement and the substantial economic penalty that typically would be required by investors in the event that shareholder approval is not forthcoming, this alternative approach generally is viewed as unworkable. We encourage issuers and prospective investors to discuss any proposed structured PIPE transaction with an appropriate person at the applicable stock exchange to ensure that a transaction does not inadvertently trigger shareholder approval requirements.

Corporate Governance, Rights Offerings, and PIPEs

Barring a transaction in which actual control is granted to an investor, structured PIPE transactions generally are not considered change of control transactions and therefore do not trigger *Revlon*[1] duties or otherwise require the issuer to conduct an auction or otherwise seek the transaction providing the issuer with the best pricing. Rather, the decision of the board of directors to undertake a PIPE transaction is subject to the business judgment rule and the general deference accorded to a board of directors thereunder. We nevertheless encourage issuers contemplating structured PIPE offerings to consider other financing alternatives in the discharge of their fiduciary duties, including an underwritten offering of primary securities, increases to existing lines of credit, and rights offerings (and backstopped rights offering, in particular).

Pursuant to a backstopped rights offering, existing shareholders are offered the opportunity to subscribe for additional shares, with an outside investor agreeing to subscribe for all shares for which subscriptions are not otherwise received. An outside investor also may be granted the ability to acquire additional shares on the same economic terms as the shares offered in the rights offering. As with a structured PIPE offering, representation on the board of directors, governance and voting arrangements, standstills, and information rights can all be agreed on prior to the announcement of a transaction and included in a purchase agreement. Unlike a structured PIPE, however, the timing of closing is less certain due to:

1. The requirement to file and have declared effective by the SEC a registration statement relating to the rights distributed to shareholders and the securities issuable upon exercise of the rights (absent an effective shelf registration statement); and
2. Stock exchange requirements relating to the time for which the rights offering must be open.

Although the delay caused by the preparation and filing of a registration statement is minimal for well-known seasoned issuers, the 15- to 20-day period during which the offer must remain open does expose an issuer and investors to increased execution and market risk.

While backstopped rights offerings have been a popular financing technique in Europe for many years, in large part because of the existence of statutory preemptive rights, rights offerings for US companies (other than closed-end funds) generally have been viewed as a less attractive financing technique. It is worth noting, however, that rights offerings can serve to minimize shareholder criticism regarding large, discounted placements of an issuer's securities with third parties while existing shareholders do not enjoy the same opportunity and yet face the prospect of a substantial dilution in the relative value of their holdings. In the past year, however, several US issuers have successfully completed backstopped rights offerings. For example, Griffon Corporation, a New York Stock Exchange-listed company, raised more than $240 million through a backstopped rights offering and investment by GS Direct, L.L.C., an affiliate of The Goldman Sachs Group, Inc., with the newly issued shares being sold at a premium to the market price on the date the transaction was announced. Due to the success of this and other recent offerings, we believe that for issuers contemplating structured PIPE offerings the backstopped rights offering may be an alternative warranting significant consideration, particularly when an issuer has significant concerns regarding shareholder lawsuits arising out of a PIPE offering.

NOTE

1. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).