BNA, INC.

ALTERNATIVE INVESTMENT LAW

REPORT

Reproduced with permission from Alternative Investment Law Report, 2 AIR 680, 5/6/2009. Copyright © 2009 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

SECURITIES OFFERINGS

Raising Equity in Troubled Times: A Survey of Financing Alternatives and Legal Issues

BY FRANK VIVERO AND HUSAM BADAWI

The present economic crisis has eroded investor confidence and created serious liquidity concerns for many companies. At the same time, while banks have tightened their lending, the market for underwritten registered offerings has become accessible only to a handful of well-capitalized companies. Accordingly, the downturn in the financial markets has created an extremely challenging environment for capital-raising activities. In past difficult financial market environments, many small- to mid-sized companies had implemented equity financing techniques designed to avoid regulatory burdens and raise new money quickly. As a result of the loss of market capitalization resulting from the current market volatility, many more companies will be required to implement similar equity financing techniques. Moreover, large public companies that in the past have had access to a large pool of retail equity investors using registered offerings in traditional financings will need to be mindful of potential changes in circumstances, which may require different approaches to tap the capital markets.

Frank Vivero is Of Counsel and Husam Badawi is an associate at the law firm of Milbank, Tweed, Hadley & McCloy LLP. The views expressed in this article are those of the authors and do not necessarily represent the views of, and should not be attributed to, Milbank, Tweed, Hadley & McCloy LLP.

The informal fallacy of a false dichotomy involves a situation in which only two alternatives are considered, when in fact there are other options. Congress seemingly created such a false dichotomy with the enactment of the Securities Act of 1933, as amended (the ''Securities Act''), by making available two distinct forms of securities transactions to issuers. On one side is the full-scale public distribution of a substantial block of securities that is underwritten, SEC-registered, orchestrated by investment bankers and carried to fruition by a select group of broker-dealers. On the other side is the direct private placement of securities to well-heeled and sophisticated investors and sound financial institutions. In the former, regulatory protections are woven into the offering for fear that the pressure of sales activity that would accompany such an offering without the special protections afforded by the registration and prospectus delivery requirements would push retail investors to make uninformed investment decisions. In the latter, these safeguards are not required because the select group of potential investors have the investment acumen and bargaining power to fend for themselves. However, these two alternative forms of securities transactions represent two extreme points on a spectrum of offering transactions. Between both ends of the private-public spectrum are offerings that contain

elements of both private and public offerings, including Private Investment in Public Equity offerings and Equity Lines, as well as registered public equity offerings designed to accommodate special market conditions, such as Registered Directs and At-The-Market offerings.

Between both ends of the private-public spectrum are offerings that contain elements of both private and public offerings, including PIPE offerings and Equity Lines, as well as registered public equity offerings designed to accommodate special market conditions such as Registered Directs and At-The-Market offerings.

This article explores the current regulatory environment facing companies interested in raising capital, and explores from a structural and a legal standpoint the various alternative financing vehicles that are expected to provide a greater measure of success during these troubled economic times. The regulatory framework of unregistered private transactions is generally, but not invariably, less demanding. While private placements may impose no specific disclosure requirements and have a liability regime that is more circumscribed, subjecting issuers primarily to the antifraud provisions of the securities laws, such as Rule 10b(5) under the Exchange Act of 1934, as amended (the ''Exchange Act''), there are strict limitations on advertising and general solicitation activities. By contrast, the underwritten SEC-registered public offering involves detailed and specific disclosure requirements, including filing a registration statement with the SEC, which contains full audited financial statements, as well as a comprehensive liability regime, but offers the marketing flexibility to reach a wider universe of potential investors. In today's difficult markets, companies should explore each financing alternative in terms of the regulatory burden and marketing flexibility afforded along the private-public spectrum and then select the most appropriate option in light of the company's specific business objectives, legal considerations and current market conditions. The analysis of the alternative financing vehicles will first review the regulatory requirements on premarketing activities, including the impact of Regulation FD, followed by a discussion of Private Investment in Public Equity, Equity Lines, Registered Directs and At-The-Market offerings.

Regulatory Environment

Premarketing Activities – 'Testing the Waters'

In a volatile market, price fluctuations highlight the advantage of pre-marketing an offering. In such an environment, there is increased pressure to explore market interest in an offering of equity securities before a transaction is announced to avoid the potential embarrassment of not being able to sell the security after the deal is made public and the attendant negative impact on the price of the security. The issues that arise under the federal securities laws when issuers and market participants seek to determine market demand for an issuer's securities vary according to the structure of the offering.

Private Offerings

The time required to complete the registration process leads many issuers to structure offering transactions as private offerings with substantive restrictions on the dissemination of offering materials to, and solicitation of indications of interest from, investors. Rule 502(c)[1] of Regulation D promulgated under the Securities Act prohibits issuers of securities from advertising or general solicitation to attract investors. The same limitation is imposed either statutorily or by common law interpretation under other federal private offering registration exemptions.[2] State securities laws also contain similar prohibitions on advertising and general solicitation in connection with private placements of securities.[3] Accordingly, an issuer and its affiliates and agents may not engage in advertising designed to, or intended to have the direct or indirect effect of, soliciting investment interest in the securities offered and attracting investors to the private offering.

In order to locate investors for a private offering, an issuer must limit itself to institutional investors such as banks, investment companies and other financial institutions, as well as to accredited investors, being those entities or persons meeting certain financial criteria as set forth in Rule 501 of Regulation D, pursuant to the exemption afforded under Section 4(6) of the Securities Act. When dealing with any other prospective investors, an issuer should be able to demonstrate and document a ''substantial and pre-existing relationship'' between the issuer, or its authorized agents (broker-dealers and finders), and each prospective investor.[4] The SEC has also relaxed its position on the issue of ''general solicitation'' with respect to using the internet as a tool to locate investors for the purpose of raising capital.[5]

Public Offerings

Generally, public offers of securities are prohibited by Section 5(c) under the Securities Act until a registration statement has been filed with the SEC. For purposes of regulating publicity about an issuer and an offering, the pre-filing period or ''quiet period'' begins when an issuer decides to make a public offering (usually when the underwriters are engaged) and ends when the registration statement is filed with the SEC.

[1] Rule 502(c) of Regulation D provides that advertising or general solicitation includes, but is not limited to: (a) any advertisement, article, notice or other communication published in any newspaper, magazine or similar media or broadcast over television or radio; and (b) any seminar or meeting whose attendees have been invited by any general solicitation of general advertising.

[2] For example, securities being sold pursuant to Rule 144A can only be sold to ''QIBs'' (Qualified Institutional Buyers) therefore limiting the kind of investors an issuer is able to reach.

[3] Although Rule 504 of Regulation D permits advertising or general solicitation in an offering of not greater than $1,000,000, similar provisions are not found under state securities laws for any private offering.

[4] Woodtrails-Seattle, Ltd., SEC No-Action Letter (August 9, 1982).

[5] *See* IPONET SEC No-Action Letter (June 23, 1996).

 COPYRIGHT © 2009 BY THE BUREAU OF NATIONAL AFFAIRS, INC. AIR ISSN 1941-6563

The SEC has provided certain safe-harbors from the prohibition on pre-filing offers. Issuers may release a limited notice regarding the offering pursuant to Rule 135 under the Securities Act, conduct certain press activities outside the US pursuant to Rule 135e under the Securities Act and release certain factual and forward-looking information under Rules 168 and 169 under the Securities Act. The one exception to pre-filing offers is offers made by well-known seasoned issuers or ''WKSIs,''[6] a new category of issuers created under the reforms to the U.S. public offering process adopted on December 1, 2005 (the ''2005 Securities Reform Act'').

2005 Securities Reform Act

The 2005 Securities Reform Act liberalized WKSIs' ability to communicate without violating the ''gun-jumping'' restrictions of Section 5 of the Securities Act. Most significantly, WKSIs may make unrestricted oral and written offers prior to filing a registration statement pursuant to Rule 163 under the Securities Act.[7] WKSI status therefore enables issuers to engage in pre-marketing efforts to test the waters before filing a registration statement. It is important to note that only the WKSI itself can make the offer, its designated underwriters may not. Both WKSIs and non-WKSIs may communicate more than 30 days before filing a registration statement under Rule 163A of the Securities Act,[8] but both issuers and underwriters need to be mindful of the contents of their websites, which are routinely reviewed the SEC staff during the registration process.

A major advantage of qualifying as a WKSI relates to shelf-registration and the scope of permissible communications surrounding the offering process. First, A WKSI is eligible to file an automatically effective shelf registration statements (''ASR'') and post-effective amendments on Form F-3 or Form S-3. Automatic effectiveness provides WKSIs with the capacity to structure an offering without the potential delay of SEC staff review. Additionally, WKSIs may register an unspecified amount of securities to be offered, add new classes of securities to the automatic shelf registration statement after effectiveness, and even add a majority owned subsidiary as a registrant after effectiveness. Further, a WKSI may file a streamlined base prospectus that omits the type of offering, a description of the securities, the names of any selling security holders, and disclosure regarding any plan of distribution. WKSIs are also permitted to pay filing fees only at the time of filing a prospectus supplement in connection with a takedown. These reforms allow WKSIs greater freedom to react to changing market conditions by allowing them to add omitted information later.

Loss of WKSI Status

A WKSI faces two primary risks to preserving its status. An issuer may lose WKSI status by falling below the $700 million equity float threshold. Additionally, an issuer faces the risk that its shelf registration statement may expire. The loss of WKSI status can be costly for an issuer resulting in the loss of the advantages discussed earlier.[9]

An issuer's WKSI status is based on its public float at the later of 60 days prior to 1) the filing of a new shelf registration statement, or 2) the time of its most recent 1933 Act Section 10(a)(3) amendment.[10] The confluence of (artificially) depressed stock prices and an upcoming third anniversary shelf deadline may force a number of issuers off of an automatic shelf and expose them to the potential delays in capital raising attendant to a regular old shelf, *i.e.*, S-3 with the potential of SEC staff review. An issuer filing a shelf registration statement in late April would only be able to look back to late February in order to calculate public float. Likewise, an issuer filing an updated annual report would risk losing WKSI status if the issuer's public float never exceeded $700 million over the previous 60 days. Additionally, a shelf registration statement under Form S-3 or Form F-3 expires three years from the date it is declared effective.[11]

Regulation FD

Anytime a public company undertakes pre-marketing efforts to assess demand for its securities it must consider Regulation FD. Under Regulation FD, if a company discloses material nonpublic information to certain persons who would reasonably be expected to trade on the information (e.g., analysts, brokers, institutional investors and shareholders), the information must also be publicly disclosed. Regulation FD is intended to stop the flow of inside information to analysts and others who then trade on the information themselves, or pass the information on to their clients.

---

[6] A WKSI is defined as an issuer that has either 1) at least $700 million of worldwide public common equity float held by non-affiliates or 2) has sold at least $1 billion of non-convertible securities in primary offerings for cash. Additionally, WKSIs must comply with certain registration requirements governed by Form S-3/F-3; a WKSI must be current and timely in its Exchange Act reporting requirements for the previous twelve months, and a WKSI must not be an ''ineligible issuer'' as defined by certain ''bad boy'' events. ''Ineligible issuer'' includes an issuer that is not current in its Exchange Act reports, that has filed for bankruptcy in the previous three years, or has violated federal securities laws in the previous three years. *Securities Act Rule 405*.

[7] Rule 163 provides an exemption to the Section 5(c) prohibition on offers to sell before a registration statement is filed. If written, the communication must contain a prescribed legend, and must be filed promptly with the SEC upon filing of a registration statement (unless the communication has previously been filed with the SEC or is exempt as a free writing prospectus under Rule 433).

[8] Rule 163A requires that communications not refer to the securities offering, communications not be made on behalf of the issuer, and that the issuer take reasonable steps within its control to prevent further distribution of the information during the 30-day period before filing the registration statement.

[9] A 6-month grace period allows WKSIs that have lost their ability to file an ASR to continue to sell securities. Issuers that have filed a new registration statement other than an ASR may continue to sell securities from the prior shelf registration statement for the earlier of the date on which the new registration statement is declared effective, or 180 days from the expiration of the three-year period.

[10] Under Form S-3 and Form F-3, the Section 10(a)(3) update need not be made through a post-effective amendment. Rather, under these Forms, the Section 10(a)(3) update generally occurs when the issuer files its annual report on Form 10-K or Form 20-F containing the issuer's audited financial statements for its most recently completed fiscal year by the due date of such annual report. *Release No. 33-8591*, at 31.

[11] *Rule 415(a)(5)*.

Anytime a public company undertakes pre-marketing efforts to assess demand for its securities it must consider Regulation FD.

Regulation FD applies to all companies that are registered under Section 12 of the Exchange Act, or file reports under Section 15(d) of the Exchange Act, excluding open end investment companies, foreign governments and foreign private issuers. Regulation FD applies to disclosures by the issuer, or a person acting on its behalf. A ''person acting on behalf of the issuer'' is defined such that only communications by directors, executive officers, investor relations or public relations officers or other employees or agents who regularly communicate with shareholders or analysts will trigger a duty to disclose information to the public under Regulation FD. It is important to note that Regulation FD only applies when disclosure is made to certain enumerated persons, including brokers or dealers, investment advisers, institutional investment managers or anyone with whom the foregoing are associated, investment companies, or persons affiliated with investment companies, or shareholders of the company when it is reasonably foreseeable that the shareholder will trade on the basis of the nonpublic information. Additionally, Regulation FD specifically excludes disclosures made to any person that owes a duty of trust or confidence to the issuer (such as an attorney, investment banker or accountant) as well as those who expressly agree to maintain the disclosed information in confidence. Accordingly, it is advisable to obtain confidentiality agreements (preferably in writing) from potential investors whenever disclosing material nonpublic information to them in connection with pre-marketing activities. Ideally, such confidentiality arrangements would be structured in a way to terminate either upon the announcement of the transaction (whereby any confidential information previously disclosed is announced to the market, including the fact that an offering is being undertaken), or upon the termination of the offering.

In connection with the communication reforms set forth in the 2005 Securities Reform Act, the rules amended the exclusions from Regulation FD for communications made during a registered offering process. Specifically, the amendment of Regulation FD ''contemplates that, in connection with an offering, certain material non-public information can be made public through the prospectus filed as part of a registration statement or the issuer's filing of free writing prospectuses.'' Regulation FD therefore does not interfere with the ''gun-jumping'' and other rules limiting the types of communications an issuer may make in connection with a registered offering of securities. For the purpose of the registered offering exclusion, Regulation FD defines the time periods when a registered offering is deemed to begin and end. Specifically, Regulation FD does not apply to disclosures made in the following mediums in connection with a registered securities offering:

- A registration statement filed under the Securities Act, including a prospectus contained therein;
- A free writing prospectus used after filing the registration statement for the offering or a communication falling within the exception to the definition of prospectus contained in clause (a) of Section 2(a)(10) of the Securities Act;
- Any other Section 10(b) prospectus;
- A notice permitted by Rule 135 under the Securities Act;
- An oral communication made in connection with the registered securities offering after filing the registration statement for the offering under the Securities Act.

Other communications (*e.g.*, the publication of regularly released factual business information, regularly released forward-looking information or pre-filing communications) continue to be subject to the requirements of Regulation FD. Accordingly it is important to note that Rule 163 offers by WKSIs are subject to Regulation FD.

If an issuer fails to comply with Regulation FD, it would be subject to an SEC enforcement action. The SEC could bring an administrative action seeking a cease-and-desist order, or a civil action seeking an injunction and/or money penalties. In certain circumstances, the SEC could also bring an enforcement action against an individual acting on behalf of the issuer who is responsible for the violation. However, violations of Regulation FD by an issuer will not cause the issuer to become the subject of private lawsuits since such violations will not be deemed violations of Rule 10b-5 under the Exchange Act. This exclusion does not affect any potential liability an issuer may have for tipping, insider trading, entanglement with an analyst report, failure to correct, or other theories relating to disclosure.

Financing Alternatives

With the current and persistent turmoil in the capital markets, issuers are having difficulty raising capital through conventional methods. Companies, both large and small, are having to look for alternative methods to secure financing. The discussion below outlines some unconventional equity financing methods that have been gaining popularity in the recent past, and provide viable financing alternatives for companies of all sizes. Companies should evaluate each of these financing techniques in light of the foregoing discussion about the rules governing pre-marketing activities, regulation FD and the applicable liability and disclosure requirements.

Note to Readers

The editors of BNA's *Alternative Investment Law Report* invite the submission for publication of articles of interest to practitioners.

Prospective authors should contact the Managing Editor, BNA's *Alternative Investment Law Report*, 1801 S. Bell St. Arlington, Va. 22202-4501; telephone (703) 341-3889; or e-mail to sjenkins@bna.com.

 COPYRIGHT © 2009 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 1941-6563

Private Investment in Public Equity ('PIPEs')

With fewer financing alternatives, small and midsized companies cannot risk the delay that may occur if their registration statements are subjected to lengthy review by the SEC. A PIPE transaction provides quick access to capital for issuers that might not otherwise be able access the public equity market. PIPE volumes have grown from 114 transactions with an aggregate value of about $1.3 billion during 1995, to 1040 transactions with an aggregate value of about $121 billion during 2008.[12] Some have estimated the amount of capital raised through PIPEs from 1995-2000 to be almost 25% of the public equity issued during that period.[13]

In a typical PIPE, a company that does not want to commit the time and expense necessary for an underwritten public offering completes a private placement of convertible or equity securities pursuant to Section 4(2) under the Securities Act without the need for SEC review in this initial stage. The issuer and the investors negotiate the timing for the filing of the resale registration statement pertaining to the common stock or shares underlying the convertible securities. PIPEs come in two main varieties, ''Traditional'' and ''Structured''. In Traditional PIPEs, the investors commit to purchasing a fixed number of securities at a fixed price, and the transaction proceeds with the resale registration statement being filed or, in some cases, declared effective, as a condition to closing the private placement portion of the PIPE transaction. Such an approach avoids concerns with integrating the private and the subsequent public portions of the PIPE,[14] and allows the investors to sell their PIPE shares on the open market in short order. A Structured PIPE typically involves convertible securities (preferred stock or debt), with the registration statement filed either prior to, or following, the funding of the private placement.

The registration typically occurs through the filing of a Form S-3 shelf, which requires issuers to have a public float of at least $75 million if conducting a primary offering but waives the float requirement if the offering is secondary, as is the case in a typical PIPE transaction.[15] The PIPE option is particularly attractive to issuers over a conventional private placement because of the lower transaction costs involved, and because PIPEs do not usually come with significant post-closing conditions.[16] The placement agent typically acts only as an intermediary and does not buy the securities for its own account. The placement can be treated in the same fashion as a public offering and is accompanied by a private placement memorandum, or by relying on the company's already filed public reports along with a summary of the company and the offering, in each case with attendant comfort letters and opinions of counsel. The terms of the transaction are typically negotiated between the issuer and the lead investor.

Important Considerations

When considering a PIPE, issuers should consider the implications of several factors including (i) the need to obtain waivers (from lenders or holders of preemptive rights), (ii) confirming that the issuer has sufficient capacity to issue the PIPE stock, (iii) evaluating the potential dilutive effect on existing shareholders, and whether antidilution provisions under existing outstanding securities would be triggered, and (iv) evaluating any possible tax consequences to the company or to the investors.[17] Accounting issues pursuant to SFAS 133 and EITF 00-19 can also be implicated in PIPE transactions offering debt or preferred securities, and have forced some past issuers to restate their financials.[18]

Investors contemplating investing in a PIPE offering have to be mindful of recent SEC positions regarding the use of PIPEs.

Investors contemplating investing in a PIPE offering have to be mindful of recent SEC positions regarding the use of PIPEs. The SEC has been engaging in actions against various hedge funds and other investors in an effort to curb the prevalent practice of short selling company stock preceding the announcement of a PIPE transaction. The SEC has claimed that by doing so,

[12] *See* Sagient Research Systems, Inc., PlacementTracker, Private Placement Resources, http://www.sagientresearch.com/pt/GStats.cfm?type=6 (Last visited January 24, 2009). The data includes all PIPE transactions excluding Structured Equity Lines, 144-A Convertibles, Reg S Placements, and Canadian OTC-BB/Pink Sheet Companies.

[13] Susan J. Chaplinsky and David Haushalter, *Financing Under Extreme Uncertainty: Contract Terms and Returns to Private Investment in Public Equity*, (May 2006), *available at* http://ssrn.com/abstract=907676.

[14] Issuers are able to file the registration statement before the closing of the related private offering with no fear of integration issues arising due to recent SEC guidance stipulating that integration will not be a concern if (1) investors are committed to purchasing a set number of securities at a set price, (2) the closing of the private offering occurs within a short time of the effectiveness of the registration statement, and (3) there are no conditions to closing within an investor's control or that an investor can cause not to be satisfied. *See* Division of Corporate Finance, Securities and Exchange Commission, Manual of Publicly available Telephone Interpretations, (Supp. Mar. 1999) at § 3S (b), *available at* http://www.sec.gov/interps/telephone/phonesupplement1.htm.

[15] Issuers eligible to use Form S-3 for a primary offering but using such form to conduct a secondary offering have the advantage of not being required to disclose details about the selling shareholders in such form, and having the option of disclosing this information when filing subsequent prospectus supplement. This is in contrast to issuers eligible to use Form S-3 for secondary offerings only (due to not meeting the $75 million market capitalization requirement) who are required to disclose information about the selling shareholders in their Form S-3 filing.

[16] More recently, especially taking into account the difficulty of accessing the capital markets, PIPE investors have been asking for more control rights in a company as a condition for their investment in order to avoid being locked into an investment with no say. *See* Bill Schreier, *Latest Developments in Capital Market Deals*, (October 7, 2008), *available at* http://www.thecorporatecounsel.net/member/webcast/2008/10_07/transcript.htm.

[17] Stanley Keller and William Hicks, *Unblocking Clogged PIPEs: SEC Focuses on Availability of Rule 415*, Insights Volume 21, Number 5 (May 2007).

[18] Anna Pinedo and James Tanenbaum, *PIPEs and Registered Directs: Back to the Future*, Financier Worldwide Magazine's 2006 Private Equity & Venture Capital Review 2006, *available at* http://www.mofo.com/practice/docs/CapitalMarkets_FinancierWorldwide.pdf.

those investors have traded on the basis of material non-public information (knowledge of the offering itself constitutes material non-public information since the announcement of a PIPE transaction typically drives stock prices down due to the fact that PIPEs result in dilution to existing shareholders, and securities are typically sold at a discount in the PIPE) and have therefore violated Section 10b of the Exchange Act and Rule 10b-5. Additionally, these short sales, whereby the PIPE investor has typically sold short the same amount of securities it committed to purchase in the PIPE, run contrary to the requirement of there being ''investment intent'' on the part of the investor in order for the offering to qualify for the private placement exemption.[19] An investor who has engaged in such a course of action will be viewed as having made a material misrepresentation to the issuer regarding its investment intent, since it is essentially acting as an underwriter as opposed to a bona fide investor, and would therefore be considered to have violated the anti-fraud provisions of the securities laws.[20] While these developments are likely to significantly thin out the class of PIPE investors[21] by eliminating those only interested in immediately flipping their PIPE shares, they are arguably market improving developments since they eliminate investors only interested in locking in the PIPE discount profit (by short selling pre-PIPE and covering the short with PIPE shares), and have allowed room for the long-term investors to step back in.[22]

As to placement agents, care should be taken to avoid market-making prohibitions, and the issuance of research reports, and to ensure compliance with the requirements of the Financial Industry Regulatory Authority (''FINRA''). Special attention should be given to the fact that while the compensation received for the private placement portion of the offering is typically outside of the purview of FINRA regulation, such compensation would be reviewed by FINRA as part of its review of the public offering compensation if the same placement agent is enlisted to assist with the public portion of the PIPE, resulting in the possibility that overall compensation could be found to be excessive and in violation of FINRA guidelines.

Legal Issues

PIPE transactions face at least two legal hurdles: the exemption for private placements, and shareholder approval requirements. To comply with Section 4(2), an issuer must conduct the offering in a way that does not involve any general solicitation or advertisement.[23] Additionally, investors must qualify as accredited investors under the Securities Act.[24] Additionally, an issuer may need to seek approval from its shareholders if required by the exchange listing the issuer's shares. For example, NASDAQ and NYSE rules generally require shareholder approval for private placements that result in the issuance of over 20% of the issuer's total outstanding stock or over 20% of the voting power outstanding before the issuance, where the stock is being sold at a discount to the issuer's greater of book or market value, or when a single investor or a group of investors ends up with ownership of 20% or more of an issuer's stock (effectively resulting in a change of control). The shareholder approval requirements do not apply to public offerings. Additionally, companies are typically exempt from this requirement in situations where the viability of the company is at stake and the delay associated with getting the transaction approved by shareholders jeopardizes the company's ability to remain in business. Other items to keep in mind are the possibility of having to make a Hart-Scott-Rodino filing in certain circumstances, filings with the Committee on Foreign Investment in the United States where foreign investors such as sovereign wealth funds are involved, and obtaining regulatory clearances in certain cases where the investment is being made in regulated industries such as banking, insurance, gaming, or defense contracting.[25] Review by blue sky authorities might also be required in certain circumstances. Additionally, issuers should keep in mind other stock exchange requirements like the need to file certain notification forms before and after the closing of a private placement for issuances exceeding a certain percentage of the float (NASDAQ), or the need to file a supplemental listing application covering the newly issued shares (NYSE).

Regulation FD Concerns

Another major concern that companies have to be mindful of relates to disclosure and Regulation FD. If a confidentiality agreement is not obtained from the placement agent, a company risks that news of its offering will spread to traders eager to short the stock before the announcement. The same holds true for both prospective investors being approached for the PIPE, and

---

[19] While the SEC has said that ''[t]here is nothing per se illegal about 'hedging' a PIPE investment by selling short the issuer's securities,'' it remains to be seen how much an investor can hedge without undermining the representation of investment intent. *See* In re SpinnerAsset Management, LLC, SEC Order, Securities Act Release No. 8763 (Dec. 20, 2006) *available at* http://www.sec.gov/litigation/admin/2006/33-8763.pdf.

[20] See George S. Canellos and Joshua R. Pater, *Federal Courts Consider SEC's Strategy in PIPE Cases*, New York Law Journal, Volume 238 – NO. 120 (December 21, 2007).

[21] See Carol E. Curtis, *As Hedge Funds Invest in Pipes, SEC Steps Up Scrutiny*, SECURITIES INDUSTRY NEWS 12 (Oct. 23, 2006) (''Hedge funds seeking discounted securities are typically the largest group of investors in [PIPEs],'' and hedge funds comprised the ten biggest investors in PIPEs based on number of deals in 2006 (through October).

[22] The damage is arguably already done however. Due to the prior arbitrage and short selling activities that had historically been associated with PIPEs, the perception had been that PIPEs were a vehicle of almost last resort that is mostly tapped by less-than-healthy companies. One study has found that following a typical PIPE, existing shareholders have earned on average -16% and -33% returns over the following 12 and 24 month periods, respectively. It also found that the majority of companies engaging in PIPEs had negative operating cash flow, about half had declining stock prices in the year preceding the PIPE issuance, and about 28% of PIPE issuers were delisted within 2 years of the PIPE offering. Chaplinsky and Haushalter, supra note 12. This stigma might be hard to overcome in the eyes of most long-term investors except for the stronger of issuers.

[23] For instance, an issuer that filed a registration statement for an offering must withdraw the registration statement a minimum of 30 days before entering the PIPE transaction. *Rule 155*.

[24] Courts consider whether the investor needs the protection of the Securities Act by examining the number of offerees, their relationship to the issuer, the manner of the offering, information disclosure, and the sophistication of the offerees. *SEC v. Kenton Capital, Ltd.*, 69 F. Supp. 2d 1 (D.D.C. 1998).

[25] *See* Edward Best, *Latest Developments in Capital Market Deals*, (October 7, 2008), *available at* http://www.thecorporatecounsel.net/member/webcast/2008/10_07/transcript.htm.

 COPYRIGHT © 2009 BY THE BUREAU OF NATIONAL AFFAIRS, INC. AIR ISSN 1941-6563

actual investors who do decide to invest. Requiring confidentiality agreements from these investors will prevent the dissemination of the information about the offering, and ensure that they remain on their best behavior due to the applicability of insider trading liability created by the existence of the confidentiality duty through these agreements. Other items to be mindful of are the need for institutional investors participating in these transactions to set up walls within their departments to prevent the flow of information, the preference for the issuer and placement agent to monitor trading in the stock of the issuer for unusual movements, and for placement agents to be attentive to the customers they invite into these offerings.[26] With respect to Regulation FD, while there is a technical exception for disclosures made in connection with a registered offering, most issuers have chosen not to rely on that exemption,[27] and most investors will insist on the disclosure of such material non-public information they have received to the public early enough in order to avoid the implications of insider trading and Regulation FD.

COMPLICATIONS WITH STRUCTURED PIPES

Structured PIPEs bring to the regulatory forefront other issues due to the complexities involved. The SEC has recently expressed a growing concern over PIPE transactions in general, and has taken the view that any such secondary registrations purporting to register an amount exceeding 33% of an issuer's outstanding common shares held by non-affiliates would be subject to strict SEC review,[28] with some of these sizable offering being deemed to be primary offerings by the issuer. This position appears to be pursued mostly with respect to variations of Structured PIPEs commonly dubbed ''death spiral converts'' or ''toxic converts,'' which are PIPE transactions where the investors receive convertible securities with an adjustable feature based on the price of the publicly traded underlying common stock without a specified cap to limit the number of shares the investors receive. The adjustable feature results in, and has in fact resulted in, an incentive for the PIPE investors to drive the stock price down by engaging in short selling before the PIPE is fully consummated in order to receive more shares for their investment.[29] In addition to the amount of shares being registered, some of the factors considered by the SEC to determine whether a secondary offering should be deemed a primary offering by the issuer include[30]:

- Number of selling shareholders and their investment history, as well as their percentage participation in the offering.

- How the investors received the shares and the length of their holding periods.

- The relationship between the selling shareholders and the issuer.

- Whether the selling shareholders are in the business of buying and selling securities.

- The discount and other fees received by the selling shareholders, and the severity of the penalty imposed on the company for missing registration deadlines.

- Whether, based on all circumstances, the selling shareholders are effectively serving as a conduit for the issuer.

Selling shareholders deemed to be affiliates can lead to a finding that the offering is a primary one with such affiliates deemed to be underwriters. The SEC's concerns stem primarily from its desire for adequate disclosure which could be stymied unless these transactions are treated as primary ones, including the provision of adequate disclosure regarding the potential dilution resulting from the transaction, the gross and net proceeds from the offering, the payment of any fees to selling shareholders and their affiliates, the discount involved, the history of transactions between the issuer and the selling shareholders, the issuer's plans and ability to repay convertible securities, how the issuer reached the determination of the amount of securities to be sold, and any plans by the investors to hedge their positions.[31]

Companies that are not S-3 eligible (whether intrinsically, or because their offerings are deemed primary and they fail to meet the $75 million float test) may be required to pursue PIPEs subject to certain limitations:

- Use Form S-1 registration statement, which requires additional disclosures and provides no prospective incorporation by reference.

- Selling shareholders are deemed underwriters, named in the registration statement, and subject to underwriter liability.

- When convertible instruments are used, the underlying stock may be registered only at time of each conversion, resulting in liquidity problems for investors.

- The offering cannot be ''at the market'' and investors are limited to selling at a fixed price identified in the registration statement.

- Transaction cannot be registered as a continuous offering with prospectus supplements or post-effective amendments to change the fixed price, so investors are required to resell their entire investment at a one-time fixed price.

[26] *Supra* note 18.

[27] *See* Michael Kaplan, *Latest Developments in Capital Market Deals*, (October 7, 2008), *available at* http://www.thecorporatecounsel.net/member/webcast/2008/10_07/transcript.htm.

[28] Anecdotal reports have suggested that the SEC's threshold for stricter review of resale registration statements may be as low as 10% of the issuer's market float. *See* Roy E. Bertolatus, *Clean Out the PIPEs: Concerns over SEC Comments, Rules on Transactions*, Texas Lawyer, (May 8, 2007).

[29] Issuers are always advised to impose trading restrictions on PIPE investors during the pre-conversion period in order to ensure the stability of the stock price.

[30] *See* Division of Corporate Finance, Securities and Exchange Commission, Manual of Publicly available Telephone Interpretations, (Securities Act R. 415, Jul. 1997 at § 29), *available at* http://www.sec.gov/interps/telephone.shtml. The SEC has said that non-fixed convertible notes and other ''toxic'' or ''extreme convertible'' securities are less likely to pass muster.

[31] *Supra* note 17.

The integration rules were designed to catch issuers attempting to accomplish what they cannot do in one offering through the offering of several tranches of securities.

However, even if a company is eligible to file a Form S-3 and registers the sale as an ''at-the-market'' primary offering under Rule 415, the fact that the offering is a primary one results in the selling shareholders (the original PIPE investors) being deemed underwriters, exposing them to Section 11 liability and substantially raising the amount of due diligence required on the part of such investors.

Other Considerations

In light of the abovementioned concerns, the parties involved should be mindful of several key issues in negotiating documentation associated with PIPEs, including (i) whether the registration statement will be filed as a condition to the closing of the PIPE private placement portion, or shortly thereafter, (ii) possible penalties if the registration statement is held up by the SEC in cases where registration is slated to follow the private placement, (iii) negotiating cutback re-sale priority in cases where the SEC requires such, and (iv) the need to file additional registration statements if a cutback becomes a reality. Other items that investors might raise when convertible securities are issued include protections against price drops through re-set provisions (although companies are advised to place caps on such re-set provisions to avoid excessive dilution), veto rights on major transactions, and bonus provisions on certain liquidity events.[32]

With respect to both Traditional and Structured PIPEs, integration concerns present another legal issue, and can possibly bring back into play the 20% shareholder approval requirement and the 33% primary offering concern if the issuer is not cognizant of the possibility of integration of its various private offerings. The integration rules were designed to catch issuers attempting to accomplish what they cannot do in one offering through the offering of several tranches of securities. The standard SEC position leaves the door open to integrating private offerings completed within the same six-month period, and both the NYSE and NASDAQ have similar requirements mirroring the SEC's guidance. Later guidance from the staff has clarified that the SEC will not object to an issuer registering additional tranches of securities provided the later of (1) 60 days has elapsed since the sale of substantially all of the prior tranche, or (2) 6 months has elapsed since the effectiveness of the prior tranche registration statement.

Established companies that have more negotiating power in the financing arena can opt for an alternative to the PIPE which provides the company with the desired flexibility and control over its funding needs, but exposes investors to greater degrees of possible liability than a PIPE.

Integration concerns also arise with respect to the basic structure of a PIPE. If a PIPE transaction is not conducted properly, with the substantial completion, or at least the irrevocable commitment, of the investors in the private placement, and the subsequent registered offering properly conducted, the result could be the integration of the private and the public portions of the PIPE into a single offering in the eyes of the SEC (commonly referred to as a ''burst PIPE''). With a burst PIPE, the issuer might lose the Section 4(2) exemption for the private portion of the offering (due to the general solicitation associated with the public offering), and could be found liable for Section 5 and ''Gun Jumping'' violations (offering a security without a Section 10 prospectus, and selling unregistered securities).

Equity Lines

Established companies that have more negotiating power in the financing arena can opt for an alternative to the PIPE which provides the company with the desired flexibility and control over its funding needs, but exposes investors to greater degrees of possible liability than a PIPE. An Equity Line involves an issuer obtaining the right to effectively lock investors into a purchase of a specified amount of its common stock through the exercise of a ''put'' when it chooses, subject to certain negotiated conditions, and no right on the part of the investors to revoke the put. The transaction is typically conducted as a private placement to effectuate the sale of the securities under the Equity Line coupled with registration rights to the investors. It should be noted that an existing trading market has to exist as an Equity Line is not permitted to effect an initial public offering.

Important Considerations

The SEC views Equity Lines as indirect primary offerings. As such, an issuer is allowed to register for resale the securities implicated in the Equity Line, even before an issuer exercises its put option through the Equity Line, assuming certain conditions are complied with:

- The put option must have been fully transacted, giving only the company the right to exercise such put, and, except for conditions outside the investors' control, the investors must be irrevocably bound to purchase the securities upon exercise of the put by the issuer, and must not have the ability to transfer their obligations under the Equity Line;
- The resale registration statement must be on a form that the issuer is eligible to use for a primary offering; and
- In the prospectus, the investors must be identified as both underwriters and as selling shareholders.

[32] *Id.*

 COPYRIGHT © 2009 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 1941-6563

Consequently, in order for the Equity Line to be considered proper by the SEC, the only exit mechanism from the put would be in the sole control of the company, or through customary representations and warranties and conditions against material adverse changes, which are not within an investor's control. If such conditions are not complied with, the issuer can attempt to register the resale of the shares assuming it (i) is eligible to use Forms S-3 or F-3 for a primary offering, (ii) complies with Rule 415(a)(4) of the Securities Act for at-the-market offerings, and (iii) discloses the fact that it is in potential violation of Section 5 in connection with the private transaction.

Equity lines have the advantage of allowing an issuer to call upon the investors (by exercising its put option) only if and when it is in need of the proceeds. However, since the price of the Equity Line will typically float with the market, an issuer will face similar problems to those discussed in the context of the ''toxic converts'' above. These issues are less pronounced in this scenario since the issuer has final say in when, if ever, the Equity Line is exercised. The flexibility allowed the issuer does come at a price to the investors in an Equity Line, who are treated as underwriters and subject to liability associated with such status.

Registered Directs

Companies that want to dispense with the large discounts associated with PIPEs and Equity Lines can go further down the SEC registered route and opt for an instrument that offers investors immediate liquidity, without the undesirable underwriter liability concerns. Such is what Registered Direct offerings provide. A Registered Direct offering is a public offering that allows an issuer to pre-market its securities similar to a PIPE, and also avoids triggering the shareholder approval requirements arising from large discounted private placements. In a Registered Direct, an investment bank acts as placement agent to market the securities primarily to institutional investors. An issuer without a shelf registration statement may file a single-purpose registration statement and close as soon as the registration statement is declared effective. An issuer with a shelf registration statement may conduct a shelf takedown overnight or over a couple of days. The issuer should be mindful of the requirement to update the registration statement by filing a prospectus supplement immediately before the offering is priced, or an 8-K disclosing material information before investors make an investment decision, if it believes that the current public disclosure is lacking.[33] A Registered Direct that is conducted as a shelf take-down allows the issuer to test the waters through a placement agent: the placement agent may engage in a non-deal road show, and assess demand for an offering without the issuer ever committing to a public offering. As long as the placement agent does not disclose financing information prematurely, and ensures that financing discussions are confidential, the placement agent can engage in valuable targeted marketing without having to file a prospectus supplement.

Important Considerations

Registered Directs combine the appeal of a registered offering, with the targeted marketing appeal and cost and time efficiencies of a private placement.[34] The announcement of a Registered Direct transaction does not typically result in the same short selling that is typically associated with announcements of underwritten offerings or PIPEs. While dilution is still an issue for existing investors, new investors are not typically given as large of a discount as that received by PIPE investors since liquidity, or the lack thereof, is not a concern in these offerings, which are already registered. However, since a Registered Direct is a public offering, the placement agent involved will typically require similar accountant comfort letters, opinions of counsel, certificates, and representations and warranties from the issuer, and will need to perform satisfactory due diligence, leading to transaction costs that are somewhat higher than a typical PIPE.[35] Additionally, since the offering is typically sold directly to investors with the placement agent taking a more passive role, the issuer will have to deal with the logistical issue of coordinating issuances of the shares directly to the several purchasers and coordinating receipt of their funds, compared to the typical underwritten offering process where the lead underwriter takes control of the shares and handles fund and share movements and distributions.[36]

Issuers engaging in Registered Directs should note that while the exchanges exempt public offerings from the shareholder approval requirement is triggered when the 20% threshold is exceeded, the fact that a Registered Direct is per se a public offering for SEC purposes does not always pass muster with the exchanges who, in certain circumstances, might consider these transactions to be private placements since they do not involve firm commitment underwriting and are typically marketed to a limited number of investors.[37] This is especially true in deals that are completely premarketed and fully ''sold'' before announcement.

It should be noted that integration of prior private offerings with a Registered Direct is less of a concern because of Securities Act Rule 152 which leads to a finding against integration if the private placement is completed prior to the filing of the registration statement. Assuming that the prior private offering was conducted appropriately, the SEC has stated that ''under Rule 152 the filing of a registration statement following an offering otherwise exempt under Section 4(2) does not vitiate the exemption under Section 4(2).''[38]

Disclosure and Regulation FD issues also arise in the context of these financings. Similar to PIPEs, where marketing materials are usually limited to already available public information, it is the knowledge of the offering which constitutes material non-public information. Confidentiality agreements should be, and typically are, utilized in these transactions with respect to placement agents and potential investors, and the other concerns discussed in the PIPE context should be kept in mind when an issuer is conducting a Registered Direct offering.

[33] Robert Kohl, *Making the Most of a Difficult Market: Public Offering Structures That Maximize Flexibility and Limit Risk*, Mondaq Business Briefing (January 8, 2009).

[34] *Supra* note 18.
[35] *Supra* note 33.
[36] *Id.*
[37] *Supra* note 18.
[38] *See* Verticom Inc. No-Action Letter, 1986 WL 65214.

At The Market Offering Programs ('ATMs')

Companies with established trading foundations can go even further down the SEC registered route, and opt for a vehicle that gives the issuer greater control and flexibility than Equity Lines, with an even lower discount on the offering price than Registered Directs. ATMs are efficient financing vehicles that have been gaining in popularity over the past few years. In an ATM, an agent is designated to conduct the ATM, although as far as the SEC is concerned such agent is deemed to be an underwriter, and the company reserves for issuance under the program a specific number of shares. The shares, when released by the company, are typically sold publicly at the market price (although agents will sometimes reserve the right to conduct private sales, and issuers will sometimes require such private sales to be pre-approved by them). The regulatory aspect requires an existing shelf registration statement, although a WKSI can file an automatically effective registration statement on Form S-3ASR simultaneously with the program prospectus. The program prospectus itself is typically a minimal prospectus supplement containing the general terms of the proposed ATM, the plan of distribution and the maximum number of shares to be sold, and names the agent. A Form 8-K is also filed attaching the agency agreement.

The advantages of ATMs are numerous, including lower fees than a typical underwritten public offering

Sales through the program occur at the option of the issuer, who takes into account its needs and the current market price of its securities, and are typically settled on a per-sale T+3 basis, or at the conclusion of each designated sale period (e.g. at the end of a month when sales were continuously conducted). The issuer will typically have pre-set minimum prices below which the agent is not allowed to sell without pre-authorization. Either quarterly, or more frequently (following material sales), the issuer will file a pricing prospectus supplement setting forth the terms of the sales recently conducted.

Important Considerations

Some of the items an issuer should plan for from a timing perspective is the fact that the agent involved in such an offering is still subject to underwriter liability, and will therefore have to perform the typically required due diligence and obtain customary accountant comfort letters, officer certificates, and opinions of counsel. Additionally, such diligence, comfort letters, certificates and opinions will have to be updated periodically with ''bring-downs'' preceding the commencement of a sales period. The context under which disclosure concerns could arise occurs in any instance when a company wanting to utilize its ATM possesses material non-public information, and companies are advised to handle such situations the same way they would a share repurchase plan (the company should effectively abstain from trading until the information is made public).[39] ATMs have no effect on the issuer's ability to perform other types of offerings, although a company should be mindful of pressure on its stock price from an ATM if contemplating a concurrent offering.[40] Additionally, an issuer has to be cognizant of the possible need to obtain FINRA approval, and well as be mindful of other regulatory constraints imposed by Regulation M and other anti-manipulation regulation, with prohibitions against stabilization and passive market making activities.[41]

The advantages of ATMs are numerous, including lower fees than a typical underwritten public offering (agent is only paid a commission on what is sold), without the stigma of a follow-on offering since the company's news release to the public is an announcement that the company is contemplating the future sale of up to that amount of reserved shares over the course of the next several years (the typical length of an ATM is 3 years).[42] This information is typically absorbed in a much more benign fashion by the market than other financing announcements given the uncertainty involved. Additionally, the control an issuer has over the timing of, and proceeds from, the program is invaluable. While the costs for the program are put up by the issuer before any guarantee of proceeds, this structure saves time since it initiates the process and prepares both the agent and legal counsel from a diligence standpoint to proceed with sales as soon as the issuer desires.[43]

Conclusion

While the foregoing discussion has centered on only some of the financing alternatives available for companies in times of market turmoil, the methods above are by no means the only avenues available, although they are most likely the ones to succeed in the current market environment. Companies should always evaluate not only their options, but their long-term goals and strategy when looking for capital. The methods above offer alternatives previously mostly utilized by smaller companies, but the markets, and investors' appetites, have been steadily adjusting to such offerings from larger companies with greater financial needs. While these alternatives will not completely replace the customary Section 4(2) or Rule 144(A) private offering on one end of the spectrum, or the age old SEC registered underwritten public offering on the other end, the current challenging environment in the capital markets will only spur the proliferation of these financing vehicles. The financially savvy companies willing to venture beyond the beaten path for their financing needs will be the ones better able to survive the storm.

---

[39] *See* ''At the Market Offerings: Raising Equity Capital in Volatile Markets'', Goodwin Proctor (December 29, 2008), *available at* http://www.goodwinprocter.com/~/media/3421461177C747D09AAA3AC3FAC92DB7.ashx.

[40] *Id.*

[41] *Supra* note 33.

[42] Companies engaging in such programs should bear in mind the obligation to renew their shelf registration statement before expiration if the length of the ATM exceeds the viability of the shelf, and are typically required to make such representation to the agent in the sales agency financing agreement, the equivalent of the underwriting agreement.

[43] *Supra* note 33.

 COPYRIGHT © 2009 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 1941-6563