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### "Clean Out the PIPEs: Concerns Over SEC Comments, Rules on Transactions"

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Private investment in public equity (PIPE) transactions involves a private placement of securities by an already-public company, with the issuer committing to register the securities for resale promptly after the private placement is completed. Although variations exist, in the most standard PIPE transaction the investors in the private placement enter into an irrevocable commitment to purchase securities at a fixed price; but the investors are not required to close and fund their purchase until after the issuer has filed a registration statement covering resales of the securities sold in the private placement and the registration statement is about to become effective.

U.S. Securities and Exchange Commission staff has permitted PIPE transactions through its interpretation of Rule 152 under the Securities Act of 1933, which provides that an issuer may decide to make a public offering and/or to file a registration statement subsequent to a private placement without causing the private placement itself to be part of the public offering.

The staff formulated its position in no-action letters issued in the early 1990s, in particular Black Box Inc. (publicly available June 26, 1990) and Squadron, Ellenoff (publicly available Feb. 28, 1992). The gist of the staff's position in Black Box and Squadron, Ellenoff was later incorporated into Manual of Publicly Available Telephone Interpretations published by the SEC's Division of Corporation Finance. The manual's principal test for qualifying as a permissible PIPE transaction is as follows:

The Division staff raises no objection when securities are privately placed with the closing of the private placement contingent on filing or effectiveness of a resale registration statement as long as the purchasers in the private placement are irrevocably bound to purchase the securities subject only to the filing or effectiveness of the registration statement or other conditions outside their control and the purchase price is established at the time of the private placement.

Although issuers typically sell securities in PIPEs at a discount to their market price, PIPEs have been popular with issuers because of the speed and predictability with which the issuer can price and sell the private placement, while investors benefit from receiving securities that are practically freely tradable.

Over time, the PIPEs market developed more exotic features, sometimes with appropriately colorful descriptions. In particular, structured PIPEs have evolved in which the first-step private placement involves the sale of preferred stock or debt securities that are convertible into common stock at a conversion price that automatically adjusts downward if the company's share price falls below the initial conversion price. When the parties set the limit at a low price, or where there is no limit on the downward adjustment, the prospect of large-scale conversions and sales at declining prices can create enormous selling pressure pushing the issuer's share price downward. Lawyers call these transactions toxic or death spiral PIPEs.

In structured PIPEs, the private placement of convertible securities typically closes and funds before the issuer files its registration statement covering resales. The issuer has a contractual commitment to file the resale registration statement promptly after the private placement closes. The issuer generally becomes subject to a penalty if the SEC doesn't declare the registration statement effective during a specified period following the closing date of the private placement.

#### NOTES AND COMMENTS

Starting about a year ago, a number of issuers that had committed to register the resale of securities sold in structured PIPE private placements were surprised to receive SEC comments on their resale registration statements questioning whether they were eligible to register resales with a shelf registration under SEC Rule 415, according to the Aug. 1, 2006, issue of The PIPEs Report. As a practical matter, to give PIPE investors the highly marketable securities they've bargained for, the

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PIPE issuer has to register sales on a continuous basis through a Rule 415 shelf registration. Most public companies, including micro-cap issuers, can use Rule 415 to allow selling shareholders, such as PIPE investors, to conduct ongoing “secondary” public offerings of securities they acquire in a private placement; but only larger issuers, those having a market “float” (the amount of outstanding common equity securities held by non-affiliates of the issuer) of at least \$75 million, can use Rule 415 to conduct ongoing “primary” offerings of their own securities. The SEC was taking the position that the issuers receiving the new Rule 415 comment were registering so many shares that their PIPEs sales should be collapsed into a single transaction and treated as primary distributions by the registrants rather than private placements by the issuers followed by separate secondary distributions by the PIPEs investors.

Typically, SEC staff raised these questions in circumstances in which the issuer was registering a large number of shares relative to its market float. For example, in one comment letter from December 2006, the staff noted as follows:

We note that you are registering for resale on the Form S-1 more than twice the number of shares of common stock that are currently outstanding. ... Given the nature and size of the transactions being registered, advise the staff of the company’s basis for determining that the transactions on the new Form S-1 are appropriately characterized as secondary offerings that are eligible to be made on a shelf basis under Rule 415(a)(1)(i).

Anxiety and uncertainty resulted from this round of comment letters, which circulated quickly through blogs and other correspondence among lawyers.

Early on, the SEC provided little substantive guidance as to the circumstances in which it would challenge the registrant’s right to register resales of its securities under Rule 415. Practitioners questioned whether the SEC was revisiting its longstanding rules regarding PIPEs and under what circumstances an issuer might expect to encounter resistance from the SEC on filing the resale registration statement.

One cause for anxiety was the issuer’s contractual commitment to file a resale registration statement and use its best efforts to have it declared effective. As noted above, in most cases the issuer would become subject to penalties if the SEC did not declare the resale registration statement effective within a stated time period. Issuers with a market float of less than \$75 million found themselves in a serious bind. The only practical way to effect the continuous public offering would be through a Rule 415 shelf registration — and Rule 415 would not be available for a micro-cap issuer if the SEC determined that its PIPE sales were really primary issuer distributions, rather than secondary public resales by the PIPEs investors.

Within the past few months, the SEC has started putting some parameters around its review of PIPEs transactions. SEC staffers are articulating the SEC’s position at various speaking engagements. For example, the director of the SEC Division of Corporation Finance, John H. White, said in a February speech that SEC staff has not changed its position with regard to traditional PIPEs but is simply addressing the recent development of convertible debt transactions that some lawyers are structuring in an abusive manner.

Nevertheless, SEC staffers have cautioned practitioners in speeches that they should expect staff comments when an issuer registers for resale more than one-third of its outstanding common shares held by non-affiliates — although anecdotal reports suggest the SEC’s threshold for stricter review of resale registration statements may be as low as 10 percent of the issuer’s market float.

Where an issuer receives comments questioning its eligibility to effect a resale registration under Rule 415, the issuer should also anticipate further staff comments regarding additional disclosure in its prospectus in the event that the SEC allows the issuer to go forward with its resale registration, including disclosures regarding payments to investors and their affiliates, profits selling shareholders will receive on conversion and comparisons regarding numbers of shares registered relative to the public float for the shares prior to the PIPE transaction.

The SEC, issuers and practitioners are still working out the exact scope and workings of the new rules for review. It appears that issuers engaged in traditional PIPE transactions selling securities at fixed prices (including fixed conversion prices for any equity securities the investor acquires upon conversion) should continue to be able to rely on the staff’s historical

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position in PIPE transactions, particularly if the amount of securities sold is relatively small in relation to the pre-transaction public float.

Micro-cap companies should anticipate additional scrutiny by the SEC and the possibility of significant impediments in effecting registration of public resales. In this environment, issuers should put practical contractual limits on adjustments in conversion rates and liquidated damages for failure to have their resale registration statement declared effective by a specified date.

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