Sponsor Backed PIPEs: COVID-19 and the Race for Liquidity

April 22, 2020

PIPEs (private investments in public equity) are currently a key focus for many of our clients. Not unlike the 2008 financial crisis, the pressure on corporate balance sheets resulting from the economic consequences of COVID-19 is sending many companies on a race for near-term liquidity. Sponsor backed PIPEs may even in the best of times provide an attractive source of financing (and for the funding sponsor, an appealing investment opportunity) for reasons that include cost effectiveness and the speed with which they can be completed. But PIPEs are especially attractive in times of financial distress given the unavailability of traditional financing markets to many companies.

PIPE transactions tend to be particularly bespoke. Here are some key points to consider:

What Kind of PIPE?

Preferred stock instruments are the most typical form of PIPE investments. These can take the form of convertible preferred, which offers equity upside while providing downside protection, or more debt-like non-convertible preferred, which offers a higher return than debt at the cost of greater risk due to the instrument's lower place in the capital structure and weaker covenant protections. PIPEs also sometimes take the form of straight common stock, convertible notes, warrants, or any combination of the forgoing.

Basic considerations for a preferred stock investment include: What coupon will the instrument bear? Will dividends be paid-in-kind (PIK), cash-paid, or a choice at the issuer's option? Will the preferred participate in dividends paid to the common? If convertible, how is the conversion price determined (at market, at a premium or at a discount to current trading prices)? Can the issuer force conversion if the common stock trades above the conversion price over a certain period? Can the issuer redeem the preferred and, if so, when and at what price? Is there a mandatory redemption date on which the holders can force the issuer to redeem the preferred or is the preferred perpetual? Will the preferred holders have board representation? What covenant protections will the holders have, and how will these be enforced?

Equity-like preferred will typically contain conversion rights, and may be perpetual (*i.e.*, no "maturity date" at which they become-redeemable). Negotiations are likely to focus on dividend rights, conversion rights, conversion price, issuer redemption rights, protective covenants, governance and stockholder rights and obligations, including transfer restrictions, registration rights and standstills. In addition to basic anti-dilution adjustments for common stock splits and the like, sponsors may request adjustments to the conversion price to account for new equity issuances at less than the then-current trading price or below the conversion price, but these need to be carefully structured. Some now rare forms of these adjustments (sometimes called a "full ratchet") can result in a death spiral for the common holders, in which the preferred converts into an increasingly greater portion of the total equity of the issuer. The more aggressive form of these adjustments is typically seen only in distressed or other special situations.

In contrast, debt-like preferred negotiations usually focus on coupon rate and redemption/put rights at maturity. Conversion rights may be limited or non-existent, and covenants will seek to police the issuer's financial condition, capital structure, and leakage payments on junior securities. Debt-like preferred is sometimes accompanied by warrants to provide a form of equity upside to the holder.

Structuring must take into account the limitations under the issuer's existing debt and other senior securities. In particular, the issuer should either ensure that the preferred will not be characterized as "disqualified" stock under existing agreements, resulting in its being treated as indebtedness, or, if it is so characterized, ensure that the preferred will fall within the issuer's permitted debt incurrence capacity. Issuers should also ask themselves whether they are comfortable that they can comply with ongoing financial maintenance covenants, if any. In addition, issuers may seek to maximize the extent to which preferred is treated as equity rather than debt for ratings agency purposes, which may run up against a sponsor's desire for certain kinds of protections (such as redemption rights).

Investors, particularly in distressed situations, should keep in mind that the transaction may later be reviewed in a bankruptcy proceeding, and aspects of it (like dividends, or the issuance of a note) may be subject to avoidance actions under the bankruptcy law and state fraudulent conveyance statutes.

Pure common stock purchases are typically less complex, but the parties will still debate such matters as governance rights, standstills, transfers restrictions and registration rights.

Is a Stockholder Vote Needed to Obtain All the Anticipated Benefits of the Deal?

PIPE transactions can range widely in size, from issuances of below 10% to above 50% of a company's common stock on an as-converted basis. Under exchange rules, the issuance of common stock, or securities convertible into or exercisable for common stock, equal to or greater than 20% of a company's (pre-issuance) common stock or voting power generally requires a stockholder vote unless (1) a minimum price requirement is fulfilled that effectively requires an "at or above market" sale (and for Nasdaq companies, such issuance is not in connection with the acquisition of stock or assets of another company) and (2) for NYSE companies, no purchaser or group of related purchasers acquires more than 5% of the company's common stock or voting power. (The NYSE has recently waived the 5% limitation through June 30, 2020 in order to facilitate emergency capital raising during the COVID-19 crisis.) Sponsors making a preferred stock investment that would otherwise require a stockholder vote may agree to cap conversion of the preferred stock at 19.9% until the stockholder vote is obtained. Alternatively, sponsors sometimes structure their investment in two steps: a 19.9% tranche that can close immediately, and the balance contingent upon obtaining stockholder approval. In either case, the coupon will often ratchet up and other rights might come into play if the vote does not go through after a period of time. While these incentivizing techniques (referred to as "penalties" or "sweeteners") are well developed, state law limits on provisions that are viewed as coercive and exchange requirements cabin what can be done to protect a sponsor's interests.

NYSE rules also require stockholder approval whenever a listed company issues equity securities (including convertible securities) to, among others, a "substantial security holder" (generally, a holder of 5% or more of outstanding common stock or voting power) where the securities to be issued exceed 1% of the issuer's outstanding common stock or voting power prior to the issuance. If the issuance to a substantial security holder meets an "at or above market" minimum price requirement, stockholder approval is required only if the securities to be issued exceed 5% of the issuer's outstanding common stock or voting power. Because PIPEs are sometimes a mechanism for an existing stockholder to provide financing, this requirement may be a barrier around which parties need to structure. (The NYSE's temporary relief also waives these 1% and 5% limitations through June 30, 2020, provided that the sale is for cash, meets the minimum price requirement, is not used to fund an acquisition by the issuer and is approved by the company's audit committee or a comparable committee comprised solely of independent directors.) Note that the waiver does not apply to certain M&A transactions in which a related party, including a substantial security holder, has an interest.

In cases where significant amounts of equity are being issued, parties also need to be aware that the transaction may be deemed by the exchanges to constitute a "change of control" requiring stockholder approval (which may exist even for acquisitions that a sponsor would not consider to be a "control" investment). Issuances that would result in a change of control also raise fiduciary duty issues for the board of directors of the issuer.

The exchanges may provide relief from stockholder voting requirements in the event a company is under severe financial distress, although availability is limited to extreme, exigent circumstances. The exchanges are of course aware of the pressure COVID-19 is placing on issuers and will take that into account.

Note that, separate from any exchange requirements, an issuer will need to obtain stockholder approval if it does not have enough common stock authorized to satisfy its obligation to issue shares upon conversion of a convertible security or, if the PIPE investment is structured as straight common, to sell newly issued shares to the investor.

What Is the Path to Exit?

Investors in PIPEs must pay close attention to the drafting of the governing documents to ensure they have a viable path to exit and liquidity. For convertible securities, the unfettered right to convert into common stock, together with negotiated registration rights for resale, can provide such a pathway. Of course, conversion and sale will not be an effective exit where the convertible securities are out of the money (*i.e.*, the common stock trading price is lower than the conversion price). Investors can also obtain the benefit of registration rights with respect to the preferred security itself.

Other provisions protect the ability of the investor to exit in the face of certain one-time events, such as a liquidation or cash merger. Preferred stock is vulnerable in a merger unless there are specific provisions in the preferred instrument as to how the preferred is treated or the preferred holders have a separate consent right. Without such protections, generally the only remedy of an unhappy preferred holder in a merger is appraisal.

The specific rights of a preferred holder, like those of a lender, are contractual in nature and the company and its directors owe no fiduciary duties to the holder with respect to those rights. However, holders of preferred securities do not benefit from the type of creditors' remedies available to holders of debt securities. For instance, a preferred holder cannot attach assets or force an issuer into bankruptcy. As a result, it can be easier to enforce one's rights as a convertible debtholder than as a preferred holder, which may induce some PIPE investors to seek to structure their investments as debt instruments rather than preferred securities.

A PIPE investor may view liquidity and dividends as interrelated. For example, an investor may believe that if it is getting a security with an attractive current-pay dividend it does not need to be overly concerned with exit rights, because in the meantime it will receive a steady and respectable cash flow. But the declaration and payment of preferred dividends requires affirmative board action. Moreover, an issuer may pay dividends only out of surplus, the determination of which is largely in the hands of the board. Without robust exit rights, an investor might be surprised to find itself holding a security for a long time without any current cash return.

One feature often used to mitigate these concerns allows the holder to require the issuer to redeem the instrument in certain circumstances. These forced redemption provisions are typical in the context of a change of control, but may also be exercisable by the holder at will, frequently after the passage of some period of time. The holder upon exercise would receive the greater of liquidation value and, for convertible securities, as-converted value. However, as with dividends, redemption requires that the issuer have adequate surplus. If the board determines that the company is unable to redeem the preferred, the holders will be forced to wait, perhaps indefinitely.

Investors will often seek to include automatic remedies upon the occurrence of a triggering event such as the failure to pay dividends or honor a redemption right. These might include an increase to the coupon rate, a right to designate an additional board member or a right to force the company to initiate a sales process. Investors should consider whether these remedies are adequate to incentivize the issuer to make these payments. Other creative remedies may be available depending on the circumstances.

Private equity sponsors and other PIPE investors who control the issuer must keep in mind their and their appointed directors' fiduciary obligations in dealing with the preferred holders. For instance, a board that authorizes the sale of a company's assets in order to generate funds to pay for the redemption of the preferred stock may be at risk if value to the common holders of redeeming the preferred (thus, for example, eliminating the continued accretion of the preferred's liquidation preference) is less than the cost to the common holders of forgone profits that could have been generated by the sold-off assets.

Can Investors Get Representations and Warranties about the Target Business?

The scope of representations and warranties provided by issuers varies widely depending upon the circumstances. In principle, a PIPE—particularly one in which the securities are convertible into common stock—is like any other investment and investors will want some assurance that the business is "as advertised" in its public filings. Investors may seek a basic representation as to the absence of material misstatement or omissions in public filings, and more specific business representations on a range of matters. Investors may also request that any damages paid by the issuer in case of a breach be grossed up to account for the investor's interest in the issuer. Survival periods and other limitations on the issuer's liability may also be negotiated.

Any Tax Considerations?

Investors holding preferred stock in a PIPE transaction should carefully consider whether non-cash dividends will be subject to current taxation. Generally, a dividend that is declared on preferred stock and paid in kind as additional preferred shares will be taxable to the holder, even though the holder receives no cash. As discussed below, making the preferred "participating" can often avoid this result, but there are pitfalls and careful structuring is needed in each case.

On the other hand, dividends that are not declared but just accrue and are added to the preferred stock's liquidation preference generally are not taxable, but there are important exceptions. For example, if the holder of preferred stock increases its interest in the issuer (*e.g.*, through an accreting liquidation preference) and holders of another class of stock receive dividends in cash or other property, the holder of the preferred stock will be deemed to have received a taxable dividend equal to the increase in the liquidation preference. The same issue will arise if the issuer has convertible debt outstanding and pays interest to the debtholder because, for these purposes, the payment of interest to a holder of convertible debt is treated as a distribution of property to a holder of another class of stock. These somewhat counter-intuitive rules are known as the "disproportionate distribution" rules.

"Discount preferred" (*e.g.*, preferred stock that is issued for $1,000 but that is mandatorily redeemable, or where the holder has a put, at a price greater than $1,000 at a later time) can also cause the holder to recognize current taxable income before the receipt of cash. However, this rule only applies to preferred stock. If the preferred is treated as common stock for tax purposes—which may be the case if the preferred holder, independent of any conversion privilege, has the right to share in the benefits of a common stockholder with respect to dividends or liquidation—the discount preferred rules will not apply to it. Structuring preferred stock to be treated as common stock for tax purposes can also help mitigate the risk of current taxation on PIK dividends (subject to carefully avoiding the “disproportionate distribution” rules described above).

What about Similar Transactions Involving Private Companies?

Private companies often undertake similar transactions. While many features of these deals are similar to a traditional public company PIPE, they can raise added complexity. The most important issues relate to the path to exit, since even when the instrument is convertible into common stock there is no ready public market into which shares can be sold. Potential tools to address these issues include redemption rights after the anticipated investment period has elapsed, together with contractual forced IPO and drag-along sale rights in order to provide the sponsor a mechanism to achieve liquidity in the event redemption does not occur.

PIPEs are very much in vogue and can offer terrific opportunities for financial sponsors in a market in which putting capital to work in more traditional private equity investments is difficult, but they can be tricky transactions that are often executed under great time pressure. Support from experienced counsel early in the process is critical for a successful outcome.

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For more information regarding the coronavirus, please visit our Coronavirus Resource Center.

Please do not hesitate to contact us with any questions.

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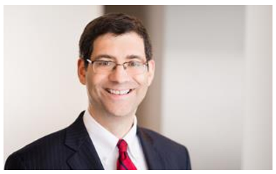

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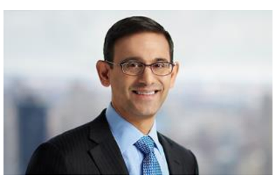

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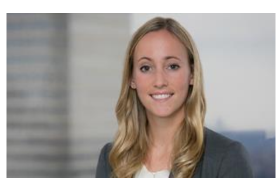

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