Preferred Equity PIPEs Provide Flexibility in the Age of COVID-19

August 17, 2020

PIPEs (private investments in public equity) provide investors and public companies with a flexible vehicle for bespoke capital solutions that can be executed quickly in the volatile markets that have arisen in the COVID-19 environment. PIPEs offer publicly traded issuers an attractive alternative to traditional underwritten offerings during times of uncertainty in the public markets and provide investors with a unique opportunity to negotiate tailored transactions directly with the issuer. While PIPEs are highly negotiated transactions with unique features depending on the industry and liquidity profile of the issuer, we highlight here certain key considerations that both investors and issuers should consider in evaluating potential investment structures and terms, particularly with respect to convertible and preferred instruments.

Size Matters — The NYSE and Nasdaq Stockholder Approval Rules

The primary legal impediment to effecting large PIPE offerings are the NYSE and Nasdaq rules requiring shareholder approval of certain transactions — these requirements should be considered at the outset. Both stock exchanges require an issuer to obtain shareholder approval prior to an issuance of securities that will result in “change of control,” as such term is defined by each stock exchange. While both stock exchanges consider all of the facts and circumstances at hand, it is generally understood that an issuance would result in a change of control if an investor or group would (or could) acquire more than 20% of the outstanding shares of common stock or voting power after the issuance, particularly when the investor or group would then also have the largest ownership position. In addition, the “20% rules” require that, other than in public offerings, shareholder approval must be obtained prior to an issuance of 20% or more of a company’s outstanding common stock or voting power at a price that is less than a Minimum Price tied to market price, and as defined by each stock exchange. In determining the number of shares to be issued in a transaction, convertible securities must be counted on a fully converted basis, and the Nasdaq rule further requires counting all shares that may eventually be issued in connection with the transaction, including as a result of anti-dilution adjustments. Both stock exchanges, however, allow for certain structuring alternatives, including imposing caps on the total number of shares to be offered upon conversion, or, where the transaction is offered above the Minimum Price but anti-dilution adjustments may cause it to be deemed a discounted issuance, imposing a floor on the conversion or exercise price. In the event that shareholder approval will be required, significant additional time should be built into the deal timeline. See our client alerts here and here regarding certain portions of the shareholder approval requirements that were temporarily waived by the NYSE and Nasdaq, respectively, to facilitate capital raising during the COVID-19 pandemic. While both waivers were initially made effective through June 30, 2020, the NYSE has since extended the relief through September 30, 2020. As of the time of publishing, Nasdaq had not extended its waiver.

Payment-in-Kind vs. Cash Pay Dividends

Preferred stock includes many features that offer flexibility to both parties to negotiate deal-specific terms. Dividends or interest payments, for example, may be fixed or variable, cumulative or non-cumulative, paid quarterly, semi-annually or otherwise, and in cash or “in kind.” While terms vary greatly from one deal to the next, the majority of convertible preferred stock PIPEs include an in kind dividend at the issuer’s option that accrues and compounds on a cashless basis. The dividend rate may increase in the event of uncured defaults or after a certain period of time, and non-payment may trigger certain protections such as a springing board appointment right.

Conversion Features

Convertible securities can offer investors the opportunity to participate in the upside of the company by converting into publicly traded common stock at a negotiated price. In return, the issuer often receives a lower coupon rate than a traditional debt or non-convertible preferred security would provide. Deal participants should consider when either the issuer or the investor may have the option or the obligation to convert the security into common stock. In many cases, holders may optionally convert at a negotiated premium to the pre-investment market price, either immediately after issuance or after a fixed time. Mandatory triggering events may include the issuer’s common stock trading at a specified premium for a certain period of time, or a change of control of the issuer. In the event of a mandatory trigger event occurring, in addition to shares of common stock based on the conversion formula, the holder may receive “make whole” shares.

Governance and other Features

One of the most highly negotiated portions of a PIPE term sheet, the governance rights granted to preferred holders dictate the relative control that the investor will have over the issuer, and its investment, on a go forward basis. In addition to voting on an as converted basis with the issuer's common stock, preferred holders may negotiate for consent or veto rights over certain key corporate decisions, from those as fundamental as a sale of the company to more operational decisions such as the incurrence of additional indebtedness or transactions with affiliates. Where significant equity stakes are involved, investors often negotiate for proportional representation on the board and/or its committees, or board observer rights. These rights are typically tied to maintenance of certain level of ownership in the company and sunset when the investor's ownership drops below the negotiated level.

Pursuant to standstill provisions, investors may be prevented from acquiring more equity in or entering into voting agreements or initiating proxy fights with the issuer until a certain date or until their ownership percentage falls below a certain level. Contractual lock-up provisions may further prevent investors from transferring their securities for a specified period of time other than to certain permitted transferees. Information rights, preemptive rights and anti-dilution rights should also be considered and negotiated by the deal parties.

Redemption Rights

Typically, the convertible preferred securities issued in PIPEs are subject to redemption or repurchase at some future point in time. The PIPE issuer may have the right to optionally redeem its preferred shares on a certain time horizon and at a certain price. In the alternative, the investor may have the ability to require the issuer to repurchase its shares if the company has not met certain agreed-upon milestones, or upon the occurrence of a change of control or other enumerated "fundamental changes" at the company — the definition of which should be carefully negotiated. The consideration to be paid for redemption ranges from deal to deal and is subject to negotiation.

Registration Rights

Since PIPEs are private placements, the securities issued are by definition restricted. In every PIPE, the issuer undertakes to register the offered securities after closing prior to an agreed date in order to allow the investor liquidity. The exact form of such registration rights, however, are negotiated, including, among others: (i) timing for filing and going effective on the resale registration statement following execution of the purchase agreement, (ii) the number of times investors may exercise their demand registration rights and (iii) whether or not investors have piggyback registration rights, allowing them to request that their shares be included with the Company's own registration of newly issuable shares.

Related Professionals

- **Steven M. Peck**
  Partner
- **Peter J. Antoszyk**
- **Stephen A. Boyko**
  Partner
- **Gary J. Creem**
  Partner