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IS THERE A PLACE FOR PIPES ON THE LONDON MARKETS? ARE PIPES HELPING TO KEEP THE LIQUIDITY FLOWING AND THE CAPITAL MARKETS IN ORDER?

Private investment in public equities (PIPEs), is a transaction in which a public company issues equity securities in a private placement to one or more substantial investors (whether overseas or strategic company, wealthy individuals or private equity houses) usually at a discount to the market price of its shares. PIPEs have been a feature of the U.S. and Asian markets for some time, and are now, also emerging in Europe as an attractive financing option for public companies. In the current market, traditional financing options are either unavailable or have become relatively expensive. As a result private equity funds, without debt financing for buyouts, are becoming more interested in investing in PIPEs, particularly in view of the reduced equity values of many public companies.

Investor sentiment in the UK, led by traditional long funds, has been opposed to offers which were not made on a pre-emptive basis and which diluted existing investors. **But in today's current market, do these arguments still hold up?**

Companies with maturing debt that they are unable to refinance and financial and other depository institutions striving to meet capital adequacy requirements are increasingly turning to PIPEs, which offer several advantages.

The main thing that seems to be holding back European PIPEs is unfamiliarity.

PIPE STRUCTURES AND TERMS

A PIPE transaction is usually effected either by way of a placing which is an issue of new shares for cash to selected investors, or by way of a placing and open offer which is a placing of new shares to institutional investors (who, in most cases, effectively underwrite the issue and ensure that it will be taken up), subject to an open offer being made to existing shareholders to take up their pro rata entitlements (in effect, a clawback by existing shareholders).

Private equity and venture capital investors have influenced PIPE transactions in the following ways:

- More due diligence;
- Increased focus on deal terms reflecting the investor's longer-term strategy, including transfer restrictions and governance rights; and
- More convertible preferred and convertible debt PIPEs.

Due Diligence

PIPE transactions can create a tension between the high level of private M&A style diligence that an investor may expect and the restrictions imposed on listed companies in disclosing non-public, price sensitive inside information on a selective basis.

The UK's various regulatory rules require equal treatment of all shareholders and the provision of consistent information to all investors. An issuer will therefore need to consider how it justifies providing information to a PIPE investor that is not provided to other investors.

The risks of insider trading and inappropriate use of information will be a primary consideration. Assuming the transaction is announced, these issues can typically be managed on a short-term basis by means of confidentiality and standstill/lock-up arrangements.

Any relevant information provided to an investor, to the extent that it is material to an investment decision, should ultimately be included in the deal announcement and prospectus (if required) to cleanse the investor of any inside information received.

Many European public companies are not required to disclose PIPE-related transaction documents (which are marketed and completed on a confidential basis), and often are only required to provide a brief description of the transaction without highlighting specific deal terms. Unlike in the United States therefore, detailed European PIPE transaction terms remain, in many cases, confidential.

In the current volatile market, confidentiality is a key consideration for many companies. Confidentiality is particularly important for companies that are concerned about the market impact of announcing a public offering, particularly an offering which is dilutive to existing shareholders. By choosing to do a PIPE, the issuer avoids the immediate possibility that the market will put downward pressure on the issuer's share price and potentially lower the price at which the securities are sold in the offering. In addition, convertible debt and convertible

PIPEs (see later) are often effected at a premium to market so the issuer obtains the benefit of not doing an at-the-market offering.

Post-deal Rights

Without adequate influence over the management, private investors are reluctant to inject capital. This is why they push for board seats, which many targets are uncomfortable conceding ground on. But private equity has to take a strong stance, especially since its investors pay management fees precisely for a different level of access. Investors could buy public stakes on their own, so PIPEs purchasers have to improve on this by getting more control of the target.

Traditionally, PIPE investors tend to be public market investors that focus on short-term investments, such as hedge funds. Investors with a longer-term strategy, such as private equity and venture capital investors, have historically avoided PIPEs primarily because of the inability to obtain control over the issuer.

The most common post deal rights are:

- An issuer will typically consider requiring an investor to agree to a period of post-deal lock-up restrictions as to the manner in which the investor can sell its stake and standstill obligations preventing the investor from acquiring additional shares or making a public takeover offer. The thresholds in terms of timing and size of stake will vary. Standstill agreements typically terminate once the investor's ownership percentage falls below a threshold percentage and in some cases after a period of time from issuance;
- Although practice has varied, it appears that a PIPE investor can realistically expect to have governance rights including the right to a board appointee in return for a stake of between 10-15% with potentially two seats at a level of investment above 20%. The investor may also seek anti-dilution rights, requiring that it be given the right to participate in all future capital raisings, both pre-emptive and non pre-emptive, on a pro rata basis. Although less common, some investors have obtained negative control rights, e.g. veto rights over certain major corporate transactions; and
- The investor and the issuer may seek to agree provisions on future business co-operation.

THRESHOLD LIMITS

In most transactions, investors are looking for at least 20% in order to have the control they want. This raises two major issues in Europe: pre-emption rights and mandatory offer thresholds.

Pre-emption rights protect existing shareholders by restricting the amount their stock can be diluted by. For even larger PIPEs, consideration of mandatory takeover offers kicks in at 30% in Europe.

Authority to Allot Shares

UK listed companies are required to seek authority to allot shares under the Companies Act 2006 (“**2006 Act**”), typically up to one-third of their issued share capital. Recently, the Association of British Insurers (“**ABI**”) has amended its guidelines to permit UK listed companies to authorise the allotment of shares up to a further one-third of issued share capital for fully pre-emptive rights issues. A number of companies have sought to take advantage of this increased flexibility at their 2009 annual general meetings.

Statutory Pre-emption Rights

The 2006 Act requires that a UK company issuing equity securities for cash must first offer the shares to holders of relevant shares in proportion to the nominal value of their existing shareholdings. Listed companies typically disapply statutory pre-emption rights so as to permit:

- Non pre-emptive issues of up to 5% of the company’s issued share capital (in line with the ABI’s guidelines) in any one-year period or 7.5% in a three-year period; and
- Pre-emptive offerings.

If a company does not have sufficient authority or needs to disapply pre-emption rights, it will require a deal-specific shareholder authorisation.

CONCERT ISSUES

Private equity can be put off PIPEs by acting-in-concert issues. In negotiating with existing shareholders of the target, PIPE investors need to be careful that their actions cannot be deemed as acting in concert. Negotiations to encourage shareholders to agree to a PIPE deal could easily be perceived as a deliberate attempt to influence the board in an irregular manner via alliances.

Rule 10b-5 Opinion Letter

If the PIPE transaction involves a US private placement, the legal advisers to the issuer and the underwriters are typically requested to provide a Rule 10b-5 opinion letter.

An opinion letter relating to Rule 10b-5 under the US Securities Exchange Act of 1934 assists the underwriters in establishing a due diligence defence and confirms that lawyers have undertaken certain due diligence procedures and that, in the course of such procedures, nothing has come to their attention that would cause them to believe that the prospectus contains an untrue statement of material fact or omits to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

The delivery of 10b-5 opinion letters will be a condition of the underwriting, set out in the underwriting agreement, and requires the repetition of representations and warranties, comfort by the auditors and documentary and management due diligence each time the 10b-5 opinion letters are to be delivered.

EXIT ISSUES

PIPE investors must expect potential difficulty in selling their stake and existing shareholders should anticipate the major stake in the company changing hands in the short to medium term.

Options (i) sell stake to another investment house — almost like a secondary sale; (ii) buy everyone else out; or (iii) facilitate a sale to third party.

CONVERTIBLE DEBT/CONVERTIBLE PREFERRED SECURITIES

In the U.S., although common stock PIPEs are still prevalent, many private equity and venture capital investors prefer to invest in a more senior position in the capital structure. As a result, the U.S. markets are seeing an increase in highly structured convertible debt and convertible preferred PIPEs. It has yet to be seen whether European investors appetite will follow suit.

Because debt securities are as a matter of law senior in right of payment to equity securities, convertible debt PIPEs provide the strongest down-side protection. However, many issuers are prohibited from issuing convertible debt under the financial covenants in their existing loan agreements. In addition, convertible debt PIPEs typically cannot be structured to qualify as equity for accounting and rating agency purposes.

Preferred stock securities typically have a liquidation preference, therefore convertible preferred PIPEs also provide down-side protection relative to common stockholders. Also, convertible preferred PIPEs can be structured to qualify as equity for accounting and rating agency purposes.

Many convertible preferred and convertible debt PIPE deals include anti-dilution protection, which is triggered if the company issues new equity or equity-linked securities at a purchase price below the investor's conversion price or fair market value. The dilution protection usually lasts for a certain period of time after closing and may also require that the new issuance exceed a certain minimum threshold.

Anti-dilution protection can be structured in different ways. The most aggressive type is full ratchet protection, in which the investor's purchase, conversion or exercise price is lowered to equal the price of the new dilutive issuance. More typical is weighted-average anti-dilution protection. In this case, the investor's purchase, conversion or exercise price is lowered based on a weighted-average calculation of the dilutive impact of the new issuance which takes into account not only the lower price of the new issuance but also the size of the offering and the number of shares of common stock issued.

WHICH SECTORS ARE CURRENTLY ATTRACTIVE FOR PIPES? HOW WILL PIPES DEVELOP?

The Healthcare space is considered by some to be the most likely to see the highest level of demand for PIPEs over the next 12 to 18 months, followed closely by financial services. Many believe that PIPE activity in the Healthcare sector will be fueled mainly by the high volume of young, high growth companies that may not have enough available capital to fund further growth.

It is increasingly common to see the issue of warrants as part of the deal terms and it may be that we see more syndicated multi-investor PIPE activity than single investor transactions over the next 12 to 18 months.

CONCLUSION

In the current market, private equity investors are having to seek new opportunities. In the absence of leverage for acquisitions, private equity firms appear to be deploying capital by identifying excellent companies in sectors where they have high levels of expertise, and in which they are willing to make significant, long-term minority investments.

Board and committee representations, together with other provisions contained in the purchase agreement or the financing instrument itself, enable private equity firms to carefully monitor their investments.

Venture capital investors are also finding more opportunities in the PIPE market. Why invest in a start-up when you can invest in a company that is already public and negotiate the same terms?

In general, private equity and venture capital investors are investing in these companies with a longer-term view than traditional PIPE investors. The private equity mentality tends to be about getting to something bigger, perhaps buying the company down the road or helping the company do a merger. The venture capital mentality has been more about looking for a longer-term exit.

Dr. Amnon Mandelbaum, senior managing director at Sunrise Securities Corp., a New York City based boutique investment bank which has acted as the financial advisor and placing agent for over US\$1 billion of transactions in the London market, believes that PIPEs will become a useful source of finance in Europe and as with the U.S. markets may become a main source of financing. Dr. Mandelbaum points out that in 2009 there were approximately 1,912 PIPE transactions raising around \$62 billion compared to only approximately \$16.4 billion raised via IPO's.

Existing shareholders may be reluctant to accept PIPEs, but if the company is saved from the brink of collapse surely they cannot complain?

RECENT DEALS

Barclays Bank structured its June 2008 fundraising as a placing and open offer, with funding commitments provided by three new, and a number of key existing shareholders and no involvement of underwriting banks. The offer comprised:

- A firm placing of shares with Sumitomo Mitsui Banking Corporation up to the limit of Barclays' existing section 89 disapplication; and
- A fully section 89-compliant open offer with clawback, allowing existing shareholders a partial means of participating in the share issue. Qatar Investment Authority, China Development Bank and Temasek acted as conditional placees.

As the issue was also conducted within the 10% pricing discount limit imposed by the Listing Rules, no shareholder approval of the deal was required.

Usaha Tegas (Tegas) agreed to participate in a non pre-emptive firm placing of **Johnston Press** shares equal to 10% of share capital. The firm placing was announced alongside, and was conditional on, Johnston Press's rights issue. An EGM was held to approve both the rights issue and to approve the disapplication of pre-emption rights in connection with Tegas' investment. In addition, Tegas agreed to acquire a further 10% stake from members of the Johnston family, conditional on the passing of the EGM resolution. The record date for participation in the rights issue was set so that the shares acquired by Tegas ranked for participation in the rights issue, allowing Tegas to maintain its 20% stake and also to benefit from the pricing discount built into the rights issue, lowering the overall cost of investment.

Warburg Pincus took a 10% stake in a firm placing with a conditional placing of up to a further 10% stake in **Premier Food's** March 2009 placing and open offer. Premier issued new shares representing 65% of the enlarged share capital by way of a placing and open offer, such shares were issued at a 9% discount to the closing market price on the day before the offer was announced.

Both the firm placing and the placing and open offer were subject to shareholder approval of a section 89 disapplication. Premier Foods and Warburg Pincus entered into a relationship agreement under which Warburg Pincus has the right to appoint one director to the Premier Foods board for so long as it retains an interest of over 10%. Warburg Pincus also agreed to certain restrictions on making acquisitions of further Premier Foods' shares and not to make a public offer for Premier Foods.

A sample of PIPE transactions undertaken by partners at Brown Rudnick:

- Representing **Somero Enterprises**, a US company listed on AIM, as general corporate counsel including a PIPE transaction with existing shareholders;
- Represented **Rodman & Renshaw** in connection with a PIPE investment in an AIM-listed life sciences company;
- Advised **Infinity-Bio Energy** on AIM-related matters related to (i) the issue of \$155 million of senior unsecured convertible notes pursuant to Reg D exemption under the Securities Act; and (ii) a \$75 million PIPE transaction;
- Represented **Futuremedia Plc**, a technology client providing e-learning solutions, in connection with PIPE investments by M.A.G. Capital \$4 million and Cornell Capital \$2.5 million;

- Represented fabless telecommunications semiconductor device company in multiple private financings, its Nasdaq IPO, public follow-on financings, PIPE financing and 144A convertible debt placement, as well as tender and exchange offers, acquisitions and strategic investments;
- Represented **Evergreen Solar, Inc.** in two PIPE financing transactions responsible for raising an aggregate of \$40 million; and
- Represented **Cluff Gold** as US counsel on various PIPE transactions.

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For further information contact:

LENA HODGE
+44.20.7851.6083
lhodge@brownrudnick.com

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