Coming down the PIPE: private investments in public equity

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The global COVID-19 pandemic has had a significant impact on financial markets. With businesses closed on a temporary or permanent basis stock markets have become increasingly volatile. Consequently, for many issuers who are in need of liquidity, traditional sources of funds may not be available. For many issuers, the time, cost and uncertainty of a public offering is simply not an option right now.

In this environment, creativity and flexibility are key for many issuers to obtain much needed financing. One potential source of financing may be a private investment in public equity (PIPE) transaction. This bulletin provides a primer on PIPE transactions and highlights key considerations for issuers as well as some key differences in PIPE transactions in Canada as compared to those carried out in the United States.

What is a PIPE transaction?

In a PIPE transaction, investors, typically large accredited investors, acquire equity or equity-linked securities, such as convertible debentures or preferred shares, often at a discount to the market price, directly from a publicly traded company on a private placement basis. The investor is typically able to freely resell the securities either at the end of the statutory hold period (generally four months in Canada) or through a prospectus (or registration statement in the United States) if it negotiates for registration rights. As discussed below, registration rights (or “qualification rights” in Canada) are sometimes provided in Canadian deals, but are a key and customary feature of a U.S. PIPE transaction.

Sources of private investment

PIPE transactions can be placed through an agent or an underwriter to a broad group of investors or placed directly by an issuer to a single investor or a small group of investors. PIPE transactions are sometimes made to existing shareholders and other times made to new investors. Large existing shareholders often can be a prime (and for some, the only) source of funding during an economic slow down. By virtue of their position, these shareholders are familiar with the issuer and sometimes are so invested

in the issuer that it is in their interest to try to help the company weather the storm over the short to medium term.

On the other hand, some issuers are able to attract new investors, such as well-capitalized private equity firms who may be looking to make investments when valuations are down. Even prior to the COVID-19 outbreak, increasing numbers of yield-seeking investors had begun pouring into the private equity asset class. Armed with a record U.S. $1.5 trillion cash pile globally, in the coming months private equity investors can be expected to actively seek strategic opportunities to engage with listed companies.[1] For example, in April 2020, an affiliate of Roark Capital Group made a $200 million preferred share investment in The Cheesecake Factory, Inc. which had undoubtedly been affected by the COVID crisis.

Advantages and disadvantages of PIPE transactions

There are a number of benefits to a PIPE transaction. Compared to a public offering, a PIPE transaction can usually be completed without the need to file a prospectus (or registration statement in the U.S.), can generally be completed more rapidly with little to no regulatory review, far less public disclosure is required and at lower cost. In addition, issuers can create new, or cement existing, relationships that can enhance investor confidence in the issuer.

Potential disadvantages to issuers include offerings at larger discount to market, dilutive effects of the offering and, where convertible securities are issued, there can be a drag or overhang on the stock.

Commonly negotiated provisions

The terms of any PIPE transaction will vary based on the negotiating power and key drivers for the issuer and investor. Target companies may be able to negotiate standstill or transfer restrictions, including hold periods that are longer than the statutory restrictions. However, the majority of the rights are negotiated in favour of the investor. The following are some of the rights commonly required by PIPE investors.

Board seats

In most Canadian PIPE transactions, investors will negotiate a right to nominate at least one individual to the board of directors. This nomination right will typically terminate when the shareholdings of the investor fall below a certain threshold, which varies depending on the initial size of the offering. We often see board rights fall away if the investor owns less than 10 per cent of the as-converted shares. Some investors also negotiate a board observer right, however, board observer rights can raise questions of selective disclosure in Canada and are generally resisted. Recently, many U.S. PIPE deals are being completed without the investor negotiating for board seats – investors seem more focussed on discounts rather than board seats.

Registration rights

In the United States, registration rights are an important and customary feature of a PIPE transaction. U.S. investors will almost always receive some combination of demand, piggyback and/or resale registration rights to enable them to freely sell the securities acquired. In Canada, registration rights are not sought as frequently. Provided that an investor owns less than 20 per cent of the issuer's shares, such investor will generally be able to freely resell its shares after the end of a four month statutory hold period in Canada. Investors that own 20 per cent or more of the issuer are deemed to be a "control person" and are subject to further resale restrictions. Notwithstanding that many Canadian investors may not strictly require registration rights to resell the issuer's securities, some negotiate for such rights over concerns that due to a lack of liquidity in the stock, it may be difficult to sell large blocks of shares without a prospectus.

Pre-emptive/participation rights

In order to avoid dilution in future offerings, investors in Canadian deals will often negotiate for pre-emptive rights or what are more appropriately called "participation rights". These rights enable an investor to participate in future offerings in order to maintain its level of equity ownership. In the U.S., most post-COVID deals are getting done without pre-emptive rights. U.S. investors are also more likely to negotiate for related rights such as put/call or other anti-dilution rights. The Toronto Stock Exchange prohibits blanket anti-dilution rights that enable a holder of a convertible stock to participate at any future offering price, which can limit the rights subject to negotiation on Canadian PIPE deals.

Regulatory matters

Securities laws and take-over bid rules

Securities laws

PIPE transactions are private placements and are subject to applicable Canadian or U.S. securities laws. The issuance of securities in a PIPE transaction are generally made to an accredited investor in transactions that are exempt from the prospectus or registration requirements under Canadian or U.S. securities laws.

As the initial transaction is done by way of a private placement, there will be little (or no) involvement by the Canadian securities commissions or the SEC and no prospectus or other disclosure document will be required.

Depending on the size and materiality of the transaction, a press release and, in Canada, a "material change report", may be required by the issuer.

Take-over bid rules

In Canada, a PIPE transaction will generally not trigger take-over bid (referred to as a tender offer in the United States) rules since the transaction is between the investor and a reporting issuer. Any future purchase of shares by the investor from any other shareholder that results in the investor becoming a 20 per cent or more shareholder (or any purchase if it already is a 20 per cent shareholder) will be considered a take-over

bid and will be subject to the formal take-over bid requirements unless an exemption is available.

In the U.S., there is no threshold that triggers a tender offer. Like in Canada, future purchases of shares may trigger the U.S. tender offer rules, however, the trigger is not based on crossing a certain threshold in share ownership but rather generally based on the often cited "eight factor" test from the 1979 case of *Wellman v. Dickinson*.

Exchange requirements

In conducting a PIPE transaction in Canada, issuers and investors will also need to be aware of the rules of any stock exchange that the issuer's shares are traded on. Stock exchange approval will generally be required in Canada or the U.S. in relation to the issuance of listed shares or securities convertible into listed shares.

A key consideration will be whether the applicable stock exchange requires shareholder approval for the transaction. In Canada, the TSX will most likely be interested in the following:

- Any discount to market price that does not fall within permitted ranges (15-25 per cent depending on share price);
- Whether dilution will exceed 25 per cent;
- The creation of any new 20 per cent shareholder; and
- The involvement of insiders.

In the United States, shareholder approval may be required if dilution is in excess of 20 per cent and the shares are issued at a discount.

Shareholder reporting requirements

In Canada, an investor that acquires 10 per cent or more of the outstanding shares of a reporting issuer will become subject to both early warning and insider reporting requirements. Early warning reporting requires the investor to issue a press release and file a related report that sets out a description of the transaction, its shareholdings and certain of its intentions with respect to the target. The press release must be filed no later than prior to the opening of trading on the business day after the securities are acquired and the related report is due within two business days. Subsequent press releases and reports will be required if the investor increases or decreases its shareholdings by 2 per cent or more from a prior report or if there is a change in a material fact in a prior report.
An investor will also need to make insider filings setting out details regarding the number of shares of the target held. These filings must be made within 10 days of the initial purchase and subsequent reports are due within five days of any purchase or sale of securities.

In the United States, an investor may be required to file a Schedule 13D or Schedule 13G if its shareholdings is in excess of 5 per cent. The Schedule 13D or 13G will contain information regarding the investor, its shareholdings, the transaction and its intentions with respect to the target company.

The investor may also need to file insider reports on Forms 4 or 5 with the SEC if it acquires 10 per cent or more of the outstanding shares of the target and may also be subject to the SEC's short swing profit rules applicable to insiders.

Conclusion

In sum, PIPE transactions in Canada are quite similar to those carried out in the U.S. However, there are some notable differences between Canadian and U.S. PIPE transactions that should be borne in mind when negotiating deals.

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[1] As per a study conducted by Preqin Ltd. published December, 2019.

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