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Filling the Sponsor PIPE-line

During periods of volatility, companies and investors often seek alternative financing structures that are impacted less by rapidly changing market conditions. With companies needing financing for operations or acquisitions or facing limitations on the availability of refinancing to pay off maturing or expensive debt, a PIPE (a private investment in public equity) by an existing or new financial investor offers a potential alternative source of liquidity while representing an attractive opportunity for sponsors looking to put capital to work in a choppy M&A market.

A PIPE involves a private, non-registered issuance of securities in a public company. Sponsor PIPEs raise a number of key financial, governance and process issues that should be addressed by the parties at the outset in order to facilitate an efficient route to a desired outcome, especially since speed of execution is one of the primary benefits of a PIPE transaction.

In current market conditions, sponsor PIPE investments offer a potential alternative source of liquidity for issuers and an attractive outlet for financial investors to put capital to work.

Below we summarize some of those key considerations:

Financial

» **Security —** While there is a range of potential securities issued in PIPE investments, many financial sponsor PIPEs are structured as convertible preferred equity. The conversion feature offers the investor participation in the upside of the issuer's common equity while offering downside protection in the form of a liquidation preference that is senior to the issuer's common equity (but subordinated to any debt). From the issuer's perspective, issuing convertible preferred equity rather than convertible debt facilitates presenting the investment as "smart money" supporting the issuer's equity story and, depending on the terms, potentially treating the security as equity rather than debt from an accounting or ratings agency perspective.

» **Coupon —** If structured as convertible preferred equity, the securities typically will accrue a dividend. Depending on the liquidity profile of the issuer, rather than being paid currently in cash, the dividend may accrue and compound on a cashless basis (referred to as a pay-in-kind (PIK) feature).

» **Conversion —** Most PIPEs have a conversion option into the issuer's listed common stock at a modest premium to the pre-investment market price, sometimes after a short period of non-convertibility. Many also feature a mandatory conversion right for the benefit of the issuer that requires conversion when the stock trades at a significant premium to the conversion price for a specified period of time (effectively cutting off the coupon and the liquidation preference when the conversion feature is significantly "in-the-money"). For PIPEs issued in periods of significant price volatility, one or both of these premiums may be larger than normal.

» **Redemption** — Most sponsor PIPEs will include optional or mandatory redemption features tied to a "maturity" date or a change of control of the issuer or other similar fundamental event. In some cases, such as upon a sale of the issuer, the redemption price may be the greater of the liquidation preference (occasionally with a premium or a make-whole) or the as-converted value implied by the deal price.

» **Dilution Protection** — Parties will negotiate whether any preemptive rights or anti-dilution terms are included to protect the sponsor's percentage stake in the issuer.

Governance

The governance construct for the investment will be reflected in a series of inter-related provisions that reflect the anticipated depth and duration of the relationship between the investor and the issuer as well as the size of the sponsor's stake. These include:

- **Board Rights —** The sponsor usually will get minority/proportional representation on the board of directors (and committees), which may be supplemented by board observer rights. These rights usually sunset if the sponsor reduces its ownership stake below specified levels.
- **Voting/Consent Rights —** In addition to typically having voting rights on an as-converted basis with the issuer's common stock, the sponsor's preferred equity may be granted consent/veto rights over certain key corporate actions. These may include changes to the organizational documents or the relative seniority of the investment security, as well as additional matters such as payment of dividends or incurrence of debt.
- **Registration Rights —** In order to facilitate the resale of the securities into the public markets, the sponsor may negotiate for shelf, demand and/or piggyback registration rights.
- **Standstill —** The issuer may negotiate for a "standstill" period during which the sponsor is prohibited from acquiring additional shares or seeking greater control.
- **Lock-Up —** The sponsor may agree to a period during which it is prohibited from selling shares it acquires in the investment, as well as limitations on the size of the block it can sell to a single investor or certain types of investors.

Process

- **Shareholder Vote —** In order to expedite execution, PIPEs usually will be structured to avoid the requirement for shareholder approval. NYSE and Nasdaq rules generally require shareholder approval for the issuance of more than 20% of the common or voting stock outstanding prior to the issuance (note that much lower thresholds may apply to issuances to related parties); therefore, the issuance, including any conversion and voting features, usually will be capped below those levels, at least until a subsequent shareholder approval is obtained.
- **Regulatory Approvals —** A PIPE investment typically requires a period between signing and closing so that required regulatory approvals can be obtained. These will include antitrust clearances in relevant jurisdictions, and, depending on the identity of the sponsor and issuer, may involve additional regulatory regimes such as CFIUS or industry-specific approvals.
- **Board Process —** While most PIPE investments from a new financial investor will not involve conflicts and therefore the board's actions would be reviewed under the deferential business judgment rule, additional procedural safeguards such as an independent special committee may be required and enhanced scrutiny may apply if members of the board have conflicts of interest with the investor (e.g., if the sponsor is already a significant shareholder in the issuer or has board representation).
- **Restrictions in Existing Agreements —** Existing debt instruments and other contractual arrangements may place limitations on the terms of the PIPE investment.

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With the current uncertainties affecting all corners of the M&A and financing markets, we expect that both financial investors and companies will be looking for alternative structures to satisfy their respective needs and goals where the structure and terms are relatively less exposed to the daily vicissitudes of broader market sectors. PIPE investments offer a potential financing opportunity with the benefits of an established framework coupled with opportunities for necessary customization.

If you have any questions about the matters addressed in this *Kirkland M&A Update*, please contact the following Kirkland attorneys or your regular Kirkland contact.

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