



PIPES – How They Help/Hurt Early Stage Companies

December 18, 2005

By: Paul J. Marino and Patrick Michel

This article briefly touches upon how early stage companies that have just completed a reverse merger into a public shell use Private Investment in Public Equity (a “**PIPE**”) as a means of securing financing.

For some early stage companies the path to a liquidity event or even return on investment is a long and winding road (for example a biotech company has many hurdles to clear including Federal Drug Administration approval before it sees any real return on investment) (for more information, *see*, “The Drug Development Cycle”, pg. 3). As a result of this long investment cycle many private investors are reluctant to invest. This reluctance can be attributed to the time horizon for return on investment and the lack of a discernable (or at least a predictable) exit strategy. For the investor that is willing to invest, the valuations placed on companies with a long rate of return cycle are usually unacceptably low—at least to the management team. As a result, many early stage companies go forward with a reverse merger and then seek a PIPE investment.

While the companies taking part in a reverse merger do not actually have a traditional initial public offering (in fact they usually become public by merging with a public shell [sometimes called a reverse merger]) they usually become public only to receive a private investment from a singular (or sometime syndicated) source. This private investment in a public equity is often times referred to as a PIPE.

In general a PIPE is defined as a private placement of equity or equity-linked securities by a public company to accredited investors that is followed by the registration of the resale of those securities with the Securities and Exchange Commission (the “**SEC**”).

A PIPE can be structured in a variety of different ways including, common stock, preferred stock, convertible debt, or another transaction linked to an equity investment. In the case of a reverse merger and subsequent PIPE investment, the transaction is usually structured as a registered direct offering. A registered direct offering is similar transaction as a traditional PIPE but here the entity has already been registered, typically through an off the shelf registration statement (a registered direct offering is often used in a reverse merger transaction (in this context a reverse merger is where a private entity purchase a public entity (usually a shell operating company) with the sole intention of becoming a public company).

Besides the excitement of being publicly traded, a PIPE provides a company with a readily accessible amount of capital, the ability of the Company to direct shares into the hands of preferred investors who might otherwise not be interested or cannot invest in a private placement, lower transaction costs for multiple transactions, and less market risk once the initial sale cycle has played itself out.

Before considering a PIPE transaction, a company should consider the downside associated with not only entering into a PIPE transaction but also being a public company. For instance, a PIPE transaction may have unintended consequences on existing shareholders such as dilutive effects on the common holders (usually the management team). Further, like private placements, once the company sells its stock (assuming there are no transfer restrictions) it has less control over the shares of the company, which could be problematic if the common stock sold has full voting rights. Another downside is that the purchase price is often at a larger discount to market value than a traditional underwritten offering. Finally, because the company is now a publicly traded company it is now subject to volatile price swings. This is a result of a number of different factors one of which is that many PIPE investors (especially those specializing in early stage companies) are not long-term investors (for example, many hedge funds and short sellers participate in PIPE transactions).

Further, a company entering into a PIPE transaction should also consider the rigors associated with being a public company. For example, a company will need to keep resale registration statement effective for two (2) years. Further, all public companies must comply with Regulation FD, which requires an issuer to disclose publicly any material, non-public information that it has disclosed selectively, unless it receives confidentiality agreements from the recipients of the information. Furthermore, a PIPE transaction with subsequent registration rights often impose monetary penalties on the issuer if the registration statement is not filed and is not declared effective within specified numbers of days. The registration requirements associated with being a public company should receive great thought because in today's "Spitzersized/SOX" environment public companies, small or large may face more scrutiny from the SEC (referring to Elliot Spitzer the Attorney General of New York and the Sarbanes Oxley regulation. Lastly, if a broker-dealer is among the purchasers, the SEC may deem the resale registration statement as a primary registration statement and require that the issuer meet the \$75 million float test of Form S-3.

There is an alternative approach to complying with Regulation FD and that is to issue a Rule 135c compliant press release stating the issuer's intention to do a private financing, but this eliminates one of the key advantages to a PIPE transaction—to not disclose the transaction until after definitive agreements have been executed. However, that disadvantage applies more to established public companies than it does a startup seeking capital.

In general, there are three types of PIPE transactions, (i) a "Good" PIPE, (ii) a "Not-as-Good" PIPE and (iii) a "Bad" PIPE. A "Good PIPE" is the most common type of PIPE transaction and includes the sale of securities (common or preferred stock, debt

or convertible debt) at fixed price or fixed conversion ratio. The second type of PIPE is a “Not-as-Good” PIPE. A “Not-as-Good” PIPE is the sale of fixed price or fixed value securities accompanied by value sweeteners such as warrants or other kickers. A “Bad PIPE” (no not a bag pipe) is the sale of variable-priced securities (floating ratio convertible debt, for example) or sale of securities accompanied by variable-priced sweeteners (so-called toxic or death spiral warrants—not as common as they once were because of the proliferation of PIPE offerings—*i.e.*, more competition for “Good” PIPE). A Bad PIPE is often the last resort transaction for a corporation and as a result is fittingly referred to as “last resort financing”.

Some factors a company should consider in deciding to pursue a PIPE transaction:

- Speed – PIPE financings are typically faster transactions to execute in comparison to a fully underwritten offering.
- Cost – The expenses related to PIPE are generally lower than public offerings but higher than complete private placements.
- Pricing – This can vary considerably based on the stage of a company in its growth cycle.

Generally, investors are willing to pay a premium for the liquidity of a PIPE deal.

- Regulatory – Early stage companies should consider the ongoing burden of public filings including resources and costs.

The process of determining if a PIPE deal is right for a company should begin with a strategy discussion of the growth path of the company and the potential sources of the financing. PIPE transactions have particular allure for those companies who underestimate the value/goodwill that is being given up in the transaction. Financial advisors and good counsel can help management chart a course for a successful PIPE deal. However, for every door a PIPE deal opens another door closes. PIPE deals should be looked at in terms of an overall financing strategy and not solely as interim financing.

It is important to keep in mind that a successful PIPE deal can launch an early stage company in to new arenas. A poorly planned PIPE deal can limit the growth path of even the most prosperous early stage company.

This article is not intended to be legal advice nor should it be construed as the legal opinion of the authors. If you have any questions/comments regarding this article please email: info@yvcs.org

Copyright © 2005 YVCS