CLOGGING THE PIPES: THE SEC CRACKS DOWN ON "DEATH SPIRAL" CONVERTIBLES

By John P. Cleary, Esq.
Procopio, Cory, Hargreaves & Savitch LLP

PIPE is an acronym for a private investment in public equity. In a PIPE, a publicly traded company issues securities with a commitment to register the securities for resale promptly upon closing the transaction. The Securities and Exchange Commission (SEC) has permitted PIPE transactions through Rule 152 under the Securities Act of 1933, as amended, which provides a safe harbor for issuers completing private placement offerings and subsequently registering the securities for resale to the public.

Typically, the SEC raises no objection when securities are privately placed with the closing of the transaction contingent on the filing or effectiveness of a resale registration statement as long as (a) the purchasers in the private placement are irrevocably bound to purchase the securities subject only to the filing or effectiveness of the registration statement, and (b) the purchase price is established at the time of the private placement. These are known as "traditional" PIPEs. Traditional PIPEs typically attract long term-investors who are betting on the performance of the company and its stock price.

In recent years, non-traditional, or "structured" PIPEs have evolved in which the first-step private placement involves the sale of debt securities that are convertible into common stock at a conversion price that automatically adjusts downward if the company's share price falls below the initial conversion price. Unlike traditional PIPEs, the purchase price is not set at the time of the private placement and the debenture is convertible for a fixed dollar amount rather than a specific

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number of shares. These have been colloquially dubbed "toxic" or "death-spiral" convertibles, and have drawn the intense scrutiny of the SEC.

The Mechanics of a "Death-Spiral"

When there is no limit on the downward adjustment of the conversion price, the prospect of large-scale conversions and sales at declining prices can create selling pressure which pushes the issuer's share price downward. Structured PIPE investors are ambivalent towards the performance of the company because they can reap substantial gains as the stock spirals downward.

To illustrate the strategy, an investor will short sell the company's stock at a price of "X" per share. A high volume of short selling pushes the share price down to X-1. The investor's conversion price is then reset to the discounted X-1. The investor then partially converts the debenture at X-1 to cover the shares it sold at X, delivers the shares necessary to cover the short sales and has a large number of shares left over, which it can then sell when the price hits X-2. The more the investor pushes down the market price with this strategy, the more profit it makes on each conversion. If the investor short sells at X per share, it will make much more if it can convert its shares to cover at X-4 than it will make by covering at X-2. The "death spiral" continues until the company is forced to issue huge amounts of virtually worthless stock. The investor already locked in its profit with short sales while the ordinary shareholders get crushed.

The SEC Acts to Curb PIPE Abuses

To give PIPE investors the liquidity of marketable securities, after the closing the issuer has to register resales of the PIPE shares through a Rule 415 shelf registration. Starting about a year ago, many issuers began receiving SEC comments on their resale registration statements questioning whether they were eligible to register resales of the PIPE shares. The SEC was taking the position that the issuers receiving the new Rule 415 comment were seeking to register so many shares that their PIPE transaction should be treated as a primary offering rather than a private placement followed by separate secondary distributions by the PIPE investors.

The SEC – through its staff in public speaking engagements – recently has cautioned that comments should be expected when an issuer registers for resale more than one-third of its outstanding shares held by non-affiliates. Because the number of conversion shares is virtually unlimited in structured PIPE transactions, the SEC's action is, for the most part, directed toward the abuses of "death spiral" convertibles. As a result of the SEC's stance on Rule 415, most "death spiral" convertibles have either been converted to traditional PIPEs or aborted.

It appears that issuers engaged in

traditional PIPE transactions selling securities at fixed prices should continue to be able to rely on the SEC's historical position in PIPE transactions, particularly if the amount of securities sold is relatively small in relation to the public float.

Convertible Debt in Microcap Financings

Although the SEC's recent action to protect microcap issuers has helped curb abuses, issuers still must be vigilant against predatory investors seeking convertible debt instruments. Typically, PIPE transactions impose upon the issuer a contractual commitment to file a resale registration statement and use its best efforts to have it declared effective by the SEC. More often than not, the issuer is subject to cash penalties if the SEC does not declare the resale registration statement effective within a stated time period. As a result of these provisions, PIPE investors who have their liquidity blocked by the SEC are able to effectively rescind their investment through the liquidation clause.

No matter what the SEC's position, issuers should avoid structured PIPEs at all costs and maintain some control over dilution by insisting on limits on adjustments in conversion rates and liquidated damages. "Death spiral" convertible debentures are, in most cases, the kiss of death when it comes to financing for a company seeking to raise capital.

Mr. Cleary is an attorney with Procopio, Cory, Hargreaves & Savitch LLP. Reach him at 619.515.3221 or jpc@procopio.com.