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ANNA T. PINEDO AND JAMES R. TANENBAUM,
MORRISON & FOERSTER LLP

▶ WHAT NEXT FOR HYBRID FINANCINGS?

PIPE and registered direct transactions have become important hybrid financing alternatives for companies that need to raise capital in difficult market environments or that need to raise capital quickly, or both. We believe the number of PIPEs and registered directs will continue to increase in 2007 and that the amount raised in these hybrid financings also will increase in 2007. We do expect to see several important changes in these markets.

Due to regulatory and accounting developments, we believe there will be more transactions involving the sale of shares of common stock at a discount and fewer transactions involving convertible securities and warrants. Companies and financial intermediaries involved in hybrid financings have been puzzling over the application of EITF 00-19, 'Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock'. This accounting standard affects the embedded conversion feature in convertible debt and preferred securities, as well as the treatment of warrants. Given uncertainty regarding the appropriate treatment of these instruments, companies are choosing to issue only common stock in PIPEs and registered directs. This accounting standard also has introduced uncertainty regarding the treatment of liquidated damages provisions requiring a PIPE issuer to pay liquidated damages to purchasers for failure to register the resale of the securities sold in the private placement. As a result, liquidated damages are now being capped. More recently, the NASD/NASDAQ published a proposal for comment changing the valuation methodology for warrants in applying the exchange's shareholder approval listing requirements. Often referred to as the '20 percent rule', these rules require that NASDAQ-listed companies seek shareholder approval for a transaction that may result in an issuance of 20 percent or more of the company's pre-transaction shares outstanding at a discount. Many issuers will elect not to issue warrants until the treatment of warrants is clarified.

The SEC remains focused on developments in the private placement/PIPE market. We expect that the SEC will continue with enforcement actions relating to insider trading/market manipulation claims in the PIPEs market. The SEC recently announced that it is considering measures designed to curb abuses involving short selling in connection with offerings. We think the PIPE and registered direct markets will once again be led by sector investors and that the role of arbitrage buyers will decline. Sector buyers tend to have a buy-and-hold approach and usually do not seek the downside protection or arbitrage opportunity presented by warrants and convertible securities – also suggesting more common stock transactions.

In parallel, the SEC also is focused on private placements where issuers have offered a disproportionately large number of securities relative to their pre-transaction float. In these instances, the SEC has been evaluating whether issuers not eligible to avail themselves of short-form registration statements (Form S-3 registration statements) on a primary basis (for sales of their own shares) may use these short-form registration statements in connection with PIPEs. We expect that these concerns may have the short-term effect of having smaller public companies choose other transaction formats or pursue smaller financings, or, where available to them, pursue registered direct offerings. The SEC developments limiting the use of resale shelf registration statements do not affect larger public companies. We expect to see a continuation of the 2006 trend toward more large hybrid financing transactions, especially more registered direct offerings, for larger companies. Issuers appreciate the rapidity to market and lower transaction costs associated with registered directs. Also, well-known seasoned issuers (WKSIs) will continue using automatically effective shelf registration statements in connection with PIPEs (for the resales) and registered directs (as immediate 'takedowns' off the shelf registration statement). ■

Anna T. Pinedo and James R. Tanenbaum are partners at the law firm Morrison & Foerster.
Anna Pinedo can be contacted on +1 (212) 468 8179 or by email: apinedo@mofo.com. James Tanenbaum can be contacted on +1 (212) 468 8163 or by email: jtanenbaum@mofo.com