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Rescue and Recovery Capital – A Guide for Companies and Investors

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In light of the significant liquidity challenges and deterioration in the stock prices and asset values the COVID-19 pandemic has caused for many otherwise healthy public companies, many of those same companies and investors are exploring rescue and recovery capital solutions that would not have been on their radar before. These solutions can involve a wide array of securities, ranging from plain vanilla common stock to bespoke convertible preferred stock and convertible debt, and a wide variety of transaction structures including PIPEs, backstopped rights offerings and registered direct offerings (sometimes known as public PIPEs) that can be executed with the necessary speed, precision and flexibility the circumstances demand.

The common thread is that these solutions can be flexible and are highly tailored to the individual circumstances of the companies and investors involved. There is a wide and ever-shifting range of issues and considerations that must be navigated in order to structure and implement a rescue and recovery capital transaction. The purpose of this article is to provide answers to a few of the initial questions that may be on the minds of companies and investors that will require careful evaluation with counsel at all steps along the road.

What should companies and investors be thinking about at the present time?

- Given the uncertainty about the length and scope of the disruption to the economy and financial system caused by COVID-19, as well as the path to and shape of the ultimate recovery, management and boards need to consider and continually update their Scenario A, B and C liquidity needs based on various assumptions.
- A PIPE or similar transaction is an essential arrow in the quiver of a publicly traded company that may be the best financing alternative available to meet the most urgent liquidity needs, from an imminent debt maturity to working capital necessary to continue operating.
- PIPEs and similar transactions, if structured appropriately, are a fast, precise and flexible tool to address the needs of both companies and investors to create not

only a lifeline but a safety net for companies impacted by the pandemic.

- A PIPE or similar transaction can also offer a patch to shore up liquidity positions that are under pressure but not yet unstable before the situation becomes a crisis. Support from an institutional investor helps alleviate uncertainty on the part of all stakeholders (*i.e.*, stockholders, lenders, employees, customers, tenants, etc.).
- Investors with the courage of their convictions to step in to provide capital where other financing sources have retreated may be in the right place at the right time. Dry powder across the investment fund universe is currently at record levels – nearly $2.6 trillion, including around $800 billion allocated to private buyouts.[1] In the current financing environment, with the M&A and debt markets that provide the fuel and raw material for leveraged buyouts reeling and under pressure, funds are looking for creative ways to put their capital to work. Additional funds are currently being raised that are explicitly and directly focused on investing in COVID-19-impacted companies, including minority equity investments.
- For investors, the appropriate mix of downside protection, board representation and veto rights/covenant protection is key. The security should be designed to both capitalize on a successful recovery and also to become a fulcrum security in a restructuring context.

Transaction Structures

What is a PIPE?

A PIPE is a private investment in public equity — an investor or a group of investors negotiates an agreement to buy newly issued securities directly from a public company in a securities purchase transaction exempt from the registration requirements of the Securities Act.

These transactions can be structured as investments in common stock or other securities that are already publicly listed or in a new class or series of debt or equity securities that are often convertible into common stock. The advantage to a new security is the company and investor can negotiate bespoke rights, privileges and preferences (including the coupon and form of payment (*i.e.*, any payment-in-kind provisions), seniority, operational/financial covenants, conversion rights (if any), board representation and other governance rights) to fit the company’s liquidity needs and the investment thesis of the investor.

A PIPE can also be structured on a “delayed draw” basis whereby the investor commits to fund additional purchases at subsequent closings timed to allow the company to meet other financial obligations it is relying on the PIPE to fund in an efficient manner. This structure is akin to an equity commitment allowing the company to defer incurring dilution or a preferred stock payment or accrual until it actually needs the funds. At the same time, this structure will likely be subject to a minimum “must take” requirement on the part of the investor and possibly an unused commitment fee.

Because PIPEs are unregistered, private offerings, the equity sold is subject to restrictions on resale and investors should expect to receive registration rights to facilitate unrestricted resales. These registration rights can include shelf, demand and/or piggyback rights, subject to customary blackouts, although the scope of these terms varies from deal to deal and is subject to negotiations.

What is a backstopped rights offering?

A backstopped rights offering is a tool most commonly used by debtors exiting chapter 11 but also available to distressed companies trying to raise equity capital quickly while allowing existing stockholders a first right to buy at the proposed price and thereby avoid having their position diluted by another investor. The rights offering is then “backstopped” by a committed PIPE providing the company certainty of funding at the commencement of the offer. In the rights offering, every existing stockholder receives a subscription right by means of a dividend. Then, for a period of time usually measured in weeks, the rights can be exercised to purchase a pro rata portion of a fixed number of additional securities (which can be common stock, warrants, convertible preferred stock or any other security) offered at a specific price per security, usually at a discount to the current trading price. Following the expiration of the offering, any securities underlying the rights that were not exercised are purchased at the same price by the backstop investor. The PIPE pursuant to which the investor purchases securities to honor its backstop commitment can also be combined with a concurrent PIPE for the same type of securities (or a different type) to guarantee the investor a minimum stake in the company even if the rights offering is fully subscribed.

What is a registered direct offering?

A registered direct offering is a public offering in which an investor or a group of investors negotiates an agreement to buy newly issued securities directly from the company. Registered direct offerings are usually the same class of securities already listed or publicly traded (often common stock) and the price is established following negotiations with prospective investors and with reference to the prevailing market price of common stock. A registered direct is similar to a direct PIPE, except the offering is registered under the Securities Act and the securities sold (and issuable upon exercise or conversion of the securities sold) are therefore not subject to any resale restrictions.

What terms are available for the securities sold?

The terms of securities sold in rescue and recovery capital investments are flexible and subject to negotiation. While common stock is often the easiest security to structure and provides more liquidity options as it already has a public trading market, bespoke transactions often utilize convertible preferred stock to allow the investor to participate in the equity upside if the rescue is successful and the company recovers while providing debt-like yield (payable in cash, common stock or additional preferred stock) and principal protection through a liquidation preference and redemption rights, potentially at a premium. These terms vary widely from transaction to transaction based on company-specific factors, including the accounting treatment of the security and the company's existing debt covenants, as well as the overall market.

While convertible preferred equity is one vehicle used, common or non-convertible preferred stock accompanied by a warrant, convertible debt or debt which provides the company the option to settle the principal at maturity with common stock, are other variations on the theme that can be structured to meet the needs of the investor and the company. Debt which provides the company the option to settle the principal at maturity with common stock allows the company to possibly avoid the dilution associated with an equity issuance if business and the debt markets return to a degree of normalcy and a lower cost of debt financing is available to repay the note at maturity. Optionality and financial flexibility are the primary drivers of this type of debt structure.

These instruments also often include a mandatory conversion provision that effectively cuts off the downside protection and yield when common stock has been trading at a significant premium to the conversion price for a specified period of time. At that point, the investor has achieved significant return on capital and, from the company's perspective, should be satisfied that it has achieved its objectives for the investment. The common stock at that point will be registered for resale, allowing the investor to more-or-less immediately realize its equity upside from a resale in the market.

What other rights and protections can investors expect?

A wide range of governance and other rights and protections are found in these types of investments, and these represent some of the most complex, critical and highly negotiated points in the entire transaction. These rights and protections frequently include:

- board and committee representation;[2]
- voting rights (*i.e.*, a convertible security with rights vote on an as-converted basis with the common stock on director elections and other matters submitted to stockholders);
- veto rights with respect to future debt incurrences, restricted payments, equity issuances, related party transactions, changes of control and other matters;
- financial/operational covenants;
- preemptive rights; and
- commitment fees payable in cash, securities or a combination thereof.

Structuring Considerations

Is there a limit on the number of shares of common stock (or securities convertible into or exercisable for common stock) issuable without first obtaining stockholder approval?

Yes. Both the NYSE and Nasdaq have a "20% rule"[3] and a "change of control rule"[4] which may require stockholder approval of an investment transaction involving a securities issuance, depending on the size of the investment, the terms of the securities sold and other relevant circumstances. Note, however, both exchanges have a financial viability exception we discuss below.

Importantly, these stock exchange limits apply only to the issuance of common stock. One common structure is to embed a hard-wired cap in the terms of a convertible security to prevent the issuance of common stock or voting power in excess of the percentage thresholds until stockholders approve the removal of the cap. In this way, the transaction can close and provide the company with liquidity in advance of the required stockholder approval. However, if the shareholders do not approve, the terms of the hard-wired cap will remain in place in the securities the investor already owns. To address this, the deal documents will require the company to call a special meeting (and file a proxy statement with the SEC) and obtain the required stockholder approval on an expedited basis. Depending on the ownership of the company, the investor may obtain agreement from significant stockholders up front to support the stockholder approval, although shares that are issuable under the cap (in the first part of the transaction) may not be entitled to vote to approve the remainder of the transaction. Depending on whether or not the SEC elects to review the proxy statement, 60 to 120 days should be budgeted to complete the stockholder approval process post-closing. Both NYSE and Nasdaq look unfavorably on penalties and sweeteners that apply if the approval is or is not obtained (such as an increased coupon or conversion ratio or a success fee payable to the company) although provisions of this nature may be acceptable if not deemed too coercive.

What is the “20% rule”?

Both Nasdaq and the NYSE require listed companies to obtain prior shareholder approval for the issuance of common stock (or securities convertible into, exercisable for or repayable with common stock) equal to, following issuance, more than 20% of the outstanding shares of common stock or voting power existing before the issuance. This rules applies in a privately negotiated transaction, including PIPEs and, for these purposes, registered directs.

Both Nasdaq and the NYSE may aggregate multiple transitions into a single issuance for these purposes, depending on the timing and interconnectedness of the transactions. Under ordinary circumstances, there are a few substantive differences between the NYSE’s 20% rule and the Nasdaq’s 20% rule. However, in light of COVID-19, the NYSE has waived the rules related to differences through June 30, 2020 on a temporary emergency basis. For further details, please see **our recent memo on the subject**.

Is there an exception to the 20% rule if the security is priced at market?

Yes, the 20% rule does not apply if the offering price (or conversion/exercise price, if applicable) is equal to or greater than a “minimum price” equal to the lower of (i) the most recent closing price at the time the purchase agreement is signed, or (ii) the average of the five most recent closing prices.

The minimum price exception effectively requires stockholder approval for any privately negotiated transaction priced at a discount to market, which can present particularly difficult structuring issues for convertible securities with coupons and relatively common conversion price adjustments (*i.e.*, issuances of equity below market value or cash distributions in excess of a negotiated threshold).

What is the “change of control rule”?

The change of control rule requires stockholder approval of any issuance or potential issuance of securities that would or could result in a change of control of the company. While both Nasdaq and NYSE make the determination of whether an issuance is a change of control for these purposes based on all the facts and circumstances, it is generally understood that an issuance would result in a change of control if an investor (or group) would (or could) acquire more than 20% of the outstanding shares of common stock or voting power *after* the issuance, particularly when the investor (or group) would then also have the largest ownership position.

While the rule only applies to transactions involving the issuance of securities, other elements of the transaction are also relevant to the analysis. For example, whether or not an investor or group receives board representation and other governance rights along with securities clearly impacts whether or not it has gained control of the company as a result of the transaction.

Is there an exception to stock exchange stockholder approval requirements for financially distressed companies?

Yes, if the delay in securing stockholder approval would seriously jeopardize the financial viability of the enterprise.

If this exemption is sought, audit committee approval needs to be obtained and the stock exchange needs to be consulted as soon as possible to discuss the relevant facts and circumstances and determine if the exemption will be available. There is no clear set of guidelines from Nasdaq or the NYSE as to when a company is no longer “financially viable” for these purposes, although, based on precedent, it is undoubtedly a high standard to meet that requires providing a detailed written analysis of the company’s circumstances and need for the exemption to the stock exchange. The analysis should cover matters such as the company’s current cash position and ability to meet current obligations, as well as whether or not the company would be rescued or forced to file for bankruptcy depending on receipt of the exemption to structure the transaction as proposed.

We expect, however, that companies with businesses that have been seriously impaired by the impact of COVID-19 will find stock exchange regulators to be a more receptive audience to these entreaties in the current environment than they would have been just a few short months ago. Nasdaq, for one, has recently stated that the impact of disruptions caused by COVID-19 will be considered in its review of any pending or new requests for a financial viability exception.

Importantly, even when relying on this exception to the stockholder approval rules, companies must notify their stockholders at least ten days prior to issuance. Unfortunately, Nasdaq has made clear that it will not entertain requests for a notice period shorter than 10 days, and that convertible securities cannot be issued before the 10-day notice period has expired, even if they would not convert until after the notice period ends.

Do backstopped rights offerings require stockholder approval?

They may, although the standard is higher than it would be for a direct investment PIPE. Because all stockholders have equal access to a rights offering, the capital raised is not necessarily dilutive to existing stockholders even if priced at a discount to the market price. For this reason, the 20% rule will generally not apply to the PIPE required to complete the backstop commitment portion of the transaction, although, if a backstop commitment party receives a fee or is able to purchase stock on terms different than those made available to the stockholders, those factors need to be considered. Also, depending on the terms of the transaction, taken as a whole, the stock exchange change of control rules could be implicated.

Are any other approvals required?

As part of the structuring of any of these investments, the company's debt and other significant agreements should be carefully reviewed for any potential conflicts. For example, some credit agreements will restrict the issuance of debt or preferred equity, particularly preferred equity with mandatory redemption features, and many agreements have change of control provisions that cover circumstances such as the issuance of significant additional shares of common stock (or securities convertible into, exercisable for or repayable with common stock) that must be evaluated in conjunction with these investments.

Hart-Scott–Rodino (*i.e.*, anti-trust) filings and waiting periods may be necessary depending on the terms of the transaction and its participants. CFIUS or industry-specific approvals may also be necessary depending on who the investor is and what industry the company is in.

Any special considerations in the board room?

Process is always critical. Depending on the size of the investment and the strength and scope of any investor governance and voting rights, a rescue or recovery capital investment can implicate change of control considerations that should be front of mind for the board and its advisors. In addition, where the investor is a significant stockholder already or has board representation, a special committee with its own independent advisors may be required.

Also, depending on the facts surrounding the particular investment, the parties can agree to certain "standstill" restrictions. These could include limiting the investor's ability to accumulate additional shares of common stock or otherwise seeking control of the company or "standstill on voting" restrictions requiring the investor to vote in accordance with the recommendations of the board up to a fixed percentage of the voting power of the company it controls, often for a fixed period or until the investor no longer owns a significant percentage of the company's equity.

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Proskauer's cross-disciplinary, cross-jurisdictional Coronavirus Response Team is focused on supporting and addressing client concerns. We will continue to evaluate the CARES Act, related regulations and any subsequent legislation to provide our clients guidance in real time. Please visit our Coronavirus Resource Center for guidance on risk management measures, practical steps businesses can take and resources to help manage ongoing operations.

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[1] *Source: Preqin Ltd*

[2] In structuring these and other provisions that directly impact the pre-existing voting rights of common stockholders, careful attention should be paid to NYSE Rule 313 and Nasdaq Rule 5640, which provide that common stock voting rights cannot be disparately reduced or restricted through any corporation action or issuance and therefore the board representation and voting rights need to be proportionate to ownership. To maintain this proportionality, the level of the rights (*i.e.*, the number of board seat) should diminish and eventually sunset as the investor's ownership level decreases.

[3] Nasdaq Rule 5635(d); NYSE Rule 312.03(c).

[4] Nasdaq Rule 5635(b); NYSE Rule 312.03(d).

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