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Key Considerations for Private Investments in Public Companies (PIPEs) in Canada



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Introduction

To assist interested parties in navigating a private investment in public equity (PIPE) transaction in Canada, we have prepared the following summary of key considerations.

What is a PIPE Transaction?

- PIPE transactions are private placements of securities issued by public companies that are usually significant, but still minority, investments. In most cases, PIPEs are offered only to certain accredited investors, including institutional investors, private equity investors, and strategic investors (such as sovereign wealth funds).
- The issuance of securities in a PIPE transaction is made under one of the exemptions from the prospectus requirements of Canadian securities laws. Accordingly, there is minimal involvement of any securities commission. However, stock exchanges have established regulations relating to pricing and shareholder approval requirements.

Who is a Typical PIPE Issuer?

An issuer that needs to raise money in circumstances where it may not be able to do so by way of a public offering, including (i) issuers in financial distress (or otherwise seeking to improve their balance sheet), and (ii) issuers who may not have access to institutional investors because of low market capitalization and a small trading float.

Who is a Typical PIPE Investor?

- Traditionally, PIPE investors have tended to be public market investors that focus on short-term investments. Investors with a longer-term strategy, such as private equity investors, have historically avoided PIPEs because of the inability to obtain control over the issuer.
- More recently however, private equity investors have shown an interest in acquiring substantial minority positions if the issuer is a strong company, established in one of the industries that the investor has experience in, and is one where the investor may be able to negotiate some control rights.



Advantages and Disadvantages

Advantages of a PIPE Transaction

- A PIPE transaction offers several advantages for an issuer, including:
 - can be completed relatively quickly;
 - transaction expenses lower than the expenses an issuer would incur in connection with a public offering;
 - minimal involvement of any Canadian securities commission;
 - marketed and completed on a confidential basis. (The transaction will be disclosed to the public only after definitive purchase commitments are received from the PIPE investor.);
 - the issuer may be able to expand its base of accredited and institutional investors and may develop a strategic relationship with a large shareholder; and
 - the issuer may be able to negotiate certain protections, such as hold periods and/or standstills.
- For an investor, advantages of a PIPE transaction include:
 - the ability to receive a discount to the current market price in order to compensate for the initial four-month statutory hold period;
 - the ability of the investor to negotiate additional governance rights and protections, such as board seats, anti-dilution protection, pre-emptive rights, registration rights, or veto rights; and
 - high upside if equity bought at a discount based on broad market factors (e.g. a well run company with a depressed price due to poor general market conditions).

Disadvantages of a PIPE Transactions

- PIPE transactions have a few disadvantages for an issuer, including:
 - the offering would be restricted to those purchasers who meet prospectus exemption requirements, principally accredited investors;
 - in order to compensate for the initial four-month statutory hold period, PIPE investors will require a discount to market on the purchase price; and
 - in general, a reporting issuer cannot sell more than 20% of its outstanding stock at a discount without receiving prior shareholder approval.
- For an investor, disadvantages of a PIPE transaction include:
 - equity capital at higher risk than debt (as a result, more exposure to issuer's downside risk); and
 - reduced liquidity due to a limited ability under securities laws to exit a substantial/control position.

Types of Security

- PIPE transactions may involve the sale of various types of securities, including common equity, convertible preferred equity (incorporating variable dividend ranges and possible payment in-kind dividends), convertible debentures (typically unsecured), inducement warrants (at fixed or variable pricing), or other equity or equity-like securities.
- The sale of common equity is usually preferred by issuers, while PIPE investors may favour the acquisition of preferred equity or convertible debentures. Preferred equity and convertible debentures often contain terms:
 - granting a liquidation preference over common equity or priority over equity securities;
 - allowing for the ability to convert into common equity if beneficial to the PIPE investor; and
 - allowing for the payment of preferential dividends or interest.



Summary of Process and Key Agreements

- The negotiation and implementation of a PIPE transaction typically involves the following:
 - negotiation of a confidentiality agreement and any exclusivity arrangements between the PIPE investor and the issuer;
 - due diligence review of the issuer by the PIPE investor and its advisors. (However, since reporting issuers are subject to significant public disclosure requirements, diligence is generally expedited);
 - submission by the issuer of a listing application and compliance with applicable stock exchange requirements; and
 - negotiation of a subscription agreement and any additional agreements to be entered into concurrently with the closing of the PIPE transaction.
- The subscription agreement for a PIPE transaction is the most substantive definitive document and will generally contain:
 - representations and warranties of the issuer with respect to the issuer's business and related matters;
 - representations and warranties of the PIPE investor relating to its status as an exempt purchaser and to the availability of subscription funds;
 - the terms of any convertible securities or incentive warrants, if applicable;
 - the terms of any issuer protections or PIPE investor rights; and
 - specific interim covenants and termination provisions for the benefit of each of the issuer and the PIPE investor.
- In certain cases, the terms relating to the issuer protections and PIPE investor rights may be set out in one or more additional stand-alone agreements.



Commonly Negotiated Issuer Protections and PIPE Investor Rights

- In addition to the terms contemplated by the PIPE securities themselves, it is common for the issuer and the PIPE investor to negotiate additional protections and rights. These will vary based on the specifics of the transaction and the needs and bargaining power of the parties involved.
- a standstill (which expires after an agreed period or at such time as the PIPE investor's ownership falls below a certain threshold) under which the PIPE investor (subject to any negotiated exceptions) will agree not to:

Issuer Protections

- In the case of significant investment (i.e., more than 10% of the company), issuers will typically negotiate:
 - a hold period beyond the four-month statutory period (typically 1-3 years) during which the PIPE investor will not sell its securities (subject to any negotiated exceptions) to any person and/or agree to limitations on the manner in which resales may be made or to whom they may be made; and
 - acquire any additional securities of the issuer (or, alternatively, additional securities above an agreed percentage) or
 - engage in actions that the issuer's board of directors may consider hostile (for example, proxy contests involving the replacement of directors and unsolicited take-over bids).



PIPE Investor Rights

- In general, the size of a PIPE investment (either measured as a percentage of outstanding equity or as a dollar size) often supports certain governance rights in favour of the investor.
- Governance rights tend to be one of the most highly negotiated provisions in PIPE transactions involving the sale of equity as they govern the ongoing relationship of the issuer and PIPE investor. Some of the most commonly negotiated governance rights are set out below.

Board Seats/Observation Rights

- The right, subject to applicable corporate and securities laws and stock exchange requirements, to nominate one or more directors to the board of directors of the issuer.
- PIPE investors may also negotiate for such nominee to either be on specified committees of the board or to be considered for inclusion on such committees.
- Board representation is usually proportional to the equity ownership of the PIPE investor and is often conditioned on the PIPE investor maintaining ownership above a certain threshold.
- If board appointment is not possible, observation rights are usually negotiated.

Anti-Dilution Protection

- Convertible securities will generally include anti-dilution provisions occasioned on:
 - a consolidation of the outstanding common equity;
 - a stock dividend or other distributions of common equity to existing holders or a payment of an extraordinary cash dividend; and/or
 - the issuance of convertible securities with unequal conversion terms.

- Anti-dilution protection can be structured in different ways. The most aggressive structure is full ratchet protection, in which the investor's purchase, conversion or exercise price is lowered to equal the price of the new dilutive issuance. More typical though is weighted-average anti-dilution protection where the price is lowered based on a weighted-average calculation of the dilutive impact of the new issuance.
- Anti-dilution protection usually lasts for a certain period of time after closing and may also include a requirement that the new issuance exceed a certain minimum threshold.

Pre-emptive Rights

- In addition to anti-dilution protection, PIPE investors may also bargain for pre-emptive rights permitting the investor to participate in future offerings to preserve their proportional holdings.

Commonly Negotiated Issuer Protections and PIPE Investor Rights

Registration Rights

- Registration rights are used more often in the United States than in Canada. In the U.S., statutory hold periods are longer and stricter resale restrictions apply to “affiliate” investors (who generally hold 10% of the company). This differs from Canada, where stricter resale restrictions apply to “control persons” (who generally hold 20% of the investment).
- Canadian issuers do, however, provide PIPE investors with rights similar to registration rights, particularly so where the size of the investment relative to the liquidity of the security may result in a decrease in public market liquidity.
- Typical negotiated sub-rights include the threshold at which registration rights fall away, the number of registration rights provided, postponement rights for the issuer in certain circumstances, and an allocation of the costs of the registration rights.

Veto Rights

- Although less common, some PIPE investors negotiate for negative control rights in respect of certain matters including:
 - amendments to the issuer’s articles and/or bylaws;
 - the issuance of new classes of equity or senior debt securities, or additional indebtedness; and
 - substantive change to the issuers business plan or operations.
- Negative control rights, if broad enough to potentially have a “material affect on control” of the issuer, may require the approval of the issuer’s shareholders.



Regulatory Considerations

Securities Laws

- As noted earlier, the issuance of securities in a PIPE transaction is made under one of the exemptions from the prospectus requirements of Canadian securities laws, and accordingly, there is minimal involvement of any securities commission.
- All of the securities acquired under a PIPE transaction will generally be subject to a four-month statutory-hold period before they can be sold (further restrictions apply if the investor is a control person), unless the investor relies on a private placement exemption to effect a subsequent sale.
- In a case where a PIPE investor acquires more than 10% of the issuer, it will be subject to certain additional requirements under applicable securities laws depending on the number, class and voting rights of securities acquired, including “insider reporting requirements” and “early warning requirements.”

Control Person: A PIPE investor that owns more than 20% of the outstanding voting securities of the issuer or who holds enough shares to “materially affect” the control of an issuer (i.e., has board nomination rights or other positive or negative controls) is a Control Person. A Control Person’s additional acquisition of securities, or sale of its existing securities, are more restricted. For example, a control person, subject to certain limited exemptions, cannot buy more shares, in the market or privately, unless it makes a formal take-over bid open to all shareholders at the same price.



Stock Exchange Requirements

- While there is little involvement of any Canadian securities commission in the regulation of a PIPE transaction, the Canadian stock exchanges do have regulatory oversight.
- As the main exchanges, the Toronto Stock Exchange (TSX) and the TSX Venture Exchange (TSXV) have the most well defined process, rules and regulations.
- In particular, the TSX and TSXV have rules relating to when shareholder approval of a PIPE transaction may be required and acceptable pricing of the issuance.
- Shareholder approval is generally required for a PIPE transaction if:
 - the PIPE investor will hold (or can exercise convertible securities that allow it to acquire) more than 20% of the shares of the issuer (required by both TSX and TSXV);
 - the PIPE investor will be able to materially affect control of the business of the issuer through board nomination rights or other positive or negative controls on the business (required by both TSX and TSXV);
 - the price per share of the issued securities is lower than the Market Price (less the maximum permitted discount) (TSX only; not permitted by TSXV);
 - the shares or other securities issued have anti-dilution provisions that may result in shares being issued a price lower than the Market Price (less the maximum permitted discount) (TSX only; not permitted by TSXV); or
 - the total number of shares issued or issuable is greater than 25% of the number of shares outstanding (on a non-diluted basis) and the price per share is less than the Market Price (TSX only; not permitted by TSXV).
- For the TSX, **Market Price** means the volume weighted average price of the shares on the TSX, or another stock exchange where the majority of the trading volume and value of the listed securities occurs, for the five trading days immediately preceding the date the price protection form is received.
- For the TSXV, **Market Price** means the last closing price of the listed securities before either the issuance of the news release or the filing of the price reservation form required to fix the price, subject to a 5 cent minimum.
- Shareholder approval for a PIPE may be obtained either by (i) a resolution approved by more than 50% of shares voted at a shareholder meeting (excluding any shares held by the PIPE investor), or (ii) written consent of holders of more than 50% of the shares (excluding the PIPE Investor) based on disclosure of the material terms of the transaction.
- Under the TSXV rules, if the PIPE investor will become an “insider” of the issuer pursuant to the PIPE transaction, the PIPE investor will be required to submit a personal information form (PIF) to help the exchange determine the public quality of the investor.
- Similarly, the TSX routinely requires a PIF from any new insiders of its listed companies created through a PIPE, although technically PIFs are only required from insiders upon the request of the TSX.
- A PIPE investor that is a corporation or other kind of fund will be required to provide PIFs for each of its primary managing officers.

Other Regulatory Approvals

Competition Act (CA)

- If the PIPE transaction would result in the PIPE investor (inclusive of affiliates) holding more than 20% of the voting securities of the issuer, the transaction may be subject to pre-merger notification under the *Competition Act* (Canada) if (i) the combined assets in Canada or combined gross revenues from sales in, from and into Canada of the investor and the issuer together with their affiliates exceed C\$400 million, and (ii) the assets in Canada or revenues of the issuer's business in and from Canada exceed C\$96 million. If subject to notification, the PIPE investor and the issuer must file a notification and not complete the transaction until expiry of a waiting period, unless the parties receive a waiver to the notification provisions.

Investment Canada Act (ICA)

- If PIPE transaction would result in the PIPE investor (inclusive of affiliates) holding more than 1/3 of the voting securities of the issuer, the transaction may be subject to review and approval under the *Investment Canada Act* (Canada) if the PIPE investor is a “non-Canadian” and certain financial thresholds are triggered. The financial threshold is based on the identity of the PIPE investor. If the PIPE investor is controlled by a “trade agreement investor” member country (i.e., the U.S.) the financial threshold is an “enterprise value” of the issuer of C\$1.613 billion. If the PIPE investor is controlled by a “world trade organization” country member, this enterprise value threshold falls to C\$1.075 billion. For PIPE investors that are “state owned enterprises” the review threshold is a book value of the assets of the target of C\$428 million. The PIPE transaction may also be reviewed under the ICA if it raises a national security concern. If subject to review, the PIPE investor may not close the transaction until the Minister under the ICA has approved the transaction.



Authors

Darrell Peterson

403.298.3316
petersond@bennettjones.com

Gordon Cameron

646.992.4322
camerong@bennettjones.com

For more information on Bennett Jones' Corporate Finance and Private Equity and Investment Funds group's services and lawyers, please visit

BennettJones.com/CorporateFinance

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