

## Death Spiral Financing

by Alina Marian

“Death spiral”, “toxic”, “dangerous to your health”, “the grimmest of reapers”, are just some of the words used to characterize some of the Private Investments in Public Equity (PIPE) transactions. A PIPE deal involves private investors who purchase restricted shares from a public company at a predetermined price. In return, the company files a resale registration statement, thus allowing the investor to resale the shares to the public<sup>1</sup>. The mechanism of a PIPE deal can be broken down by each of the letters forming its acronym<sup>2</sup>: it involves a *private* party willing to make an *investment* in a *public* company who, in return, wants to raise capital by selling *equity*.

As its name suggests, a PIPE transaction has a dual nature, combining aspects of a private placement transaction with aspects of a public offering<sup>3</sup>. The first component is the private placement of securities issued by a public company. Such securities can range from common stock, convertible or non-convertible bonds, convertible or non-convertible preferred stock, to warrants, or any combination of them. According to Section 5 of the Securities Act of 1933, it is unlawful to offer to buy or to sell any security, “unless a registration statement has been filed” with the SEC (15 USCS § 77e). However, precisely because of the private aspect of PIPEs, these types of transactions are exempt from the registration requirements. Section 4(a)(2) of the Securities Act of 1933 states that registration requirements will not apply to “transactions by an issuer not involving any public offering.”( 15 USCS § 77d). Moreover, Rule

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<sup>1</sup> J. D. Hogboom, *Private Investment in Public Equity: An Overview*. New Jersey Law Journal, CLXXVII (7), 621st ser., 2004, [https://www.sec.gov/info/smallbus/gbfor25\\_2006/hogoboom\\_invest.pdf](https://www.sec.gov/info/smallbus/gbfor25_2006/hogoboom_invest.pdf), (last visited January 13, 2017).

<sup>2</sup> D. J. Hoffer, *Quagmire: Is the SEC Stuck in a misguided war against PIPE financing?* (2011), Transactions: The Tennessee Journal of Business Law, 12, 9-36, <http://trace.tennessee.edu/cgi/viewcontent.cgi?article=1198&context=transactions>, (last visited January 13, 2017).

<sup>3</sup> *Id.*, at 13.

506 of Regulation D also provides safe harbor from registration requirements to investors and companies involved in a private transaction (17 CFR 230.506).

The second aspect of a PIPE—the public aspect—involves the investors obtaining liquidity for their investment by being able to resell the securities to the general public.<sup>4</sup> This can be achieved in two different ways. First, the issuer can file a registration statement with the SEC to register the reoffer and resale of the common shares held by the private investors. The registration statement can be negotiated to be a condition of closing the deal or, more frequently, to be filed with the SEC within a number of days after the private placement is closed.<sup>5</sup> Once the resale registration is approved, the investors can freely sell their shares on the public market.<sup>6</sup>

Another way investors can obtain liquidity in their investment is by getting around the registration requirement all together. Rule 144 of the Code of Federal Regulations (CFR) establishes the following exemption: “If any person sells a non-exempt security to any other person, the sale must be registered unless an exemption can be found for the transaction.” Section 4(a)(1) of the Securities Act establishes such an exemption, if the transaction involves a “person other than an issuer, underwriter, or dealer.” Section 2(a)(11) of the Securities Act, broadly defines the term “underwriter” to mean any person who purchases securities from an issuer “with a view to ... distribution”. The term “with a view to” refers, in this context, to having the intention to distribute (resell) the securities obtained from the issuer, and it has been deemed to require knowledge of the mental state of the purchaser.

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<sup>4</sup> J. T. Hartlin, *Despite Recent Setbacks in the Courts, the SEC Remains Focused on Short Sales in PIPE Transactions*, 2009, <https://www.paulhastings.com/docs/default-source/PDFs/1351.pdf>, (last visited January 10, 2017).

<sup>5</sup> *Id.*, at 163.

<sup>6</sup> L. M. Lerner, *Disclosing Toxic PIPEs: Why the SEC Can and Should Expand the Reporting Requirements*. *The Business Lawyer*, 58(2), 655-688, 2003, <http://www.jstor.org.ezproxy.fau.edu/stable/pdf/40688136.pdf?acceptTC=true>, (last visited January 9, 2017).

Consequently, the preliminary note to Rule 144 states that, in order to determine the intention of the investors, prominence must be given to such factors as the length of time the investors hold on to the securities. Pursuant to Rule 144 (i), if six months elapse between the purchase of the securities and their subsequent resale, the purchaser is not considered to be engaged in the distribution of securities (17 CFR 230.144(i)), and therefore, he/she is not an underwriter.<sup>7</sup> Thus, a PIPE investor can freely resell the unregistered securities after holding them for six months.

This type of financing has been increasingly popular over the past twenty years. From 300 PIPE deals in 1996, there has been a significant growth to over 1200 deals in 2007<sup>8</sup>. According to Placementtracker, a prominent research and analysis provider of the PIPE market, there were 898 such transactions in 2015, totaling \$50.7 billion<sup>9</sup>.

The popularity of PIPEs can be attributed to a few undeniable advantages they offer. From the public companies' point of view, such transactions allow them to raise capital faster, and more efficiently than through more conventional methods, while getting around regulatory obstacles. The investors, on the other hand, are attracted by the potential for bigger returns, greater liquidity, and a more secure investment.<sup>10</sup>

And yet, in spite of all the above-mentioned advantages—some might argue because of some of these advantages, there has been a lot of literature written about the ethical and legal ramifications of a certain type of PIPE deal, structured in a way that it often leads to the destruction of the company

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<sup>7</sup> E., Klein, *How To Raise Capital Using A PIPE*, Sept. 5, 2013, <https://www.law360.com/articles/470125/how-to-raise-capital-using-a-pipe>, (last visited January 16, 2017).

<sup>8</sup> Hoffer, *supra* note 2, at 11.

<sup>9</sup> S. R. Systems, *PlacementTracker Publishes 2015 PIPE Market League Tables*, Jan. 12, 2016, <http://globenewswire.com/news-release/2016/01/12/801442/0/en/PlacementTracker-Publishes-2015-PIPE-Market-League-Tables.html>, (last visited January 16, 2017).

<sup>10</sup> Hoffer, *supra* note 2, at 20.

involved, hence the “death spiral” name. In such transactions, the investor extends a loan to a public company in exchange for convertible securities, such as bonds or preferred stock, which can be later converted into common stock, usually at a discount to the market price at the time of the conversion. This discount amounts to an “unlimited price reset provision”<sup>11</sup>, ensuring that, regardless what the market price of the stock is on the day of the conversion, the investor will be able to convert its securities at a price below the market. Thus, a PIPE investor can benefit even if the company’s price per share is severely devalued. The discount—usually between ten and thirty percent,<sup>12</sup> is included as an incentive for the initial illiquidity of the convertible securities,<sup>13</sup> given that the investor, as presented above, has to wait 60 days to be able to convert and sell his/her share, or until the company files a resale registration certificate.

In addition, a typical “death spiral” loan does not state a predetermined number of shares of common stock, but instead it allows for a flexible conversion rate which is always less than the market rate at the time of conversion.<sup>14</sup> Consequently, the lower the price of the stock, the more shares are necessary to be issued when the investor converts its securities into common stock. For example, an investor extends a \$1,000,000 loan to a public company in exchange for convertible bonds. Instead of a fixed conversion rate— \$1,000,000 in exchange for 40,000 shares, for example, the loan allows for a “floating conversion ratio.”<sup>15</sup> When the investor decides to convert his/her debenture, the initial \$1,000,000 investment can be converted in 500,000 shares if the price is \$2.00 a share or, alternatively, 1,000,000 shares if the price per share falls to \$1.00.<sup>16</sup>

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<sup>11</sup> Lerner, *supra* note 6, at 658.

<sup>12</sup> *Id.*

<sup>13</sup> Klein, *supra* note 7.

<sup>14</sup> A. Phung, *What are 'death spiral' convertible bonds?*, June 8, 2006, <http://www.investopedia.com/ask/answers/06/deathspiralbond.asp>, (last visited January 16, 2017).

<sup>15</sup> *Id.*

<sup>16</sup> M. Levine, *Death-Spiral Convertible Financier Has a Lot of Fun*, March 12, 2015, <https://www.bloomberg.com/view/articles/2015-03-12/death-spiral-convertible-financier-has-a-lot-of-fun>, (last visited January 7, 2017).

This situation creates an incentive for the investor to actually drive the stock price down, by selling the stock short prior to the conversion, knowing that once the conversion is made, the price will fall even further. There is little risk for the investors since they can use the convertible debenture to cover their short positions. Furthermore, at the time of the conversion, the stock is being diluted by the extra shares entering the market, which drives the price per share even lower, hence the phrase “death spiral financing.”<sup>17</sup> Meanwhile, the PIPE investor is comfortable with the stock price dropping knowing that, thanks to the reset price provision, he/she will convert at a price below the market.

In 2003, Thomas Newkirk, at the time the Associate Director of the SEC’s Division of Enforcement, famously summarized this situation: “Certain convertible securities, particularly those referred to as “toxic” or “death spiral” convertibles, present the temptation for persons holding the convertible securities to engage in manipulative short selling of the issuer’s stock in order to receive more shares at the time of conversion.”<sup>18</sup>

The aftermath of such a deal can be devastating for the company who undertakes it. In 2000, at the climax of the dot-com bubble, dozens of small cap companies looking to finance their rapid growth lost upwards of 98 percent of their value within one year of closing a PIPE loan.<sup>19</sup> In some cases, following the devaluation of the stock, PIPE investors can convert to enough stock to actually gain control of the company. In such instances the investors can choose to liquidate the company, or sell it to the highest bidder.<sup>20</sup>

The question, of course, is why any company would enter a loan that can potentially have destructive consequences to their value. Usually, they are small cap companies in desperate need of financing, but who don’t want to, or

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<sup>17</sup> Lerner, *supra* note 6, at 658.

<sup>18</sup> N. Nead, *Death Spiral Finance: Avoiding the Temptation for Easy Money*, March 22, 2016, <http://investmentbank.com/death-spiral/>, (last visited January 10, 2017).

<sup>19</sup> *PIPEs: Quick Financing, the Hail Mary Pass and New Investors*, <http://www.placementtracker.com/News/PR11.15.04FinEngineering.htm>, (last visited January 02, 2017).

<sup>20</sup> Lerner, *supra* note 6, at 658.

cannot go through the traditional venues. A good example of such a company is MannKind Corporation. In August of 2015, MannKind, a small cap pharmaceutical company, had a \$100 million loan in convertible debt that had to be repaid or refinanced by the 15<sup>th</sup> of that month<sup>21</sup>. Already in a bad financial position, due to mismanagement in the development of their product, inhaled insulin Afrezza, MannKind did not have many options available to them. The company decided to restructure the debt with a combination of discounted stock and additional debt. According to Adam Feuerstein writing for *The Street*, the worst part of the debt restructuring deal was the “stock-for-debt exchange (...), a classic definition of the death spiral financing”. Even though MannKind managed to negotiate a floor price for the conversion, the results of this transaction were devastating for its stock price.<sup>22</sup>

The graph below<sup>23</sup> is emblematic of “death spiral” loans’ aftermath. In June 2015, the price per share of Mannkind stood at around \$6.50. Two months



<sup>21</sup> A. Feuerstein, *MannKind Relies on 'Death Spiral' Financing to Help Settle Looming Debt*, July 29, 2015, <https://www.thestreet.com/story/13236205/1/mannkind-relies-on-death-spiral-financing-to-help-settle-looming-debt.html>, (last visited January 16, 2017).

<sup>22</sup> *Id.*

<sup>23</sup> Stockcharts,

<http://stockcharts.com/csc/sc?s=MNKD&p=W&yr=2&mn=0&dy=0&i=t32540145135&r=1484599262477>, (last visited January 16, 2017).

later, when the restructured deal came into effect, the price started dropping and it never recovered, hitting all-time lows in October, 2016. As of January 16, 2017 Mannkind (MNKD) is trading at \$0.69.

The 2015 agreement allows MannKind to issue new convertible debt in 2018 to cover \$28 million of the \$100 million they owe. The conditions of the 2018 issuance are similar to those of the previous transaction.<sup>24</sup> This could be a classic example of being bound to repeat history if we don't learn from our mistakes, or maybe just an example of a company desperate to stay afloat through any means necessary, even at the expense of its shareholders.

While many companies that enter a PIPE transaction see the value of their stock diminish, PIPE investors tend to recover their money with a substantial return. An article in Bloomberg BusinessWeek reveals some of the inner workings of such investors. The article is constructed as a reveal piece directed at Josh Sason, a 27-year-old who built a multi-million-dollar fortune by using "death spiral" lending techniques.<sup>25</sup> His company, Magna, has been diversified over the years to include a "ventures department" and an entertainment department. Sason even made a cameo in "Bleed for this", a movie in which he invested a few million dollars.<sup>26</sup> But his company's beginnings are a lot less glamorous.

Sason set up Magna as a last resort lender for struggling penny stock companies. According to one of Magna's former employees, they would look up companies online and cold-call them, offering money in exchange for steep-discounted stock.<sup>27</sup> More often than not such companies were eager to accept the deal. Based on an analysis of 80 public filings from companies that have entered financing contracts with Magna, Bloomberg BusinessWeek reveals that their shares drop on average 55 percent over the year following

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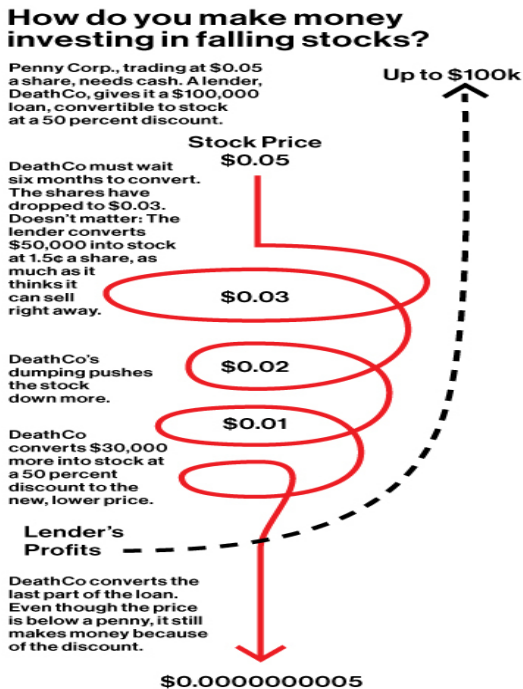
<sup>24</sup> Feuerstein, *supra* note 21.

<sup>25</sup> Z. Faux, *Josh Sason Made Millions From Penny-Stock Financing*, March 12, 2015, <https://www.bloomberg.com/news/articles/2015-03-12/josh-sason-made-millions-from-penny-stock-financing>, (last visited January 16, 2017).

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

the closing of the loan. While Josh Sason calls his company a “global investment firm”, Faux, the Bloomberg author, thinks a different moniker would be better suited: “pawnshop for penny stocks”. The graph below<sup>28</sup> shows how Josh Sason rarely loses in a “death spiral” deal:



GRAPHIC BY BLOOMBERG BUSINESSWEEK; DATA: COMPILED BY BLOOMBERG

Not surprisingly, PIPE investors like to conduct their transactions far from the public eye. To quote Josh Sason, the antihero of the above Bloomberg article, “I’m not going to give away the details of how we do what we do, (...) We create businesses, and we invest.”<sup>29</sup> It is this propensity for being under the

<sup>28</sup> Bloomberg Business Week, <https://assets.bwbx.io/images/users/iqjWHBFdfxIU/iUXVIOEVdrNY/v2/400x-1.jpg>, (last visited January 2016).

<sup>29</sup> Faux, *supra* note 25.



radar that raises ethical and legal questions regarding PIPE deals.

PIPEs, when structured properly, succeed in getting around the disclosure regulations established by the SEC through the Securities Act of 1933—directed at the primary markets, and the Securities Exchange Act of 1934—directed at the secondary markets. The primary purpose of these regulations is to “compel full disclosure to the public of all material information and to prevent fraud and misrepresentation in the interstate sale of securities.”<sup>30</sup> We will focus on the disclosure requirements to highlight the way “toxic” PIPE transactions manage to stay under the radar.

The Securities Act of 1934, in Sections 13(d)(1), 13(d)(3), and 14(d)(1), establishes disclosure rules meant to protect the public interest when an entity makes a tender offer—wanting to gain control of a company by purchasing more than 51 percent of its common stock, or acquires five percent or more of a company’s common stock, exercisable within sixty days<sup>31</sup>. Such disclosure rules were put in place by Congress to ensure a company has notice when somebody accumulates a large portion of its common stock<sup>32</sup>.

Section 13(d)(1) requires “any person who, after acquiring directly or indirectly the beneficial ownership of any equity security is (...) the beneficial owner of more than 5 per centum of such class” to file, within 10 days, any documents the SEC considers necessary or appropriate. The information required by the SEC is extensive, ranging from disclosing the background and identity of all persons involved, the source and amount of the funds, the purpose of the transaction, to “information as to any contracts, arrangements, or understandings... including but not limited to transfer of any of the securities, joint ventures, loan or options arrangements.”<sup>33</sup> Section 14(d)(1) of the Securities Act of 1934 establishes similar disclosure rules for those

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<sup>30</sup> Lerner, *supra* note 6, at 671.

<sup>31</sup> Lerner, *supra* note 6, at 659.

<sup>32</sup> M. Gill, & D. O’Neal, Section 13(d): *The Challenges of “Group Membership*, March 2009, [http://www.alston.com/Files/Publication/3d644b01-c52a-442d-afaa-a02ae6cd005f/Presentation/PublicationAttachment/79bfe8af-9c88-4d42-9b6b-3e9e91b1e38f/Section%2013\(d\)%20Article\\_1.pdf](http://www.alston.com/Files/Publication/3d644b01-c52a-442d-afaa-a02ae6cd005f/Presentation/PublicationAttachment/79bfe8af-9c88-4d42-9b6b-3e9e91b1e38f/Section%2013(d)%20Article_1.pdf), (last visited January 10, 2017).

<sup>33</sup> *Id.*

initiating a tender offer in a bid to gain control over a company (17 C.E.R. §§ 240.14d-1 to -101).

Investors can circumvent these disclosure rules by timing their actions carefully. PIPE transactions usually take longer than sixty days, therefore, at the time of the initial contract, the PIPE investors are not viewed as potential owners of five percent or more, or as tender offerors, even though they could potentially manipulate the company's stock by engaging in short selling, and eventually even gaining control of the company<sup>34</sup>.

PIPE investors also manage to avoid the disclosure requirements contained in Regulation Fair Disclosure (FD). Regulation FD was passed by the SEC in order to level the play field between institutional investors and individual investors, by requiring public companies to not exclude the general public when disclosing relevant information.<sup>35</sup> Aiming to promote full and fair disclosure, Regulation FD requires that when an issuer discloses material nonpublic information to certain individuals or entities, the issuer must make that information available to the general public.<sup>36</sup> However, Regulation FD applies only to the company issuing the stock, it does not cover the intentions of the private investor, even though he/she could gain control of the company by taking a short position in the stock and starting the "death spiral."<sup>37</sup>

In the Selective Disclosure and Insider Trading, Securities Act Release No. 33-7881, the SEC states: "selective disclosure leads to a loss of investor confidence in the integrity of our capital markets. Investors who see a security's price change dramatically and only later are given access to the

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<sup>34</sup> Lerner, *supra* note 6, at 659.

<sup>35</sup> *Regulation Fair Disclosure – Reg FD*, Investopedia, Nov. 25, 2003, <http://www.investopedia.com/terms/r/regulationfd.asp?ad=dirN&qo=investopediaSiteSearch&qsrc=0&o=40186>, (last visited January 16, 2017).

<sup>36</sup> Regulation FD, 17 C.F.R. §§ 243.100-.103, 2002.

<sup>37</sup> Lerner, *supra* note 6, at 660.

information responsible for that move rightly question whether they are on a level playing field with market insiders.”<sup>38</sup>

In view of this opinion, it makes sense for the SEC to take another look at the mechanisms surrounding PIPE transactions. That does not mean that the SEC has not kept an eye on these deals, especially given the toxicity of some of them. In the instances when the SEC decided to pursue legal action against PIPE deals, it argued that the short selling under these conditions violates Section 5 of the Securities act of 1933.<sup>39</sup> Another argument brought forth by the SEC was that such investors are guilty of insider trading, in violation of Section 10(b), Rule 10b-5 and Section 17(a) of the Securities Act.<sup>40</sup>

The SEC’s attitude towards a PIPE investor engaging in short selling prior to the issuer obtaining a resale registration statement, has been that it violates the registration requirements stated in Section 5 of the Securities Act. In a short sale the seller does not yet own the shares he/she puts up for sale, but rather he/she borrows the securities from another party. Next the short seller delivers the securities to a buyer, completing the sale. The buyer has full ownership of the shares delivered in the transaction, while the short seller still has to return the securities to the entity that lent them. This part of the short sale is known as “covering” the short position, and it is achieved when the short seller buys securities on the market and returns them to the party from whom he/she borrowed them<sup>41</sup>. In a short sale, profit is made if the stock’s price decreases between the time the short sale is made and the time it is covered. If the securities’ price increases, the short seller incurs a loss.<sup>42</sup> PIPE investors use short sales to hedge their investment in the public company, and generally

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<sup>38</sup> *Final Rule: Selective Disclosure and Insider Trading*, United States Securities and Exchange Commission, <https://www.sec.gov/rules/final/33-7881.htm>, (last visited January 16, 2017).

<sup>39</sup> Hoffer, *supra* note 2, at 25.

<sup>40</sup> Hartlin, *supra* note 4, at 164.

<sup>41</sup> Hoffer, *supra* note 2, at 26.

<sup>42</sup> *Id.*

cover their short position with the share obtained through the conversion of their convertible debenture.

Another avenue the SEC used against PIPE investors has been the insider trading violation. If an investor trades—usually by shorting the stock, knowing that there is a PIPE deal in the making, the SEC has argued that he/she is guilty of insider trading.<sup>43</sup> An insider trading claim has to be proven by showing that the information used by the trader is material and non-public, and that the trader with knowledge of this information had either a fiduciary duty to the shareholders of the issuer—the classic theory of insider trading, or that the trader misappropriated confidential information, thus breaching the duty of confidence owed to the issuing company itself—the misappropriation theory.<sup>44</sup> The misappropriation theory has been at the base of insider trading claims against PIPE investors, since they are not actual corporate insiders of the company. The SEC believes that the confidential agreement the two parts of a PIPE transaction create when entering the contract, also creates the fiduciary duty of loyalty on the part of the investor towards the issuer.<sup>45</sup>

So far the SEC has been unsuccessful in proving its claims against PIPE investors who refused to settle. One case that brings together both of the claims analyzed above is *SEC vs. Mangan*.<sup>46</sup> *Mangan* represented a registered broker-dealer who acted as the placement agent for a PIPE offering involving CompuDyne Corporation in 2001. After the PIPE transaction was closed, but before it was announced publicly, Mangan instructed his broker to open a short position in CompuDyne, whose share price was \$14.16. Immediately after the public announcement of the PIPE deal, the share price climbed to \$15.20, before falling and closing at \$14.25.<sup>47</sup>

In December 2006, the SEC filed a complaint against John F. Mangan, Jr. stating that the defendant committed an unlawful insider trading act, in

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<sup>43</sup> Hoffer, *supra* note 2, at 28.

<sup>44</sup> Hartlin, *supra* note 4, at 170.

<sup>45</sup> Hoffer, *supra* note 2, at 31.

<sup>46</sup> 598 F. Supp.2d 731 (W.D.N.C. 2008).

<sup>47</sup> Hartlin, *supra* note 4, at 165.

violation of Section 10(b), Rule 10b-5 and Section 17(a), by short selling CompuDyne securities before the PIPE deal was announced to the public. In addition, the SEC claimed that Mangan violated Section 5(a) and Section 5(b) of the Securities Act by engaging in the sale of unregistered securities when he covered his short position in CompuDyne with securities obtained through the PIPE transaction.<sup>48</sup>

The Court ruled against the SEC, dismissing both the claim of insider trading, as well as the claim of selling unregistered securities. In relation to the latter, the Court went so far to call the SEC's Section 5 violation claim "creative."<sup>49</sup> The Court contradicted the SEC's view that the shares used to cover the short position are basically sold at the time the position is created, resulting in an unregistered sale of securities. The defendant, the Court noticed, absent the closing of the PIPE transaction, would have had to cover his short position with shares purchased in the public market. Additionally, the shares sold in the short position were unrestricted, the buyers being free to trade them. Consequently, the Court concluded that "no sale of unregistered securities occurred as a matter of law."<sup>50</sup>

Regarding the insider trading claims, the court stated that the most important factor in its decision was the relation between changes in the CompuDyne stock price and the public announcement of the PIPE transaction: "price movement is determinative of materiality under this factual record."<sup>51</sup> CompuDyne price per share actually rose right after the public announcement of the PIPE deal and it closed higher than it was at the time Mangan decided to take a short position in the stock. Therefore, the Court concluded that the defendant's knowledge of the transaction was "immaterial as a matter of law,"<sup>52</sup> since the PIPE did not have a negative influence on the stock price.

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<sup>48</sup> *Id.*

<sup>49</sup> *Id.*, at 168.

<sup>50</sup> *SEC vs. Mangan*, Civil Action No. 3:06-CV-531 (W.D.N.C. Dec. 28, 2006), <http://online.wsj.com/public/resources/documents/mangan.pdf>, (last visited January 16, 2017).

<sup>51</sup> *Id.*

<sup>52</sup> *SEC vs. Mangan*, *supra* note 49.

It is significant for the purpose of our article to follow the fate of the CompuDyne Corporation. On August 7<sup>th</sup>, 2007, less than a year after the SEC brought claims against Mangan, CompuDyne announced that it had entered into an agreement to be purchased by an investor group via a cash tender offer.<sup>53</sup> The agree-on offer price was \$7.00 per share, a “significant premium”<sup>54</sup> of 32 percent over the August 6<sup>th</sup> 2007 closing price of CompuDyne stock. Compare this to the 2001 price per share, around \$15.00. While there were many circumstances that contributed to CompuDyne’s eventual demise, the PIPE transaction it entered in 2001 was at least a symptom, if not a contributing factor, of the company’s precarious financial situation.

## Conclusion

PIPEs are the answer that free markets offer companies looking to obtain capital in exchange for equity, without having to go through the lengthy and expensive process of a public offering. This type of financing presents many advantages for both parties, the private investors, and the public companies. It is because of these advantages PIPEs have increased in popularity, and undoubtedly, they will continue to be part of the corporate financing landscape. Along with this increase in popularity, there’s also been an increase in literature written about PIPEs. More specifically, about a certain type—the so called “toxic” PIPEs, who tend to lead to severe devaluation of the involved company’s stock. By including a reset price provision—allowing the investors to convert their securities at a discount to the market price at the time of the conversion, these deals essentially ensure that the investor will always make a sizable return, even if the stock drops considerably. Moreover—due to the floating conversion ratio, PIPEs even offer investors an incentive to drive the price down, which they can achieve through short selling the stock. The short

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<sup>53</sup> *CompuDyne Corporation Agrees to be Acquired by Investor Group for \$7.00 Per Share in Cash* [Press release], The Gores Group, Aug. 7, 2007, <http://www.gores.com/pressreleases/computdyne-corporation-agrees-to-be-acquired-by-investor-group-for-7-00-per-share-in-cash/>, (last visited January 15, 2017).

<sup>54</sup> *Id.*

selling starts the “death spiral”, which is only made worse by the eventual conversion and, consequently, dilution of the stock.

The experts’ points of view have not been uniform. There has been a lot of opinions written in defense of such transactions, arguing that the companies who enter them are usually in a bad financial position. They argue that a PIPE loan, even structured in such a way that it could turn toxic, at least gives the company a chance to recover. Other researchers have underlined that toxic PIPE deals rarely have a happy ending for anyone, but the PIPE investors. Furthermore, the ones who suffer in the end are the shareholders, the individual investors who are largely kept in the dark with respect to the intentions of the PIPE investor.

The SEC’s claims against PIPEs investors have largely been based on the sale of unregistered securities, as well as insider trading. The courts, however, have ruled against these claims, finding the SEC’s arguments “creative.”

One aspect the SEC has, mostly, ignored so far, is the disclosure requirements that PIPE investors manage to avoid. By engaging in short selling and manipulating the stock price to drop, PIPE investors are essentially in a position to acquire more shares of the company, to the point where they can even gain control over it. In such cases many have argued that the disclosure rules 13(d)(1), 13(d)(3) and 14(d)(1)—applicable to tender offerors and purchasers of more than five percent of a company’s stock, should extend to the PIPE investors. The general public has a right to know if the PIPE investor intends to open a short position in the company, given the significant consequences such an action has on the company’s stock value.