Can Your Company Afford to Become (Stay) a Public Company?.......
Can It Afford Not To?

By: Craig V. Butler, Esq.

This article is the first in a series of two articles that will analyze the financial costs to be a public company, and the financing opportunities that public companies have over private companies. The impetus for both articles is the simple fact that the primary reason many private companies are considering going public in the current marketplace is access to financing. In order to properly make this decision companies should know both the cost of getting and being a public company, as well as the typical financing options that might be available to them. As these articles will discuss, while there are several financing sources available to public companies that are not available to private companies, each company needs to determine total "cost" of this financing, including the costs of being a public company, in order to determine if being a public company is the proper direction the company should take at this time. The first article looks at financing opportunities available to public companies that are not usually available to private companies. The second article, due to be published in the August 2010 edition of The Isolated Offering, will take a look at the costs that it takes for a private company to go public and then the cost of being an existing public company, so those companies determine if the possible financing options are worth the price of being a public company. It should be noted that these articles are not meant to encourage private companies to go public merely for the financing opportunities, nor is it meant to discourage companies wanting to go public (or those that are public to go private) due to the costs involved in being a public company, but are merely meant to inform companies in those situations to determine if becoming or staying a public company is worth the cost of being a public company.

This first article discusses financing options available to public companies. This article precedes the one related to the cost of being a public company because there are many existing public and private companies that are in desperate need of financing alternatives and I want to get the options out to these companies as soon as possible, especially considering the questions many companies have about these alternative financing options. With the scarcity of traditional financing (e.g. bank financing) many companies are looking for alternate financing options. Many people have heard of these types of transactions (PIPEs, equity lines, etc.) but do not know how they operate and how to access these options. The purpose of this article is to shed some light on the basics of these transactions. Regarding the alternate financing options mentioned herein, these are obviously not the only financing options available to public companies, as financing can take many forms, pretty much as broad as a financing source and company can create. Also, even within the options listed herein, the descriptions for each are the most common structure for that option; however, some of these options can take on different

structures that are not listed herein. With that said, here are several of the most common alternate financing structures available to public companies.

Traditional PIPEs. First, it is important to understand that PIPE merely stands for Private Investment in Public Equity, which means that any private investment transaction with a public company that results in the investor getting public equity is technically a PIPE. However, this article only discusses the most typical PIPE transactions and not all the varied one-off investment transactions that public companies may enter into with investors. Under the most popular PIPE transaction a private investor purchases, in a private placement, the public company's securities. Normally, these initial securities take the form of convertible debentures or preferred stock, usually with warrants and/or anti-dilution rights. The shares underlying the conversion of the purchased securities are illiquid, non-registered securities when originally purchased with the conversion being at a discount to the fair market value of the company's common stock. Typically, the investor gives the company at least a portion of the funds at the time of the close of the investment transaction, after which time the company files a registration statement registering the shares underlying the convertible instrument (the timing of the funds versus the registration statement is important when comparing a PIPE to an equity line financing, discussed below). After the effectiveness of the registration statement, from time to time, the investor elects to convert a certain amount of the debenture or preferred shares, at a discount to market value, into a certain number of free trading shares of the company's common stock. Due to the nature of PIPES and with the conversions happening at the behest of the investor, having certain limitations in place, such as a floor price on the price of the common stock (under which conversions cannot occur), 9.9% investor ownership limitation, and, most importantly, the ability of the company to repay the conversion amount prior to issuing the shares underlying the conversion, are important to help ensure the company's stock price does not spiral downward. In the past PIPEs had a very negative image, for good reason, due to the failure of companies to demand concessions from the investors, especially floor prices, which allowed investors to convert their convertible securities into common stock and sell those shares, driving down stock prices, many times to under a penny a share, and often times accompanied by short selling, further driving down the stock price. However, over the last few years, the SEC and courts have stepped in to limit the number of shares a company can register in its registration statement (no more than 20% of the company's public float) and to limit short selling, so PIPEs are once again viable options for public companies and there are currently options for many public companies involving PIPEs.

Pros: Timing of funds (or portion thereof) in advance of registration statement, available to most public companies, current activity in market place, recent SEC actions and court decisions favors companies.

Cons: Conversions done at timing and request of investor (not company), sometimes done with convertible debentures (meaning if not converted is debt owed by company and on company books), normally company is locked into deal for the term of the debenture (unless have a prepayment provision), registration statement required (normally), public perception may drive down stock price in advance of the conversions, which are likely to drive down the stock price further.

Non-Traditional PIPEs. These are similar to the traditional PIPE discussed above, with one important difference, no registration statement is required. For a non-traditional PIPE the investment vehicle can either be the purchase of a convertible security by the investor(s), convertible at a discount to the fair market value of the stock, or the direct purchase of shares of the public company's common stock at a discount to fair market value. However, instead of then filing a registration statement to register the shares, the investor(s) are willing to wait the six months under the Rule 144 holding period. In exchange for this though, the investors will sometimes require certain of the investment funds be placed in escrow to pay legal fees and audit fees for at least one year, and for an investor relations firm, all to help ensure the company maintains timely compliance with the filings the company must file under the Securities and Exchange Act of 1934 (the "'34 Act"). These have become a very popular investment vehicle recently, even more so than traditional PIPEs.

Pros: No registration statement required, usually is done with multiple investors to create a varied shareholder base (as opposed to one shareholder, decision-maker), available to most public companies, current activity in market place, normally less negative implication in market because restricted shares are sold.

Cons: Typically done for smaller amounts than a traditional PIPE, often a portion of funds put in escrow to cover legal and audit fees (so not all funds can be used in company discretion).

Equity Line Financing (ELFs). Under a typical equity line financing structure, an investor agrees to purchase a certain dollar amount of the company's common stock over a specified period of time (usually 2-3 years). The stock is purchased at a discount to market value (currently, this discount can be as little as a 10% discount to the stock's price over the pricing period!). Under a normal scenario the company issues the investor a certain number of shares (usually based on a percentage of the total amount of the line) up front and the company files a registration statement, registering the shares underlying the equity line, as well as the up front shares. This differs from a PIPE, where the company normally receives at least some of the investment proceeds prior to filing (and paying for) the registration statement. Once the registration statement is effective the company may elect to draw down a certain amount of the total equity line. The amount that can be drawn down by the company at any given time is usually tied to the 5 or 10 average stock price, or volume-weighted stock price, so companies with a solid stock price and higher liquidity in its stock will benefit more from an equity line than other companies. Under some of the more popular equity lines, the company is not required to draw down on the line if it does not choose to do so (and if it doesn't, it is only out the cost of the transaction documents, the registration statement, and the up front shares). This gives the company the flexibility to not use the line (and not issue the company's common stock) if its situation changes and it does not need the funds. This differs from a PIPE, where the conversion is normally in the sole discretion of the investors. However, some equity lines are structured that certain draw downs must be made every quarter or year, meaning that the company cannot just sit and not use the line, but this is negotiable.

Pros: Normally company not required to draw down on the line unless it chooses to do so, low discount from fair market value, available to most public companies, current activity in market place, recent SEC actions and court decisions favor companies.

Cons: Company must file registration statement in advance of receiving any funds from the investor, public perception, likely increased selling of company's stock when deal announced in anticipation of dilution.

These three vehicles are the most common alternate financing options currently available to public companies, and most public companies will qualify for one or more than one of these financing alternatives. However, there are other alternate financing options, such as Registered Direct Offerings (RDOs), and At-the-Market Offerings (ATMs), however many of those options require a company have more than a $75 million public float. For companies that do not have that public float the companies must be "S-3 eligible," which means the company must meet the requirements to file an S-3 registration statement, and must have a class of securities listed on a national exchange or one of 7 listed smaller exchanges, which does not include OTC Bulletin Board or Pink Sheets. So the only way a company traded on the OTC Bulletin Board or Pink Sheets can use a RDO is to meet the $75 mil public float requirement, which excludes many companies that need alternate financing options. For this reason those options are not discussed in this article.

Bottom line is that if you are a public company that cannot qualify for traditional financing most likely there are options available to you for financing, such as the options listed above. You should be aware though that if you are a pre-revenue company, many of these options will be severely limited due to the shell rules and the concerns being pre-revenue will cause most investors. If you need an introduction to a financing source, or have questions about these alternate financing options, you should start by asking your corporate securities attorney to get the ball rolling.

Look for the second portion of this article, relating to the costs to become and stay a public company, in the August edition of The Isolated Offering. If you have any questions related to the content of this article please contact the author.

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The Lebrecht Group, APLC provides comprehensive advice on a variety of corporate and securities law matters. Please contact us if you have any questions.

Craig V. Butler, Esq. is an attorney with The Lebrecht Group, APLC, located in Irvine, California and Salt Lake City, Utah. He can be reached at (949) 635-1240 or via e-mail at cbutler@thelebrechtgroup.com with questions or comments. Please visit our website at www.thelebrechtgroup.com for future updates and other information.