Private Investments in Public Equity (PIPEs) in Switzerland

When going public, a corporation traditionally used to renounce the possibility of raising equity privately. This is not necessarily the case any longer with so-called Private Investments in Public Equity (PIPEs), by the means of which a public company raises new equity from a small number of sophisticated private investors. PIPEs allow to raise equity in a quick, confidential, secure, flexible and cost-effective way. It has repeatedly been pointed out that in times when capital markets prove to be reluctant and banks tighten their credit policy, PIPEs may represent a "marriage in paradise". In fact, they allow companies that are likely not to succeed in pre-emptive rights issues due to the difficult market conditions or the small size of the offering, or in raising the necessary funds by way of a bank debt because their revenue and profit situation is not sound enough for such a financing structure or because they lack the collaterals, to meet hedge funds, private equity investors or institutional investors that find themselves under pressure to put the funds committed to them to work. If you add the scheduled exit over the stock market, everything seems to be too good to be true.

However, in Switzerland PIPEs have not been discovered (yet) as a genuine fund raising alternative, mainly because they are considered to be difficult to structure, e.g. due to the statutory pre-emptive right of the existing shareholders. Evidence suggests that in Switzerland, too, PIPEs are not only suitable for recapitalization[12], but also for growth financing purposes[13]. This article tries to set out, *inter alia*, the possibilities of withdrawing the pre-emptive right or the cases in which such a withdrawal would be desirable in order to widen the scope of PIPEs in Switzerland, especially with mid- and small-cap companies, as well as the legal consequences of such PIPE transactions.

While there are three **different capital increase options** available to create new shares (ordinary capital increase, capital increase out of authorized capital, capital increase out of conditional capital), the authorized and conditional capital increase will be the preferred routes for PIPE transactions, either by the issuance of shares or the issuance of equity-linked instruments. There is no time pressure, the board of directors enjoys great flexibility in determining the size of the capital increase and the issue price, which considerably improves the position of the target company during the negotiations with the investors and also improves the transaction security. Finally, the shareholders are not able to challenge the withdrawal of the pre-emptive right by the board of directors as long as it remains within the competence decided by the shareholders' meeting. The reverse side of the increased flexibility is that the board of directors always remains liable under art. 754 CO. However, as long at the issue price will correspond to the market price in a liquid market, the shareholders will not incur any damage.

A company under Swiss law is not allowed to issue either equity securities or equity-linked debt instruments without offering them first to the existing shareholders for subscription. However, the conduct of such a rights offering does not prevent a PIPE to be carried out in parallel **(pre-emptive PIPE)**, which could even be desired in order to strengthen the rights offering *(Back Stop Underwriting)*[14]. The allocation of the unexercised pre-emptive rights to the PIPE investor (instead of their placement in the market by the underwriting banks) bears the advantage that the discount on the issue price against the market price (hence the dilution for the non-exercising sharehold-

[12] See, e.g., Uster Technologies AG (2009, non-preemptive placement of new shares from authorized capital with Toyota Corporation Industries), Rieter (2009, non-preemptive placement of treasury shares with private investors), Schweizerische Rückversicherungs-Gesellschaft AG (Swiss Re) (2009, placement of convertible perpetual capital instruments with Berkshire Hathaway), Credit Suisse (CS) (2008, placement of mandatory convertible notes and treasury shares with various investors from the Middle East), UBS AG (2007 und 2008, placement of mandatory convertible notes with the Singapore Sovereign Funds GIC and with the Swiss Confederation). In none of these transactions, the withdrawal of pre-emptive rights was to our knowledge challenged nor were liability claims brought forward against the board of directors.

[13] See, e.g., Addex Pharmaceuticals Ltd (2010, non-preemptive placement of new shares from authorized capital and of mandatory convertible notes in an amount of CHF 20 mio with BVF Ltd in order to finance its clinical research programme. The new shares and MCNs after conversion amounted to approx. 30% of the outstanding share capital), Petroplus Holdings AG (2010), non-preemprive placement of new shares from authorized capital in an amount of USD 146 mio in an Accelerated Bookbuilding Offering (ABO) with institutional investors in order to finance the indirect acquisition of a refinery. The new shares constituted 9.99% of all outstanding shares); see also, e.g., Zurich Financial Services AG (ZFS) (2009), non-preemptive placement of treasury shares and new shares from authorized capital in an amount of CHF 1.26 bn to finance the acquisition of AIG US Personal Auto Group and to cover additional regulatory capital requirements). In all these PIPE transactions, the new shares were issued out of authorized capital, the mandatory convertible instrumwents were backed by conditional capital and, to our knowledge, the withdrawal of (advance) pre-emptive rights was not challenged nor were liability claims brought forward against the board of directors.

[14] See, e.g., Siegfried Holding AG (2010), which entered into a Back Stop Underwriting with a group of shareholders in order to strengthen its rights issue, or the at-market rights issue conducted by Ypsomed Holding AG (2010), in which the shareholder Willy Michel committed not only to exercise his rights, but also to subscribe for all shares not taken up in the offering (Rump). The shares paid in by Mr. Michel were paid in by set-off of a loan while the shares offered in the rights issue where paid in in cash.

ers) may be lower, and often such a placement guarantee is a condition *sine qua non* for a bank to sponsor the offering. The issue price fixed for the rights offering shall in this cases constitute the floor in order to prevent the shareholder's pre-emptive right from being undermined. If the shareholders however were offered the shares by way of a bookbuilding, it seems appropriate that the shares may be sold without another rights offering at a price at the bottom end of the price range. In a pre-emptive PIPE, the issuer cannot guarantee a minimum and even less a fixed amount of shares to be reserved for the PIPE investor: the take-up rate will mainly depend on the offer price. PIPE investors do not like this uncertainty all the more that they bear some risks and costs which are not indemnified. Therefore, a PIPE will be more successful if the pre-emptive rights can be withdrawn **(non-preemptive PIPE)**. As such a decision represents a major interference into the financial and participation rights of the shareholders, it is subject to strict formal (e.g. qualified majority by the shareholders) and material conditions. A withdrawal is commonly deemed permitted if (i) the withdrawal is justified by a (qualified) objective interest of the company, (ii) all shareholders are treated equally, and (iii) the withdrawal sufficiently complies with the general principle of considerate exercise of rights. First, a "**valid reason**" must be defined in the articles of association of the company. In connection with PIPE transactions, the enlargement of the shareholder basis, either through the acquisition of a participation by important (strategic) investors to ensure the further growth of the company[15] or as a protection against a financially insufficient takeover bid[16], may be in the interest of the company and therefore constitutes a valid reason for the withdrawal of the pre-emptive right[17]. Moreover, the strengthening of the shareholder's equity for recapitalization purposes is also accepted as a reason for a withdrawal, for instance, when a potential investor conditions his investment to obtaining a majority stake in the company. In recent years the recapitalization purpose has been invoked on several occasions to grant new investors access to a public company by way of a withdrawal of the pre-emptive right. This occurred either directly, by injection of new cash into the company against the issuance of shares of (mandatory) convertibles notes[18], or indirectly, because an underwriter purchased the company's debts and converted them into new sharesand then placed them with new investors[19]. In recapitalization procedures the placement of new shares *"en bloc"* with an investor may represent the only and, hence, authorized solution to save the company. As a compensation for their waiving a part of their claims, the company can allocate bonus warrants to certain creditors (e.g. banks or bondholders)[20]. The question whether certain special situations on the capital market may justify the withdrawal of the pre-emptive rights, especially in order to "raise equity in a quick and flexible manner"[21], has not been entirely clarified. The "objectivity" and the "vested interest of the company" in a PIPE transaction especially consist in the fact that the company can justify the withdrawal of the pre-emptive rights in such cases with the argument that in a difficult or volatile market environment, it can raise additional equity at relatively low costs (no bank underwriting costs, potentially no obligation to publish a prospectus), in a efficient and opportunist way (without subscription period and without taking the risk of the volatility of the markets), tailor-made (especially in small tranches, for which a bank underwriting would be too expensive) and without any placement risk. Second, the company must also comply with the principle of equal treatment of its shareholders. Finally, the withdrawal must be compatible with the principle of considerate exercise of rights. The withdrawal of the pre-emptive or advance subscription right complies with this principle in particular when the issuance price (or the conversion price in case of an equity-linked instrument) of the new shares is set in accordance with the market price[22].

Overall, when withdrawing the pre-emptive rights, the board of directors **needs to assess the global situation and to weight the interests at stake.** It shall in particular evaluate the size and stage of development of the company and the sector within which it oper-

[15] E.g., the articles of associations of Actelion AG, Addex Pharmaceuticals Ltd, AFG Arbonia-Forster-Holding AG, Basilea Pharmaceutica AG, BB Biotech AG, Evolva Holding AG, Lonza Group AG, Santhera Pharmaceuticals Holding AG or Uster Technologies AG contain such a provision.

[16] In this case, the shares are allocated to a "friendly" investor that undertakes not to tender the newly subscribed shares in case of a takeover bid and to observe a lock-up period, if need be. For instance, the articles of association of Santhera Pharmaceuticals AG, Addex Pharmaceuticals Ltd or Uster Technologies AG contain such a provision.

[17] In general, such a participation can also be taken later on - e.g., when the company issues a (mandatory) convertible bond without advance subscription right.

[18] See, e.g., the cases Tornos AG (2002), Mikron AG (2003), 4M Technologies Holding AG (2003 and 2007) or the issuance of mandatory convertible notes by UBS AG (2008) and Swiss Re (2009).

[19] See, e.g., the cases Swisslog AG (2004) and Swissmetal AG (2004). Von Roll AG (2003) placed the non-pre-emptive tranche with banks and bondholders.

[20] See, e.g., Tornos AG (2002), Mikron AG (2003) and von Roll AG (2003).

[21] E.g., the articles of associations of Addex Pharmaceuticals Ltd, AFG Arbonia-Forster-Holding AG, Basilea Pharmaceutica AG, Cytos Biotechnology AG, Evolva Holding AG and Lonza Group AG contain such a provision.

[22] A price fixed by bookbuilding or a fixed price with discount ranging from 5 to 10% of the (expected) market price is probably justified.

ates, the ratio between new and existing equity, a possible discount of the current market price, the dispersion and the liquidity of the shares, the expected actual impact of the non-pre-emptive share issue on the balance of power / control at the shareholders' meeting, as well as the interests at stake of a shareholder that might sue the company or possible funding alternatives available to the company. Shareholders might be expected to be more sympathetic to a request for withdrawal of the pre-emptive rights from a young growth-oriented company than from a larger, mature company. A minor capital increase compared to the existing equity (approximately 10 to 15% of the capital issued), a broad dispersion of the shares without a shareholder holding a material interest (5 to 10% of the voting rights), a share trading in a liquid market, and an issue price at market are more likely to justify the withdrawal of the pre-emptive rights. The issue might be different if a non-pre-emptive PIPE entails a substantial capital dilution for the existing shareholders or if the balance of power shifts among the shareholders (this can already occur when an investor acquires a 20 to 30% interest) because the pre-emptive right is for example withdrawn in favor of an existing shareholder or the issue comprises a considerable number of new shares, or when the PIPE transaction leads to a material reduction of the free float and of the liquidity of the shares. As a basic principle, the board of director's decision-making process has to be clear, well structured and transparent. The funding alternatives need to be thoroughly assessed and compared: the company should explain why a non-pre-emptive issue of shares is the most appropriate means of raising capital, and why other financing methods have been rejected.

In order to allow the PIPE investor to exit over the stock exchange, the new shares need to be listed and therefore the issuer must draft a **listing prospectus**. However, the Listing Rules exempt the issuer from the duty to prepare a listing prospectus if (i) the issuer has already published an information document equivalent to a listing prospectus and if such document is not older than twelve months, (ii) if the securities to be listed account for less than 10% of securities of the same class that have already been listed during the previous twelve-month period (which includes the conditional but non-issued shares that are already listed), or (iii) the securities to be listed are issued in connection with equity-linked instruments, provided the securities which will then be listed are of the same class as the securities that are already listed[23].

Even though the board of directors is obliged by law and by contractual confidentiality obligations and limitations to protect the secrets of the company or third parties, it may grant a due diligence if it is justified by the interest of the company and if a declaration of intent from the investor is available. By establishing agreements with the parties involved in the transaction, the board of directors has to make sure that protected confidential information be not transmitted to third parties (confidentiality agreement) and that the addressee does not misuse the information transmitted (standstill agreement).

Various confidential facts according to the prohibition of insider dealing may play a role in a PIPE transaction. First, the fact that the investor and the company plan a PIPE, second, certain facts obtained on the occasion of the due diligence. The investor is not allowed to decide about the execution of a PIPE transaction or the subscription of additional securities – in excess of the planned number – on the basis of confidential facts, if any. However, it is widely acknowledged that transactions based on one's own concrete plans are not within the scope of the provision. The maxim "no one can be his own insider" applies[24], as a matter of principle, to such cases. Therefore, parallel purchases on the stock exchange could be possible. However, if the investor comes to know other confidential facts after he took his decision, such purchases may become insider dealing as the purchaser may exploit his inside knowledge when performing such securities transaction. It is therefore important, in practice, to thoroughly document the decision-making processes. If the investor finally renounces to conduct the PIPE transaction after having learned confidential facts, he is not liable under insider dealing laws: the insider offence can only be committed by buying or selling securities, but not by renouncing a transaction. In order to avoid insider dealing because of the transmittal of confidential information during the due diligence, PIPE transactions should therefore ideally be carried out shortly

[23] In theory, this exemption enables to issue new shares out of conditional capital amounting up to 50% of the outstanding capital without preparing a listing prospectus, provided the equity-linked instrument itself is not listed and converts into securities of the same class as those already listed. Addex Pharmaceuticals Ltd took advantage of this exemption in 2010 when issuing shares and MCNs totaling approx. 30% of the share capital on a fully diluted basis.

[24] This principle will be legalized according to art. 44a of the bill of the new Stock Exchange and Securities Trading Act.

after the publication of the financial data of the target company.

PIPE transactions qualify as a matter of principle as price-sensitive facts in the sense under the ad hoc publicity obligation. They arise in the sphere of activity of the issuer and are capable of triggering a significant price change and, hence, of influencing the average market participant in his investment decision. As a consequence, the target company must provide information as soon as it has knowledge of the main elements of the price-sensitive fact. However, in practice it will generally postpone the disclosure until the signing of final agreements as the fact is based on a plan or decision of the company, the disclosure of which might compromise its legitimate interests.

A PIPE transaction is **subject to the obligation to disclose shareholdings** when the PIPE investor and the seller/the company, respectively, directly or indirectly, fall below or exceeds the thresholds of 3, 5, 10, 15, 20, 25, $33^{1/3}$, 50 and $66^{2/3}$% of the voting rights in the company. The obligation to notify is already triggered by the conclusion of the transaction and not only with the closing of the investment agreement or by way of the subscription or allotment of the shares. Participation certificates, dividend-right certificates and ordinary bonds are not subject to the disclosure obligation under the Stock Exchange Act, as they do not confer any voting rights in the target company. However, the disclosure obligation applies also to the acquisition, sale or granting (writing) of all type of options (i.e. call, put and conversion rights) the underlying securities of which are shares subject to notification. This is also true for derivatives or financial instruments that provide only for cash settlement. This can be very relevant because PIPEs are often linked to warrants or conversion rights. In practice, it is possible to structure the transaction so that signing of the investment agreement, subscription of the new shares, execution of the capital increase, entry into the commercial register, disclosure of participations and press release all occur on the same day. Careful consideration should also be placed in the analysis of a potential "**acting in concert**" between the PIPE investor and the company, namely when the parties enter into lock-up, standstill and non-tender agreement, or arrangements on the composition of the corporate bodies of the issuer.

If the PIPE investor does not want to make a **mandatory offer** for all listed equity securities of the target company, he must not exceed the threshold of $33^{1/3}$% of the voting rights of the target company afterclosing. Unlike the obligation to disclose major shareholdings, the obligation to make an offer is only triggered at the moment of the acquisition of ownership. In certain constellations, the execution of an option deal may already trigger the obligation to make an offer. The setting of floors and caps, which prevent the conversion price to fall below a certain level or limit the number of shares to be issued after the conversion, as well as the possibility to repay the PIPE investor in cash rather than in shares, are instruments aimed at preventing mandatory offers. Finally, the rules regarding the acting in concert or organized groups, e.g. between investors, existing shareholders and investors or investors and the target company, also apply to mandatory offers. However, the action in concert must be aimed at "gaining control of the company". Simple purchase rights (provided that they do not refer to a controlling majority), rights of first refusal and of repurchase and lock-ups, which do not affect the voting rights, are not sufficient. Nor do the following PIPE relevant facts meet the requirements for the presence of a "common control": mere parallel conduct in the period preceding a general meeting of shareholders, one-time understandings about aspects of secondary importance for the development of the target company, or promise made by the majority shareholder that a representative will be elected into the board of directors provided that the control does not pass or be exercised in common. The influence is only considered as exercised in "common" if the interested parties strive for a common objective, i.e. to control the target company. PIPE investors would be considered as acting in concert if they appointed in common the majority of the board of directors and determined the strategy of the target company or if, on the basis of a shareholder's agreement with an existing shareholder, veto rights were granted in view of important resolutions to be taken by the target company such as resolutions regarding the dividend policy, strategic orientation of the group companies, acquisitions, amendments of the articles of incorporation including modifications of the equity capital, etc. In order to avoid the mandatory offer, the target could by amending its articles of incorporation completely exempt the acquirer of shares from the obligation to make an offer (opting-out) or at least raise the threshold triggering such a mandatory offer to 49% (opting-up). However, after the listing, the adoption of

an opting-out or opting-up is governed by very strict rules, which, in the result, almost impedes such introduction once the company is listed. Finally, the investor could also rely on certain exemptions from the obligation to launch an offer, such as the reorganization of companies in financial distress, the temporary exceeding of the threshold or the impossibility to control the target company.

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