

**QUAGMIRE:**  
**IS THE SEC STUCK IN A MISGUIDED WAR AGAINST PIPE**  
**FINANCING?**

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*Abstract:*

*A popular non-traditional capital formation option is the “PIPE” deal: Private Investment in Public Equity. Over the last ten years, companies have raised more than \$100 billion using PIPE transactions. The Securities and Exchange Commission (“SEC”) has increased its regulatory oversight of PIPE transactions as they have become more popular. The SEC believes that some PIPE investors who take a short position in a PIPE issuer’s publicly traded shares violate Section 5 of the Securities Act by selling unregistered securities, and that PIPE investors who trade on knowledge of an impending PIPE transaction are guilty of insider trading. The purpose of this article is to demonstrate that the SEC’s aggressive enforcement against PIPE deals is misguided both because it is based on flawed interpretations of the law and because it ignores the benefits of PIPE financing. Although most of the existing scholarship on PIPE financing shares the SEC’s negative views, these articles ignore the benefits and exaggerate the risks associated with PIPE financing. This article makes the case for PIPE financing by fully considering its benefits and risks.*

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### Table of Contents

I.	INTRODUCTION.....	10
II.	OVERVIEW OF PIPE FINANCING.....	13
	<i>A. Description of PIPEs</i> .....	13
	<i>B. Overview of Federal Securities Law Compliance Issues</i> .....	13
	1. Private Placement Compliance.....	14
	2. Public Offering Compliance.....	16
	<i>C. Structural Alternatives</i> .....	17
	1. Traditional PIPEs.....	17
	2. Structured PIPEs.....	18
	3. “Death Spiral” Structured PIPEs.....	18
III.	BENEFITS OF PIPE TRANSACTIONS.....	20
	<i>A. Benefits to PIPE Issuers</i> .....	20
	<i>B. Benefits to PIPE Investors</i> .....	22
IV.	SEC’S PUBLIC POSITIONS ON PIPE INVESTOR SHORT SALES.....	24
	<i>A. The SEC’s Flawed Interpretations of the Law</i> .....	25
	1. Section 5 Unregistered Sale of Securities.....	25
	2. Insider Trading.....	28
	3. The Mark Cuban Insider Trading Case.....	31
	<i>B. Ignored Benefits and Overstated Risks of PIPEs</i> .....	34
V.	CONCLUSION.....	36

### I. INTRODUCTION

Company X is a small public company with a promising idea, but cultivating this idea into a marketable product will take time and money. The management of Company X believes that its idea is close to yielding a product that will generate big returns for its investors. Success seems right around the corner for Company X—if only Company X could manage to stay afloat a little while longer. Company X, like many small public companies in research-intensive businesses, is quickly burning through its cash. Company X needs to raise more capital to bring its idea to market. Unfortunately, Company X is having difficulty raising capital using traditional sources, a problem exacerbated by the current global financial crisis.

Fortunately for Company X, there are alternative methods of raising capital. A popular non-traditional capital formation option is the “PIPE” deal: Private Investment in Public Equity. PIPE deals have become popular because they offer investors greater liquidity than conventional private placements, and because PIPE deals allow issuing

companies to raise capital quickly and efficiently.<sup>1</sup> PIPE deals also have the potential for superior returns and other contractual features that enhance the investment's overall security.<sup>2</sup>

PIPEs emerged as a capital financing alternative approximately twenty years ago.<sup>3</sup> Initially, PIPEs were only used by small-capitalization companies that were desperate for financing.<sup>4</sup> Eventually, however, PIPEs became more popular among both the investment community and issuers who recognized the versatility of the PIPE financing structure.<sup>5</sup>

The tremendous growth in PIPE transactions evidences the popularity of PIPE deals.<sup>6</sup> The number of PIPE deals increased from around 300 in 1996 to over 1200 in 2007.<sup>7</sup> The total amount of capital raised in PIPE transactions also increased significantly over the last decade. PIPE transactions raised \$56 billion in 2007 compared to \$4 billion in 1996.<sup>8</sup> In the last 10 years, companies raised more than \$100 billion using PIPE transactions.<sup>9</sup>

The SEC has increased its regulatory oversight of PIPE transactions as they have become more popular.<sup>10</sup> The increasing complexity of PIPE transactions, as well as the possibility of investor injury inherent in PIPE transactions, contributed to the SEC's increased oversight.<sup>11</sup> Some commentators believe the SEC's fears of investor injury have

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<sup>1</sup> Marc. I. Steinberg & Emmanuel U. Obi, *Examining the Pipeline: A Contemporary Assessment of Private Investments in Public Equity*, 11 U. PA. J. BUS. & EMP. L. 1, 7, 20 (2008); see also STEVEN DRESNER & E. KURT KIM, PIPEs 95-96 (Updated Ed. 2006); Leib M. Lerner, *Disclosing Toxic PIPEs: Why the SEC Can and Should Expand the Reporting Requirements Surrounding Private Investments in Public Equities*, 58 BUS. LAW. 655, 656 (2003) ("A PIPE transaction combines the speed and certainty of a private placement with the pricing benefits that flow from the increased liquidity to purchasers of freely tradable, registered securities."); Michael C. Macchiarola, *Get Shorty: Toward Resurrecting the SEC's Ill-Fated Pursuit of PIPE Arbitrageurs*, 4 VA. L. & BUS. REV. 1, 8 (2009).

<sup>2</sup> Steinberg & Obi, *supra* note 1, at 21.

<sup>3</sup> *Id.* at 24.

<sup>4</sup> *Id.* at 25; see also Zachary T. Knepper, *Future-Priced Convertible Securities and the Outlook for "Death Spiral" Securities-Fraud Litigation*, 26 WHITTIER L. REV. 359, 359 (2004) (noting that PIPE issuers "tend to be small, thinly-traded, and (most importantly) desperate for cash").

<sup>5</sup> Steinberg & Obi, *supra* note 1, at 25.

<sup>6</sup> DRESNER & KIM, *supra* note 1, at 9-11.

<sup>7</sup> Steinberg & Obi, *supra* note 1, at 5; see also Sagient Research Systems, Inc., General Market Stats—All PIPEs, <http://www.sagientresearch.com/pt/GStats.cfm?Type=6> (for up-to-date statistics).

<sup>8</sup> Steinberg & Obi, *supra* note 1, at 5.

<sup>9</sup> DRESNER & KIM, *supra* note 1, at 11. The amount of capital raised in PIPE transactions compared to capital raised in traditional seasoned equity offerings also evidences PIPE deals' popularity. For a thorough discussion of the reasons companies choose PIPEs versus seasoned equity offerings, see Hsuan-Chi Chen et al., *The Choice of Equity Selling Mechanisms: PIPEs versus SEOs*, J. CORP. FIN (forthcoming), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1139887](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1139887); see also Na Dai, *The Rise of the PIPE Market, in COMPANION TO PRIVATE EQUITY* (Douglas Cumming ed., 2009), available at <http://ssrn.com/abstract=1350950> (noting that in 2007 there were 377 seasoned equity offerings that collectively raised \$75 billion); William K. Sjostrom, Jr., *PIPEs*, 2 ENTREPRENEURIAL BUS. L.J. 381, 408 (2007) (noting a seasoned equity offering consists of an issuer selling shares of common stock at a market discount to a syndicate of underwriters, and the underwriters quickly resell the securities to the general public, while a PIPE deal is similar to a seasoned equity offering, but instead of selling shares of common stock to a syndicate of underwriters, the issuer sells common stock or securities convertible into common stock at a market discount to a syndicate of hedge funds).

<sup>10</sup> Steinberg & Obi, *supra* note 1, at 32; Sjostrom, *supra* note 9, 382-83.

<sup>11</sup> Steinberg & Obi, *supra* note 1, at 32; Sjostrom, *supra* note 9, 382-83.

merit because issuing a large number of shares through a PIPE offering may dilute the value of shares held by an issuing company's existing shareholders.<sup>12</sup>

Consequently, the SEC has increased its enforcement actions in the PIPE transaction context.<sup>13</sup> Many PIPE enforcement actions focus on the rules governing short sales by PIPE investors.<sup>14</sup> The SEC believes that some PIPE investors who take a short position in a PIPE issuer's publicly traded shares violate Section 5 of the Securities Act by selling unregistered securities, and that PIPE investors who trade on knowledge of an impending PIPE transaction are guilty of insider trading.<sup>15</sup>

The SEC's positions on these legal issues do not withstand scrutiny, but the issues on PIPE investor short sales are far from settled. Although a number of trial courts have examined the SEC's positions, no appellate court has yet weighed in. The SEC recently filed a high-profile appeal in the Fifth Circuit Court of Appeals.<sup>16</sup> This appeal examined whether investors who trade on knowledge of an impending PIPE transaction are guilty of insider trading.<sup>17</sup> This appeal drew a lot of attention because the defendant is Mark Cuban, the controversial owner of the National Basketball Association's Dallas Mavericks.<sup>18</sup> Unfortunately, the Fifth Circuit declined to reach the District Court's broad holdings regarding insider trading.<sup>19</sup>

The purpose of this article is to demonstrate that the SEC's aggressive enforcement of PIPE deals is misguided, both because it is based on flawed interpretations of the law and because it ignores the benefits of PIPE financing. Section I of the article gives background on PIPE financing. Section II discusses the benefits of PIPE financing for issuers, their shareholders, and PIPE investors. Section III explains why the SEC's aggressive enforcement of PIPE deals is misguided.

Existing scholarship on PIPE financing is mostly negative, but these articles have ignored the benefits and exaggerated the risks associated with PIPE financing.<sup>20</sup> This article makes the case for PIPE financing by fully considering its benefits and risks.

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<sup>12</sup> Steinberg & Obi, *supra* note 1, at 32; Sjostrom, *supra* note 9, 382-83.

<sup>13</sup> DRESNER & KIM, *supra* note 1, at 188-89; *see* SEC v. Mangan, 598 F. Supp. 2d 731 (W.D.N.C. 2008); SEC v. Mangan, SEC Litigation Release No. 19,955 (Dec. 28, 2006); SEC v. Langley Partners, SEC Litigation Release No. 19,607 (Mar. 14, 2006); SEC v. Shane, SEC Litigation Release No. 19,227, 2005 SEC LEXIS 1158 (May 18, 2005); Complaint, SEC v. Spiegel, Inc., (N.D. Ill. 2003) (Civ. A. 03-C-1685) (2003 WL 22176223); *see also* Complaint, SEC v. Rhino Advisors, Inc. (S.D.N.Y. 2003) (Civ. Action No. 03 CIV 1310 (RO)) (SEC filed a civil cause of action against an investment adviser who allegedly directed a PIPE investor's short sales in a death spiral litigation).

<sup>14</sup> Jeffrey T. Hartlin, *Despite Recent Setbacks in the Courts, the SEC Remains Focused on Short Sales in PIPE Transactions*, 37 SEC. REG. L.J., Article 3 (2009).

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

<sup>16</sup> SEC v. Cuban, 620 F.3d 551 (5th Cir. 2010).

<sup>17</sup> *Id.* at 553.

<sup>18</sup> *Id.* at 552.

<sup>19</sup> *Id.* at 558.

<sup>20</sup> *See* George L. Majoros, Jr., *The Development of "PIPEs" in Today's Private Equity Market*, 51 CASE W. RES. L. REV. 493, 494 (2001) (taking a largely negative view of PIPE deals, focusing largely on the "disastrous results" early PIPE deals produced); *see also* Knepper, *supra* note 4, at 360 (concluding that some private death spiral litigation is warranted because PIPE investors who sell short damage PIPE issuers and innocent investors);

## II. OVERVIEW OF PIPE FINANCING

### A. Description of PIPEs

A PIPE is generally defined as “any privately negotiated equity or equity-linked investment in a public company.”<sup>21</sup> PIPE stands for Private Investment in Public Equity, and PIPE transactions can be understood by examining its acronym’s components.<sup>22</sup> First, PIPEs are *privately* negotiated transactions between a narrow group of investors and a public company.<sup>23</sup> Second, PIPEs involve direct *investments* in companies.<sup>24</sup> Third, PIPEs are used by *public* companies to raise capital.<sup>25</sup> Fourth, PIPEs involve the sale of *equity* or equity-linked investments.<sup>26</sup>

PIPE transactions involve a two-step process that combines features of a private placement transaction with features of a registered public offering.<sup>27</sup> The PIPE deal process can be better understood by using Company X as an example.

First, prior to commencing the PIPE transaction, Company X probably sought other forms of financing. If Company X was either unable to locate financing or unsatisfied with the terms of the financing available, Company X would next contact various investment banks to examine the possibility of PIPE financing. The investment banks then contact hedge funds and other sophisticated investors to gauge interest in the PIPE deal.

Once interest in the PIPE transaction is ascertained, terms of the PIPE deal are negotiated. PIPE transactions tend to be highly negotiated. Thus, there are often significant differences between various PIPE deals with respect to the attributes of the PIPE securities.<sup>28</sup>

### B. Overview of Federal Securities Law Compliance Issues

Understanding the PIPE transaction process requires some understanding of federal securities law compliance issues. First, it is important to understand why the private placement component of a PIPE deal is necessary.

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Lerner, *supra* note 1, at 658 (concluding that the SEC should expand disclosure rules covering death spiral PIPE investors, particularly in the context of short sales); Macchiarola, *supra* note 1, at 15 (agreeing with the SEC’s position that PIPE investors who sell short PIPE issuer stock prior to public announcement of the PIPE transaction, and subsequently use PIPE shares to close out the short position are guilty of violating Section 5’s prohibition on selling unregistered securities). For examples of neutral scholarly articles on PIPE financing, see Sjoström, *supra* note 9, at 413 (concluding it is an open question whether further regulation of PIPE financing is warranted, and further regulation of PIPEs should be done in a measured and transparent manner); Steinberg & Obi, *supra* note 1, at 47 (concluding that issuers and investors must both proceed with PIPEs in a strategic manner given the uncertainty engendered by recent regulatory developments).

<sup>21</sup> Steinberg & Obi, *supra* note 1, at 20.

<sup>22</sup> DRESNER & KIM, *supra* note 1, at 2.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

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

<sup>27</sup> Steinberg & Obi, *supra* note 1, at 20.

<sup>28</sup> Steinberg & Obi, *supra* note 1, at 21.

Section 5 of the Securities Act of 1933 governs registered public offerings.<sup>29</sup> Section 5 makes it illegal for any person to sell securities unless the person has filed an effective registration statement with the SEC.<sup>30</sup> Section 5 is relevant to PIPE transactions for two reasons: first, the private placement component of a PIPE transaction must comply with Section 5's exemption requirements;<sup>31</sup> and second, the resale of the securities after the private offering triggers Section 5's requirements.<sup>32</sup>

Registration under Section 5 is both complicated and expensive.<sup>33</sup> Section 5's registration expense creates an incentive for businesses like Company X to utilize exemptions to the registration requirement.<sup>34</sup> Section 5 exemptions allow issuers like Company X to sell securities without filing a registration statement.<sup>35</sup> A number of exemptions are particularly relevant to PIPEs, and perhaps the most relevant exemption is the Section 4(2) private placement exemption.<sup>36</sup>

### 1. Private Placement Compliance

PIPE transactions start with a private placement transaction.<sup>37</sup> The private placement exemption states that all "transactions by an issuer not involving any public offering" are not subject to the Section 5 registration requirement.<sup>38</sup> The purpose of Section 4(2)'s exemption is to excuse sales when there is either no need for registration or when the benefits of registration are too attenuated.<sup>39</sup> Utilizing the private placement exemption is cheaper and more convenient than Section 5 registration, but compliance with the private placement exemption has historically been challenging due to the lack of statutory guidance with respect to its application.<sup>40</sup> Consequently, issuers have sometimes relied on ambiguous judicial and administrative interpretations in attempting to understand how to comply with the private placement exemption.

The most often cited judicial interpretation of the private placement exemption is the United States Supreme Court's decision in *SEC v. Ralston Purina*.<sup>41</sup> In *Ralston Purina*, the Supreme Court examined whether a public corporation offering company stock to all employees qualified for the Section 4(2) exemption. The primary conclusion of *Ralston Purina* is that the critical inquiry in determining the applicability of the private placement

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<sup>29</sup> Steinberg & Obi, *supra* note 1, at 6-7.

<sup>30</sup> Steinberg & Obi, *supra* note 1, at 6-7.

<sup>31</sup> DRESNER & KIM, *supra* note 1, at 78.

<sup>32</sup> *Id.*

<sup>33</sup> Steinberg & Obi, *supra* note 1, at 7.

<sup>34</sup> *Id.* at 7.

<sup>35</sup> *Id.* at 11.

<sup>36</sup> Macchiarola, *supra* note 1, at 7.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*; see also DRESNER & KIM, *supra* note 1, at 78-79.

<sup>39</sup> Steinberg & Obi, *supra* note 1, at 12; see also DRESNER & KIM, *supra* note 1, at 78.

<sup>40</sup> Steinberg & Obi, *supra* note 1, at 12.

<sup>41</sup> *Id.* at 12; *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953).

exemption is whether the offerees are able to “fend for themselves,” thus making registration unnecessary.<sup>42</sup>

*Ralston Purina* and later lower court decisions have explained several factors in determining how to apply the private placement exemption including:

the number of offerees and their relationships to each other and to the issuer; the manner of the offering; the sophistication and expertise of the offerees; the nature and type of information provided to offerees either directly or indirectly . . . and the precautions employed by the issuer to prevent the resale of the underlying securities.<sup>43</sup>

However, it is difficult for issuers to determine, even using these factors, whether the Section 4(2) private placement exemption applies to some private placements. Accordingly, the Rule 506 (of Regulation D) safe harbor has become the primary exemption used in PIPE offerings.<sup>44</sup>

Rule 506 serves as a Section 4(2) private placement exemption safe harbor.<sup>45</sup> Compliance with the Rule 506 safe harbor is not nearly as difficult or complicated. An offering qualifies for the Section 4(2) private placement exemption if an issuer satisfies Rule 506’s requirements.<sup>46</sup> Regulation D, including Rule 506, was designed to give investors greater certainty than could be obtained by relying on *Ralston Purina* and other judicial and administrative interpretations.<sup>47</sup> However, an investor’s failure to satisfy Regulation D does not preclude the investor from relying on Section 4(2).<sup>48</sup>

Applying Rule 506 is different than applying Section 4(2). Section 4(2) focuses on offerees, whereas Rule 506 generally focuses on purchasers.<sup>49</sup> Rule 506 prohibits more than 35 non-accredited purchasers and allows an unlimited number of accredited investors.<sup>50</sup>

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<sup>42</sup> Steinberg & Obi, *supra* note 1, at 12.

<sup>43</sup> *Id.* at 12-13.

<sup>44</sup> Steinberg & Obi, *supra* note 1, at 17; *see also* DRESNER & KIM, *supra* note 1, at 80-81 (noting that Regulation D, which provides issuers with safe harbors from registration requirements, was promulgated by the SEC in 1982 to “provide issuers with greater certainty than reliance on interpretations of the Section 4(2) exemption”).

<sup>45</sup> Steinberg & Obi, *supra* note 1, at 18; *see also* Sjostrom, *supra* note 9, at 391 (noting that “if a private offering complies with the conditions specified in Rule 506, the offering will be deemed exempt under Section 4(2)”).

<sup>46</sup> Steinberg & Obi, *supra* note 1, at 18.

<sup>47</sup> DRESNER & KIM, *supra* note 1, at 80.

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

<sup>49</sup> Steinberg & Obi, *supra* note 1, at 18.

<sup>50</sup> *Id.* The federal securities laws define the term “accredited investor” in Rule 501 of Regulation D as (1) a bank, insurance company, registered investment company, business development company, or small business investment company; (2) a private business development company as defined in the Investment Advisers Act of 1940; (3) a charitable organization, corporation, or partnership with assets exceeding \$5 million; (4) a director, executive officer, or general partner of the company selling the securities; (5) a business in which all the equity owners are accredited investors; (6) a natural person who has individual net worth, or joint net worth with the person’s spouse, that exceeds \$1 million at the time of the purchase; (7) a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year; or (8) a trust with assets in excess of \$5 million, not formed to acquire the securities offered, whose purchases are made by a sophisticated person. *See* 17 C.F.R. § 230.50(a) (2011) (defining “accredited investor”); *see also* SEC v. *Ralston Purina Co.*, 346 U.S. 119, 125

As PIPE investors in a Rule 506 offering are typically all accredited investors, Rule 506 compliance problems are rare in PIPE deals.<sup>51</sup> Almost all hedge funds qualify as accredited investors under the Rule 506 safe harbor, and PIPE transactions are usually marketed to accredited investors so the issuer does not have to comply with the disclosure requirements for unaccredited investors.<sup>52</sup> The only SEC filing required in a Rule 506 offering is a nine page Form D that discusses basic information about the offering.<sup>53</sup> Form D must be filed within 15 days after the first sale of securities.<sup>54</sup> Because securities issued pursuant to Rule 506 are considered restricted securities, PIPE investors cannot generally sell the securities for at least one year, unless the subsequent sale is registered with the SEC.<sup>55</sup>

Executing the private placement component of a PIPE transaction requires one more step than traditional private placement transactions. Before the private placement component of a PIPE transaction is completed, the PIPE issuer covenants to file a registration statement covering the shares purchased in the private placement transaction.<sup>56</sup> This step ensures that PIPE investors will be able to sell the shares on the open market once the PIPE shares have been registered and the SEC declares the resale registration effective.<sup>57</sup>

## 2. Public Offering Compliance

Ensuring compliance with federal securities laws during the secondary or public offering component of a PIPE transaction involves filing a registration statement and avoiding integration issues. The secondary offering or resale of securities in PIPE transactions typically requires the issuer to file a registration statement.<sup>58</sup> Most PIPE transactions register using Form S-3.<sup>59</sup> Form S-3 utilizes a condensed reporting form that allows issuers to incorporate required information by reference to information contained in the company's quarterly and annual reports.<sup>60</sup> Form S-3 is used in most PIPE transactions because it is less time consuming and less expensive than other registration forms.<sup>61</sup>

In addition to registration statement issues, the secondary offering component of a PIPE transaction also implicates integration issues. Integration occurs when two or more offerings, which an issuer structures as separate exempt offerings, are treated by the SEC as a single non-exempt offering.<sup>62</sup> The purpose of integration is to prevent issuers from

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(1953) (touchstone of private offering exemption is that offerees are able to “fend for themselves” and thus do not need protection of federal securities laws).

<sup>51</sup> Steinberg & Obi, *supra* note 1, at 18.

<sup>52</sup> Sjostrom, *supra* note 9, at 391-92.

<sup>53</sup> *Id.* at 392.

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

<sup>55</sup> *Id.* at 392-93.

<sup>56</sup> *Id.* at 393; *see also* Macchiarola, *supra* note 1, at 8.

<sup>57</sup> Macchiarola, *supra* note 1, at 8.

<sup>58</sup> Sjostrom, *supra* note 9, at 393.

<sup>59</sup> *Id.*

<sup>60</sup> *Id.*

<sup>61</sup> *Id.* at 393-94.

<sup>62</sup> *Id.* at 395; DRESNER & KIM, *supra* note 1, at 23-24.



structuring a single offering into multiple offerings to avoid the Securities Act's registration requirement.<sup>63</sup> If the SEC integrates multiple offers so that the single offer does not qualify for an exemption, then the offers were made in violation of the Securities Act.<sup>64</sup> Consequently, each purchaser in the offering has a right to rescind the transaction.<sup>65</sup> Integration is relevant to PIPE transactions because PIPEs involve two distinct offerings: a private offering followed by a public offering.<sup>66</sup> Fortunately for PIPE investors, integration is seldom an issue in PIPE transactions because of Securities Act Rule 152.<sup>67</sup>

Under Rule 152, offerings made prior to the registration statement's filing and made under circumstances that did not require registration do not become offerings which are prohibited by the Securities Act because of the subsequent registration.<sup>68</sup> Therefore, integration will not be an issue in PIPE transactions as long as the private offering complies with a Section 5 registration exemption, and the issuer completes the offering before the filing of the registration statement.<sup>69</sup>

### C. *Structural Alternatives*

PIPEs come in many varieties, and the two most common forms of PIPE transactions are traditional PIPEs and structured PIPEs.

#### 1. Traditional PIPEs

In traditional PIPEs, "the issuing company covenants to file a registration statement covering the applicable securities with the SEC promptly after the closing of the private offering made pursuant to Rule 506."<sup>70</sup> A typical traditional PIPE involves selling common stock at a fixed price and at a discount or premium of the market price depending on the contractual features of the PIPE.<sup>71</sup> Some traditional PIPEs also involve selling convertible preferred stock.<sup>72</sup>

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<sup>63</sup> Sjoström, *supra* note 9, at 395.

<sup>64</sup> *Id.*

<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

<sup>67</sup> *Id.*

<sup>68</sup> *Id.* at 395-96.

<sup>69</sup> Stephen M. Graham, *Financing Alternatives for Public Companies*, 1704 PRAC. L. INST. 369, 383 (2008) ("Failure to complete the private placement before filing the registration statement would vitiate the exemption for the private placement (resulting in a 'burst' PIPE), because the SEC takes the position that filing a registration statement constitutes a 'general solicitation,' which would make a private placement exemption unavailable.").

<sup>70</sup> Steinberg & Obi, *supra* note 1, at 21-22.

<sup>71</sup> *Id.* at 22; *see also* DRESNER & KIM, *supra* note 1, at 99-101 (noting the basic terms of a traditional PIPE include the following: "standard representations and warranties . . . that must be brought down at closing; delivery to the placement agent of a comfort letter and legal opinion . . . ; before an investor obtains unlegended stock certificates, delivery by the investor to the issuer and the issuer's transfer agent of a certificate as to the investor's compliance with the prospectus delivery requirement; closing conditions limited to (1) no occurrence of any material adverse change between execution and closing, and (2) the SEC's willingness to declare effective the resale registration statement").

<sup>72</sup> Steinberg & Obi, *supra* note 1, at 22.

## 2. Structured PIPEs

Structured PIPEs typically utilize preferred stock or debt securities that are convertible into the company's common stock.<sup>73</sup> An investor's obligations in a structured PIPE are often contingent upon the SEC declaring effective a registration statement covering the securities.<sup>74</sup> Structured PIPE closings are generally delayed until the registration statement is effective. This feature allows PIPE investors to walk away from the transaction if registration does not occur.<sup>75</sup>

Another advantage some structured PIPEs offer is a variable and contractually linked reset mechanism that adjusts the conversion price downwards if the company's common stock market price falls below set conversion prices.<sup>76</sup> Accordingly, one commentator stated that structured PIPE investors "do not assume price risk during the pendency of the resale registration statement."<sup>77</sup> Consequently, a structured PIPE is often more advantageous for PIPE investors than for PIPE issuers.<sup>78</sup> In fact, some structured PIPEs can cause tremendous downward movement in issuer stock prices.

## 3. "Death Spiral" Structured PIPEs

Some commentators have dubbed the most notorious structured PIPE deal a "death spiral."<sup>79</sup> In a death spiral, the PIPE issuer sells the PIPE investor convertible debt.<sup>80</sup> When PIPE investors convert debt into equity, this creates more shares and dilutes the share price.<sup>81</sup> This creates an incentive for PIPE investors to convert more debt because the lower price allows the investor to receive more shares.<sup>82</sup> Further conversions cause more price drops as the supply of shares increases; as the process repeats itself, the stock's price

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<sup>73</sup> *Id.* at 23; see also DRESNER & KIM, *supra* note 1, at 105-06 (noting the standard terms of a structured PIPE transaction include the following: "[a] private placement is . . . made to selected accredited investors; [i]nvestors commit to purchase securities at a fixed price or at a variable/reset price; [f]or transactions involving variable/reset pricing . . . parameters – which may include a cap on the number of shares that may be issued; [t]he purchase agreement generally contains a limitation on blackout periods; [p]romptly following execution of purchase agreements with investors, the transaction funds and closes; [t]he issuer files a resale registration statement covering resales from time to time of securities sold in the transaction; [t]he issuer may be obligated to make penalty payments if it fails to meet any registration statement deadline; [i]nvestors are named in the resale registration statement as 'Selling Stockholders'; [t]he resale registration statement is kept effective until securities may be sold under Rule 144(k)").

<sup>74</sup> Steinberg & Obi, *supra* note 1, at 23.

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> Sjostrom, *supra* note 9, at 384-85.

<sup>78</sup> Steinberg & Obi, *supra* note 1, at 23-24.

<sup>79</sup> See *id.*; see also Knepper, *supra* note 4, at 361-62 (noting that these types of structured PIPE deals are also known as future-priced convertible securities, toxic PIPEs, resetting convertibles, floorless convertibles, and toxic convertibles); *Death Spiral*, INVESTOPEDIA, available at <http://www.investopedia.com/terms/d/deathspiral.asp> (last visited Mar. 3, 2011) (defining "death spiral").

<sup>80</sup> *Death Spiral*, INVESTOPEDIA, available at <http://www.investopedia.com/terms/d/deathspiral.asp> (last visited Mar. 3, 2011).

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

decreases.<sup>83</sup> Downward price pressures in death spirals are often exacerbated by short selling, and the process creates a vicious circle—the “death spiral.”<sup>84</sup>

“Death” applies because issuer stocks often performed poorly subsequent to the consummation of the PIPE transaction. In fact, many early death spiral issuers experienced catastrophic losses subsequent to consummating the PIPE deal.<sup>85</sup> Consequently, a significant amount of early scholarly articles on PIPE financing discussed how to deal with the death spiral problem.<sup>86</sup> In fact, one commentator suggested that it was the dramatic losses experienced by death spiral issuers and the sense that death spiral investors were “vultures” benefiting from the destruction of small companies that led to the SEC’s increased scrutiny and enforcement in the PIPE context.<sup>87</sup> This interpretation is bolstered by the SEC’s public comments.

Thomas Newkirk, Associate Director of the SEC’s Division of Enforcement, said the following about death spiral financing: “[c]ertain 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>88</sup> Director Newkirk’s comment was made in the context of a death spiral litigation settlement and he further highlighted the SEC’s desire to address death spiral financing issues: “This case demonstrates this risk to issuers and investors. The \$1 million penalty imposed here shows the Commission’s determination to address these abuses.”<sup>89</sup>

However, the injuries associated with death spiral PIPEs no longer exist in American Securities markets. Industry leaders,<sup>90</sup> news outlets,<sup>91</sup> investment commentators,<sup>92</sup>

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<sup>83</sup> *Id.*

<sup>84</sup> Steinberg & Obi, *supra* note 1, at 24.

<sup>85</sup> See Knepper, *supra* note 4, at 359-60.

<sup>86</sup> See generally Knepper, *supra* note 4; Lerner, *supra* note 1; Majoros, *supra* note 20 (describing potential solutions to death spiral issues).

<sup>87</sup> See generally Lerner, *supra* note 1 (describing SEC regulation and enforcement of PIPEs).

<sup>88</sup> SECURITIES & EXCHANGE COMMISSION, *SEC Settles with Rhino Advisors, Thomas Badian* (2003), <http://www.sec.gov/news/press/2003-26.htm>.

<sup>89</sup> *Id.*

<sup>90</sup> Telephone Interview with Colin Lancaster, President & Chief Operating Officer, Stark Investments (Nov. 24, 2009) (noting death spiral PIPEs no longer occur in the United States but do occur in other parts of the world).

<sup>91</sup> See Erik Krusch, *Corporate Finance: PIPEs, RDOs and ELFs Driving Liquidity*, WESTLAW BUSINESS CURRENTS, Nov. 6, 2009, [http://currents.westlawbusiness.com/Articles/2009/11/20091103\\_0021.aspx?src=WBSignon](http://currents.westlawbusiness.com/Articles/2009/11/20091103_0021.aspx?src=WBSignon) (“The Securities and Exchange Commission (SEC) killed off the PIPE death spiral earlier this decade through pointed comment letters and enforcement actions.”).

<sup>92</sup> See Mary Moore, *PIPE Financing Sheds Off Bad Rap and Sluggish Activity*, BOSTON BUS. J., Nov. 12, 2007, available at <http://boston.bizjournals.com/boston/stories/2007/11/12/focus4.html> (“With tightening by the Securities and Exchange Commission, death spirals are nearly non-existent among today’s PIPEs, industry experts said, and the market is attracting increasing numbers of traditional, well-heeled firms that are doing bigger deals than ever before.”).

financial scholars,<sup>93</sup> and members of SEC advisory committees<sup>94</sup> agree that death spiral PIPEs have basically disappeared from the American marketplace.

Most commentators attribute the disappearance of death spiral PIPEs to: 1) increased competition among hedge funds vying for PIPE investments resulting in more favorable terms for PIPE issuers;<sup>95</sup> 2) increased SEC scrutiny, particularly in screening PIPE registrations;<sup>96</sup> and 3) greater awareness and appreciation among PIPE issuers of the risks associated with death spiral PIPEs.<sup>97</sup> That death spiral PIPE financing and its catastrophic effects no longer exist in the United States marketplace is important because it should alleviate the stigma associated with early PIPE deals.

### III. BENEFITS OF PIPE TRANSACTIONS

Current PIPE transactions include different benefits for PIPE issuers and PIPE investors, and this article discusses the benefits to both.

#### A. Benefits to PIPE Issuers

PIPE issuers like Company X generally choose PIPE transactions over other financing alternatives because PIPE issuers often have no other alternatives and because PIPE financing offers advantages over traditional capital formation options.<sup>98</sup> For example, PIPE financing requires lower transaction expenses, fewer public disclosure requirements, less preparation, and less time than traditional capital formation options.<sup>99</sup>

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<sup>93</sup> See Steinberg & Obi, *supra* note 1, at 24 (noting that death spirals have largely been relegated to the sidelines in the context of PIPE transactions).

<sup>94</sup> See David Feldman, SEC Advisory Committee on Smaller Public Companies, Record of Proceedings 166 (June 17, 2005) available at <http://www.sec.gov/info/smallbus/acspc/acspctranscript061705.pdf> (noting that “[t]he death spiral deals are a thing of the past for the most part”).

<sup>95</sup> Steinberg & Obi, *supra* note 1, at 24 (noting that the terrible effects of death spirals led to innovative solutions from private and public sectors which led to disappearance of death spirals); see also *PIPEs: Quick Financing, the Hail Mary Pass and New Investors*, FIN. ENGINEERING NEWS, Oct. 26, 2004, available at <http://www.sagientresearch.com/pt/News/PR11.15.04FinEngineering.htm> (suggesting that death spirals are rare because there are so many PIPE investors willing to agree to more issuer friendly terms).

<sup>96</sup> See Laura Anthony, *The Demise of the Death Spiral – SEC Interpretation of Rule 415*, LEGAL & COMPLIANCE, LLC, Oct. 22, 2009, <http://securities-law-blog.com/2009/10/22/the-demise-of-the-death-spiral-sec-interpretation-of-rule-415/> (“The SEC staff made it clear that its interpretation of Rule 415 was meant to curtail death spirals and other toxic offerings which tended to flood the market with penny stocks whose value continued to decline. The SEC’s efforts worked.”); Moore, *supra* note 92 (noting death spirals’ non-existence is due to “tightening by the Securities and Exchange Commission”); see also Krusch, *supra* note 91 (“The Securities and Exchange Commission (SEC) killed off the PIPE death spiral earlier this decade through pointed comment letters and enforcement actions.”).

<sup>97</sup> See SECURITIES & EXCHANGE COMMISSION, Alan L. Beller, *SEC Investor Summit*, (May 10, 2002), <http://www.sec.gov/investor/summit/isummit051002.htm>. When asked about the SEC’s view on death spiral convertibles, Director Beller stated: “This is a relatively recent phenomenon that I guess one might hope has run its course. I think a lot of the earlier issuances of death spiral preferreds were due in part, frankly, to an under-appreciation of their consequences to issuers and in the marketplace. I think those consequences are now much better understood, and our anecdotal evidence, at least, is that one is seeing less of this.” Director Beller also noted that increased disclosure rules would likely decrease the amount of death spiral convertibles in the future. *Id.*

<sup>98</sup> Sjostrom, *supra* note 9, at 386.

<sup>99</sup> DRESNER & KIM, *supra* note 1, at 100.

Most PIPE issuers are small public companies.<sup>100</sup> Although some PIPE issuers may eventually generate tremendous wealth, PIPE issuers typically have small market capitalizations, weak cash flow, and poor-performing stocks.<sup>101</sup> Some PIPE issuers are “in high-growth or research-intensive businesses and have a continuing need for cash.”<sup>102</sup> Most PIPE issuers will run out of cash within a year without additional financing; therefore, traditional financing is generally not an option.<sup>103</sup> Few investment banks are willing to finance PIPE issuers like Company X, and often, PIPE issuers lack the upside potential to attract traditional private equity financing.<sup>104</sup>

PIPE financing requires lower transaction expenses than other financing alternatives. For example, the cost of conducting a registered offering pursuant to the Securities Act is frequently substantial.<sup>105</sup> “[T]he costs of preparing the registration statement, including accountant, attorney, investment banker and printer fees, easily can run into the tens if not hundreds of thousands of dollars.”<sup>106</sup> Additionally, one commentator concluded that PIPEs are more cost-effective for issuers because PIPEs allow issuers to bypass road shows and advertising that are usually required for successful public offerings.<sup>107</sup>

Furthermore, PIPE financing requires less preparation than other financing alternatives because PIPE financing has fewer public disclosure requirements.<sup>108</sup> The disclosures required in preparing a public offering registration statement are detailed and complex, and the document’s length can be massive.<sup>109</sup> PIPE transactions, on the other hand, are commonly closed “within seven to ten days of receiving definitive purchase commitments whereas a follow-on underwritten equity offering can take from three to nine months.”<sup>110</sup> PIPEs can be completed quickly because they are structured to avoid pre-closing SEC review and clearance, and because PIPE investors typically perform less due diligence on PIPE issuers than underwriters in a public offering.<sup>111</sup>

Finally, PIPE financing carries potential long-term benefits for PIPE issuer shareholders. PIPE issuer shareholders derivatively enjoy the benefits that PIPE issuers enjoy. PIPE deals make it more likely that PIPE issuers like Company X will get their ideas to market, and PIPE issuer shareholders thus benefit. Conversely, if Company X is unable

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<sup>100</sup> Sjostrom, *supra* note 9, at 386.

<sup>101</sup> *Id.*

<sup>102</sup> DRESNER & KIM, *supra* note 1, at 66.

<sup>103</sup> Sjostrom, *supra* note 9, at 386-87.

<sup>104</sup> *Id.* at 387.

<sup>105</sup> MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 38-39 (4<sup>th</sup> ed. 2007); *see also* DRESNER & KIM, *supra* note 1, at 100.

<sup>106</sup> STEINBERG, *supra* note 105, at 38-39.

<sup>107</sup> Lerner, *supra* note 1, at 664.

<sup>108</sup> DRESNER & KIM, *supra* note 1, at 100.

<sup>109</sup> *Id.*

<sup>110</sup> Sjostrom, *supra* note 9, at 386 n.34 (citing James R. Tanenbaum & Anna T. Pinedo, *The Law: Legal and Regulatory Framework*, in PIPES: A GUIDE TO PRIVATE INVESTMENTS IN PUBLIC EQUITY 77, 100 (rev. & updated ed. 2006)).

<sup>111</sup> *Id.*

to locate financing and later goes out of business, its shareholders will lose their investments. Accordingly, the potential benefits that PIPE issuer shareholders enjoy are generally associated with the increased likelihood that the PIPE issuer will stay in business.

### B. *Benefits to PIPE Investors*

Hedge funds are the biggest investors in PIPE transactions.<sup>112</sup> Hedge funds do not have a universal definition. The term “hedge fund” generally refers to privately managed investment funds that are exempt from many securities laws.<sup>113</sup> Hedge funds are generally exempt from the 1933 Securities Act’s public offering requirements, the 1934 Exchange Act’s periodic reporting requirements, and the 1940 Investment Company Act’s registration requirements.<sup>114</sup> Hedge funds are distinct from financial market players such as underwriters, market makers, or broker-dealers that are specifically regulated by other federal legislation.<sup>115</sup> These exemptions, which are consistent with the purposes of securities regulation, allow hedge funds to employ complex trading strategies that would otherwise be prohibited or less effective.<sup>116</sup> When hedge funds avoid SEC regulation, it is not the result of dishonest behavior; rather, it is because hedge funds are “structured in an open and above-board fashion to take advantage of the exclusions that Congress has seen fit to build into the securities laws regime.”<sup>117</sup>

Hedge funds invest in PIPE transactions because PIPE transactions offer investors 1) more liquidity than private placements;<sup>118</sup> 2) greater security than private placements and traditional equity offerings;<sup>119</sup> and 3) superior returns compared to private placements and traditional equity offerings.<sup>120</sup>

First, PIPE transactions offer investors more liquidity than private placements.<sup>121</sup> PIPE investors reduce the illiquidity associated with private placements by requiring PIPE issuers to file a registration statement, which is later declared effective, covering the stock issued in the PIPE transaction. Once the registration statement is declared effective, PIPE investors have the option of selling PIPE shares in the public market.<sup>122</sup> Consequently, PIPE deals provide investors with a cost-effective exit from their investment.<sup>123</sup> PIPE

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<sup>112</sup> DRESNER & KIM, *supra* note 1, at 68; Sjostrom, *supra* note 9, at 382.

<sup>113</sup> Erik J. Greupner, *Hedge Funds are Down-Market: A Call for Increased Regulation?*, 40 SAN DIEGO L. REV. 1555, 1558-59 (2003).

<sup>114</sup> Dale A. Oesterle, *Regulating Hedge Funds*, 1 ENTREPRENEURIAL BUS. L.J. 1, 7 (2006).

<sup>115</sup> *Id.* at 4.

<sup>116</sup> *Id.* at 4-5.

<sup>117</sup> Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC’s Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 976 (2006).

<sup>118</sup> Steinberg & Obi, *supra* note 1, at 20.

<sup>119</sup> See generally Lerner, *supra* note 1, at 656 (discussing increased liquidity from PIPE transactions).

<sup>120</sup> Sjostrom, *supra* note 9, at 382, 387-88 (noting PIPE deals earn hedge funds market-beating returns).

<sup>121</sup> Lerner, *supra* note 1, at 656 (“A PIPE transaction combines the speed and certainty of a private placement with the pricing benefits that flow from the increased liquidity to purchasers of freely tradable, registered securities.”).

<sup>122</sup> Macchiarola, *supra* note 1, at 8.

<sup>123</sup> See generally Graham, *supra* note 69 (discussing this cost-effective exit strategy).

investors often include penalty provisions “requiring an issuer to make payments if the resale registration statement fails to become effective within prescribed time periods.”<sup>124</sup>

Second, PIPE transactions offer investors greater security than private placements and traditional equity offerings. PIPE deal structures present less investment risk than private placements and traditional equity offerings for two reasons: (1) PIPE investors purchase issuer stock or securities convertible into stock at a discount of market prices; and (2) PIPE investors hedge their investment by selling short the PIPE issuer stock.<sup>125</sup> So on one hand, PIPE investors purchase issuer stock or securities convertible into stock at a discount of market prices.<sup>126</sup> In fact, the discount provided to PIPE investors is “more advantageous than the discount generally applicable in a pure private placement transaction.”<sup>127</sup> On the other hand, PIPE investors hedge their investment by selling short the PIPE issuer stock. To execute a short sale, an investor borrows common stock from a broker-dealer and sells this borrowed stock on the open market.<sup>128</sup> The investor then covers the short sale at a later date by buying shares in the open market and returning these shares to the lender.<sup>129</sup> Short selling is profitable when the stock price drops because the investor buys the stock at a lower price and makes a profit on the difference.<sup>130</sup> Conversely, investors lose money on short sales when the stock price rises.<sup>131</sup> PIPE investor short sales insure against possible decreases in the value of PIPE issuer stock.

Third, PIPE transactions offer investors superior returns compared to private placements and traditional equity offerings.<sup>132</sup> Hedge funds, the primary investor in PIPEs, typically use an absolute return approach to investing.<sup>133</sup> An absolute return approach to investing seeks to make money in various market environments, including declining markets.<sup>134</sup> One commentator suggests that hedge funds can make money on PIPE deals regardless of whether the common stock price increases or decreases subsequent to the transaction.<sup>135</sup> If the common stock price decreases below the discounted price following a PIPE deal, the hedge fund will lose money on the PIPE shares, but the loss will be exceeded by gains on the short sale.<sup>136</sup> If the common stock price increases following a PIPE deal, the money lost on the short sale will be exceeded by an increase in the common stock value

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<sup>124</sup> Macchiarola, *supra* note 1, at 9.

<sup>125</sup> *Id.*; see also Alan J. Berkeley & Erin E. Troy, *PIPEs Hedging Under Scrutiny*, SP038 ALI-ABA 597, 600 (2009); Graham, *supra* note 69, at 377; Steinberg & Obi, *supra* note 1, at 21; Sjostrom, *supra* note 9, at 388.

<sup>126</sup> Macchiarola, *supra* note 1, at 8-9.

<sup>127</sup> Steinberg & Obi, *supra* note 1, at 21.

<sup>128</sup> Sjostrom, *supra* note 9, at 388.

<sup>129</sup> *Id.*

<sup>130</sup> *Id.*; see also Brigitte Yuille, *Short Selling: What Is Short Selling?* INVESTOPEDIA (2010), available at <http://www.investopedia.com/university/shortselling/shortselling1.asp>.

<sup>131</sup> Sjostrom, *supra* note 9, at 388.

<sup>132</sup> See *id.* at 387.

<sup>133</sup> *Id.*

<sup>134</sup> For an overview of the hedge fund industry by the SEC staff, see SECURITIES & EXCHANGE COMMISSION, *Implications of the Growth of Hedge Funds* (2003), <http://www.sec.gov/news/studies/hedgefunds0903.pdf>.

<sup>135</sup> Sjostrom, *supra* note 9, at 388.

<sup>136</sup> *Id.*

because the shares were purchased at a discounted price.<sup>137</sup> However, an industry leader stated that there can still be tremendous risk for PIPE investors because (1) the distressed state of PIPE issuers increases the risk of misrepresentation or fraud; and (2) PIPE investors often carry a net “long” profile—they believe in the company and will lose money in a down market, even if partially hedged.<sup>138</sup>

Nevertheless, PIPE financing can be very lucrative for PIPE investors due to PIPE issuers’ few financing options.<sup>139</sup> In addition to offering common stock at discounted prices to PIPE investors, PIPE issuers are usually required to offer dividends, interest, and warrants.<sup>140</sup> Some commentators have estimated that PIPE financing costs between 14.3% and 34.7%.<sup>141</sup> The fact that PIPE issuers often perform poorly subsequent to PIPE transactions is not surprising when one considers PIPE issuers’ financially distressed state and PIPE financing’s high costs.<sup>142</sup>

#### IV. SEC’S PUBLIC POSITIONS ON PIPE INVESTOR SHORT SALES

The SEC’s aggressive enforcement against PIPE investors is misguided because it is based on flawed interpretations of the law, and because it ignores the benefits and exaggerates the risks of PIPE financing. The SEC believes that some PIPE investors who take a short position in a PIPE issuer’s publicly traded shares violate Section 5 of the Securities Act by selling unregistered securities and that PIPE investors who trade on knowledge of an impending PIPE transaction are guilty of insider trading.<sup>143</sup> The SEC’s positions on these issues do not withstand scrutiny.

Unfortunately, there are currently no appellate decisions examining the SEC’s positions on PIPE investor short sales. Thus, PIPE investors are left with four options when faced with a potential PIPE deal: PIPE investors can risk an SEC enforcement action by proceeding with short selling strategies; proceed with a less secure investment by failing to sell short the PIPE issuer’s stock; increase the issuer’s cost of financing; or abandon the PIPE deal altogether.<sup>144</sup> Regrettably, there is no reason to believe that appellate guidance is imminent on either the issue of PIPE deal insider trading or the issue of Section 5 unregistered sales of securities.

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<sup>137</sup> *Id.*

<sup>138</sup> E-mail Interview with Colin Lancaster, President & Chief Operating Officer, Stark Investments (Feb. 19, 2010).

<sup>139</sup> See Sjostrom, *supra* note 9, at 388.

<sup>140</sup> *Id.* at 387.

<sup>141</sup> *Id.*

<sup>142</sup> *Id.*

<sup>143</sup> *Id.* at 400-07.

<sup>144</sup> See Steinberg & Obi, *supra* note 1, at 37 (supporting the proposition that PIPE issuers may have to raise the cost of financing to compensate for the uncertainty created by the SEC’s aggressive enforcement).



*A. The SEC's Flawed Interpretations of the Law*

## 1. Section 5 Unregistered Sale of Securities

The SEC is aggressively enforcing its position that short selling by PIPE investors violates Section 5.<sup>145</sup> The SEC's Section 5 position is misguided because the conduct in question does not involve a sale or transfer of unregistered securities, and the SEC's position is inconsistent with the purpose of Section 5 of the Securities Act.<sup>146</sup>

Section 5(a) of the Securities Act prohibits selling securities through interstate commerce or the mails, when a registration statement is not in effect as to that security, or an exemption from registration is not available.<sup>147</sup> The same prohibition applies under Section 5(c) to an offer to sell a security.<sup>148</sup> The elements of a Section 5 violation are that "1) the defendant offered to sell or sold a security, 2) the defendant did so through the use of mails or interstate commerce, and 3) no registration statement was filed or was in effect as to that security."<sup>149</sup>

The SEC asserts that the short sales conducted in connection with PIPE deals "constitute Section 5 violations 'because shares used to cover a short sale are deemed to have been sold when the short sale was made.'"<sup>150</sup> Identifying the weakness of the SEC's argument requires an understanding of short sales.

The principles underlying short sales are not complicated.<sup>151</sup> "A short sale is the sale of a security that the seller does not yet own (or owns but chooses not to deliver)."<sup>152</sup> A short seller borrows the securities from another party and "delivers the borrowed security to

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<sup>145</sup> See, e.g., SEC v. Langley Partners, SEC Litigation Release No. 19,607 (Mar. 14, 2006); SEC v. Shane, SEC Litigation Release No. 19,227, 2005 SEC LEXIS 1158 (May 18, 2005); Complaint, SEC v. Spiegel, Inc., No. 03C-1685, 2003 U.S. Dist. LEXIS 17933 (N.D. Ill. 2003); see also SEC v. Mangan, SEC Litigation Release No. 19,955 (Dec. 28, 2006).

<sup>146</sup> See generally SEC v. Mangan, 598 F. Supp. 2d 731 (W.D.N.C. 2008); SEC v. Lyon, 529 F. Supp. 2d 444 (S.D.N.Y. 2008) (explaining the SEC's Section 5 position). The arguments against the SEC's Section 5 position are well articulated in Mangan's trial brief, available at Mangan Brief, SEC v. Mangan, No. 3:06-cv-531, 598 F. Supp. 2d 731, 2007 WL 4901007 (W.D.N.C. Apr. 16, 2008).

<sup>147</sup> 15 U.S.C. § 77e(a) (2010). Section 5(a) of the Securities Act states: "Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale."

<sup>148</sup> 15 U.S.C. § 77e(c) (2010). Section 5(c) of the Securities Act states: "It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 8."

<sup>149</sup> See SEC v. 800 America.com, 2006 U.S. Dist. LEXIS 85571, at \*28 (S.D.N.Y. Nov. 28, 2006).

<sup>150</sup> Steinberg & Obi, *supra* note 1, at 33.

<sup>151</sup> Knepper, *supra* note 4, at 368.

<sup>152</sup> *Id.*

the short-sale purchaser, thereby completing the trade.”<sup>153</sup> The short seller is still required to return the securities to the party that lent them; this is known as “covering” the short position.<sup>154</sup> A short seller typically covers the short position by repurchasing the security in the marketplace.

Short sales are typically viewed as either a bet that a security will decrease in value, or a hedge that mitigates the risk of loss if a security decreases in value. Typically, short sellers earn profits if “the stock’s price falls between the time the short sale trade is made and the time the short sale is covered.”<sup>155</sup> If the stock price increases after the short sale, the short seller will incur a loss.<sup>156</sup> PIPE investors often have a net long position, so PIPE investor short sales may be best characterized as hedges.

The SEC’s Section 5 position is wrong because Section 5 is not violated; the conduct in question does not involve a sale or transfer of unregistered securities. PIPE transactions are structured to make the sale or transfer of an unregistered security impossible. When a PIPE investor opens a short position, it borrows and sells a registered security. If the PIPE shares are successfully registered, PIPE investors then typically close out the short position with (their own) registered shares. If the shares are never registered, the PIPE investor would be forced to close out the short position with shares purchased on the open market, which are registered. Consequently, it is impossible for the PIPE investor to sell an unregistered security even if the PIPE shares are not successfully registered.

Furthermore, the SEC’s position does not further the purpose of Section 5 of the Securities Act.<sup>157</sup> The primary purpose of Section 5 of the Securities Act is to protect investors by promoting full disclosure of information necessary to make informed investment decisions.<sup>158</sup> Professor Sjostrom explains why the SEC’s position does not increase disclosure:

Whether a PIPE investor covers short sales with PIPE shares or open market purchases has no impact on an issuer’s disclosure obligations. Disclosure regarding the resale of PIPE shares will be set forth in the resale registration statement, and this disclosure will be the same regardless of the type of shares used by a PIPE investor to cover a short position.<sup>159</sup>

In addition to failing to fulfill the purpose of Section 5, the SEC’s Section 5 position has not persuaded the few trial courts that have examined it. PIPE investors have recently been named as defendants in three cases that went to trial. In all three cases, the courts held that the SEC had no basis to allege that the delivery of PIPE shares to close a short position effectively converted the underlying short sale into an unregistered resale of the PIPE shares

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<sup>153</sup> *Id.*

<sup>154</sup> *Id.*

<sup>155</sup> *Id.* at 368-69.

<sup>156</sup> *Id.* at 369.

<sup>157</sup> Sjostrom, *supra* note 9, at 406 (Professor Sjostrom points out that “[t]he SEC’s position may make sense conceptually. It does not, however, appear to further the policy behind Section 5”).

<sup>158</sup> SEC v. Lybrand, No. 00Civ.1387(SHS), 2000 WL 913894, at \*10 (S.D.N.Y. 2000); *see also* Macchiarola, *supra* note 1, at 4-5 (The primary purpose of the Securities Act “was to provide full and fair disclosure on the special occasion of a public offering.”); Sjostrom, *supra* note 9, at 406.

<sup>159</sup> Sjostrom, *supra* note 9, at 406.

at the time of the short sale.<sup>160</sup> These holdings contradict the SEC's public position on short selling by PIPE investors, but the SEC has not appealed any of them.

The SEC interpretation of Section 5 of the Securities Act related to PIPE investor short sales went unchallenged for some time.<sup>161</sup> The SEC, based on its reading of Section 5, repeatedly extracted disgorgement and penalties from PIPE investors who preferred to settle rather than challenge the SEC's interpretation.<sup>162</sup> This came to a screeching halt when John Mangan, Jr. decided to challenge the SEC's interpretation.

In *SEC v. Mangan*, the SEC alleged that John Mangan, Jr. sold short shares of a PIPE issuer prior to and after the public announcement of the PIPE transaction.<sup>163</sup> Once the registration statement became effective, Mangan used the shares he purchased in the PIPE transaction to close his short position.<sup>164</sup> The SEC asserted that Mangan's short sales violated Section 5 of the Securities Act because the SEC believed Mangan "sold" the shares when he opened the short position.<sup>165</sup>

The SEC's argument did not prevail, and the court granted Mangan's motion to dismiss the charges.<sup>166</sup> In dismissing the unregistered securities claim, the court stated that Mangan did not violate existing securities laws:

[a]nd what we have here, it seems to me, is a post hoc ergo propter hoc argument by the government that because the PIPE in fact was not registered and because the PIPE shares were later in fact used, he in effect sold the PIPE. Well, maybe, but I don't think he [Mangan] did anything illegal. In short, no sale of unregistered securities occurred as a matter of law.<sup>167</sup>

The *Mangan* court's decision and attitude towards the SEC's position were not isolated. In *SEC v. Lyon*, the SEC alleged that Edwin Lyon, a hedge fund manager, sold short shares of PIPE issuers prior to the registration statement's effectiveness.<sup>168</sup> Once the registration statement became effective, Lyon used the shares he purchased in the PIPE transactions to close his short positions.<sup>169</sup> The SEC asserted, as it did in *Mangan*, that Lyon's short sales violated Section 5 of the Securities Act because Lyon effectively sold the shares when he opened the short positions.<sup>170</sup>

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<sup>160</sup> See generally Julie Spellman Sweet, *PIPEs: A Review of Key Legal Issues*, 1761 PRAC. L. INST. 371, 395-403 (2009) (discussing *SEC v. Mangan*, *SEC v. Lyon*, and *SEC v. Berlacher*).

<sup>161</sup> Macchiarola, *supra* note 1, at 23-24.

<sup>162</sup> *Id.*

<sup>163</sup> Complaint, *SEC v. Mangan*, 598 F. Supp. 2d 731 (W.D.N.C. 2006) (No. 3:06-cv-531).

<sup>164</sup> *Id.*

<sup>165</sup> *Id.*

<sup>166</sup> *Mangan*, 598 F. Supp. 2d at 733 n.5 (W.D.N.C. 2008) (noting that the court dismissed the Section 5 claim on October 25, 2007).

<sup>167</sup> Sweet, *supra* note 160, at 405-07.

<sup>168</sup> Complaint, *SEC v. Lyon*, 529 F. Supp. 2d 544 (S.D.N.Y. 2006) (No. 06 Civ. 14338(SHS)).

<sup>169</sup> *Id.*

<sup>170</sup> *Id.*

The *Lyon* court dismissed all of the SEC's Section 5 claims brought against Lyon. Most importantly, the *Lyon* court stated that the SEC's allegations had "not stated a plausible claim . . . for distributing unregistered securities."<sup>171</sup> Despite the setbacks in *Mangan* and *Lyon*, the SEC continued to use its Section 5 argument, and was once again challenged in *SEC v. Berlacher*.

In *SEC v. Berlacher*, the SEC alleged that Robert Berlacher, a hedge fund operator, violated Section 5 of the Securities Act when Berlacher used shares purchased in a PIPE deal to close out a short position.<sup>172</sup> Like the *Lyon* and *Mangan* courts, the *Berlacher* court dismissed the charges related to the short sales.<sup>173</sup>

The SEC's trial court losses have not added certainty to the PIPE financing marketplace. On the contrary, the SEC's losses, combined with the lack of appellate decisions on the issue, and the SEC's continued Section 5 enforcement actions in the PIPE context, have created confusion and uncertainty in the financial marketplace.<sup>174</sup> This uncertainty is highlighted by the conclusions of scholarly articles on PIPEs.<sup>175</sup> However, despite the lack of certainty in the financial marketplace, these judicial decisions demonstrate the flaws in the SEC's Section 5 position.

## 2. Insider Trading

The SEC also believes a PIPE investor who trades on knowledge of an impending PIPE transaction is guilty of insider trading. The SEC aggressively enforces its insider trading position in the PIPE context.<sup>176</sup> This position, like the SEC's position on unregistered securities, does not withstand scrutiny.

The SEC's position on PIPE investor insider trading is flawed because it does not require sufficient evidence to establish a breach of a fiduciary or fiduciary-like duty necessary to bring an insider trading claim.<sup>177</sup> Additionally, reasonable arguments have been made that

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<sup>171</sup> *Lyon*, 529 F. Supp. 2d at 447.

<sup>172</sup> Complaint, *SEC v. Berlacher*, (Civil Action No. 07-3800) (E.D. Pa. 2008), 2010 WL 3566790.

<sup>173</sup> See generally *SEC v. Berlacher*, Civil Action No. 07-3800, 2010 WL 3566790 (E.D. Pa. Feb. 4, 2008) (order granting motion to dismiss in part).

<sup>174</sup> See Berkeley & Troy, *supra* note 125, at 613-14 ("[T]he SEC does not appear inclined to cede its position that it is a violation of Section 5 of the Securities Act to use shares obtained in a PIPE transaction to cover a short position taken in the PIPE issuer.").

<sup>175</sup> Steinberg & Obi, *supra* note 1, at 6 ("[G]iven the uncertainty engendered by recent regulatory developments, both issuers and investors must proceed with PIPE transactions in a strategic manner."); see also Sjostrom, *supra* note 9, at 383 (explaining that "a more measured and transparent SEC approach to PIPE regulation is in order").

<sup>176</sup> See, e.g., *SEC v. Langley Partners*, SEC Litigation Release No. 19,607 (Mar. 14, 2006); *SEC v. Shane*, SEC Litigation Release No. 19,227, 2005 SEC LEXIS 1158 (May 18, 2005); see also *SEC v. Mangan*, Litigation Release No. 19,955 (Dec. 28, 2006); Complaint, *SEC v. Lyon*, 529 F. Supp. 2d 544 (S.D.N.Y. 2006) (No. 06 Civ. 14338(SHS)).

<sup>177</sup> A significant amount of legal scholarship discusses the "duty problem" inherent in insider trading cases brought pursuant to the misappropriation theory. See Michael G. Capeci, Note, *SEC Rule 10B5-2: A Call For Revitalizing the Commission's Efforts in the War on Insider Trading*, 37 HOFSTRA L. REV. 805, 806 (2009) ("The duty problem is the uncertainty surrounding which relationships courts recognize as creating a fiduciary or fiduciary-like duty under the misappropriation theory of insider trading. The duty problem burdens the Commission, courts, and market players because determining if an investor is in such a relationship is difficult given the present state of the securities laws."); see also Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1319 (2009) ("Despite the Supreme Court's explicit dictate that fiduciary principles underlie

the SEC's position wrongly assumes that knowledge of an impending PIPE transaction is always material<sup>178</sup> and that information regarding an impending PIPE deal is always non-public.<sup>179</sup> This article will limit its discussion to the fiduciary duty flaw in the SEC's position.

Appellate courts have not yet provided much guidance on the issue of PIPE deal insider trading. The SEC recently brought an enforcement action against Mark Cuban, owner of the National Basketball Association's Dallas Mavericks, related to trades he made on information of an impending PIPE deal.<sup>180</sup> The United States District Court for the Northern District of Texas dismissed the insider trading case brought against Cuban,<sup>181</sup> and the SEC recently appealed the decision to the Fifth Circuit Court of Appeals.<sup>182</sup>

Although Mark Cuban was not a PIPE investor, this case is relevant to PIPE investors because its central issue is whether trading on information of an impending PIPE deal qualifies as insider trading. Unfortunately, the Fifth Circuit declined to reach the District Court's broad holdings regarding insider trading.<sup>183</sup>

Understanding the problems with the SEC's position requires some background on insider trading. Insider trading is trading while in possession of information that is material, non-public, and in breach of a fiduciary duty owed to either the shareholders of the company whose shares are traded or to the information's source.<sup>184</sup> There is no federal law or statute that expressly prohibits insider trading.<sup>185</sup> Instead, insider trading claims are brought using Section 10(b) of the Exchange Act and related judicial decisions.<sup>186</sup> The SEC seeks to promote market integrity and investor confidence by pursuing insider trading.<sup>187</sup> The Supreme Court has emphasized that investors would be less likely to "venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law."<sup>188</sup>

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the offense of insider trading, there have been recent repeated instances in which lower federal courts and the Securities and Exchange Commission . . . have disregarded these principles.").

<sup>178</sup> See *Basic v. Levinson*, 485 U.S. 224, 231-32 (1988) (noting that information is "material" if a reasonable investor would view the information as having significantly altered the total mix of information available); see also *Berkeley & Troy*, *supra* note 125, at 605 (noting that there is little case law supporting the proposition that a company's plan to seek financing is material).

<sup>179</sup> See *Berkeley & Troy*, *supra* note 125, at 606 (suggesting that expectation of a PIPE offering is public information even if the issuer has not made a public announcement. The commentator suggests that investors could easily anticipate that a PIPE or other similar financing will follow by looking at the issuer's financials and burn rate, especially if the issuer has previously engaged in PIPE transactions.).

<sup>180</sup> *SEC v. Cuban*, SEC Litigation Release No. 20,810 (Nov. 17, 2008).

<sup>181</sup> *SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009).

<sup>182</sup> Brief of the SEC, *SEC v. Cuban*, 620 F.3d 551 (2010) (No. 09-10996).

<sup>183</sup> *SEC v. Cuban*, 620 F.3d 551, 558 (5th Cir. 2010).

<sup>184</sup> *United States v. Chestman*, 947 F.2d 551, 566 (2d Cir. 1991); see generally STEPHEN M. BAINBRIDGE, *SECURITIES LAW: INSIDER TRADING* (1st ed. 1999) (discussing the history, elements and issues of insider trading).

<sup>185</sup> *Capeci*, *supra* note 177, at 808.

<sup>186</sup> *Id.*; *Nagy*, *supra* note 177, at 1315.

<sup>187</sup> *Nagy*, *supra* note 177, at 1318.

<sup>188</sup> *United States v. O'Hagan*, 521 U.S. 642, 658 (1997); see also *Nagy*, *supra* note 177, at 1318; Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1115 (1985) ("The primary

The SEC pursues insider trading under two theories: the classical theory and the misappropriation theory.<sup>189</sup> According to the classical theory of insider trading, a defendant violates Section 10(b) of the Exchange Act and Rule 10b-5 by trading in possession of material non-public information in breach of a fiduciary duty owed to the shareholders of the company whose shares are traded.<sup>190</sup> The classical theory of insider trading generally includes trading by corporate insiders and people such as attorneys and accountants, who may temporarily be considered corporate insiders, as well as others who temporarily become fiduciaries of the company.<sup>191</sup> “Liability [under the classical theory] is premised on the ‘relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.’”<sup>192</sup> This fiduciary relationship gives rise to a “duty to disclose” confidential information prior to trading.<sup>193</sup>

Under the misappropriation theory, a defendant violates federal insider trading law “when he misappropriates confidential information for securities trading purposes, in breach of a [fiduciary] duty to the source of the information.”<sup>194</sup> The misappropriation theory is distinguishable from the classical theory because the classical theory is based on the breach of a duty to the issuer or its shareholders, while the misappropriation theory is based on the breach of a fiduciary duty to the source of the information.

The SEC typically bases its PIPE investor insider trading claims on the misappropriation theory of insider trading because PIPE investors are not corporate insiders or “temporary” corporate insiders such as attorneys, accountants, and others who temporarily become fiduciaries of the company.<sup>195</sup>

A fiduciary duty cannot be unilaterally thrust upon an individual without consent; rather, a fiduciary duty must arise with the knowledge and consent of the person to be bound by the duty.<sup>196</sup> A fiduciary duty is “[a] duty of utmost good faith, trust, confidence, and candor owed by a fiduciary to the beneficiary; a duty to act with the highest degree of honesty and loyalty toward another person and in the best interests of the other person.”<sup>197</sup> A fiduciary duty does not arise in a normal arms-length transaction, even if the transaction is related to the issuance or underwriting of securities.<sup>198</sup>

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policy reason for proscribing trading while in possession of material nonpublic information is to make investors confident that they can trade securities without being subject to informational disadvantages.”).

<sup>189</sup> See BAINBRIDGE, *supra* note 184.

<sup>190</sup> *Chiarella v. United States*, 445 U.S. 222, 227-30 (1980).

<sup>191</sup> *O’Hagan*, 521 U.S. at 652; *Dirks v. SEC* 463 U.S. 646, 655 (1983).

<sup>192</sup> *SEC v. Cuban*, 634 F. Supp. 2d 713, 720 (N.D. Tex. 2009) (quoting *Chiarella*, 445 U.S. at 228).

<sup>193</sup> *Chiarella*, 445 U.S. at 228.

<sup>194</sup> *O’Hagan*, 521 U.S. at 652.

<sup>195</sup> *SEC v. Cuban*, 620 F.3d 551, 554 (5th Cir. 2010).

<sup>196</sup> *United States v. Falcone*, 257 F.3d 226, 234 (2d Cir. 2001); *United States v. Chestman*, 947 F.2d 551, 567 (2d Cir. 1991).

<sup>197</sup> BLACK’S LAW DICTIONARY 581 (9<sup>th</sup> ed. 2009).

<sup>198</sup> See *Walton v. Morgan Stanley & Co.*, 623 F.2d 796, 798-99 (2d Cir. 1980).

By itself, the receipt of information about an impending PIPE deal is insufficient to create a fiduciary duty.<sup>199</sup> At a minimum, an express contract requiring PIPE investors to keep the information confidential ought to be required in order to create a fiduciary-like duty. However, there is some disagreement about whether even a contractual obligation to keep information confidential is sufficient to create the fiduciary-like duty necessary to support an insider trading action. Some case law suggests that a contractual obligation of confidentiality is sufficient to create a fiduciary duty.<sup>200</sup> However, some legal scholars believe that those cases were wrongly decided, and that prior Supreme Court precedent requires something more than a mere confidentiality agreement.<sup>201</sup> These scholars believe that a confidentiality agreement is not sufficient to create a fiduciary or fiduciary-like duty to act loyally to the source of information.<sup>202</sup>

The SEC's current position is that a confidentiality agreement alone is sufficient to create the fiduciary duty necessary to support an insider trading claim. This position was recently examined in *SEC v. Cuban*.

### 3. The Mark Cuban Insider Trading Case

In *SEC v. Cuban*, the SEC brought a claim against Mark Cuban under the misappropriation theory of insider trading.<sup>203</sup> The SEC alleged that after Cuban agreed to maintain the confidentiality of a planned PIPE transaction by Mamma.com Inc., he sold his stock in the company without disclosing to Mamma.com that he intended to trade on this information.<sup>204</sup> By selling his stock, Cuban avoided substantial losses when the Mamma.com stock price declined following the public announcement of the PIPE deal.<sup>205</sup>

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<sup>199</sup> *Chestman*, 947 F.2d at 568.

<sup>200</sup> See Stephen Bainbridge, *The SEC Appeals Brief in the Mark Cuban Insider Trading Case*, PROFESSOR BAINBRIDGE.COM, Feb. 2, 2010, <http://www.professorbainbridge.com/professorbainbridge.com/2010/02/the-sec-appeals-brief-in-the-mark-cuban-insider-trading-case.html> (citing *SEC v. Talbot*, 430 F. Supp. 2d 1029 (C.D. Cal. 2006) (holding that absent an express agreement to maintain the confidentiality of information, the mere reposing of confidential information in another does not give rise to the necessary fiduciary duty)).

<sup>201</sup> See Amended Brief of Amici Curiae in Support of Defendant's Motion to Dismiss, *SEC v. Cuban*, 634 F. Supp. 2d 713 (2009) (No. 3:08-cv-02050 (SAF)), 2009 WL 1257407 ("In the context of a business relationship, a confidentiality agreement alone is insufficient to create a fiduciary or similar relationship of trust and confidence between the parties. Under both state and federal common law, a confidentiality agreement alone creates only an obligation to maintain the secrecy of the information, not a fiduciary or fiduciary-like duty to act loyally to the source of the information. In the absence of any other facts or circumstances indicating the existence of a fiduciary or similar relationship of trust and confidence, there can be no insider trading liability based on the misappropriation theory pursuant to Section 10(b)."). The friend of the court brief was submitted by the following law professors: Allen Ferrell, Greenfield Professor of Securities Law, Harvard Law School; Stephen Bainbridge, William D. Warren Professor of Law, UCLA Law School; Alan R. Bromberg, University Distinguished Professor of Law, SMU Dedman School of Law; M. Todd Henderson, Assistant Professor of Law, University of Chicago Law School; Jonathan R. Macey, Sam Harris Professor of Corporate Law, Finance, and Securities Regulation, Yale Law School; see also Bainbridge, *supra* note 200 (noting that the U.S. Supreme Court decisions in *Chiarella* and *Dirks* require more than a contract to create a fiduciary duty).

<sup>202</sup> Bainbridge, *supra* note 200.

<sup>203</sup> *Cuban*, 634 F. Supp. 2d at 717.

<sup>204</sup> *Id.* at 718.

<sup>205</sup> *Id.*

In its complaint, the SEC alleged that Cuban owned 600,000 shares of Mamma.com, approximately a 6% stake in the company.<sup>206</sup> In the spring of 2004, Mamma.com decided to raise capital through a PIPE transaction.<sup>207</sup> Once the PIPE deal was close to realization, Mamma.com's CEO decided to inform Cuban, the company's largest shareholder, of the impending deal.<sup>208</sup> The CEO prefaced his phone call with Cuban by informing him that he was about to share confidential information with him.<sup>209</sup> Cuban agreed to keep the information confidential.<sup>210</sup> The CEO, relying on Cuban's promise to keep the information confidential, proceeded to inform Cuban of the PIPE deal.<sup>211</sup>

Cuban was angry upon receiving the news and said he did not like PIPE offerings because they "dilute existing shareholders."<sup>212</sup> Several hours later, Mamma.com's CEO sent Cuban an e-mail with the contact information of the investment bank conducting the PIPE deal.<sup>213</sup> Cuban contacted the investment bank's sales representative who supplied Cuban with confidential information about the transaction.<sup>214</sup> One minute after ending his call with the sales representative, Cuban called his broker and ordered him to sell all 600,000 of his Mamma.com shares.<sup>215</sup> Some of his shares were sold in afterhours trading on June 28, 2004.<sup>216</sup> The remainder of Cuban's shares was sold during normal trading hours on June 29, 2004.<sup>217</sup> After the market closed on June 29, 2004, the PIPE deal was announced to the public.<sup>218</sup>

Mamma.com's stock price opened at a substantially lower price on June 30, 2004, and the stock price continued to decline for several days.<sup>219</sup> "Cuban avoided losses in excess of \$750,000 by selling his shares prior to the public announcement."<sup>220</sup> After the sale, Cuban filed a required disclosure statement with the SEC and stated that he had sold his shares because of the company's PIPE transaction.<sup>221</sup> The SEC responded by bringing an enforcement action against Cuban.<sup>222</sup>

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<sup>206</sup> *Id.* at 717.

<sup>207</sup> *Id.*

<sup>208</sup> *Id.*

<sup>209</sup> *Id.*

<sup>210</sup> *Id.*

<sup>211</sup> *Cuban*, 634 F. Supp. 2d at 717.

<sup>212</sup> *Id.*

<sup>213</sup> *Id.* at 718.

<sup>214</sup> *Id.*

<sup>215</sup> *Id.*

<sup>216</sup> *Id.*

<sup>217</sup> *Cuban*, 634 F. Supp. 2d at 718.

<sup>218</sup> *Id.*

<sup>219</sup> *Id.*

<sup>220</sup> *Id.*

<sup>221</sup> *Id.*

<sup>222</sup> *Cuban*, 634 F. Supp. 2d at 718.



Cuban moved to dismiss the SEC's complaint under Federal Rule of Civil Procedure 12(b)(6) for failure to state a claim upon which relief can be granted, and under Rule 9(b) for failing to plead fraud with particularity.<sup>223</sup> Cuban argued that the SEC's complaint only alleged that he had entered into a confidentiality agreement with Mamma.com, and that such an agreement is not sufficient by itself to establish a claim under the misappropriation theory, "because the agreement must arise in the context of a preexisting fiduciary or fiduciary-like relationship, or create a relationship that bears all the hallmarks of a traditional fiduciary relationship."<sup>224</sup> "[T]he facts pleaded [did] not demonstrate that he had such a relationship with Mamma.com."<sup>225</sup>

In *Cuban*, the district court properly analyzed the fiduciary duty issue: it dismissed the SEC's claim and concluded that the SEC did not adequately allege that Cuban entered into an agreement sufficient to create the fiduciary duty necessary to establish liability under the misappropriation theory.<sup>226</sup> The court concluded "that a duty sufficient to support liability under the misappropriation theory can arise by agreement absent a preexisting fiduciary or fiduciary-like relationship."<sup>227</sup> However, the court also concluded that the agreement "must consist of more than an express or implied promise merely to keep information confidential."<sup>228</sup>

In *Cuban*, the district court correctly concluded that to create a duty sufficient to support liability under the misappropriation theory, an agreement must "impose on the party who receives the information the legal duty to refrain from trading on or otherwise using the information for personal gain."<sup>229</sup> Furthermore, the district court illustrated why a confidentiality agreement is not sufficient in distinguishing non-use and confidentiality:

A person who receives material, nonpublic information may in fact preserve the confidentiality of that information while simultaneously using it for his own gain. Indeed, the nature of insider trading is such that one who trades on material, nonpublic information refrains from disclosing that information to the other party to the securities transaction. To do so would compromise his advantageous position.<sup>230</sup>

The district court concluded that Mamma.com's agreement did not require Cuban to abstain from trading on the information of the impending PIPE deal; the agreement only required Cuban to keep the information confidential.<sup>231</sup> Consequently, the district court correctly dismissed the insider trading charges against Mark Cuban.

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<sup>223</sup> *Id.*

<sup>224</sup> *Id.*

<sup>225</sup> *Id.*

<sup>226</sup> *Id.* at 731.

<sup>227</sup> *Id.* at 725.

<sup>228</sup> *Id.*

<sup>229</sup> *Id.*

<sup>230</sup> *Id.* UCLA Law School Professor Stephen Bainbridge points out that this use/confidentiality distinction has long been emphasized in legal scholarship but is something that courts have often ignored. See Bainbridge, *supra* note 201; see also BAINBRIDGE, *supra* note 184.

<sup>231</sup> *Cuban*, 634 F. Supp. 2d at 727-28.

Unfortunately, the Fifth Circuit Court of Appeals declined to reach the district court's broad holdings regarding insider trading.<sup>232</sup> The Fifth Circuit should have affirmed the decision of the *Cuban* district court that an agreement can support an insider trading claim under the misappropriation theory only if the agreement includes both a duty of confidentiality and a duty of non-use. Affirming the district court's decision would have added certainty, and alleviated the fiduciary duty problem which one commentator stated "burdens the Commission, courts, and market players because determining if an investor is in such a relationship is difficult given the present state of the securities laws."<sup>233</sup>

Instead of providing guidance for investors seeking to understand PIPE investor insider trading actions, the Fifth Circuit avoided the most complex insider trading issues.<sup>234</sup> The Fifth Circuit reversed the district court's dismissal of the insider trading charges on the narrow ground that it disagreed with the district court's reading of the complaint.<sup>235</sup> The Fifth Circuit remanded the case to the district court for further proceedings without reaching its holdings regarding the necessity of a fiduciary duty in an insider trading complaint based on the misappropriation theory.<sup>236</sup>

### *B. Ignored Benefits and Overstated Risks of PIPEs*

The SEC's aggressive enforcement ignores the benefits and overstates the risks associated with PIPE financing. The SEC's aggressive enforcement is flawed because it: ignores the disappearance of death spiral PIPEs from the American marketplace; assumes a causal connection between PIPE transactions and injury to PIPE issuer shareholders; ignores the benefits of PIPE financing; and ignores other remedies available for PIPE issuers and PIPE issuer shareholders.

Death spiral PIPE deals played a major role in the early negative perception of PIPE financing.<sup>237</sup> The disastrous results of early death spirals contributed to the SEC's aggressive enforcement of PIPEs.<sup>238</sup> The SEC feared that death spiral PIPE financing presented PIPE investors with the temptation "to engage in manipulative short selling of the issuer's stock in order to receive more shares at the time of conversion."<sup>239</sup> The SEC's aggressive enforcement stance was more reasonable in the context of a PIPE market that included death spiral PIPEs. The SEC, however, has failed to acknowledge the disappearance of death spiral PIPEs in the current American marketplace.

The SEC's current aggressive enforcement stance, in the context of a PIPE market that does not include death spiral PIPEs, is less reasonable. Relying on questionable legal arguments may have been more justified when PIPE issuers and PIPE issuer investors were experiencing the catastrophic losses of early death spiral PIPEs. But that justification no longer exists, and the SEC should consider this point in examining its aggressive

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<sup>232</sup> SEC v. Cuban, 620 F.3d 551, 552 (5th Cir. 2010).

<sup>233</sup> Capeci, *supra* note 177, at 806.

<sup>234</sup> *Cuban*, 620 F.3d at 555.

<sup>235</sup> *Id.* at 556-57.

<sup>236</sup> *Id.* at 558.

<sup>237</sup> Steinberg & Obi, *supra* note 1, at 24.

<sup>238</sup> See generally SECURITIES & EXCHANGE COMMISSION, *supra* note 88 (explaining this aggressive enforcement).

<sup>239</sup> *Id.*

enforcement of PIPEs. The absence of death spiral PIPEs, however, is not the only positive development in the recent PIPE financing market.

The PIPE market has evolved over the last ten years, and many of PIPE financing's developments have been positive. PIPE financing has become more institutionalized.<sup>240</sup> PIPEs now attract "an extremely diverse group of professional investors, ranging from Warren Buffet's Berkshire Hathaway to traditional mutual fund investors and numerous hedge funds pursuing an arbitrage or deep value investment platform."<sup>241</sup> Legal scholars recognize that the PIPE financing market has evolved into a mainstream financing alternative that is here to stay.<sup>242</sup> This increased institutionalization of PIPE financing is another factor that should persuade the SEC that its aggressive enforcement of PIPE investors is no longer helpful.

Furthermore, the SEC's aggressive enforcement of PIPE investors incorrectly assumes a causal connection between PIPE transactions and injury to PIPE issuers. PIPE issuers often perform poorly subsequent to a PIPE transaction, but this is not surprising considering the distressed state of most PIPE issuers.<sup>243</sup> PIPE issuers have weak cash flow and poorly performing stocks prior to engaging in PIPE deals.<sup>244</sup> More than half of PIPE issuers will run out of cash within a year, unless they receive additional financing.<sup>245</sup> PIPE issuers were already performing badly prior to PIPE deals; thus, PIPE financing should not be blamed when PIPE issuers continue to perform badly.

Moreover, the SEC's aggressive enforcement against PIPE investors ignores the benefits of PIPE financing. PIPE financing is a versatile financing option that benefits PIPE issuers, PIPE issuer shareholders, and PIPE investors.<sup>246</sup> This is not to say that PIPE financing has no weaknesses. Mark Cuban correctly pointed out that the price of existing equity shares is often diluted by a PIPE offering.<sup>247</sup> However, the SEC's aggressive enforcement against PIPE investors would make more sense if PIPE financing was a less beneficial financing tool, especially given the weak legal ground that the SEC occupies regarding its Section 5 and insider trading positions.

Without PIPE financing, many PIPE issuers would not be able to raise capital. Small public companies that have good ideas, but little cash, would most likely go out of business at a higher rate without the financing alternative that PIPE deals offer. Consequently, PIPE issuer shareholders derivatively benefit from PIPE financing because their companies have a better chance of staying in business with access to PIPE deals. PIPE financing is not a magic pill that can cure all of the problems of PIPE issuers. However, it

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<sup>240</sup> Steinberg & Obi, *supra* note 1, at 25 ("PIPEs today have expanded to include more established issuers who seek to benefit from the efficiency and cost effectiveness that PIPEs bring to the table.").

<sup>241</sup> DRESNER & KIM, *supra* note 1, at 205.

<sup>242</sup> See Steinberg & Obi, *supra* note 1, at 47 ("PIPE as a financing structural alternative is becoming a mainstay in the investment community [that continues] to offer suitable issuers the opportunity to raise capital efficiently while providing investors with a versatile investment tool that seeks to maximize financial returns.").

<sup>243</sup> Sjostrom, *supra* note 9, at 387.

<sup>244</sup> *Id.*

<sup>245</sup> *Id.* at 386.

<sup>246</sup> See Steinberg & Obi, *supra* note 1, at 47.

<sup>247</sup> See SEC v. Cuban, 634 F. Supp. 2d 713, 717 (2009)

can give PIPE issuers a fighting chance to survive long enough to bring good ideas to market.

Moreover, PIPE financing benefits “a diverse group of professional investors ranging from Warren Buffett’s Berkshire Hathaway to traditional mutual fund investors and numerous hedge funds pursuing an arbitrage or deep value investment platform.”<sup>248</sup> The participation of such sophisticated investors benefits all market participants by adding liquidity to the marketplace by buying and selling assets against market sentiment.<sup>249</sup>

Lastly, the SEC’s aggressive enforcement of PIPE investors ignores other remedies like private litigation that are available to unsatisfied PIPE issuers and PIPE issuer shareholders. In fact, PIPE issuers have already brought the following types of causes of action against PIPE investors: common law fraud, breach of contract, civil conspiracy, and federal racketeering violations.<sup>250</sup> Fraudulent inducement claims generally involve allegations that the PIPE investor made material misrepresentations or omitted material facts in negotiating the purchase agreement.<sup>251</sup> PIPE issuers have not experienced much success against PIPE investors,<sup>252</sup> but the existence of these private lawsuits demonstrates that there are ways to enforce PIPE issuer rights besides SEC enforcement actions.

## V. CONCLUSION

The SEC’s aggressive enforcement against PIPE financing is misguided. The SEC’s positions on PIPE investor short sales are especially troubling because the positions are based on flawed legal reasoning, and because PIPE financing is a good thing. Small public companies that are desperate for cash need PIPE financing. In many cases, PIPE financing is the only financing alternative these companies have. PIPE financing has become a mainstream financing tool that is too popular to disappear.

Nevertheless, the issues related to PIPE investor short sales are far from settled. The Fifth Circuit Court of Appeals missed an opportunity to add clarity on the insider trading issue by affirming the trial court’s conclusion that an agreement can support a misappropriation insider trading claim only if the agreement includes both a duty of confidentiality and non-use. Additionally, the Section 5 unregistered securities issue will likely continue to cause confusion, until an appellate court has the opportunity to decide the issue.

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<sup>248</sup> DRESNER & KIM, *supra* note 1, at 205.

<sup>249</sup> See REPORT OF THE PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, *Hedge Funds, Leverage and the Lesson of Long-Term Capital Management* 11 (1999), available at <http://www.mfainfo.org/images/pdf/PWG1999.pdf>.

<sup>250</sup> DRESNER & KIM, *supra* note 1, at 188 (noting “both ‘death spiral’ and ‘naked shorting’ lawsuits allege that the defendants engaged in illegal market manipulation designed to lower the price of the issuer’s stock by short selling. Whereas death spiral lawsuits target the holders of future-priced securities, naked short lawsuits target the broker-dealers, placement agents, and market makers in the issuers’ stock.”).

<sup>251</sup> *Id.*

<sup>252</sup> *Id.*