

BLOOMBERG CORPORATE LAW JOURNAL

VOL. 2

WINTER 2007

NO. 1

CORPORATE

PIPE TRANSACTIONS IN ITALIAN COMPANIES

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PIPE (private investment in public entities) transactions are an increasingly common way for American public companies to raise money on a faster and less expensive timeline than traditional public offerings. Although there are many variations, the original and most “standard” is a sale by the issuer of common stock in a private placement (usually in reliance upon Regulation D of the Securities Act of 1933, as amended) to a small set of institutional or professional investors, at a discount to recent trading prices, often with warrants to purchase additional shares, and an obligation by the issuer to file a registration statement (most commonly on Form S-3) with the Securities and Exchange Commission registering the resale of the common stock and warrant shares. This avoids the time required for filing a registration statement regarding a primary public offering by the issuer, while also offering some reasonable liquidity for the investors.

Companies incorporated outside of the United States have increasingly listed their securities, typically represented by American Depositary Shares (ADSs), on United States trading markets in order to better gain access to American investors. In addition, American private equity funds and other professional investors have recently explored investments in foreign companies as a means to diversify their investment portfolios.

However, often such foreign companies’ local corporate laws differ from commonly accepted American corporate law. As an example, Italian corporate law has numerous differences from the corporate laws of most American states. These differences require a slower and more complex corporate authorization process for a PIPE offering by an Italian com-

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pany than American investors expect. The purpose of this article is to highlight the main steps for a PIPE offering by an Italian company and differences from such an offering by an American company such that American investors can adjust their expectations to the actual process.

INCREASE OF AUTHORIZED SHARES

Italian companies do not have the same concept of “authorized but unissued” shares as American companies. Normally the company’s bylaws must be amended at an extraordinary shareholders’ meeting to provide for a capital increase for shares for a specific transaction. Note that the authorized capital is reflected in the bylaws rather than the certificate of incorporation, as is usual for an American company. Calling a shareholder meeting for a public company is a long process that usually takes several months, and so substantially undermines many of the advantages of a PIPE transaction.

One alternative is that, rather than meeting separately every time the issuer proposes to consummate an equity offering, the shareholders can instead meet one time to amend the bylaws to delegate the power to provide for capital increases, up to a specified amount, to the board of directors for a maximum of five years from the shareholder meeting. In that case, the board of directors must meet to approve the capital increase for each particular transaction, but board meetings would be required in any event and can be called much more quickly than a shareholder meeting.

However, regardless of whether the capital increase is approved at a shareholders’ meeting or a board meeting, the process of authorizing the capital increase takes a certain minimum amount of time that is longer than the time that would normally be required by an American company to authorize a transaction. The board of directors must first meet and approve a board report regarding the capital increase, which must specify the proposed purchase price. The board must “justify” the proposed purchase price. Typically the board report references the book value of the company (called “net worth” for Italian companies), the recent trading prices of the company’s securities or ADSs and, in some cases, a valuation report of an independent third party appraiser (even if the securities or ADSs are publicly traded). Unlike an American PIPE transaction, Italian law does not simply allow the board to negotiate a price with the investors in good faith.

In addition, most Italian companies have a separate advisory board called a board of statutory auditors. These essentially are either lawyers or accountants whose role is to verify that the company complies with applicable law and its bylaws. The board of statutory auditors must review the board report and issue an opinion stating whether it agrees with the proposed issuance price.

If the authority to increase the capital has been delegated by the shareholders to the board of directors, then at least fifteen days after the issuance of the board report, the board of directors must meet a second

time to actually approve the capital increase. Further complicating this process is the fact that Italian boards of directors may not approve actions by a written consent in lieu of a meeting; they must actually meet, although teleconferences are usually allowed. Additionally, the bylaws specify a call period before the board meeting, which usually cannot be waived. A typical call period is about one week, and two days for an “emergency” meeting.

If that authority has not been delegated to the board of directors, then at least thirty days after the issuance of the board report, the shareholders must hold an extraordinary meeting to approve the capital increase. In either case, the meeting must be attended by an Italian notary public. An Italian notary public (not to be confused with an American notary) is a specially qualified attorney who confirms that certain major transactions are in compliance with applicable Italian law and the company’s bylaws. In particular, the notary must attend director and shareholder meetings at which the bylaws are amended. The notary drafts both the minutes of the meetings and the bylaws. At that point, the company has duly authorized shares and executes the subscription materials; closing often occurs a few days later to allow for international wire transfers and deliveries of the securities.

The important lesson to be learned from this process is that the company must have a final purchase price more than two weeks (and more than a month in the case of a shareholder approved capital increase) before signing the subscription agreement. This is contrary to the typical process for an American company of finalizing pricing very shortly before signing – often the day before.

PRE-EMPTIVE RIGHTS

Italian shareholders are guaranteed pre-emptive rights, proportionate to their current percentage ownership of outstanding shares of the company, for new issuances of shares that are paid for in cash. Statutory pre-emptive rights are much more common in many European countries than in most American states, and reflect a cultural priority of protecting current shareholders against potential dilution rather than maximizing a company’s flexibility in raising capital to the eventual potential benefit of all shareholders. Italian companies that are listed on Italian trading markets have some limited exceptions for offerings of shares (essentially for offerings of up to ten percent of outstanding shares at market price), but those exceptions currently do not appear to apply to Italian companies listed only on American or other non-Italian trading markets.

Compliance with the pre-emptive rights means a public offering by the company of the shares to its current holders (which would need to be registered as a primary offering by the company under a registration statement if in the United States), at a specified proposed price, for a minimum of thirty days, only after which, to the degree not subscribed by the current shareholders, could the company sell the shares to the PIPE

investors. Essentially, the company would need to conduct a public offering and then, to the degree not subscribed, be able to consummate a subsequent PIPE offering. Few potential PIPE investors would agree to a transaction on these terms.

As an alternative, the company can “exclude” the pre-emptive rights if doing so is “in the interest of the company.” While black-letter law on the limits of the meaning of “in the interest of the company” is scarce, Italian practitioners usually view this to mean that the proposed new investors must be able to provide some benefit to the company beyond the money they would pay for the shares. One of the most common justifications is that the investor is in the same industry as the issuer or has specialized experience in investing in companies in the same industry as the issuer, such that the investor could provide strategic advice and input to the issuer beyond its role as a shareholder. The fact that complying with the pre-emptive rights would not be likely to result in a successful offering or that excluding pre-emptive rights would result in a faster offering on better terms for the issuer are not usually considered sufficient justifications. Rather, the company must be able to demonstrate that the investor is quantitatively different than the existing shareholders.

If the company wishes to exclude the pre-emptive rights for a PIPE offering, the board of directors must explain, on a case-by-case basis for each proposed investor, why it feels the exclusion is justified for such investor in the board report relating to the capital increase. If the shareholders approve the capital increase, then they also vote upon the exclusion of the pre-emptive rights at the same extraordinary shareholders meeting that authorizes the capital increase. If the board of directors approves the capital increase, then it similarly approves the exclusion of the pre-emptive rights at the second board meeting that authorizes the capital increase.

The lesson to be learned from this is that the company needs to have the exact name of each proposed recipient, the number of shares to be issued to each recipient and information from each investor about its industry classification (in the case of an entity) or other investment experience in the board report, which must be issued more than two weeks before it can increase the capital and thus consummate the PIPE, and more than one month when the exclusion of the pre-emptive rights and increase of capital is approved at a shareholders meeting. This is contrary to the typical process for an American company of finalizing the investor list, like pricing, very shortly before signing—often the day before. In addition, investors may need to provide more information to the company about their industry experience than they normally would. Essentially, the company and the investors must negotiate and agree to the final price of the shares and final investor list and allocation, and then wait for more than two weeks before they can consummate the PIPE.

WARRANTS

PIPE transactions often include warrants to purchase additional shares, usually at a premium to the purchase price of the PIPE shares and exercisable beginning six months after the consummation of the PIPE, as an additional incentive for the PIPE investor. For an American company, issuing warrants involves little more than checking to make sure that enough authorized but unissued shares exist and obtaining board approval (typically at the same time that the board authorizes the issuance of the PIPE shares and approves PIPE transaction as a whole).

For an Italian company to authorize such warrant shares, it must approve a capital increase and exclude the pre-emptive rights for these warrant shares, which is done at the same time and in the same manner as the capital increase and exclusion of the pre-emptive rights for the PIPE shares. However, Italian warrants have restrictions that are not typical for PIPE warrants issued by American companies, including the following.

No Cashless Exercise or Non-Cash Payment for Warrant Shares

PIPE warrants for American companies often allow a “cashless exercise,” which means that the warrant holder can elect to forfeit some of its warrant shares as payment of the exercise price, so that the warrant holder does not have to come up with cash to pay the exercise price. Another common provision of American PIPE warrants is to allow payment of the exercise price by delivery of other outstanding shares held by the warrant holder. A third common provision of American PIPE warrants is to allow payment by delivery of a promissory note. None of these payment methods are allowed for PIPE warrants in Italian companies. Rather, all shares of Italian companies, including warrant shares, must be paid for in cash.

“Net Worth” Floor for Warrant Exercise Price

Italian companies cannot sell shares, including warrant shares, for a price lower than the book value (called “net worth”) of the company at the time of the capital increase relating to those shares. The board usually references the net worth, expressed in Euros, in the board report regarding the capital increase. American investors typically want warrants issued with the exercise price stated in dollars. In that case, the warrants must have a floor in Euros equal to the net worth of the company at the time of the capital increase. This means that if the exchange rate between dollars and Euros changed to such a degree that, on the date of exercise, the dollar exercise price no longer equaled the Euro net worth, the dollar exercise price would have to increase to the degree necessary to meet the Euro net worth floor. Effectively, American investors need to be aware of the exchange rate risk if the net worth and exercise price are close in amount.

Five Year Term or Less in Some Cases

Many American PIPE warrants begin to be exercisable six months after issuance and terminate five years after exercisability, and so have a total term of five and a half years. This is not possible for Italian PIPE warrants in the case of companies whose shareholders have delegated the power to affect a capital increase to the board of directors. Under Italian law, the shares related to any such capital increase must be issued within five years of the date of the shareholders meeting that delegated the power to the board of directors. That means that warrants issued pursuant to that board authority must expire no later than five years after the date of the shareholder's resolution approving the relevant capital increase. Often the board meeting authorizing the capital increase for the PIPE will take place months or even years after the shareholders' meeting, which case the maximum term of the warrants will be less than five years.

CONCLUSION

Investments in foreign companies, especially European companies, have become an attractive way to diversify portfolios for many American private equity funds and professional investors. PIPEs in Italian companies can be done with many of the advantages of a PIPE in an American company, in that the timetable is shorter than a public primary offering by the company, is often on better terms and has reasonable liquidity. American investors need to understand, however, that Italian companies are governed by a different set of corporate laws from American companies that reflect different priorities.

As a result, American investors should be aware of the fact that in a PIPE transaction in an Italian company, compared to a similar transaction in an American company: (a) the transaction may take longer to consummate, including a minimum of more than two weeks between the finalization of the pricing and investor list and allocation and closing, (b) the investor may be asked to present more information about itself (in order to exclude the pre-emptive rights), and (c) the warrants may have less value, given that their exercise price must be paid in cash and the term may be shorter.