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

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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 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 have ignored the benefits and exaggerated 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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Introduction

Company X is a small public company with a promising idea. 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.¹ PIPE deals also have the potential for superior returns and other contractual features that enhance the investment’s overall security.²

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

¹ 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 (2008); see also STEVEN DRESNER & E. KURT KIM, *PIPES 100* (Updated Ed. 2006); Michael Macchiarola, *Get Shorty: Toward Resurrecting the SEC’s Ill-Fated Pursuit of PIPE Arbitrageurs*, 4 VA. L. & BUS. REV. 1 (2009); 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 (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.”).

² Steinberg & Obi, *supra* note 1, at 7.

³ *Id.* at 24.

⁴ *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 (2004) (noting that PIPE issuers “tend to be small, thinly-traded, and (most importantly) desperate for cash”).

⁵ Steinberg & Obi, *supra* note 1, at 25.

The tremendous growth in PIPE transactions evidences the popularity of PIPE deals.⁶ The number of PIPE deals increased from around 300 in 1996 to over 1200 in 2007.⁷ 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 1996.⁸ In the last 10 years companies raised more than \$100 billion using PIPE transactions.⁹

The Securities and Exchange Commission (“SEC”) has increased its regulatory oversight of PIPE transactions as they have become more popular.¹⁰ 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.¹¹ Some commentators believe the SEC’s fears of investor injury have 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.¹²

Consequently, the SEC has increased its enforcement actions in the PIPE transaction context.¹³ Many PIPE enforcement actions focus on the rules

⁶ DRESNER & KIM, *supra* note 1, at 11.

⁷ Na Dai, *The Rise of the PIPE Market* (2009) available at <http://ssrn.com/abstract=1350950>. For up-to-date statistics, see Sagient Research Systems, Inc., General Market Stats—All PIPEs, at <http://www.sagientresearch.com/pt/GStats.cfm?Type=6>.

⁸ Dai, *supra* note 7.

⁹ 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* (2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1139887; see also William K. Sjoström, Jr., *PIPEs*, 2 ENTREPRENEURIAL BUS. L.J. 381, 408 (2007). A seasoned equity offering consists of an issuer selling shares of common stock at a market discount to a syndicate of underwriters; the underwriters quickly resell the securities to the general public. *Id.* 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. *Id.* See also Dai, *supra* note 7 (noting that in 2007 there were 377 seasoned equity offerings that collectively raised \$75 billion).

¹⁰ Steinberg & Obi, *supra* note 1, at 32; Sjoström, *supra* note 9, 382-83.

¹¹ Steinberg & Obi, *supra* note 1, at 32; Sjoström, *supra* note 9, 382-83.

¹² Steinberg & Obi, *supra* note 1, at 32; Sjoström, *supra* note 9, 382-83.

¹³ DRESNER & KIM, *supra* note 1, at 189. See SEC v. Rhino Advisors, Inc., Civ. Action No. 03 CIV 1310 (RO) (S.D.N.Y. 2003) (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); Complaint, *SEC v. Spiegel, Inc.*, No. 03C-1685, 2003 U.S. Dist. Lexis 17933 at 6 (N.D. IL 2003), available at <http://www.sec.gov/litigation/complaints/comp18020.htm>; SEC v. Shane, Litigation Release No. 19227,

governing short sales by PIPE investors.¹⁴ 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.¹⁵

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. That may soon change. Recently the SEC filed a high-profile appeal in the Fifth Circuit Court of Appeals.¹⁶ This appeal will examine whether investors who trade on knowledge of an impending PIPE transaction are guilty of insider trading.¹⁷ This appeal will draw a lot of attention because the defendant is Mark Cuban, the controversial owner of the National Basketball Association's Dallas Mavericks.¹⁸

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 to PIPE issuers, PIPE issuer 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.¹⁹ These articles have ignored the benefits and exaggerated the risks associated with PIPE

2005 SEC LEXIS 1158 (May 18, 2005); SEC v. Langley Partners, SEC Litigation Release No. 19,607 (March 14, 2006), available at <http://www.sec.gov/litigation/litreleases/lr19607.htm>; Complaint, SEC v. Mangan, 598 F. Supp. 2d 731 (W.D.N.C. 2008); SEC v. Mangan, SEC Litigation Release No. 19955 (Dec. 28, 2006), available at <http://www.sec.gov/litigation/litreleases/2006/lr19955.htm>.

¹⁴ Jeffrey T. Hartlin, *Despite Recent Setbacks in the Courts, the SEC Remains Focused on Short Sales in PIPE Transactions*, 37 SEC. REG. L.J., issue 2, article 3 (2009).

¹⁵ *Id.*

¹⁶ SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Texas 2009).

¹⁷ *Id.*

¹⁸ See [nba.com](http://www.nba.com), *Mark Cuban Biography*, available at http://www.nba.com/mavericks/news/cuban_bio000329.html.

¹⁹ See George Majoros, Jr., *The Development of "PIPEs" in Today's Private Equity Market*, 51 Case W. Res. L. Rev 493 (2001) (taking a largely negative view of PIPE deals, focusing largely on the "disastrous results" early PIPE deals produced); Lerner, *supra* note 1, at 655 (concluding that

financing. This article makes the case for PIPE financing by fully considering its benefits and risks.

I. 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.”²⁰ PIPE stands for Private Investment in Public Equity, and PIPE transactions can be understood by examining its acronym’s components.²¹ First, PIPEs are *privately* negotiated transactions between a narrow group of investors and a public company.²² Second, PIPEs involve direct *investments* in companies.²³ Third, PIPEs are used by *public* companies to raise capital.²⁴ Fourth, PIPEs involve the sale of *equity* or equity-linked investments.²⁵

PIPE transactions involve a two step process that combines features of a private placement transaction with features of a registered public offering.²⁶ 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

the SEC should expand disclosure rules covering death spiral PIPE investors, particularly in the context of short sales); Knepper, *supra* note 1, at 359 (concluding that some private death spiral litigation is warranted because PIPE investors who sell short damage PIPE issuers and “innocent investors.”); Macchiarola, *supra* note 1, at 1 (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 Sjostrom, *supra* note 9, 407 (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 1 (concluding that issuers and investors must both proceed with PIPEs in strategic manner given the uncertainty engendered by recent regulatory developments).

²⁰ Steinberg & Obi, *supra* note 1, at 20.

²¹ DRESNER & KIM, *supra* note 1, at 2.

²² *Id.*

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

²⁶ Steinberg & Obi, *supra* note 1, at 20.

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 is 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.²⁷

B. Overview of Federal Securities Law Compliance Issues

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

Section 5 of the Securities Act of 1933 governs registered public offerings.²⁸ Section 5 makes it illegal for any person to sell securities unless a registration statement is filed with the Securities and Exchange Act and effective.²⁹ 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.³⁰ Second, the resale of the securities after the private offering triggers Section 5's requirements.³¹

Registration under Section 5 is both complicated and expensive.³² Section 5's registration expense creates an incentive for businesses like Company X to utilize exemptions to the registration requirement.³³ Section 5 exemptions allow issuers like Company X to sell securities without filing a registration statement.³⁴ A number of exemptions are particularly relevant to PIPEs, and perhaps the most relevant exemption is the Section 4(2) private placement exemption.³⁵

²⁷ Steinberg, *supra* note 1, at 21.

²⁸ *Id.* at 6-7.

²⁹ *Id.*

³⁰ DRESNER & KIM, *supra* note 1, at 78.

³¹ *Id.*

³² Steinberg & Obi, *supra* note 1, at 1.

³³ *Id.* at 1.

³⁴ *Id.*

³⁵ Macchiarola, *supra* note 1, at 7.

1. Private Placement Compliance

PIPE transactions start with a private placement transaction.³⁶ The private placement exemption states that all “transactions by an issuer not involving a public offering,” are not subject to the Section 5 registration requirement.³⁷ Section 4(2)’s exemption’s purpose is to excuse sales when there is either no need for registration or when the benefits of registration are too attenuated.³⁸ 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.³⁹ Consequently, issuers have sometimes relied on ambiguous judicial and administrative interpretations to ascertain compliance with the private placement exemption.⁴⁰

The most often cited judicial interpretation of the private placement exemption is the United States Supreme Court’s decision in *SEC v. Ralston Purina*.⁴¹ In *Ralston Purina* the United States 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 exemption is whether the offerees are able to “fend for themselves” thus making registration unnecessary.⁴²

Ralston Purina and later lower court decisions have explained several factors in determining how to apply the private placement exception including: “1) the number of offerees and their relationships to each other and to the issuer; 2) the manner of the offering; 3) the offerees’ sophistication and expertise; 4) the nature and type of information provided to offerees either directly or indirectly; and 5) the precautions employed by the issuer to prevent the resale of the underlying securities.”⁴³ However, it is difficult for issuers to determine, even using these factors, whether the Section 4(2) private placement applies to some

³⁶ *Id.*

³⁷ *Id.* at 12; *see also* DRESNER & KIM, *supra* note 1, at 78-79.

³⁸ Steinberg & Obi, *supra* note 1, at 12; *see also* DRESNER & KIM, *supra* note 1, at 78.

³⁹ Steinberg & Obi, *supra* note 1, at 12.

⁴⁰ *Id.*

⁴¹ Steinberg & Obi, *supra* note 1, at 12; *S.E.C. v. Ralston Purina Co.* 346 U.S. 119 (1953).

⁴² Steinberg & Obi, *supra* note 1, at 12.

⁴³ *Id.* at 13.

private placements. Accordingly, the Rule 506 (of Regulation D) safe harbor has become the primary exemption used in PIPE offerings.⁴⁴

Rule 506 serves as a Section 4(2) private placement exemption safe harbor.⁴⁵ Compliance with the Rule 506 safe harbor is not difficult or complicated. An offering qualifies for the Section 4(2) private placement exemption if an issuer satisfies Rule 506's requirements.⁴⁶ 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.⁴⁷ However, an investor's failure to satisfy Regulation D does not preclude the investor from relying on Section 4(2).⁴⁸

Applying Rule 506 is different than applying Section 4(2). Section 4(2) focuses on offerees; Rule 506 generally focuses on purchasers.⁴⁹ Rule 506 prohibits more than thirty-five non-accredited purchasers, and allows an unlimited number of accredited investors.⁵⁰

⁴⁴ 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 SEC in 1982 to "provide issuers with greater certainty than reliance on the Section 4(2) exception.").

⁴⁵ Steinberg & Obi, *supra* note 1, at 17; Sjostrom, *supra* note 9, at 391 (noting "if a private offering complies with the with the conditions specified in Rule 506, the offering will be deemed exempt under Section 4(2)).

⁴⁶ Steinberg & Obi, *supra* note 1, at 18.

⁴⁷ DRESNER & KIM, *supra* note 1, at 80.

⁴⁸ *Id.*

⁴⁹ Steinberg & Obi, *supra* note 1, at 18.

⁵⁰ *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. An employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of \$5 million; 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 a sophisticated person makes. *See* Rule 501(a) of the 1933 Act, 17 C.F.R. § 230.501(a) (defining "accredited investor"); *see also* S.E.C. v. Ralston Purina Co. 346 U.S. 119 (1953) (touchstone of private offering

As PIPE investors in a Rule 506 offering are typically all accredited investors, Rule 506 compliance problems are rare in PIPE deals.⁵¹ 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.⁵² The only SEC filing required in a Rule 506 offering is a nine page Form D that discusses basic information about the offering.⁵³ The Form D must be filed within fifteen days after the first sale of securities.⁵⁴ 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.⁵⁵

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.⁵⁶ 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.⁵⁷

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.⁵⁸ Most PIPE transactions register using Form S-3.⁵⁹ Form S-3 uses a condensed reporting form that allows issuers to incorporate required information

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

⁵¹ Steinberg & Obi, *supra* note 1, at 18.

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ Sjostrom, *supra* note 9, at 393.

⁵⁶ Sjostrom, *supra* note 9, at 393; Macchiarola, *supra* note 1, at 8.

⁵⁷ Macchiarola, *supra* note 1, at 8.

⁵⁸ *Id.*

⁵⁹ Sjostrom, *supra* note 9, at 393.

by reference information contained in the company's quarterly and annual reports.⁶⁰ Form S-3 is used in most PIPE transactions because it is less time consuming and expensive than other registration forms.⁶¹ 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.⁶² Integration's purpose is to prevent issuers from structuring a single offering into multiple offerings to avoid the Securities Act's registration requirement.⁶³ 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.⁶⁴ Consequently, each purchaser in the offering has a right to rescind the transaction.⁶⁵ Integration is relevant to PIPE transactions because PIPEs involve two distinct offerings: the private offering followed by a public offering.⁶⁶ Fortunately for PIPE investors, integration is seldom an issue in PIPE transactions because of Securities Act Rule 152.⁶⁷

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.⁶⁸ Therefore, integration will not be an issue in PIPE transactions provided the private offering complies with a Section 5 registration exemption and the issuer completes the offering before the filing of the registration statement.⁶⁹

⁶⁰ *Id.*

⁶¹ *Id.*

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

⁶³ Sjostrom, Jr., *supra* note 9, at 395.

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.* at 396

⁶⁹ Stephen Graham, *Financing Alternatives for Public Companies*, 1704 PLI/Corp 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").

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.”⁷⁰ 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.⁷¹ Some traditional PIPEs also involve selling convertible preferred stock.⁷²

2. Structured PIPEs

Structured PIPEs typically utilize preferred stock or debt securities that are convertible into the company’s common stock.⁷³ An investor’s obligations in a structured PIPE are often contingent upon a registration statement covering the securities being declared effective by the SEC.⁷⁴ Structured PIPE closings are

⁷⁰ Steinberg & Obi, *supra* note 1, at 21-22; see also Graham, *supra* note 69, at 379 (2008).

⁷¹ Steinberg & Obi, *supra* note 1, at 1; see also Dresner & Kim, *supra* note 1, at 100. The basic terms of a traditional PIPE include the following: 1) standard representations and warranties that must be brought down at closing; 2) delivery to the placement agent of a comfort letter and legal opinions; 3) before an investor obtains unlegended stock certificates, delivery by the investor to the issuer and the transfer agent of a certificate as to the investor’s compliance with the prospectus delivery requirement; 4) closing conditions limited to (a) no occurrence of any material adverse change between execution and closing, and (b) the SEC’s willingness to declare effective the resale registration statement.

⁷² *Id.*

⁷³ Steinberg & Obi, *supra* note 1, at 1; see also Dresner & Kim, *supra* note 1, at 105. The standard terms of structured PIPE transaction include the following: 1) A private placement is made to selected accredited investors; 2) Investors commit to purchase securities at a fixed price or at a variable/reset rate; 3) For transactions involving variable/reset pricing parameters – which may include a cap on the number of shares that may be issued; 4) The purchase agreement generally contains a limitation on blackout periods; 5) Promptly following execution of purchase agreements with investors, the transaction funds and closes; 6) The issuer files a resale registration statement covering resales from time to time of securities sold in the transaction; 7) The issuer may be obligated to make penalty payments if it fails to meet any registration statement deadline; 8) Investors are named in the resale registration statement as “selling stockholders”; 9) The resale registration statement is kept effective until securities may be sold under Rule 144(k).

⁷⁴ Steinberg & Obi, *supra* note 1, at 1; see also Graham, *supra* note 69, at 379-80.

generally delayed until the registration statement is effective. This feature allows PIPE investors to walk away from the transaction if registration does not occur.⁷⁵

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.⁷⁶ Accordingly, one commentator stated that structured PIPE investors "do not assume price risk during the pendency of the resale registration statement."⁷⁷ Consequently, a structured PIPE is often more advantageous for PIPE investors than for PIPE issuers.⁷⁸ 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."⁷⁹ In a death spiral the PIPE issuer sells the PIPE investor convertible debt.⁸⁰ When PIPE investors convert debt into equity this creates more shares, and dilutes the share price.⁸¹ This creates an incentive for PIPE investors to convert more debt because the lower price allows the investor to receive more shares.⁸² Further conversions cause more price drops as the supply of shares increases; as the process repeats itself the stock's price decreases.⁸³ Downward price pressures in death spirals are often exacerbated by short selling, and the process creates a vicious circle, the "death spiral."

"Death" applies because issuer stocks often performed poorly subsequent to consummating the PIPE transaction. In fact, many early death spiral structured PIPE issuer shareholders experienced catastrophic losses subsequent to

⁷⁵ Steinberg & Obi, *supra* note 1, at 1.

⁷⁶ *Id.* at 23.

⁷⁷ Sjostrom, Jr., *supra* note 9, at 384-85.

⁷⁸ Steinberg & Obi, *supra* note 1, at 24.

⁷⁹ See Steinberg & Obi, *supra* note 1, at 24; see also Knepper, *supra* note 4, at 360 (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); Steinberg & Obi, *supra* note 1, at 24; For basic definition of "death spiral" see Investopedia, *death spiral*, available at <http://www.investopedia.com/terms/d/deathspiral.asp>.

⁸⁰ See Steinberg & Obi, *supra* note 1, at 24.

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.*

consummating the PIPE deal.⁸⁴ Consequently, a significant amount of early scholarly articles on PIPE financing discussed how to deal with the death spiral problem.⁸⁵ 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.⁸⁶ 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.”⁸⁷ Director Newkirk’s comment was made in the context of a death spiral litigation settlement, and 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.”⁸⁸

However, the injuries associated with death spiral PIPEs no longer exist in American Securities markets. Industry leaders,⁸⁹ news outlets,⁹⁰ investment commentators,⁹¹ financial scholars,⁹² and members of SEC advisory committees⁹³

⁸⁴ See Knepper, *supra* note 4, at 360.

⁸⁵ See Lerner, *supra* note 1, at 655; see also Knepper, *supra* note 4, at 359; see also Majoros, *supra* note 19, at 493.

⁸⁶ See generally Lerner, *supra* note 1, at 655.

⁸⁷ SEC settlement with Rhino Advisors, Thomas Badian, Available at: <http://www.sec.gov/news/press/2003-26.htm>

⁸⁸ *Id.*

⁸⁹ Telephone Interview with Colin Lancaster, President & Chief Operating Officer, Stark Investments (November 24, 2009) (noting death spiral PIPEs no longer occur in the United States, but do occur in other parts of the world).

⁹⁰ See Erik Krusch, *Corporate Finance: PIPEs, RDOs and ELFs Driving Liquidity*, Westlaw Business Currents, November 6, 2009. Available at 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.”).

⁹¹ See Mary Moore, *PIPE financing sheds off bad rap and sluggish activity*, Boston Business Journal, November 9, 2007 – available at: <http://boston.bizjournals.com/boston/stories/2007/11/12/focus4.html>.

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;⁹⁴ 2) increased SEC scrutiny, particularly in screening PIPE registrations;⁹⁵ or 3) greater awareness and appreciation among PIPE issuers of the risks associated with death spiral PIPEs.⁹⁶ Why death spirals are no longer used in the United States is not

(“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.”)

⁹² 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); Katrina Ellis, *Are PIPEs a Bet on Growth Options?*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1030970 (“Death spiral PIPEs are rarely used”).

⁹³ See David Feldman, Record of Proceedings, SEC Advisory Committee on Smaller Public Companies (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.”).

⁹⁴ Steinberg & Obi, *supra* note 1, at 24 (Terrible effects of death spirals led to innovative solutions from private and public sectors which led to disappearance of death spirals); see also Brian Overstreet, President of Sagient Research Systems, 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).

⁹⁵ See Laura Anthony, *The Demise of the Death Spiral – SEC Interpretation of Rule 415*, available at <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.”); See also Krusch, *supra*, note 90 (“The Securities and Exchange Commission (SEC) killed off the PIPE death spiral earlier this decade through pointed comment letters and enforcement actions.”); See Moore, *supra*, note 91 (Noting death spirals non-existence is due to “tightening by the Securities and Exchange Commission.”); see also John P. Cleary, *Clogging the PIPEs: The SEC Cracks Down on “Death Spiral” Convertibles*, available at <http://www.procopio.com/assets/011/6442.pdf> (“As a result of the SEC’s stance on Rule 415, most “death spiral” convertibles have either been converted to traditional PIPEs or aborted.”).

⁹⁶ See Alan L. Beller, Director, Division of Corporation Finance, SEC Investor Summit (May 10, 2002). 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

important. 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.

II. Benefits of PIPE Transactions

Current PIPE transactions include different benefits for PIPE issuers and PIPE investors, and thus this article will discuss 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 other advantages over traditional capital formation options.⁹⁷ For example, PIPE financing requires lower transaction expenses, less public disclosure requirements, less preparation, and less time than traditional capital formation options.⁹⁸

PIPE issuers like Company X generally have no other financing alternatives to PIPE financing. Most PIPE issuers are small public companies.⁹⁹ Although some PIPE issuers may have an idea that may eventually generate tremendous wealth, PIPE issuers typically have small market capitalizations, weak cash flow and poor performing stocks.¹⁰⁰ Some PIPE issuers are “in high-growth or research-intensive businesses and have a continuing need for cash.”¹⁰¹ Most PIPE issuers will run out of cash within a year without additional financing; therefore traditional financing is generally not an option.¹⁰² Few investment banks are willing to loan PIPE issuers like Company X money, and often PIPE issuers lack the upside potential to attract traditional private equity financing.¹⁰³

PIPE financing requires lower transaction expenses than other financing alternatives. For example, the cost of conducting a registered offering pursuant

Beller also noted increased disclosure rules would likely decrease the amount of death spiral convertibles in the future. Available at: <http://www.sec.gov/investor/summit/summit051002.htm>.

⁹⁷ Sjostrom, *supra* note 9, at 386.

⁹⁸ DRESNER & KIM, *supra* note 1, at 100.

⁹⁹ Sjostrom, *supra* note 9, at 386; DRESNER & KIM, *supra* note 1, at 66-67.

¹⁰⁰ Sjostrom, *supra* note 9, at 386; DRESNER & KIM, *supra* note 1, at 66-67.

¹⁰¹ DRESNER & KIM, *supra* note 1, at 66.

¹⁰² Sjostrom, Jr., *supra* note 9, at 386-87.

¹⁰³ *Id.* at 387.

to the Securities Act is frequently substantial.¹⁰⁴ “The 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.”¹⁰⁵ 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.¹⁰⁶

Further, PIPE financing requires less preparation than other financing alternatives because PIPE financing has less public disclosure requirements.¹⁰⁷ The disclosures required in preparing a public offering registration statement are detailed and complex, and the document’s length can be massive.¹⁰⁸ PIPE transactions, on the other hand, are commonly closed “within seven to ten days of receiving definitive purchase commitments whereas a traditional equity offering can take from three to nine months.”¹⁰⁹ 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.¹¹⁰

Finally, PIPE financing carries potential long term benefits for PIPE issuer shareholders. PIPE issuer shareholders derivatively enjoy the benefits PIPE issuers enjoy. PIPE deals make it more likely PIPE issuers like Company X will get their ideas to market, and PIPE issuer shareholders thus benefit. Conversely, if Company X is unable to locate financing and later goes out of business its shareholders will lose their investment. Accordingly, the potential benefits PIPE issuer shareholders enjoy are generally associated with the increased likelihood that the PIPE issuer will stay in business.

¹⁰⁴ DRESNER & KIM, *supra* note 1, at 100; MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW § 3.01 (4th ed. 2007).

¹⁰⁵ Steinberg, & Obi, *supra* note 1, at 38-39.

¹⁰⁶ Lerner, *supra* note 1, at 1.

¹⁰⁷ DRESNER & KIM, *supra* note 1, at 100.

¹⁰⁸ *Id.*

¹⁰⁹ Sjoström, *supra* note 9, at 381; (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).

¹¹⁰ Sjoström, *supra* note 9, at 381.

B. Benefits to PIPE Investors

Hedge funds are the biggest investor in PIPE transactions.¹¹¹ 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.¹¹² 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.¹¹³ Hedge funds are also not financial market players such as underwriters, market makers, or broker-dealers that are specifically regulated by other federal legislation.¹¹⁴ 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.¹¹⁵ When hedge funds avoid SEC regulation it is not the result of dishonest behavior, but instead 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.”¹¹⁶

Hedge funds invest in PIPE transactions because PIPE transactions offer investors 1) more liquidity than private placements,¹¹⁷ 2) greater security than private placements and traditional equity offerings,¹¹⁸ and 3) superior returns compared to private placements and traditional equity offerings.¹¹⁹

First, PIPE transactions offer investors more liquidity than private placements.¹²⁰ 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

¹¹¹ DRESNER & KIM, *supra* note 1, at 68; Sjostrom, *supra* note 9, at 382.

¹¹² Erik J. Greupner, *Hedge Funds are Down-Market: A Call for Increased Regulation?*, 40 SAN DIEGO L.REV. 1555, 1558-59 (2003).

¹¹³ Dale A. Oesterle, *Regulating Hedge Funds*, 1 ENTREPRENEURIAL BUS. L.J. 1, 7 (2006).

¹¹⁴ *Id.* at 4.

¹¹⁵ *Id.*

¹¹⁶ Troy Paredes, *On the Decision to Regulate Hedge Funds: The SEC’s Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 976 (2006);

¹¹⁷ Steinberg & Obi, *supra* note 1, at 20-21.

¹¹⁸ *See generally* Lerner, *supra* note 1, at 656.

¹¹⁹ Sjostrom, *supra* note 9, at 382, 387-88 (PIPE deals earn hedge funds market beating returns).

¹²⁰ 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.”).

the registration statement is declared effective PIPE investors have the option of selling PIPE shares in the public market.¹²¹ Consequently, PIPE deals allow investors a cost effective exit to their investment.¹²² PIPE investors often include penalty provisions “requiring an issuer to make payments if the resale registration statement fails to become effective within prescribed time periods.”¹²³

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. PIPE investors purchase issuer stock or securities convertible into stock at a discount of market prices; and PIPE investors hedge their investment by selling short the PIPE issuer stock.¹²⁴ On one hand, PIPE investors purchase issuer stock or securities convertible into stock at a discount of market prices.¹²⁵ In fact, the discount provided to PIPE investors is “more advantageous than the discount generally applicable in a pure private placement transaction.”¹²⁶ 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.¹²⁷ 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.¹²⁸ 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.¹²⁹ Conversely, investors lose money on short sales when the stock price rises.¹³⁰ PIPE investor short sales insure against possible decreases in the value of PIPE issuer stock.

¹²¹ Macchiarola, *supra* note 1, at 8.

¹²² See Graham, *supra* note 69, at 369.

¹²³ Macchiarola, *supra* note 1, at 9.

¹²⁴ *Id.*; see Steinberg & Obi, *supra* note 1, at 21; Sjostrom, *supra* note 9, at 388; Alan J. Berkeley, & Erin E. Troy, *PIPEs Hedging Under Scrutiny*, SP038 ALI-ABA 597, 599-600 (2009); see also Graham *supra* note 69, at 377-78.

¹²⁵ Macchiarola, *supra* note 1, at 9.

¹²⁶ Steinberg & Obi, *supra* note 1, at 21.

¹²⁷ Sjostrom, *supra* note 9, at 388.

¹²⁸ *Id.*

¹²⁹ *Id.*; See Brigitte Yuille, *Short Selling: What Is Short Selling?* (2010) Available at <http://www.investopedia.com/university/shortselling/shortselling1.asp>.

¹³⁰ *Id.*

Third, PIPE transactions offer investors superior returns compared to private placements and traditional equity offerings.¹³¹ Hedge funds, the primary investor in PIPEs, typically use an absolute return approach to investing.¹³² An absolute return approach to investing seeks to make money in various market environments, including declining markets.¹³³ 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.¹³⁴ 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.¹³⁵ 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 because the shares were purchased at a discounted price.¹³⁶ 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 – in that they believe in the company and will lose money in a down market even if partially hedged.¹³⁷

Nevertheless, PIPE financing can be very lucrative for PIPE investors due to PIPE issuers’ few financing options.¹³⁸ In addition to offering common stock at discounted prices to PIPE investors, PIPE issuers are usually required to offer dividends, interest, and warrants.¹³⁹ Some commentators have estimated that PIPE financing costs between 14.3% and 34.7%.¹⁴⁰ The fact that PIPE issuers often perform poorly subsequent to PIPE transactions is not surprising when one

¹³¹ Sjostrom, *supra* note 9, at 387.

¹³² *Id.*

¹³³ For an overview of the hedge fund industry by the SEC staff, see U.S. Securities and Exchange Comm’n, Implications of the Growth of Hedge Funds (2003), available at <http://www.sec.gov/news/studies/hedgelfunds0903.pdf>.

¹³⁴ Sjostrom, *supra* note 9, at 388.

¹³⁵ *Id.* at 388.

¹³⁶ *Id.*

¹³⁷ E-mail Interview with Colin Lancaster, President & Chief Operating Officer, Stark Investments (February 19, 2010).

¹³⁸ Sjostrom, *supra* note 9, at 388

¹³⁹ *Id.*

¹⁴⁰ *Id.* (citing Susan J. Chaplinsky and David Haushalter, *Financing Under Extreme Uncertainty: Contract Terms and Returns to Private Investments in Public Equity* (May 2006), available at <http://ssrn.com/abstract=907676>).

considers PIPE issuers' financially distressed state and PIPE financing's high costs.¹⁴¹

III. 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 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 PIPE investors who trade on knowledge of an impending PIPE transaction are guilty of insider trading.¹⁴² The SEC's positions on these issues do not withstand scrutiny.

Unfortunately, there are currently no appellate decisions examining the SEC positions on PIPE investor short sales. Thus, PIPE investors are left with 4 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 issuers cost of financing; or abandon the PIPE deal altogether.¹⁴³

Guidance on the issue of PIPE deal insider trading is likely forthcoming because the SEC appealed the dismissal of an insider trading claim to the Fifth Circuit Court of Appeals.¹⁴⁴ Regrettably, there is no reason to believe appellate guidance on the Section 5 unregistered sale of securities is imminent.

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 5.¹⁴⁵ The SEC's Section 5 position is misguided

¹⁴¹ *Id.*

¹⁴² Sjoström, *supra* note 9, at 400-07.

¹⁴³ 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).

¹⁴⁴ *SEC v. Cuban*, 09-10996 (filed Jan. 22, 2010). Available at: <http://www.sec.gov/litigation/briefs/2010/cubanbrief0110.pdf>.

¹⁴⁵ See, e.g., Complaint, *SEC v. Spiegel, Inc.*, No. 03C-1685, 2003 U.S. Dist. Lexis 17933 (N.D. IL 2003) at 6 available at <http://www.sec.gov/litigation/complaints/comp18020.htm>; *SEC v. Shane*, Litigation Release No. 19227, 2005 SEC LEXIS 1158 (May 18, 2005); *SEC v. Langley Partners*, SEC Litigation Release No. 19,607 (March 14, 2006), available at <http://>

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.¹⁴⁶

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.¹⁴⁷ The same prohibition applies under Section 5(c) to an offer to sell a security.¹⁴⁸ The elements of a Section 5 violation are that 1) the defendant offered to sell or sold a security; 2) 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.¹⁴⁹

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.”¹⁵⁰ Identifying the weakness of the SEC's argument requires an understanding of short sales.

The principles underlying short sales are not complicated.¹⁵¹ “A short sale is the sale of a security that the seller does not yet own (or owns but chooses not to

www.sec.gov/litigation/litreleases/lr19607.htm; Mangan Complaint, *supra* note 13, at 13, 15; see also *SEC v. Mangan*, SEC Litigation Release No. 19955 (Dec. 28, 2006), available at <http://www.sec.gov/litigation/litreleases/2006/lr19955.htm>.

¹⁴⁶ *SEC v. Mangan*, 598 F.Supp. 2d 731, 733 (W.D.N.C. 2008); *SEC v. Lyon*, 529 F.Supp. 2d 444 (S.D.N.Y. 2008); *SEC v. Berlacher*, Civil Action No. 07-3800 (E.D. Pa., Feb. 4, 2008). The arguments against the SEC's Section 5 position are well articulated in Mangan's trial brief available at *SEC v. Mangan*, 2007 WL 4901007 (W.D.N.C. 2008).

¹⁴⁷ 15 U.S.C. § 77e(a). 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.”

¹⁴⁸ 15 U.S.C. § 77e(c). 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.”

¹⁴⁹ See *SEC v. 800 America.com*, 2006 U.S. Dist. Lexis 85571, at 28 (S.D.N.Y. Nov. 28, 2006).

¹⁵⁰ Steinberg & Obi, *supra* note 1, at 33.

¹⁵¹ Knepper, *supra* note 4, at 368.

deliver).”¹⁵² A short seller borrows the securities from another party, and “delivers the borrowed security to the short-sale purchaser, thereby completing the trade.”¹⁵³ The short seller is still required to return the securities to the party that lent them. This is known as “covering” the short position.¹⁵⁴ 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.”¹⁵⁵ If the stock price increases after the short sale, the short seller will incur a loss.¹⁵⁶ 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 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.¹⁵⁷ The primary purpose of the Section 5 of the Securities Act is to protect investors by promoting full disclosure of information necessary to

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ *Id.*

¹⁵⁶ *Id.*

¹⁵⁷ Sjostrom, *supra* note 9, at 404-406. (Professor Sjostrom points out that “[t]he SEC’s position may make sense conceptually”, but “[i]t does not, however, appear to further the policy behind Section 5.”).

make informed investment decisions.¹⁵⁸ Professor Sjostrom explained 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.¹⁵⁹

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 at the time of the short sale.¹⁶⁰ 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.¹⁶¹ 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.¹⁶² 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

¹⁵⁸ *SEC v. Lybrand*, 2000 WL 913894 (S.D.N.Y. 2000); see also Macchiarola, *supra* note 1, at 1, 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.

¹⁵⁹ Sjostrom, *supra* note 9, at 406.

¹⁶⁰ Julie Spellman Sweet, *PIPEs: A Review of Key Legal Issues*, 1761 PLI/Corp. 371 (2009); *SEC v. Mangan*, 598 F. Supp. 2d 731, 733 (W.D.N.C. 2008); *SEC v. Lyon*, 529 F. Supp. 2d 444 (S.D.N.Y. 2008); *SEC v. Berlacher*, Civil Action No. 07-3800 (E.D. Pa., Feb. 4, 2008).

¹⁶¹ Macchiarola, *supra* note 1, at 23-25.

¹⁶² *Id.*

transaction.¹⁶³ Once the registration statement became effective, Mangan used the shares he purchased in the PIPE transaction to close his short position.¹⁶⁴ 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.¹⁶⁵

The SEC's argument did not prevail, and the court granted Mangan's motion to dismiss the charges.¹⁶⁶ In dismissing the unregistered securities claim, the *Mangan* 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 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.¹⁶⁷

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.¹⁶⁸ Once the registration statement became effective Lyon used the shares he purchased in the PIPE transactions to close his short positions.¹⁶⁹ 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.¹⁷⁰

¹⁶³ Complaint, *SEC v. Mangan*, No. 06-0531 (W.D.N.C. filed Dec. 28, 2006) available at <http://www.sec.gov/litigation/complaints/2006/comp19955.pdf>.

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*

¹⁶⁶ *SEC v. Mangan*, 598 F.Supp. 2d 731, 733 (W.D.N.C. 2008) (Noting that the court dismissed the Section 5 claim on October 25, 2007).

¹⁶⁷ *SEC v. Mangan*, 2007 WL 4102743 (W.D.N.C.); Sweet, *supra* note 160, at 371.

¹⁶⁸ Complaint, *SEC v. Lyon*, (S.D.N.Y. filed Dec. 12, 2006) available at <http://www.sec.gov/litigation/complaints/2006/comp19942.pdf>.

¹⁶⁹ *Id.*

¹⁷⁰ *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."¹⁷¹ 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.¹⁷² Like the *Lyon* and *Mangan* courts, the *Berlacher* court dismissed the charges related to the short sales.¹⁷³

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.¹⁷⁴ This uncertainty is highlighted by the conclusions of scholarly articles on PIPEs.¹⁷⁵ 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 is aggressively enforcing its insider trading position in the PIPE context.¹⁷⁶ This position, like the SEC's position on unregistered securities, does not withstand scrutiny.

¹⁷¹ *Lyon*, 529 F.Supp. 2d at 444.

¹⁷² Complaint, *SEC v. Berlacher*, Civil Action No. 07-3800 (E.D. Pa., Feb. 4, 2008).

¹⁷³ *SEC v. Berlacher*, Civil Action No. 07-3800 (E.D. Pa., Feb. 4, 2008) (order granting motion to dismiss in part).

¹⁷⁴ See Berkeley & Troy, *supra* note 124, at 605 (Despite setbacks, "the 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.").

¹⁷⁵ 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."); Sjostrom, *supra* note 9, at 383 ("a more measured and transparent SEC approach to PIPE regulation is in order.").

¹⁷⁶ See, e.g., *SEC v. Shane*, Litigation Release No. 19227, 2005 SEC LEXIS 1158 (May 18, 2005); *SEC v. Langley Partners*, SEC Litigation Release No. 19,607 (March 14, 2006), available at <http://www.sec.gov/litigation/litreleases/lr19607.htm>; *Mangan* Complaint, *supra* note 13, at 13, 15; see

The SEC's position on PIPE investor insider trading is wrong 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.¹⁷⁷ Additionally, reasonable arguments can be made that the SEC's position wrongly assumes 1) that knowledge of an impending PIPE transaction is always material¹⁷⁸; and 2) that information regarding an impending PIPE deal is always non-public.¹⁷⁹ This article, however, will limit its discussion to the fiduciary duty flaw in the SEC's position.

The first appellate court guidance on the issue of PIPE deal insider trading is likely forthcoming. 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.¹⁸⁰ The

also SEC v. Mangan, SEC Litigation Release No. 19955 (Dec. 28, 2006), available at <http://www.sec.gov/litigation/litreleases/2006/lr19955.htm>; Complaint, SEC v. Lyon, (S.D.N.Y. filed Dec. 12, 2006) available at <http://www.sec.gov/litigation/complaints/2006/comp19942.pdf>; Complaint, SEC v. Deephaven Capital Management, LLC, No. 1:06CV00805 (D.D.C. filed May 2, 2006) available at <http://www.sec.gov/litigation/complaints/2006/comp19683.pdf>; Complaint, SEC v. Pollet, No. 05-CV-1937 (E.D.N.Y. filed April 21, 2005) available at <http://www.sec.gov/litigation/complaints/2007/comp19984.pdf>.

¹⁷⁷ 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 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.").

¹⁷⁸ See *Basic v. Levinson*, 485 U.S. 224 (1988) (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 124, at 605 (Noting that there is little case law supporting the proposition that a company's plan to seek financing is material.).

¹⁷⁹ See Berkeley & Troy, *supra* note 124, at 599-600 (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.).

¹⁸⁰ *SEC v. Cuban*, Litigation Release No. 20810 (November 17, 2008) available at <http://www.sec.gov/litigation/litreleases/2008/lr20810.htm>.

United States District Court for the Northern District of Texas dismissed the insider trading case brought against Cuban,¹⁸¹ and the SEC recently appealed the decision to the Fifth Circuit Court of Appeals.¹⁸² Although Mark Cuban was not a PIPE investor, this case is relevant to PIPE investors because the central issue is whether trading on information of an impending PIPE deal qualifies as insider trading.

Understanding the problems with the SEC's public position requires some background on insider trading. Insider trading is trading while in possession of information that is 1) material; 2) non-public; and 3) in breach of a fiduciary duty owed to either the shareholders of the company whose shares are traded or the information's source.¹⁸³ There is no federal law or statute that expressly prohibits insider trading.¹⁸⁴ Instead, insider trading claims are brought using Section 10(b) of the Exchange Act and related judicial decisions.¹⁸⁵ The SEC's goal in pursuing insider trading is to promote market integrity and investor confidence.¹⁸⁶ The United States Supreme Court 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."¹⁸⁷

The SEC uses two insider trading theories: the classical theory; and the misappropriation theory.¹⁸⁸ According to the classical theory of insider trading a defendant violates Section 10(b) of the Exchange Act and Rule 10b-5 "when he trades while in possession of material non-public information in breach of a [fiduciary] duty owed to the shareholders of the company whose shares are

¹⁸¹ *SEC v. Cuban*, 634 F.Supp.2d at 713.

¹⁸² *SEC v. Cuban*, 09-10996 (filed Jan. 22, 2010). Available at: <http://www.sec.gov/litigation/briefs/2010/cubanbrief0110.pdf>.

¹⁸³ *United States v. Chestman*, 947 F.2d 551, 566 (2d Cir. 1991); For a thorough discussion of the history, elements and issues of insider trading see Bainbridge, Stephen M., *SECURITIES LAW: INSIDER TRADING*, (1st ed. 1999).

¹⁸⁴ Capeci, *supra* note 177, at 805.

¹⁸⁵ *Id.*; Nagy, *supra* note 177, at 1315.

¹⁸⁶ Nagy, *supra* note 177, at 1318.

¹⁸⁷ *United States v. O'Hagan*, 521 U.S. 642, 658 (1997); *See also* Nagy, *supra* note 177, at 1318; Seligman, Joel, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 *Geo. L.J.* 1083, 1115 ("The primary 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.").

¹⁸⁸ *See* Bainbridge, *supra* note 183.

traded.”¹⁸⁹ The classical theory of insider trading generally covers trading by corporate insiders, and people who may temporarily be considered corporate insiders such as attorneys, accountants, and others who temporarily become fiduciaries of the company.¹⁹⁰ “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.”¹⁹¹ This fiduciary relationship gives rise to a “duty to disclose” confidential information prior to trading.¹⁹²

According to 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.¹⁹³ 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 usually 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.¹⁹⁴

A fiduciary duty cannot be unilaterally thrust upon an individual without consent; a fiduciary duty must arise with the knowledge and consent of the person to be bound by the duty.¹⁹⁵ 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 and in the best interests of the other person.”¹⁹⁶

¹⁸⁹ *Chiarella v. United States*, 445 U.S. 222, 227-30, 100 S.Ct. 1108 (1980).

¹⁹⁰ *United States v. O’Hagan*, 521 US 642, 652 (1997); *SEC v. Dirks*, 463 US 646, 655 (1983).

¹⁹¹ *SEC v. Cuban*, 634 F. Supp.2d at 720, citing *Chiarella*, *supra* note 189 at 228.

¹⁹² *Chiarella*, *supra* note 189 at 228.

¹⁹³ *O’Hagan*, *supra* note 187 at 652.

¹⁹⁴ *Steinberg & Obi*, *supra* note 1, at 1.

¹⁹⁵ *United States v. Falcone*, 257 F.3d 226, 234 (2d Cir. 2001); *Chestman*, *supra* note 183 at 566.

¹⁹⁶ *Black’s Law Dictionary* 581 (9th Ed. 2009).

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.¹⁹⁷

Receiving information about an impending PIPE deal is insufficient, by itself, to create a fiduciary duty. At a minimum, an express contract requiring PIPE investors to keep the information confidential ought to be required 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. There is case law that suggests a contractual obligation of confidentiality is sufficient to create a fiduciary duty.¹⁹⁸ 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.¹⁹⁹ 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.²⁰⁰

¹⁹⁷ See *Walton v. Morgan Stanley & Co.*, 623 F.2d 796, 798-99 (2d Cir. 1980); see also W. Prosser, *Law of Torts* § 106 (2d ed. 1955).

¹⁹⁸ See Stephen Bainbridge, *The SEC Appeals Brief in the Mark Cuban Insider Trading Case*, available at: <http://www.professorbainbridge.com/professorbainbridge.com/2010/02/the-sec-appeals-brief-in-the-mark-cuban-insider-trading-case.html#more>; See, e.g., *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).

¹⁹⁹ See *SEC v. Cuban*, Amended Brief of Amici Curiae, 2009 WL 1257407 (N.D. Tex. 2009) (“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 <http://www.professorbainbridge.com/professorbainbridge.com/2010/02/the-sec-appeals-brief-in-the-mark-cuban-insider-trading-case.html#more> (Noting that the U.S. Supreme Court decisions in *Chiarella* and *Dirks* require more than a contract to create a fiduciary duty).

²⁰⁰ *Id.*

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

3. The Mark Cuban Insider Trading Case

In *SEC v. Cuban*, the SEC brought a claim under the misappropriation theory of insider trading.²⁰¹ 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 first disclosing to Mamma.com that he intended to trade on this information.²⁰² Cuban thus avoided substantial losses when the Mamma.com's stock price declined after the public announcement of the PIPE deal.²⁰³

The SEC's complaint alleged that Cuban owned 600,000 shares of Mamma.com, or approximately a 6% stake in the company.²⁰⁴ In the spring of 2004 Mamma.com decided to raise money through a PIPE transaction.²⁰⁵ Once the PIPE deal was close to consummation Mamma.com's CEO decided to inform Cuban, the company's largest shareholder, of the impending deal.²⁰⁶ The CEO prefaced his phone call with by informing Cuban that he was about to share confidential information with him.²⁰⁷ Cuban agreed to keep the information confidential.²⁰⁸ The CEO, relying on Cuban's promise to keep the information confidential, then proceeded to inform Cuban of the PIPE deal.²⁰⁹

Cuban was angry upon receiving the news, and said he did not like PIPE offerings because they diluted the value of existing shares.²¹⁰ Several hours later Mamma.com's CEO sent Cuban an e-mail with the contact information of the investment bank conducting the PIPE deal.²¹¹ Cuban contacted the investment

²⁰¹ *SEC v. Cuban*, 634 F.Supp. 2d at 713.

²⁰² *Id.*

²⁰³ *Id.*

²⁰⁴ *Id.*

²⁰⁵ *Id.*

²⁰⁶ *Id.*

²⁰⁷ *Id.*

²⁰⁸ *Id.*

²⁰⁹ *Id.*

²¹⁰ *Id.*

²¹¹ *Id.*

bank's sales representative who supplied Cuban with confidential information about the transaction.²¹² One minute after hanging up with the sales representative Cuban called his broker and ordered him to sell all 600,000 of his Mamma.com shares.²¹³ Some of his shares were sold in afterhours trading on June 28, 2004.²¹⁴ The remainder of Cuban's shares was sold during normal trading hours on June 29, 2004.²¹⁵ After the market closed on June 29, 2004, the PIPE transaction was announced to the public.²¹⁶

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.²¹⁷ Cuban avoided losses in excess of \$750,000 by selling his shares prior to the public announcement.²¹⁸ After the sale Cuban filed a required disclosure statement with the SEC and stated that he sold his shares because of the company's PIPE transaction.²¹⁹ The SEC responded by bringing an enforcement action against Cuban.²²⁰

Cuban moved to dismiss the SEC's complaint under Fed.R.Civ.P. 12(b)(6) for failure to state a claim on which relief could be granted, and under Fed.R.Civ.P. 9(b) for failing to plead fraud with particularity.²²¹ Cuban argued that the SEC's complaint only alleged that he entered into a confidentiality agreement with Mamma.com, and that a confidentiality 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," and the facts pleaded did not "demonstrate that he had such a relationship with Mamma.com."²²²

²¹² *Id.*

²¹³ *Id.*

²¹⁴ *Id.*

²¹⁵ *Id.*

²¹⁶ *Id.*

²¹⁷ *Id.*

²¹⁸ *Id.*

²¹⁹ *Id.*

²²⁰ *Id.*

²²¹ *Id.*

²²² *Id.*

The *Cuban* 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.²²³ 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.”²²⁴ However, the court also concluded that the agreement “must consist of more than an express or implied promise merely to keep information confidential.”²²⁵

The *Cuban* 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.”²²⁶ Furthermore the *Cuban* court illustrated why a confidentiality agreement is not sufficient by distinguishing 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.²²⁷

The *Cuban* 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. Consequently, the *Cuban* court correctly dismissed the insider trading charges against Mark Cuban.

²²³ *Id.*

²²⁴ *Id.* at 725.

²²⁵ *Id.*

²²⁶ *Id.*

²²⁷ *Id.* UCLA Law School Professor Stephen Bainbridge points out that this use/confidentiality distinction has been long emphasized in legal scholarship, but is something that courts have often ignored. See Bainbridge, *supra* note 198; see also Bainbridge, *supra* note 183.

On appeal, the Fifth Circuit Court of Appeals should affirm the decision of the *Cuban* 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 *Cuban* court's decision will add certainty, and alleviate 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 securities laws."²²⁸

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 and other positive developments; 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.²²⁹ The disastrous results of early death spirals contributed to the SEC's aggressive enforcement of PIPEs.²³⁰ 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."²³¹ 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 enforcement of PIPEs. The

²²⁸ Capeci, *supra* note 177, at 806.

²²⁹ Steinberg & Obi, *supra* note 1, at 24.

²³⁰ Securities and Exchange Commission, *SEC settlement with Rhino Advisors, Thomas Badian*, (February 27, 2003) Available at: <http://www.sec.gov/news/press/2003-26.htm>.

²³¹ *Id.*

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.²³² 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."²³³ Legal scholars recognize that the PIPE financing market has evolved into a mainstream financing alternative that is here to stay.²³⁴ 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 seems to confuse correlation and causation between PIPE transactions and injury to PIPE issuers.

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.²³⁵ PIPE issuers have weak cash flow and poorly performing stocks prior to engaging in PIPE deals.²³⁶ More than half of PIPE issuers will run out of cash within a year unless they receive additional financing.²³⁷ PIPE issuers were 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.²³⁸ This is

²³² 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.").

²³³ Dresner & Kim, *supra* note 1, at 205.

²³⁴ See Steinberg & Obi, *supra*, 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.").

²³⁵ Sjoström, *supra* note 9, at 387.

²³⁶ *Id.*

²³⁷ *Id.*

²³⁸ See Steinberg & Obi, *supra* note 1, at 47.

not to say that PIPE financing has no weaknesses. Commentators have recognized that the price of existing equity shares is often diluted by a PIPE offering. However, the SEC's aggressive enforcement against PIPE investors would make more sense if PIPE financing were a less beneficial financing tool, especially given the weak legal ground 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 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 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."²³⁹ These kinds of sophisticated investors' participation benefit all market participants by adding liquidity to the marketplace by buying and selling assets against market sentiment.²⁴⁰

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 causes of actions against PIPE investors: common law fraud, breach of contract, civil conspiracy, and federal racketeering violations.²⁴¹ Fraudulent inducement claims generally involve allegations that the PIPE investor made material misrepresentations or omitted material facts in negotiating the purchase agreement.²⁴² PIPE issuers have not experienced much success against PIPE

²³⁹ Dresner & Kim, *supra* note 1, at 205.

²⁴⁰ 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>.

²⁴¹ 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.").

²⁴² *Id.*

investors,²⁴³ but the existence of these private lawsuits demonstrates that there are ways to enforce PIPE issuer rights besides SEC enforcement actions.

IV. 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 PIPE investor short sales are far from settled. The Fifth Circuit Court of Appeals has the opportunity to begin 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. The Section 5 unregistered securities issue will likely continue to cause confusion at least until an appellate court has the opportunity to decide the issue.

²⁴³*Id.*