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MARKET UPDATE

- Hudson Bay and Iroquois are among the investors hoping to profit from the volatility of investing in patents.
- Daryl Dworkin, a key SEC witness against N.I.R. Group, doesn't have a written pact with prosecutors.
- Reverse merger law firm Carrillo Huettel was charged in a stock manipulation case. 2

DATES & DEADLINES

- A listing of important events coming up in the small cap financing market..... 4

DEALFLOW

- Baring Asia made a \$106M bid to take Ambow Education private 5
- Palmaz Scientific, a developer of nanotechnology for medical devices, raised \$23M in venture equity..... 5
- A company developing an artificial human liver got \$14.26M in venture capital financing..... 5
- Molecular diagnostics company Asuragen raised \$7.5M in venture equity financing .. 6
- SPAC Blue Wolf Mongolia agreed to merge with South American lithium miner Li3 Energy 6
- Agnico-Eagle invested \$12.7M in ATAC Resources to fund its Rockla gold project.. 7

LEGAL UPDATE

- Patent investor Marathon accused Sony, Dell, and others of infringement..... 8

REGULATORY UPDATE

- WFG Investments settled with FINRA for \$200K..... 9
- Former SPAC Universal Business has until April 15 to meet Nasdaq listing standards. 9
- The SEC granted Fuqi International another extension to respond to a Wells notice.... 10

SMALL CAP EQUITY FINANCE ACTIVITY.... 15

ISSUER INDEX..... 28

HUDSON BAY, IROQUOIS AMONG INVESTORS HOPING TO PROFIT FROM VOLATILITY OF INVESTING IN PATENTS

by Dan Lonkevich

Investors in **VirnetX Holding Corp. (VHC)** recently learned a painful lesson about the risks involved in an investment strategy that depends on the vagaries of the legal system.

The Zephyr Cove, Nev.-based company is pursuing a business strategy known as patent monetization. VirnetX says that it owns 20 U.S. and 26 international patents on technologies related to security in telecommunications. Its strategy relies on winning lawsuits or negotiating licensing agreements with companies it accuses of infringing its patents.

VirnetX is one of numerous patent monetization companies that have attracted capital in recent years from investors that focus on small cap stocks. Its investors, in the past, have included **Hudson Bay Capital Management, Heights Capital, and Cowen Group.**

VirnetX was dealt a stinging defeat on March 14 when a federal court jury in

Tyler, Texas, found that **Cisco Systems** didn't infringe on VirnetX's patents.

VirnetX shares fell \$9.92, or 28%, to \$25.75 that day, cutting about \$507 million from the company's market value. Some 9.84 million shares changed hands, almost nine times VirnetX's average daily volume.

Such swings may be a necessary risk, however, to participate in a strategy that can also bring large rewards. VirnetX shares rose 28% on a single day last November when the company won a \$368 million verdict against **Apple.**

If an investor had held VirnetX for the past four years, they would have seen its value rise to 18 times where it had started, as the company also received a \$200 million settlement from **Microsoft** in 2010.

"If you're nimble enough to get in and take advantage of the opportunity when it's there and get out before it closes, you can make some money," said Mitchell Littman, a partner with the law firm of **Littman Krooks**

Patents continued on page 13

DWORKIN, KEY SEC WITNESS AGAINST RIBOTSKY, N.I.R., SAID TO HAVE NO WRITTEN PACT WITH PROSECUTORS

Daryl Dworkin, a former analyst at **The N.I.R. Group**, has no written agreement with federal prosecutors that N.I.R.'s attorneys can use to question his credibility in a lawsuit brought by the Securities and Exchange Commission.

That's the essence of a March 18 letter from Dworkin's attorney Jonathan Marks to Magistrate Judge Gary Brown of U.S. District Court in Central Islip, N.Y., hearing the SEC's civil fraud charges against N.I.R.

Dworkin pled guilty to criminal fraud charges in 2010, acknowledging that he misled investors about the value of assets held in N.I.R.'s funds. He's expected to be a key witness as the SEC tries to show that N.I.R. and its manager Corey Ribotsky were complicit in a scheme to defraud investors.

N.I.R. continued on page 11

MARKET UPDATE

Patents *continued from front page*

in New York. "It's a hot sector. PIPE investors are trying to get in and score and they hope they know when it's time to get out."

Hudson Bay and Cowen Group, both of New York, and San Francisco-based Heights Capital participated in a \$6 million private placement of common stock and warrants by VirnetX in September 2009. The stock doubled over the next six months, tripled over the year after the PIPE, and rose sixfold over two years.

Hudson Bay, Cowen, and Heights haven't recently been listed as major shareholders of VirnetX in its public filings.

After the Cisco ruling, VirnetX said in a statement that it was disappointed. It also noted that, although the jury found no infringement by Cisco, it upheld the validity of VirnetX's patents. This may mean that its \$368 million verdict against Apple will stand pending appeal, and that its other cases against telecommunications companies **Aastra Technologies (AAH**

TO) and **NEC Corp.** will also continue.

Representatives of VirnetX didn't respond to a request for comment for this article.

Downside Protection

"These investors want volatility," said John Borer, the head of investment banking at **The Benchmark Cos.** in New York.

"You get multiple shots on goal" in the patent monetization business, said Borer, as the companies involved will file numerous infringement cases. "And the volatility, with the help of hedging, allows investors to make money both ways: when the stock is running up and when it's falling."

Volatility in the patent monetization business also may not be as intimidating to investors as volatility in other industries such as biotechnology, he said. That's because patent monetization firms don't have the upfront capital costs that biotech companies do, and can typically be run with a limited cash burn rate.

Borer said that he pitched VirnetX to arrange its 2009 PIPE when he was with his previous firm, Rodman & Renshaw. VirnetX ended up hiring **Dawson James Securities** of Boca Raton, Fla., as its placement agent.

The risk/reward is "very high for these patent investors," said Joseph Smith, a partner with the law firm of **Ellenoff Grossman & Schole**, whose previous firm Weinstein Smith advised Dawson James on VirnetX's PIPE.

Smith said he remembers that deal as "convoluted" and "completely insane," because

of the many structures the investors used to protect themselves from potential loss.

VirnetX issued 2.38 million securities, each consisting of one share and a warrant to purchase an additional share, for \$2.52 each. The price reflected an 18.5% discount to where VirnetX traded at the time. The warrants, with a 5.5-year term, had an exercise price of \$3.93.

The pricing of the PIPE also was subject to anti-dilution provisions as well as a downward reset accomplished by a set of reset warrants to purchase 2.38 million shares for \$2.52 each.

"They had 200% warrant coverage," Borer said. "That kind of stuff is pretty impressive."

Hudson Bay, which invested \$1.25 million in the VirnetX PIPE, also is an investor in at least three other publicly traded companies focused on patent enforcement: **Vringo Inc. (VRNG)**, **Spherix Inc. (SPEX)** and **Marathon Patent Group (MARA)**.

Iroquois Capital, another prominent PIPE investor, also has invested in Vringo and Spherix. Iroquois wasn't listed as an investor in VirnetX's PIPE.

Future Investments

Hudson Bay recently upped the ante on its investment in patent enforcement by setting up a new company, **Network 3 Inc.** It agreed to pay \$5 million, plus stock and a share of future patent infringement awards, to buy a portfolio of patents from **Orckit Communications (ORCT)**, a Tel Aviv, Israel-based telecommunications equipment maker.

Hudson Bay and Iroquois are also working together on another investment vehicle, similar to Network 3, to acquire patent portfolios and bring future infringement cases, a person familiar with their thinking said.

Representatives of Hudson Bay, Iroquois, Heights Capital, and Cowen Group declined to comment for this article.

In the PIPE market, Hudson Bay has invested in at least 210 transactions worth \$523.8 million since 2005. Heights Capital has invested at least \$1.03 billion in 334 PIPEs since 2001. Iroquois has invested \$498 million in 548 PIPEs since 2001, and Cowen Group invested

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MARKET UPDATE

\$1.18 billion in 263 PIPEs.

That so many prominent players in private placements by small-cap companies are becoming active in patent investing is a sign of how big they think the opportunity is. It also may be an indication that the rewards of patent investing are growing substantially at a time when the profitability of PIPEs is declining.

"Losing half a billion of market value is no fun at all," said Stuart Bressman, a partner with the law firm of **Proskauer Rose** in New York, said of the patent monetization business. "It's a risky business, but everything these funds do is risky. They're in the risk business. As long as it's a smart risk, it's probably OK. And those two funds are pretty smart."

Patent Trolls

For his part, Littman said there's probably "a limited shelf life" to the patent monetization investment opportunity.

The strategy is controversial. Many in the technology industry argue that the cost of defending frivolous lawsuits filed by patent monetization firms is holding back companies from innovating.

Companies such as **VimnetX**, which focus on licensing patents and filing infringement lawsuits rather than developing products, are often referred to as "patent trolls."

President Obama said last month, in an online town hall, that "smarter patent laws" are necessary to deal with people who "don't actually produce anything themselves" and are "just trying to leverage and hijack somebody else's idea and see if they can extort some money out of them."

Reps. Jason Chaffetz, R-Utah, and Peter DeFazio, D-Ore., introduced a bill last month that would require plaintiffs who lose patent enforcement lawsuits to pay the defendants' legal costs.

The SHIELD Act (for "Saving High-tech Innovators from Egregious Legal

Disputes") would only apply to plaintiffs who bought patents on the open market, rather than developed their own technology, and who aren't using them to create products.

It's currently pending before the House Judiciary Committee.

"There's going to be a change in the law or in the way the courts are ruling," Littman said. "We just don't know when."

In the meantime, Hudson Bay, Iroquois Capital and other patent monetizers don't seem too bothered by those who disparage them as patent trolls.

Some argue that they're providing a valuable service by defending inventors and patent holders from big companies that would infringe on their intellectual property rights, and making sure they get paid for their efforts.

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