

### **BANKRUPTCY & INSOLVENCY**

#### **Bridge Financing In A Crisis Often Pits Parties Against Each Other**

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**Adversarial and emotionally charged.** When a company reaches the point where bridge financing is required, it is already in the zone of insolvency, its survival on the line. Nevertheless, the attitudes of the participants and the atmosphere of the negotiations between company and investors can vary widely, depending on whether the need for bridge financing is a surprise or a crisis. The former arises when the company has been blindsided by macroeconomic or political events unrelated to the business itself. Since the cause of the problem is external to the company, investors and executives tend to pull together, without mutual recrimination and without undue divisiveness (although a conflict remains between the enticements required by bridge investors and the promises made to earlier investors). In stark contrast, the problems that precipitate a crisis bridge financing result from within the company itself. Beyond the inevitable fear and anxiety surrounding the need for bridge financing, blame and recrimination muddy the process. Anger, defensiveness, and stubbornness can scuttle the financing process, attorney Marc Morgenstern warns, and may force the company out of existence.

**Inside and outside each have pros and cons.** Bridge financing must happen quickly if it is to save the company, keep the employees working, continue the suppliers delivering, and prevent customers from drifting away to competitors. The longer the financial crisis drags on, the less likely it is that the company will ever recover. The whole purpose of the bridge is to tide the company over in a brief lean period so it can emerge as a viable concern, not to merely prolong its death throes. Already knowledgeable about the company, insiders can usually act more quickly than outsiders. Insiders might include existing investors, officers, directors, suppliers, customers. On the other hand, the author cautions, insiders (particularly directors) may have fiduciary duties that conflict with a bridge investor's usual enticements. Insiders may be concerned with salvaging their own reputations, seeing others as responsible for the crisis and, in turn, being perceived as at fault for the company's underlying problems. The result? Intransigent, deadlocked negotiations. Self-defeating though it may be, some participants would rather lose the company than let a negotiating adversary win a point. Outsiders have fewer such conflicts but take longer to get up to speed on due diligence and deal terms. Often they may want to use collateralized debt as a way to take over the company by calling in the collateral (e.g., intellectual property in a tech company). In any event, the deal needs to get done as quickly as possible without scaring away customers, suppliers, and employees.

**Bridge investors need special enticements.** Earlier investors may have taken on startup risks, but the company outlook was optimistic when they signed up. By the time bridge investors come along, corporate viability hangs in the balance, so they demand and receive preferences not offered to the earlier investors because their risk is much higher. Most are not content to make the riskiest investment in the company's history and then be treated like earlier or subsequent investors, who invested when the company had more solid prospects. Bridge financing typically involves collateralized debt, which is

paid ahead of existing debt. If all goes well, bridge debt should be short-term. The longer the debt goes unpaid, the author emphasizes, the less likely that it will ever be repaid. The interest rate starts out high to attract investors and often rises over time. If the events that trigger default occur, the collateral can be released automatically or at the discretion of the investor. Often the debt is convertible, but the conversion security's terms and pricing pose one of the most difficult negotiating areas. Investors prefer voluntary conversion, while companies often want mandatory conversion. Preferential pricing of warrants can offset the investors' concerns.

**Anticipate conflicts when structuring security and debt instruments.** In today's world, early investors may include not only institutions but also venture capital, hedge, private equity, and angel investors in the same financing rounds and with the same rights. These diverse investors may have different goals and strategies. In crisis financing, institutional investors that have insisted on the power to veto charter changes and shareholder rights agreements may find themselves thwarted by a single investor who digs in and refuses to agree to the changes required for bridge financing. Write original agreements, the author advises, so that unanimity is not required. Even a supermajority can pose problems in the high-stress conflicts of bridge financing. Where all or almost all investors must agree, marshalling the required votes for bridge financing can be slow or impossible to accomplish. One way to work around this problem is to have each series elect a director and then be bound by that director's vote. Using series directors also speeds up the decisionmaking process during a crisis.

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