BRIDGE FINANCINGS:
PSYCHOLOGICAL AND FINANCIAL ARCHITECTURE

By: Marc Morgenstern

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Introduction and Deal Vocabulary

"Bridge" financings for operating businesses provide companies with interim cash under dramatically different circumstances; ranging from highly positive, to relatively neutral, to extremely perilous. The common characteristics of bridge financings, and the origin of the generic term itself, is that the financing permits a business to get from one economic position or business condition to another, just as a real world bridge permits individuals to cross a river or traverse a mountain valley.

The term "bridge financing" is routinely used to describe circumstances as varied as: (1) the earliest funds provided to a business (even prior to its first formal sale of securities), (2) short-term debt intended to provide interim operating capital until a planned securities offering closes, as well as (3) capital provided begrudgingly by existing investors or voluntarily by outside investors while stakeholders ponder whether a troubled business can survive and should be saved.

Whether provided at the onset of` a venture or near the businesses' end (good or bad), bridge financings possess numerous similar financial characteristics; each functions as a monetary lubricant. Because of their commonality, there are lessons to be learned by comparing and contrasting bridge financings designed for different purposes and provided at different moments in the life of a business.

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A. Seed Financings.

The "pre-seed money" provided for some start-ups is characterized as a bridge financing because it provides a company with the capital to get from an idea or business plan to a first round of capital (usually Series A Preferred Stock).

To distinguish this from other bridge financings, this article will identify this as a "Seed Bridge." This bridge round is routinely structured as an unsecured convertible note that converts automatically into a qualifying Series A Preferred Stock but with financial characteristics that reward Seed Bridge investors for having taken the earliest investment risk. A frequently used structure is a discounted conversion price to the Series A Stock when the Seed Bridge noteholder converts. As an example, a $1.00 note purchased for $1.00 converts at a 25% discount rate so that a $1.00 seed note purchases $1.33 in the Series A round. A frequent alternative is to give the Seed Bridge noteholder low priced warrants to purchase common stock.

There are several advantages to a convertible note. The documentation is minimal, usually a relatively short note. More importantly neither the company nor the purchaser needs to negotiate and fix the company's current valuation. Because the seed note converts into Series A Preferred Stock which establishes a valuation for the company at a later time through negotiation with another investor, the most adversarial element of any securities issuance (*i.e.* negotiating price) is deferred until the Series A purchase.

Like most bridge financings, this pre-seed capital satisfies relatively short-term corporate needs (*i.e.* the time required to raise the Series A round) but does not provide sufficient cash to satisfy a growing company's ultimate (long-term) capital needs. The source of bridge money is usually founding stockholders, "friends and family," or prospective investors for the company's

Series A round (including angel investors, as well as venture funds). Because of the early stage of business development, there tends to be a shared aura of good will during the structuring and sale of the Seed Bridge. There is passion and a mutual expectation that the company's future is bright, the company will provide an elegant solution to a marketplace need, and shareholder and employee wealth will be created.

A note of caution. In some ways Seed Bridge investors are betting against themselves. The bridge capital lets the company operate and create value. As the pre-money value increases for the next round of securities, the bridge noteholders' discount is of decreasing value because the investor is converting at a discount to a higher priced security. To counter this, the parties may establish a maximum pre-money value at which conversion will occur. Otherwise there is a disincentive to success.

Negotiating the price, terms, and conditions of any security involves tension and a degree of adversarial conflict since in some ways the sale of a security is a zero sum game. Whatever economic interests the buyer acquires from a company necessarily reduces the percentage of the company owned by the existing investors. The shared expectation for a Seed Bridge, however, is that the investor's money will permit the company to grow, and total shareholder value will increase. If the aggregate "economic pie" is increasing in size (value), the game is *not* zero sum. Founders, Seed Bridge noteholders, and Series A investors can all win, with the negotiation centering on the relative sharing of future value created. There is an emotional sense of urgency associated with the capital raise because the fledgling enterprise needs to be jumpstarted, but generally there is not an atmosphere of *hysteria*.

B. Surprise Bridges.

The positive psychological and financial environment for a Seed Bridge is in sharp contrast to what I define as the "Surprise Bridge". A Surprise Bridge is required when a need for cash is unexpectedly triggered by major events largely outside the control of the company, frequently global and/or macroeconomic in nature. This happened to numerous venture-backed businesses in late 2000 when the venture and private equity marketplace melted down virtually overnight. Many promising companies were founded in 1998, 1999, and 2000, that assumed that periodic equity financings would be available at increasingly higher valuations. Founders and investors shared the same assumptions. Because of the capital crash, they were unexpectedly unable to obtain operating and growth capital despite satisfying their own business plan, internal projections, and investor expectations. The macroeconomic environment changed the venture rules for the basic capital-raising philosophy in the middle of the game.

Similarly, the September 11th terrorist attacks caused the initial public offering market to come to a virtual halt literally overnight. Many companies that had confidently filed S-1's with the SEC (believing that they had wildly succeeded and fulfilled founder and investor dreams) were plunged into survival mode when they were unable to complete their IPO at any price.

The need for Surprise Bridges will always be with us because the unexpected will continue to occur, and businesses and investors will not be able to anticipate them.

The corporate environment for Surprise Bridges may well be nervous or anxious but it is generally devoid of personal hostility, internal bickering, or finger-pointing. No management or Board could have foreseen September 11th or the numerous events through the years that are the equivalent of a financial Act of God. Businesses and investors devastated by hurricanes or the

1906 San Francisco earthquake tended to pull together to respond to the need for a Surprise Bridge. Rational analysis focused on survival and the amount of money needed rather than whose fault it was that the cash shortfall existed, and therefore whose "guilt" or "failure" should cause them to disproportionately bear the economic pain caused by the unexpected need for more capital.

C. Crisis Bridges.

Unlike a Seed Bridge or Surprise Bridge, certain bridge financings are necessitated because of microeconomic events, *i.e.*, events that occur based primarily on actions or failures of the individual business and/or management. Perhaps the company's projected cash revenues were overly optimistic; or marketing expenses and the cost of customer acquisition are stunningly higher than budgeted; or the company's accounting controls were inadequate and non-accrued expenses shockingly ballooned. No matter which specific cause gave rise to the crisis, the company is out of cash when it wasn't supposed to be. In each case it was internal action (or inaction) that resulted in flawed analysis and predictions.

These facts create "Crisis Bridges." Crisis because without an immediate cash infusion company failure is *likely*. Crisis because the Board and/or the investors have lost confidence in management's abilities or business vision. Crisis because there is an acrid emotional environment -- a mutual lack of trust has developed among management, employees, directors, investors, and vendors. Because the crisis was internally generated, a different set of psychological issues need to be resolved if there is going to be a successful and meaningful bridge financing. Crisis bridges tend to be negotiated in a highly polarized, non-cohesive, negative environment that is very different from either a Seed Bridge or Surprise Bridge financing.

D. Overall Bridge Financing Environments.

Because there is a legitimate financial crisis, emotionally-charged atmospheres are the norm for both Surprise and Crisis Bridge financings. Cash is running out in each case. But in a Crisis Bridge, management, directors, investors, and institutional and trade creditors are frustrated, unhappy, and angry for different reasons than in a Surprise Bridge. Operating expectations have not been met. Mutual blame and recrimination for the circumstances, personal hostility, and psychological and emotional denial of stark financial reality are common. Acrimony abounds. These factors significantly increase the difficulty in: (1) structuring a bridge financing, (2) actually raising the money, and (3) ensuring that success is probable. Cash alone will not solve a systemic problem. Since the definition of insanity is to expect a different result from the same stimulus, unless operations and the business model are changed no amount of money will produce a good result.

Early stage investments inherently involve significant risk. An investor's goal is to obtain an enormous reward commensurate with the risk taken. The abrupt need for a Surprise Bridge combined with the clouded and troubled operating environment for a Crisis Bridge decreases normal planning for a capital raise. This necessarily increases the risk and complicates the analytical calculus for balancing risk and reward and appropriately reflecting this balance in the price and structure of the bridge security. In the words of Bob Rawson, a "financial equipoise" must be achieved.

No one knows (or can know) whether additional capital can be raised after the bridge round, or whether the amount of the bridge round will be "sufficient." The unclear path to executing a liquidity event, and therefore a basis for valuing any security being sold now, renders all aspects of structuring and selling Surprise and Crisis Bridge investments unusually murky.

Surprise Bridges include evaluation of the financial impact of an external event on the company. Crisis Bridges involve financial and operational re-evaluation of a single business that has badly stumbled within an unchanged external environment. Crisis Bridges are the exemplar of the immortal words of Pogo, "I have met the enemy and it is us."

The pervasive and cynical venture mantra based on many painful Surprise and Crisis Bridge financings is whether the interim financing will be a "bridge" or a "pier"? Said differently, will a cash infusion create real economic value (thereby justifying the bridge capital risk) or merely elongate a company's death spiral and have the net effect of "good money" being lost while trying to rescue "bad money". If additional longer-term equity cannot be raised thereafter (or the company can't be profitably sold in the timeframe created by the bridge money), then the interim financing becomes all risk without reward; a one-way pier to financial loss rather than a bridge to a successful investment creating financial reward.

The limited size of most bridge rounds rarely permits the company to operate as originally planned or substitutes for an additional equity offering. A successful bridge, however, provides at least enough time and capital to operate under a revised (generally reduced) business plan, until either the next equity round is raised or until the company can be sold. Adequate cash may defer a larger capital raise to a later time when capital markets may improve, private equity valuations may be more favorable, or equity (at any price) becomes accessible to the company. The "right" size for a bridge provides enough funds to achieve meaningful, value-creating, results with some margin for safety. One of Morgenstern's Maxims is that "cash is a proxy for time; and time is a proxy for opportunity."

There is a critical question that should not be lost in a flurry of discussion about the price, terms, valuation, and rights of a proposed bridge financing. If the business isn't working now, what operating changes need to occur for the business to be successful?

This is a time for introspection and imagination. Pretend you're the next investor. Pretend you're a new CEO brought in right now. It's easy to focus just on cash preservation by cutting employees, stretching payables, or deferring capital expenditures. But it's much more productive to analyze not only why the business go into a Crisis, but how it should be run in the future to create real value. Every operating, sales, and customer value proposition should be re-examined. Nothing should be out-of-bounds or sacred. The ongoing role, if any, should be reviewed for founders, management, and the Board just as if the company were being re-founded at this exact moment in time.

Clearly identify the company's real value. Are all of its customers really important or only a few? Is it the team results stemming from the Research and Development department that create progress or is it really only the Chief Technology Officer? Do you have an unusually collegial relationship with a particular supplier bringing value-add to the company and the supplier, or are your suppliers fungible and only price and terms matter because the product, quality, and service are uniform? If the former, consider enhancing the relationship and truly treat the supplier as a partner. Re-imagine the business from the ground up rather than the top down. If you started the business today what is the best use of its assets? What sales channel would you pursue, which products represent the highest margins and volume potential, and what is the narrowest and most focused strategy that can be executed well to maximize the probability of success?

It is painful but productive to think of Crisis as opportunity, but great management will embrace the unique potential created by the intensity of the corporate cusp point. Raw urgency forces the Board, management, and investors to make difficult changes in operations and strategy that can sometimes be accomplished only in the politically-charged environment of a Crisis. Without pain and clear risk of loss there is frequently insufficient cohesion (or motivation) for change.

E. Psychological Perspectives: internal and external

Unsuccessful bridge financings start with investors and management asserting their existing economic and contractual rights; what they won't give up and what their previous efforts and capital entitle them to. While understandable, this reflects a naive and dangerous overreliance on history and the sanctity of documents. Denial and self-righteousness are clear recipes for failure. Company survival is tenuous and must be paramount. Without a successful bridge financing, existing stakeholders may soon own 100% of nothing. This highly probable economic reality should inevitably "trump" what contracts currently say and the entitlements that their beneficiaries assume are eternal and immutable. Consequently, all stakeholders need to display flexibility in re-structuring existing terms to the extent necessary for corporate survival. Nothing can be allowed to be sacred or a given.

The corollary is that successful bridges focus with laser intensity on the needs of the bridge investor and the future of the company. Proposed financial reward and structure must be intuitive and sufficiently persuasive to overcome the inherent investment risk. A Crisis Bridge security succeeds only if it is "seductive." Rarely is a bridge investor motivated by a "fair" or "reasonable" security. The corporate objective (frequently forgotten amidst shareholder-squabbling) should be to entice someone to provide survival capital. If the corporate imperative

of bridge structure and pricing is driven by preserving existing contractual rights, protective provisions, and capital structures, then the bridge will neither succeed nor seduce. Complexity and infighting encourages potential investors to say "no." Simplicity and cooperative resolve invites "yes."

F. Executive Summary

Terms and structures for bridge financings will vary reflecting differing goals and priorities of specific bridge investors, as well as the capital needs and operating characteristics of the company. What is consistent, however, is that successful bridge rounds satisfy certain universal needs: (1) they must be executed quickly and achieve consensus among those corporate stakeholders whose approval is required (contractually or realistically) for the bridge to occur, (2) their economic and contractual terms must be sufficiently seductive so that investors will purchase the bridge security, (3) the size of the round must permit the company to achieve meaningful goals with a reasonable margin for error, and (4) the security must be harmonious with a subsequent equity raise, sale of the business, or other exit strategy.

Because it presents the most difficult issues, both human and structural, the remainder of this article analyzes Crisis Bridge financing issues and solutions for a "typical" early-stage, venture-backed, technology company. These businesses frequently have no or minimal revenues, negative cash flow, and modest tangible or financial assets. They are financed primarily with equity and unsecured trade payables. Major assets of technology companies tend to be intellectual property, proprietary technology, talented employees, and (sometimes) an incipient or nascent customer base.

These common characteristics suggest bridge financing structures that minimize bridge investors' risk, maximize financial return, and increase the likelihood of achieving the corporate goal of survival by appropriately acknowledging the reality of the corporate circumstances. The focus in on: (1) the emotional, financial, and certain legal aspects of the Crisis Bridge, and (2) how the respective stakeholders' actions and self-interest impacts the structure and terms of the bridge security itself.

Section 1 - Speed is the Imperative

Virtually by definition, Crisis Bridge financings must be structured and sold quickly. If not, the company runs out of money and must shut down or sell its assets at firesale prices, if at all. Another of Morgenstern's Maxims is that "Time is the invisible but palpable enemy."

The bridge money must come in before key employees leave, research and development is chilled, or customers migrate to better-funded or stronger competitors. If the company's financial fragility causes the loss of employees, customers, vendor support, or research and development efforts, then its marketplace value rapidly decreases. Once unleashed, these factors create a downward Archimedes spiral that tends to feed on itself. Each loss increases the probability of the next loss while simultaneously lowering the probability of obtaining more cash or new sales. Each adverse consequence rapidly decreases the probability (and value) of corporate survival. Without a robust technology and workforce, a technology company has little to offer.

Speed is *the* imperative for a Crisis Bridge. Only financial structures that work and can be implemented quickly should be considered. Since delay can be fatal, "rough country justice"

that can be achieved to re-align the interests of current investors is preferable to a more elegant and equitable plan that can't be accomplished.

Every shareholder has a basis for saying that they didn't do anything wrong and that their liquidation preference, dividend rate, ongoing consents, and veto rights should remain unchanged. But what bridge investor or new investor would want to honor those rights? Since a Crisis Bridge is required, those paper rights are illusory as demonstrated by the failed company and economics. Rights you can't really exercise are meaningless to the current holder and dangerous for the bridge investor. The bridge investor wants to see a capital structure with no prior liquidation preferences and minimal voting rights. The investor doesn't want to walk into the emotional baggage of the past, and the possibility that emotion, rather than reason, could impact on future decision-making.

In a perfect world, the financial strategy should be simple and easily understood. The process must begin with realistically identifying potential investors, and determining the impediments (internal and external) to selling the bridge security. The critical path to closing should be clearly delineated from the outset. Different investors will dictate different strategies, structures, and timetables.

Internal obstacles are frequently found in the company's Certificate of Incorporation or Bylaws, shareholder agreements, or investor protective provisions within securities purchase agreements from prior rounds of financing. The most troublesome limitations are those that stifle the company's ability to reach unilateral agreement with a new bridge investor about price, terms, or conditions because proposed provisions require obtaining time-delaying votes or consents from existing shareholders or modifications to existing contractual rights. Most

troublesome are consents that require unanimous approval from an entire class of investors. Unanimity is always hard to achieve even in the best of circumstances. Conversely, the holders of those rights have significant internal negotiating leverage because without their consent there cannot be a bridge financing.

Familiar examples would be existing investors' rights to approve the issuance of new securities, prohibitions against debt, pre-emptive rights requiring new securities to be offered to existing investors prior to (or concurrently with) a sale to new investors, or veto rights that block the company's authority to grant security interests in the company's assets (particularly its intellectual property). Less obvious, but equally important, would be determining the impact of "ratchet" or anti-dilution provisions that run in favor of existing shareholders.

Most bridge financings for venture-backed companies require some consent from certain of the existing stakeholders. Different series of Preferred Stock frequently have separate economic rights and protections. Because obtaining consents takes time and money, the minimum number of existing investors (and/or third party consents) whose approval is required to permit certain bridge financing structures must be identified promptly. The appropriate process and strategy for obtaining consents must be reviewed. If not, then the critical path sequence may be unexpectedly blocked at an inopportune moment. Any prospective bridge investor wants the certainty of knowing that negotiated terms can be honored before committing the resources required to perform due diligence and close the deal.

Section 2- Source and Motivation for Bridge Financing: the difference between Inside Investors and Outside Investors

Bridge financing comes from two dramatically different sources: inside investors and outside investors. Their respective motivations, negotiating process and posture, and financial and legal premises differ significantly.

The most probable investors are "insiders"; those who have a pre-existing relationship with the company. They are generally more motivated than new investors. This investor class includes anyone whose economic position will be better if the company survives or is sold through an orderly process than if it doesn't. Inside investors have a different risk-reward calculus than outside investors and can best (and most quickly) assess the value proposition of a bridge security. Existing investors don't want to "lose" or jeopardize the value of their existing investment.

Less obvious but frequently important "insider" investors are employees, suppliers, or customers. Each has something to lose if the crisis is not resolved. Sometimes customers provide bridge funding if the company's failure could impair the customer's ability to provide its own goods or services because they are dependent on the company's technology. Employees want to retain their jobs. Suppliers want to profit from future sales of their goods and services and to receive payment for their current receivables. Each of these constituencies already "knows the story" at some level and is familiar with the company's management and business plans.

In sharp contrast is the outside bridge investor who has a risk-reward ratio determined solely from the financial results to be obtained from the bridge security and the economic consequences arising from an ongoing successful business. Outsiders have no existing

investment to "protect." They have no motivation to purchase the bridge security other than their own prospective investment return. Unlike the insider, they usually *don't* know the story. They are usually "hearing" the story (and performing due diligence) at a moment in time when the company's prospects and credibility are inherently suspect and management is significantly distracted.

The outside investor is handicapped by having to reach an investment decision at a rapid pace dictated by the company's shortage of cash and potential failure rather than a more measured "normal" investment pace. A new outside investor has no guarantee that the company will exist if and when the conditions precedent to investment are satisfied. This sometimes discourages potentially interested outsiders from even engaging in the investment discussion.

In addition, inside and outside investors invariably operate within different legal and emotional constraints. Major existing investors (insiders) are frequently board members. Their statutory obligation is to be a fiduciary to *all* shareholders; not just the class of securities that elected them. As directors, they are also charged with the responsibility for managing the company's affairs and exercising their duty of loyalty and duty of care.

It would not be uncommon for existing investors who are <u>*not*</u> directors to question what gave rise to the need for a Crisis Bridge financing. Was it truly unforeseeable economic circumstances (a Surprise Bridge) or did management fail (a Crisis Bridge)? If management failed, did the directors adequately discharge their board responsibilities? Did the Board's conduct satisfy the Business Judgment Rule under state law so that Directors are not subject to personal liability? Particularly post-Sarbanes-Oxley, there is heightened sensitivity to the

oversight and monitoring function played by the board, as well as the potential for Director liability; not just for public companies but private companies as well.

This intrinsic conflict is exacerbated if the Board, or a Director, proposes bridge terms that while economically appropriate to create a desirable capital structure for the bridge security, diminish the rights of existing securities holders, particularly in a way that favors one class of securities over another. An example would be to convert prior rounds of preferred stock to common stock, or to otherwise modify or eliminate the liquidation preference of one or more classes of existing securities. Responsible institutional and individual investors are also sensitive to whether their proposals are consistent with <u>being</u> a good partner. Equally importantly, will they be <u>perceived</u> as a good partner not just by this company, but also by the management and boards of their other portfolio companies and prospective portfolio companies. Their institutional brand may be at risk. These concerns don't arise for outside investors since they are *not* partners in the Crisis company.

A strong factor favoring the outside investors is their intrinsic negotiating leverage. Outside investors are free to craft investment terms that satisfy them, and only them, regardless of economic impact on existing investors. Perversely enough, the restraints (legal, financial, and emotional) on insiders sometimes results in a failure to provide bridge financing because the only terms that can be agreed to by insiders without destroying relationships may not be sufficiently seductive to justify the investment risk and/or return.

If the company rejects an offer from an outside investor, all the outsider has "lost" is an investment opportunity foregone. Unlike an inside investor they have not damaged important

relationships, impaired their ongoing ability to perform as directors, or otherwise harmed their reputation as responsible members of the venture community.

Despite legal and practical considerations, the ultimate reality is binary. Existing stakeholders will either accept the terms of a proposed bridge (no matter how onerous) and have a potential to preserve some value, or reject them and fail completely. Another Morgenstern Maxim is that "it's better to have some percentage of something than 100% of nothing."

That logical proposition to me is unassailable. But in the emotional cauldron of a Crisis Bridge financing I have observed numerous examples of financial suicide in which existing investors have acted on the premise that they'd rather fail and get nothing rather than change their rights, priorities, or percentage ownership of the company in favor of someone who "doesn't deserve them". Their view is that loss has to be borne by someone else, not them. They're not to blame and shouldn't be "punished" in a capital restructuring. They have vetoed viable financings that while unattractive were the only alternative to bankruptcies or dissolutions in which the vetoing party got nothing.

Section 3- Bridge Investments are Normally Debt Instruments

Enlightened self-interest suggests that bridge investors should seek to purchase a security with the minimum risk and the maximum reward. Since debt is repaid prior to equity, most bridge financings are designed to provide downside risk protection similar to that of a lender but with upside reward characteristics of equity. Design, negotiation, and structural attention should be focused on: (1) minimizing risk by making the bridge financing a secured loan; (2) maximizing the reward elements (*i.e.*, interest rate and equity features); and (3) providing for

mandatory convertibility and release of the collateral if specified desirable corporate transactions occur in order to facilitate a subsequent equity offering or sale of the business.

The most common bridge structure is probably convertible debt.[1] Convertible debt raises traditional debt issues such as collateral, convertibility, and priority of repayment. Interest rate, payment schedule, maturity, events of default, protective provisions, and default remedies available to the Crisis Bridge investor must all be fully and clearly addressed and documented.

Combining all of those protective debt elements with upside equity features in a single Crisis Bridge financing may create legal enforceability risks for insiders (but not outsiders) such as equitable subordination. Bankruptcy courts have the power to recharacterize debt as equity. This judicial remedy permits courts to penalize bad conduct by insiders. As a consequence, form is not allowed to prevail over substance, and debt issued to a shareholder or its affiliates may be deemed to be equity, and the investor could be subordinated to other indebtedness such as trade payables. The extent of this issue is only determinable based on the facts and circumstances of a specific transaction, and does not present an actual problem unless the cash shortage results in the Crisis company filing for bankruptcy. In this instance, the court will prioritize the relative status of claims..

Different Bridge investors will have varying degrees of risk tolerance on this and other sensitive legal issues. This article assumes that: (1) if a Bridge lender negotiates a priority security interest, the granting of collateral is neither a voidable "preference" nor does it

[1] Priority preferred stock is used in rare circumstances where balance sheet considerations dictate that the bridge money must appear as equity rather than debt to shore up the balance sheet rather than simply providing capital. A common example would be retailers who routinely provide balance sheets to their vendors and landlords and whose creditworthiness is judged, in part, by their book value or ratio of debt to equity. *See*, "Preferred Stock as a Bridge Security", infra, p. 31.

constitute a "fraudulent transfer" under federal bankruptcy rules, and (2) Director approval of the structure of the security and sale satisfies the Business Judgment Rule.

Collateral

Most early-stage technology companies lack meaningful amounts of unencumbered tangible assets (inventory, receivables, or equipment) that can be pledged to a secured bridge lender. On the other hand, they frequently have general intangibles and intellectual property of considerable (if indeterminate) value. This may include a business method patent, proprietary technology, software, a web site and domain name, or trademarks, copyrights, and databases. These assets are intangible from a legal perspective and ephemeral from a business perspective.

Ideally, the bridge financing can be structured as secured debt because debt is repaid prior to equity holders (either common stock or preferred stock). All of the cash provided in the bridge is treated as debt, evidenced by a note, and secured by the company's assets. As a matter of law, secured lenders have a priority to get repaid prior to trade creditors or unsecured lenders. Through this mechanic, a relatively simple transaction puts the bridge funding in the most protected part of the company's capital structure.

If the bridge loan can't be repaid when due (*i.e.*, the "bridge" was a "pier"), the bridge lender can exercise the legal rights of any secured lender. The lender can seize the assets, sell them in a secured party sale, and retain the proceeds to the extent of the principal and accrued interest of the loan. By satisfying legal requirements, including appropriate notice of a sale, the buyer at the sale can either be an independent third party or the secured lender itself. This flexibility permits the bridge investor to determine at a later date what the best and most strategic option is. Having the company's intellectual property as collateral gives the bridge investor

structural protection now and negotiating leverage later. To the extent that the company has any worth in a "meltdown," the secured bridge lender has gained first rights to the assets and/or the value, thereby minimizing the Bridge investor's downside risk.

Foreclosing on collateral and selling the assets is never the goal of the company although sometimes it is the goal of a bridge investor who wants to gain control of the company by purchasing its distressed debt. This alternative is more normally a component of risk minimization. The real goal of most bridge investors is to give the company sufficient cash and time to permit an additional favorable equity financing or orderly sale of the business. Subsequent equity investors (and business buyers) universally need the company's assets to be unencumbered after their transaction is completed. To harmonize the bridge investor's dual strategy (*i.e.*, minimize risk by being secured while simultaneously facilitating a subsequent financing), an effective bridge loan provides that the collateral will be automatically released in specified circumstances.

A major negotiating tension between a company and any bridge investor is what subsequent equity financing will be sufficient to mandate an automatic release of collateral by the bridge lender rather than a voluntary release.

Bridge investors want assurance that they are not giving up the downside protection of collateral unless the upside reward characteristics are relatively certain. The amount and characteristics of the subsequent equity financing are therefore critical. The minimum amount of an equity round that will cause the bridge investor to release collateral is negotiated. Usually the condition precedent to automatic release is enough equity financing to permit the successful operation of the company.

By the same token, to protect the value of its equity component, the bridge lender should not release collateral unless the pre-money value of the next equity financing exceeds negotiated minimums. Limitations on the characteristics of the next round of financing (i.e., the equity can't be quadruple participating preferred) are also common conditions to releasing collateral.

Obviously the preferred position for the bridge investor is that collateral is not automatically released. This preserves the investor's flexibility to evaluate specific future investors, the value of their investment, and make an informed decision about whether the new equity justifies changing the bridge investor's position as a secured lender.

Cash Pay-in Rate

Because of the inherent uncertainty in Crisis Bridge financings, some investors are unwilling to fund the entire amount of their aggregate commitment in a lump sum at closing. They prefer to agree to fund amounts at agreed intervals (frequently monthly) approximately equal to the projected cash burn rate. This preserves the bridge investors' ability to stop funding if: (1) the cash burn rate is significantly higher or faster than projected by the company, or (2) other adverse events occur (loss of a key customer) dimming the likelihood of the bridge having a successful conclusion.

The bridge investor's total funding commitment may also he predicated on the company continuing to meet specified goals. Common examples would be personnel reduction, obtaining new customers, or selling non-core assets to generate cash. By limiting their commitment to periodic funding, bridge investors achieve a practical, self-executing, operating discipline that no set of contractual covenants or company representations can possibly achieve. This minimizes risk because their funding commitment has limits and parameters. If the conditions precedent to

funding are not satisfied, then the investor has the right to stop funding. From a risk mitigation perspective, the bridge investors may preserve a portion of their committed bridge capital simply by never putting it at risk.

The Valuation Problem and How to Avoid It

Almost certainly the most difficult aspect of structuring a bridge financing is establishing a fixed current price or value for the bridge security based on the pre-money value of the company. By definition, Crisis Bridge financings occur during bad times for a company, and frequently for the private equity markets as a whole. One consequence is that the pre-money valuation of the company is problematical for many reasons, including that there are no marketplace "comparables". References to prices paid by investors in earlier rounds of financings under different circumstances (internal or external) are wholly irrelevant.

A key characteristic of most (though not all) bridge financings is that the security automatically converts into an equity security under agreed circumstances rather than being repaid. While there are occasional bridge financings calling for repayment from the next financing, this is hard to negotiate and more difficult to achieve. New investors want their money used exclusively to fund the company's operations and growth; not to "bail-out" existing investors by repaying their bridge debt.

Because of the uncertain environment, several approaches are commonly employed to get past the troublesome pricing variable. The easiest is that the bridge security automatically converts into the next round of financing at the same price and terms as the next security. This totally avoids any discussion of the current value of the company. The bridge investor will receive whatever security the next outside investor negotiates, presumably at a time when

valuations are more certain and the prospects of survival are greater. This occurs whether the next round of financing is a "down" round or an "up" round. The shorter the presumed time period that the bridge will exist, the more common this financial approach is.

From the bridge investor's perspective, however, this should be an unacceptable interpretation of risk and reward. The bridge investor is taking the full risk now. Their risk is greater than the next round investor no matter how soon the next round is scheduled to close. Intervening events can (and do) make even the most certain of financial transactions stumble or fall. Every experienced businessperson and lawyer has lived through a deal that never closed at the 59th minute of the 23rd hour for extraordinary, "once-in-a-lifetime," reasons. If anything, this is more likely to occur during a Crisis Bridge than almost any other capital transaction. For risk-reward financial symmetry to prevail, there must be an additional element of reward inherent in the structure or pricing of the bridge security (or both).

By convention, there are two common alternatives to increase the reward potential. The first is to provide that the bridge security automatically converts into the next round security at an agreed discount which serves as the additional reward. The steeper the discount, the greater the reward. Like other bridge mechanisms, the amount of the discount can be fixed or increase over time, as can the interest rate. Through this mechanism, each dollar risked by the bridge investor buys more of the company's equity than the next round investor's dollars. The practical problem with this, however, is that the next round investor sometimes refuses to honor this contractual provision. The next round investor is unwilling to let someone else get a better deal than they have, or otherwise has business reasons that preclude the implementation of these provisions.

There are also practical technical problems relating to liquidation preferences and dividend coverage. As an example, if the bridge, investor negotiates a 50% discount to the next round of securities, then a dollar of bridge security could effectively obtain $2.00 of liquidation preference while the next round investor in a conventional preferred stock would receive only a $1.00 liquidation preference. Similarly, if the dividend rate on the next round of securities is 10%, then the bridge investor purchasing at a 50% discount effectively receives a 20% dividend rate on the bridge investment. Most importantly, the net effect is that a cash liquidation preference is established that exceeds the cash contributed that created it.

Warrants

If the focus is on upside reward, then a more acceptable alternative is to give bridge investors warrant coverage. Each dollar of bridge investment entitles the holder to receive warrants to purchase common stock of the company at a fixed price and exercisable at any time during a fixed term. The warrant exercise price may be: (1) nominal, (2) a price that approximates current fair market value, or (3) some agreed percentage of the price ultimately paid for new preferred stock.

The usual issue in negotiating warrants is the amount of warrant coverage that the bridge investors receive *i.e.*, the number of warrants granted compared to the amount of the bridge loan. Normally there is a guaranteed *minimum* amount of warrants earned at initial funding because the investor has taken a capital risk for an unknown amount of time. This is accurate no matter how certain the company is as to the size and timing of the next closing.

A common dialogue between any company and a bridge investor is for the company to assert “Well, your money’s only going to be at risk for a short period, so there shouldn’t be much

economic reward for such a small risk." The flaw is that although the company may believe in good faith that the risk is small in amount or short in duration, universal experience suggests that it is not possible to "know" the level of risk being taken. Unfortunately, Acts of God occur. When September 1lth happened, IPO's were pulled and numerous private financings were delayed or terminated. Under those unforeseen or unforeseeable circumstances, in the best case short-term bridges became longer-term bridges. At worst, short term bridges became unrepaid losses or get forced into an equity conversion.

By the same token, the number of warrants granted usually increases each month that the next round financing has not occurred because the risk being taken by the bridge investor continues to increase. Time is not the friend of the bridge investor. Another Morgenstern Maxim is that "deals, like the universe, tend toward entropy." The intrinsic natural bias in favor of randomness and against closure is a universal constant in the deal world.

Conversely, there may be a maximum number of warrants that the bridge investor can earn to protect the other existing shareholders from limitless dilution. Warrant coverage may be better received by subsequent investors than discounted purchase prices because the impact of increased warrants amounts to a rearrangement of the capital structure among the existing shareholders prior to the next investors' purchaser. As a result, the bridge investors receive a higher percentage of the upside potential than other stockholders without impacting new investors.

New investors, particularly outside investors, understandably prefer to negotiate terms for their financings that do not involve "cramming down" or rearranging existing investor relative economic relationships because there is less negotiating friction. Warrant coverage satisfies the

need of the bridge investor for increased reward while simultaneously creating a capital raising environment that is comfortable for the next investor.

In good macroeconomic conditions, conventional terms for an early-stage Crisis Bridge might provide for a minimum of 10-20% warrant coverage, a maximum of 25-30% coverage, and granting 3-5% warrants for each month that the bridge investment remains outstanding. As an example, if a bridge lender funds one million dollars, and gets 25% warrant coverage at $2.00 per share, they are entitled to 125,000 warrants. In harsh economic environments, the cost of bridge money tends to be much higher.

While an IPO is probably not the highest issue on everyone's mind in a crisis, it should not be ignored. Care must be taken to preserve a good structural corporate environment for an initial public offering. Thus, warrants should be exercisable for a specified period of years, and expire by their terms if they are not exercised in connection with an IPO. Underwriters don't like overhanging securities whose exercise can potentially impact the number of outstanding securities and the calculation of earnings per share.

Convertibility

The remaining issue relates to the numerous aspects of the convertibility of the bridge security. Should it be automatic or voluntary? If voluntary, who has the election to force conversion, the issuer or the investor? What pre-conditions must be satisfied for the conversion to occur? Under any alternative, what new security does the bridge security convert into?

The company usually prefers that the bridge note convert automatically into the next round security, no matter what the terms of the security are, because bridge debt is transformed into equity. A prudent investor, however, may be unprepared to blindly surrender the

considerable downside protection of a secured note for the unprotected equity of the next round of securities under all circumstances. The important variables are similar to those considered earlier in this article about the conditions when collateral is automatically released by the bridge lender.

Sophisticated bridge investors recognize that all follow-on investment capital is not created equal. A bridge investor might he prepared to convert automatically into a $2 million next round of securities if the financing is led by a *venture capital* fund. By the same token, the bridge investor may not choose to mandatorily convert in the event of an *angel investor* round unless more than $2 million were raised.

Rightly or wrongly, a common perception is that unlike a group of angels a new venture investor will bring more to the company's value than simply its own capital. A venture investor adds management skills, the ability to raise or provide additional capital in the future, and the competence and leverage to negotiate a price, terms, and conditions of a security that a bridge investor would be willing to convert into. The probability of corporate success is higher and so the bridge lender is more willing to automatically accommodate the new investor.

The self-interest of the bridge investor and a subsequent venture investor are thus harmonized. Automatic conversion is, therefore, usually based on: (1) the type of investor providing the financing, (2) the minimum amount raised, and (3) the nature of the security being sold by the issuer. As an example, mandatory conversion occurs only if the new security is some form of acceptable *preferred* stock with a minimum liquidation preference, dividend rate, and senior liquidation position relative to all other preferred stock, but no automatic conversion if the new security is *common* stock.

Dual Convertibility – The Janus Note

There is an approach to structuring a bridge note providing for automatic conversion but not specifying the security into which the bridge loan converts. I created a term to describe a financial investment that I think of as a "Janus bridge financing." The Roman God Janus (for whom January is named) simultaneously looked forwards and backwards. In this scenario, the bridge note converts into whichever security is most favorable to the bridge noteholder (rather than the company) through a process based on analyzing past securities issued and future securities being issued.

If the next round is an up-round (*i.e.*, the company has a higher valuation than at the conclusion of the previous round of financing), then the bridge security converts into either: (1) an existing prior round of preferred stock with a lower pre-money value, or (2) a new preferred stock at a specified pre-money value (usually lower than the most recent round). If the next round is a down round (*i.e.*, the company has a lower valuation than the previous round of financing), then the bridge security converts automatically into the new, better security.

In effect, the bridge holder (like Janus) has the opportunity to look both forward and backward depending on which view is most advantageous to the investor. Janus Notes can provide that the noteholder (rather than the issuer) has the right to choose which security the bridge loan converts into. Pre-money valuation alone may not be the sole determinant of a better security. There are numerous variables which as a composite create advantages and disadvantages that may cause reasonable investors to disagree as to what "better" means.

The most important provision from the company's perspective is simply the fact that there is an automatic conversion which simultaneously: (1) "cleans up" its balance sheet by

eliminating the bridge debt as well as (2) causing the release of the intellectual property held as collateral by the bridge holder. Both are universal prerequisites to future equity financings.

Interest

While bridge notes always have an interest component, interest is rarely paid in cash. Because the company is cash-starved, nothing could be more self-defeating than for the bridge investor to provide Crisis Bridge funds and then receive current interest payments from the cash it just infused. Similarly, recognizing that the bridge loan has to create a seductive environment for the next investor, nothing could be less enticing to the next investor than to provide cash to be used either to repay the bridge loan or pay interest on the loan. Instead, bridge interest generally accrues, and is payable either in common stock or preferred stock of the company at the time of conversion or sale. This is sometimes referred to as payment-in-kind (PIK). The choice of cash or PIK may belong to either the noteholders or the company, depending on the negotiation.

While the interest rate is fixed, the rate frequently increases over time. This both protects and rewards the investor for the length of the risk actually taken, as well as encouraging the company to aggressively get the next funds so as to avoid ever-increasing interest cost and dilution borne as a result of a PIK feature. In many ways, both the company and bridge investor benefit from this increased time pressure to get the next round of securities sold and closed as quickly as possible.

Defaults and Remedies

In order to constitute "debt" for legal purposes, the note must be either payable on demand or contain a fixed maturity date. Bridge notes should accelerate prior to maturity under

agreed circumstances including defined events of default. Among many choices, a bridge note may accelerate: (1) on sale or change-in-control, (2) upon the failure to raise agreed equity by a specified date, or (3) if the cash burn rates or cumulative losses exceed agreed amounts.

In the event of default for failure to achieve agreed goals, remedies for the noteholder may be more limited than for an equity holder. For a bridge noteholder, customary remedies are: (1) an increased interest rate, (2) an accelerating number of warrants, or (3) a conversion rate that rewards the noteholder with more stock. Under all of the remedies, each month that the company is in default, the noteholder owns a progressively higher percentage of the company than if the company had not defaulted.

A bridge equity holder (preferred or common stock) by contrast would typically acquire the right to elect all, or at least a majority, of the Board of Directors, *i.e.*, gain control of the company and its operations on a default. In addition, a bridge equity holder would obtain "drag-along" rights or other contractual agreements requiring all other stockholders to sell their stock to any buyer to whom the bridge holder wanted to sell, *provided* that the terms of the capital structure were respected. These equity remedies are inconsistent with certain legal limitations distinguishing debt from equity.

Once a bridge note is in default, the most practical alternatives are to: (1) rapidly advance any possible sale of the company or (2) have the company surrender the collateral to the bridge noteholders, preferably voluntarily.

Failing voluntary surrender, the noteholder should exercise its remedies by foreclosing on the collateral. Once the collateral has been seized, with appropriate notice the bridge noteholders can conduct a secured party sale. Frequently the noteholder is the only bidder. If the

noteholders win the bid, they then organize a new company based on the intellectual property acquired from the old company but stripped of the baggage created by the prior financings and capital structure. This creates a fresh corporate environment to attract and retain employees and management. Although there are numerous sensitive legal impediments to this sort of corporate transition, for ease of discussion we assume that all legal requirements have been satisfied.

Sale of the business prior to a subsequent equity financing.

There is an unusual set of facts that is sometimes overlooked both by companies and investors. What happens if there is a sale of the company after completion of the bridge financing but prior to completing any subsequent financings? In this event the note does not automatically convert into an identifiable security with specific provisions because the triggering event for conversion never occurs. A convertible noteholder whose upside is limited solely to a discount to the next round, and who has no warrants, only holds a secured note with accrued interest. Since the real upside reward is the ability to convert bridge debt into equity and make an equity-type return, there must be an alternative financial reward.

To accommodate this important possibility, the bridge note may provide for both: (1) a change-of-control provision with a substantial prepayment penalty (*e.g.*, 50-100%), or (2) the right of the noteholder to voluntarily convert into a specified series of preferred or common stock, at a highly advantageous price and terms. By possessing these alternatives (*i.e.*, voluntary conversion into a known security, or a substantial rate of return arising from significant prepayment penalties), the bridge holder is protected against having provided the riskiest money invested in the company, and not having obtained any return other than principal and interest.

A distressed sale following a Crisis Bridge occurs much more frequently than many assume. When the bridge amount proves to be insufficient to create a viable company, a not uncommon strategy is to sell the company at a distressed price to a strategic buyer. The goal may be simply to: (1) avoid the public embarrassment of a shut-down, (2) preserve the maximum return under bad circumstances, and/or (3) assist employees, customers, and suppliers by providing for business continuity.

The outside world doesn't know the sale price of a private company unless it is either voluntarily disclosed or mandated because the buyer is a public company and the price exceeds disclosure thresholds. Consequently, sellers can avoid some embarrassment and damage to their reputation by issuing a press release indicating only that a sale occurred. A sale (even at a modest price) is cosmetically better than a shut-down or liquidation. It's the financial equivalent of President Nixon announcing that the U.S. won the Vietnam War and then unilaterally withdrawing. Reality isn't changed but perception may be altered.

Section 4 - Preferred Stock as a Bridge Security

While not common, preferred stock is sometimes issued to bridge holders. The effective economic terms mimic those of the secured bridge holder with a notable exception. The obvious detriment to the bridge investor is that preferred stock is equity rather than debt. Unlike debt, an equity holder cannot secure their position with collateral. In the event of a corporate collapse, equity holders receive proceeds only after payment to all of the company's creditors, secured or unsecured. This compares highly unfavorably to the payment priority and economic protection accruing to a secured bridge noteholder.

When used as a bridge security, preferred stock should have liquidation preferences senior to existing preferred stock and common stock, and conversion features that mirror convertible secured bridge notes. This can best be accomplished through purchasing a participating preferred stock. Holders of a participating preferred get back the amount of their investment (like a loan) and then they participate on an "as-converted" basis with the other equity holders.

Because preferred stock is equity, whether it is convertible preferred or participating preferred, the company's balance sheet is "cleaner" than if the bridge financing is debt. As a consequence, equity bridges may be potentially useful for Delaware corporations concerned about operating during insolvency (or potential insolvency). It may ease worries about possible limitations on Board and management actions taken when the company could be in a "Zone of Insolvency." Again, for ease of discussion, we have assumed that all corporate action is appropriate and does not violate the Board's fiduciary obligations.

Conclusion

Structuring bridge financings is an exercise in achieving capital harmony; a sort of corporate finance feng shui. The inevitable struggle is creating a security that simultaneously seduces a bridge investor, adequately balances the legitimate needs of management and existing investors, effectively addresses the downside financial risk and upside potential reward of the bridge investor, and creates an operating and financial environment that facilitates subsequent equity financings or exit strategies. Each proposed economic and operating term must be considered for its current, short-term, and long-term impact.

Olympian foresight is difficult under the best of circumstances. It is unusually problematic in the tension-fraught environments in which Crisis Bridge financings tend to be negotiated. The over-arching corporate goal of meaningful and successful survival must he kept at the forefront of every discussion, negotiation, and analysis. Speed and practicality must be emphasized, egos contained, and temper tantrums minimized. Structured correctly a bridge financing can help a company survive and prosper. Designed and executed with insufficient sensitivity, the bridge will either not be raised, or if raised, will only create a longer, but ultimately self-defeating, pier.