BUSINESS 2.0

A Young Company's Nightmare: The Cram Down

In lean economic times, getting that next round of financing can mean having to swallow hard.

By Scott Herhold, August 2001 Issue

In the lexicon of finance, few terms are simultaneously as crude and as accurate as "cram down." Get used to it. The phrase is an essential part of the vocabulary of misery and desperation in venture capital today. Briefly, it describes what happens when a company accepts painful financing terms to ensure getting funding at all. The new investors -- sometimes late-stage venture capitalists, sometimes aggressive mutual funds -- essentially take control of the company, "cramming down" the interests of earlier investors. As Marc Morgenstern, a lawyer who represents several Silicon Valley firms, puts it, earlier investors' "rights and preferences are blown away." It's not unlike mortgage lenders foreclosing on a house -- and letting you sleep on a cot in the basement next to the washing machine.

Then again, companies are sometimes willing to endure the pain. Telecom equipment maker Celox Networks is an example. When it closed its second round of financing in July 2000, the company was valued at $355 million, according to one insider. But as the telecom industry collapsed, so did Celox's promise. Before Celox completed a third round in July, its new investors, Firsthand Capital Management and Putnam Investments, valued the company at a mere $70 million. That meant that the earlier investors and employees saw their interests shrink to a fifth of their previous size. Since the money keeps the company alive, CEO Kent Mathy is grateful. "Absolutely, this was an achievement," he says.

Mathy is right, in this sense: Many companies are now in such bad shape that they can't even attract cram-down investors. If they do, the new investors often insist on particularly onerous conditions called "liquidation preferences." Such terms often dictate that if the company is taken over, or forced into bankruptcy, the new investors get paid first. And depending on the deal, they can receive triple their investment before earlier investors see a penny. Call them the crammers. The losers? The founders and previous investors, particularly those who don't participate in the new round. Call them the crammees. It's undignified -- but then, so is their plight. ✦

Scott Herhold (sherhold@sjmercury.com) is a contributing writer for Business 2.0 and a tech stocks columnist for the San Jose Mercury News.

Article Page: 1 | Next Article >

Format for Printing **E-Mail This Article** **Write to the Editor**

Recent Startup Articles

- Mayberry DSL
- What Direct Marketers Are Smoking These Days
- Brilliant Plan. Will It Work?
- The Fuel Cell, Writ Small
- Show Me the C++
- **Read More Startup Articles**

Today's Top Stories

- Dr. Atkins Is Getting Fat
- America's Stealth Boom Town
- Bechtel's Power Outage
- What's Friendster Selling?
- Streaming Software Is Here

RECOMMENDED L

- Finance
- Venture Capital