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CRISIS BRIDGE FINANCINGS — 2009

Interim financings to keep troubled companies alive pending new investment or other strategies are complex and difficult projects that must be negotiated with multiple parties in a crisis atmosphere and negative environment. The author discusses the trade-offs required of stakeholders for a successful funding and addresses the structures designed to minimize bridge investors' risk, maximize financial return, and increase likelihood of survival.

By Marc H. Morgenstern *

"Bridge" financings for operating businesses provide companies with interim cash under dramatically different circumstances. They vary from: (1) the earliest funds provided to a business (even prior to its first formal sale of securities); to (2) short-term debt intended to provide interim operating capital until a planned securities offering closes; to (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. This article focuses only on the last type of bridge financing.

VOCABULARY AND ENVIRONMENT

Elsewhere,[1] I have described two kinds of bridge financings: surprise bridges and crisis bridges. They are similar because there is an unexpected immediate need for a cash infusion. They are dissimilar, however, because the triggering event precipitating the crisis creates such a different psychological and business environment in which the bridge security must be structured and sold.

Surprise Bridges

A surprise bridge is required when a need for cash is 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 had been founded assuming that periodic equity financings would be available at increasingly higher valuations. Founders and investors shared the same assumptions.

Because of the capital crash, companies were unexpectedly unable to obtain operating and growth capital despite satisfying their own business plan, internal projections, and investor expectations. The

[1] *See* Morgenstern, *The Deal*, August 4, 2006 www.bluemesapartners.com/images/CrisisBridge8406.pdf; Morgenstern, *Bridge Financings: The Art of Venture Capital Seduction,* 2002, *available at* http://www.bluemesapartners.com/articles.html.

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macroeconomic environment changed the venture rules for the basic capital-raising philosophy in the middle of the game. Everyone was equally surprised.

During a surprise bridge structuring and sale, management, directors, and investors may have understandable emotional reactions of anxiety or panic. The atmosphere, however, is generally devoid of personal hostility, internal bickering, or finger-pointing. No management or board could have foreseen September 11th or the numerous events that are the equivalent of a financial Act of God. Shocked businesses and startled investors usually pull together. Rational analysis prevails. Stakeholders jointly focus on survival and the amount of money needed rather than looking backward to ascertain whose fault it was that the cash shortfall existed. No scapegoat is sought whose "guilt" should cause them to disproportionately bear economic pain caused by the unexpected need for more capital.

Crisis Bridges

Unlike a 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, the cost of customer acquisition stunningly higher than budgeted, or accounting controls were inadequate and non-accrued expenses ballooned. No matter which specific cause gave rise to the crisis, the company is out of cash when that wasn't the shared expectation of the investors. Internal action (or inaction) resulted in flawed analysis and predictions and created an unexpected crisis.

When the precipitating event lies *within* the company, then a "crisis bridge" is necessitated. *Crisis* because without an immediate cash infusion corporate failure is *likely*. *Crisis* because the Board and/or the investors have lost confidence in management's forecasting and execution abilities. *Crisis* because there is an acrid emotional environment.

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, stakeholders are angry. Expectations have not been met. Mutual blame and recrimination, hostility, and psychological and emotional denial of stark financial reality are common. Crisis bridges are negotiated in a highly polarized, divisive, and negative environment unlike other bridge financings.

These factors cumulatively decrease the chances of structuring a bridge financing, raising the money, and ensuring business and financial success. Additional cash alone will not solve a systemic problem that led to a crisis bridge although it may for a surprise bridge. Unless operations and the business model are changed during a crisis bridge, money alone cannot produce a successful company. The definition of insanity is to expect a different result from the same stimulus.

The 2009 Environment

What is occurring on a global basis has sharply blurred the never-clear lines between a surprise bridge and a crisis bridge. Unforeseen macroeconomic events have occurred. Staggering financial losses have been incurred across virtually every asset class. This reality has sharply reduced the financial capacity of high net worth investors and venture funds alike, as well as their investment and risk appetites. Under these circumstances, it is hard to tell whether a company's cash crisis is the consequence of macroeconomic events, or microeconomic circumstances, or a combination of both.

This meltdown is compounded by overwhelming and paralyzing fear. Businesses and investors are afraid. Few purport to understand *what* has happened or *why* it happened. As net worth has decreased so has a sense of self-worth and self-confidence. No one feels confident predicting what the near-term or longer-term future is for themselves, their business, their investment portfolio, or the capital markets.

In the reality of 2009, whatever anyone thought they knew about bridge financing is still accurate to the extent that the same financial tools and variables are involved. The perceived risk/reward ratio for investments, however, has swung so unprecedentedly to

the risk side of the equation that creating a correlative reward for bridge investors has become hard to impossible.

Financial equipoise is never easy to achieve. Bridge terms that formerly were seen as good or even "seductive" may be inadequate when investors prefer the certainty of cash to any investment. Witness negative returns on Treasury bills.

To reach *beyond* seductive and to secure financing, companies may need to offer bridge terms tantamount to "pay-to-play" provisions. These financings are so harsh that any current stakeholder who fails to participate is essentially washed out.

If existing stakeholders do not want, or are unable to participate, then their motivation is steeply reduced to waive contractual rights, vote in favor of charter changes, or take any other actions that are a condition precedent to a bridge financing. Without their cooperation, it may be impossible to build a bridge and the business will collapse.

This is an environment in which venture-backed companies may survive while angel-backed businesses may fail. In a venture-backed company there are fewer investors with larger stakes. Funds are more like-minded than high net worth investors, and generally have the financial *ability* to participate. Institutions are less influenced by differing emotional and financial decision-making processes than individual investors. It is immeasurably easier to negotiate trade-offs and terms with three venture funds than with 45 high net worth investors. Of course, there may be enormous variation even among venture funds depending on the respective funds' life cycle, liquidity, and willingness and ability to commit scarce human and financial resources to a single portfolio company.

RISK AND REWARD – IS IT A BRIDGE OR A PIER?

Venture capital investments inherently involve significant risk. The venture investor's goal is to obtain a commensurate reward. The lack of planning time and the clouded operating environment complicates the analytical calculus for balancing risk and reward and appropriately reflecting them in the price and structure of the bridge security. No one knows (or can know) whether additional capital can be raised, and if the amount will be "sufficient." The exit for bridge investments is unusually murky.

Historically, the well-known venture mantra asks whether an 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. If additional equity cannot be raised (or the company cannot be profitably sold in the timeframe created by the bridge), then the interim financing becomes all risk without reward.

Most bridge rounds are comparatively small and do not permit the company to operate as originally planned nor substitute for an additional equity offering. A successful bridge, however, provides at least enough time and capital to operate under a hurriedly revised business plan. Adequate cash may defer raising capital until capital markets improve, private equity valuations are more favorable, or equity (at any price) becomes available. The "right" size for a bridge provides enough money to achieve meaningful, value-creating, results with margin for safety. One of my maxims is that "cash is a proxy for time; and time is a proxy for opportunity."[2]

A critical question should be posed even during the flurried emphasis on the price and source of bridge money. If the business is not working now, as evidenced by the need for a crisis bridge, what operating changes need to occur for the business to be successful?

The natural reaction is to focus on cash preservation by cutting employees, stretching payables, or deferring capital expenditures. It is much more productive, however, to analyze how the company should operate to create real value in a changed environment. Every operating, sales, and customer value proposition should be reexamined. No topic can be out of bounds. If a new CEO came in today to start the business with a blank piece of paper, what would the CEO do? The board should help management to refocus the business from the ground up rather than simply chopping from the top down. Cost-cutting and re-imagination should be complementary, not competing, corporate drills.

It is painful but productive to think of crisis as opportunity. Great management will seize the unique potential created by the intensity of the corporate cusp point. The CEO must embrace the crisis. If radical change is required, then the CEO must be its evangelical leader. Raw urgency forces the board, management, and investors to make difficult changes in operations and strategy. Without enough collective pain and clear risk

[2] For a compendium of "Morgenstern's Maxims," *see* http://www.bluemesapartners.com/dealmaxims.html.

of loss, there is frequently insufficient cohesion (or motivation) for change.

PSYCHOLOGICAL PERSPECTIVES: INTERNAL AND EXTERNAL

Unsuccessful bridge financings have an internal orientation. Analysis starts 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. This happens to a greater extent in crisis bridges than surprise bridges because of the anger involved. While understandable, this perspective is naïve and dangerous. Denial and self-righteousness about the sanctity of existing rights are recipes for failure. Company survival must be paramount because without successful bridge financing, current stakeholders may soon own nothing. All stakeholders need to display flexibility in restructuring terms to facilitate a bridge.

The corollary is that successful bridges focus with laser intensity on the needs of the bridge investor. The objective should be to "entice" someone to provide survival capital. The bridge's reward and structure must be intuitively understandable and sufficiently persuasive to overcome the inherent risk. If bridge structure and pricing are driven by preserving existing contractual rights, protective provisions, and capital structures, the bridge will neither succeed nor seduce. Complexity encourages potential investors to say "no." Simplicity invites "yes."

PREFACE

Terms and structures vary reflecting differing goals 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); (2) their 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.

The remainder of this article analyzes crisis bridge financing issues and solutions for a "typical" early-stage, venture-backed, technology company. Such businesses have minimal revenues, negative cash flow, and modest tangible or financial assets. They are financed primarily with equity and don't tend to have institutional debt. Tech companies have intellectual property, proprietary technology, talented employees, and (sometimes) a nascent customer base.

These common characteristics suggest financing structures that minimize bridge investors' risk, maximize financial return, and increase the likelihood of survival. Only realists should apply. The focus is 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.

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 be shut down or sell its assets at firesale prices, if at all. Another of my maxims is that "Time is the palpable but invisible enemy."

Bridge money must come in before key employees leave, research and development is chilled, or customers migrate to stronger competitors. If financial fragility causes their loss, then a company's marketplace value rapidly decreases. Once unleashed, these factors create a downward spiral that feeds on itself. Each loss increases the probability of the next.

Speed is the imperative for a crisis bridge. Only financial structures that can be implemented quickly should even be considered. Since delay can be fatal, "rough country justice" that can be achieved by realigning the interests of current investors is preferable to a more "equitable" plan that cannot be accomplished. Seeking perfection will guarantee failure.

Shareholders can argue that they did not do anything wrong. Their preference, dividend, and protective provisions should remain unchanged. But why would a bridge investor or subsequent investor honor those rights in a failing company? The bridge investor is most likely to provide capital if prior investors have no prior liquidation preferences and minimal voting rights. Consider getting that agreed to contingent on a bridge financing.

In a perfect world, the financial structure and strategy will be simple and easily understood. Pragmatically identify likely investors. Concentrate on the most probable investors. Contrary to conventional wisdom, energy should not be diffused by seeking every conceivable source of money, no matter how remote.

Miracles still happen, but not often enough to include them in a survival plan.

The critical path to a bridge closing should be clearly delineated from the outset. Different investors will require more or less information and necessitate different timetables. Some investors will require more extensive due diligence and assurances. Investment by certain investors may trigger consents and modifications that will not be sought by others.

A bridge financing is a complex project requiring critical path planning and a leader. This analysis includes all activities required to complete the bridge, time needed to accomplish the activity, and an evaluation of the interdependence of each activity. By emphasizing the time sequence and hurdles, effort will be expended earlier on those issues requiring the most time, usually those involving third parties. A Gantt chart[3] illustrating this process may be helpful.

Internal obstacles are frequently found in the charter documents, shareholder agreements, or investor protective provisions from prior rounds of financing. Most troublesome are those stifling the company's ability to reach swift and unilateral agreement with a bridge investor about price, terms, or conditions. Frequently desirable bridge provisions require time-delaying votes or consents from existing shareholders.

Consents requiring unanimous approval are the most problematic. Unanimity is hard to achieve even in the best of circumstances, and unfortunately bridges are not the best of circumstances. Because there is less animosity, surprise bridge environments are easier to work in than crisis bridges.

Obvious impediments are existing investors' rights to approve the issuance of new securities, or requiring new securities to be offered to existing investors prior to (or concurrently with) a sale to new investors. Customary negative covenants provide veto rights blocking granting security interests in the company's assets (particularly its intellectual property). Holders of those rights have significant negotiating leverage since without their consent there cannot be a bridge financing. The company must know what the most sensitive issues are in order to factor those difficulties into designing an effective bridge.

Most bridge financings for venture-backed companies require some internal consents (*e.g.*, preferred shareholders) as well as external consents, (*e.g*., landlords whose leases contain change-of-control clauses.) Different series of preferred stock frequently have separate economic rights and protections. The minimum number of existing investors (and/or third-party consents) whose approval is required to permit alternative bridge financing structures must be identified promptly. There is no sense in structuring a bridge that cannot be sold because the company lacks the will or practical ability to obtain all necessary consents.

Developing a critical path to closing that recognizes each consent, vote, or document needed will promote deal structures capable of being executed within the time available. The company must favor structures requiring the fewest changes to documents, minimum number of approvals, and relying on help from the most motivated and flexible stakeholders.

To even get an investor to engage, the company's strongest approach is to assure them that negotiated terms can be realistically honored. Without that understanding, the investor has little incentive to dedicate resources required to perform due diligence and close the deal. A solidly developed critical path facilitates that discussion.

SOURCE AND MOTIVATION FOR BRIDGE FINANCING

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

The most probable investors are "insiders:" those with a pre-existing relationship with the company. Anyone whose economic position will be better if the company survives is more motivated than new investors. Inside investors have a different risk-reward calculus and motivation than outside investors and can best (and most quickly) access the value proposition of a bridge. Existing investors do not want to "lose" or jeopardize the value of their existing investment.

Less obvious but frequently important "insider" investors are suppliers or customers. Each has something to lose (risk) if the crisis is not resolved and

[3] A Gantt chart is frequently used to illustrate, monitor, and manage the work flow of a project. Normally a bar graph is used reflecting the starting date and key elements of the project, as well as the ending date. Sophisticated users also reflect the dependency of certain actions on other actions or activities. This lets everyone on a project develop a shared understanding of the critical path to a closing.

something to gain (reward) from a successful bridge in addition to the investment merits of the bridge security. Sometimes customers provide bridge funding if the company's failure impairs the customer's ability to function because they depend on the company's technology. Suppliers may be motivated by the opportunity to profit from future sales of their goods and services, as well as to receive payment for their current receivables. These constituencies already "know the story" at some level and are familiar with the company's management and business plans.

In sharp contrast is the outside bridge investor whose risk-reward ratio is measured solely from financial results if there is a successful business. Outsiders have no existing investment to "protect" nor reward to be obtained from a broader financial relationship with the company. An outsider's only motivation is investment return.

Unlike the insider, they usually do *not* know the story. They are routinely "hearing" the story (and performing due diligence) at a moment when the company's prospects and credibility are inherently suspect and management is significantly distracted.

Outside investors are handicapped trying to reach a measured investment decision at the rapid pace dictated by a cash shortfall rather than a "normal" investment pace. A new investor has no guarantee that the company will exist if (and when) the conditions precedent to investment are satisfied. This time crunch, exacerbated by the cash crunch, sometimes discourages potentially interested outsiders from even engaging in investment dialogue.

In addition, inside and outside investors 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 overseeing the company's affairs and fulfilling their duties of loyalty, duty of care, and good faith. These are the classic legal building blocks to satisfy the business judgment rule that protects directors from personal liability under state law.

There is both a perceived and real conflict of interest if the board, or a director, proposes economically appropriate bridge terms that diminish the rights of existing securities holders, particularly in a way that favors the director's class of securities. An example would be proposed conversions of 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. Inside directors may be reluctant to provide bridge money if doing so would expose them to personal liability. Outsiders don't have these legal shackles.

Responsible institutional investors are sensitive to whether their proposals are consistent with being a good partner. Equally importantly, will they be perceived as a good partner not just by this company, but also by the management and boards of other portfolio companies, prospective portfolio companies, and venture funds. A fund's carefully cultivated institutional brand may be at risk. These concerns do not arise for outside investors since they are not partners in the crisis company and have no such constraints.

A strong factor favoring outside investors is their intrinsic negotiating leverage. Outside investors are free to craft onerous 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 result in their inability to provide bridge financing that they would otherwise be willing to provide. Sometimes the only terms that can be agreed to by insiders without destroying relationships may be insufficiently seductive to satisfy actual or perceived risk compared to reward.

If the company rejects an outsider's offer, all the outsider has "lost" is an investment opportunity foregone. Inside investors risk damaging important relationships, impairing their ongoing ability to perform as directors, or otherwise harming their reputation.

Despite these legal, practical, and psychological considerations, the ultimate reality of a true crisis is binary. Either existing stakeholders will accept the terms of a proposed bridge (no matter from whom and no matter how distasteful) and have a potential to preserve some value, or reject them and fail completely. Another of my maxims is that "it's better to have some percentage of something than 100% of nothing."

That proposition seems logically unassailable. In the emotional cauldron of crisis bridge financings, however, there are numerous examples of financial suicide. Existing investors acted on the apparently irrational premise that they'd rather fail and get nothing rather than change their rights, priorities, or percentage ownership in favor of someone who "doesn't deserve them." Such stakeholders demand that loss has to be borne by other business owners but not them. Since they're blameless, they shouldn't be "punished." Investors with this perspective have vetoed viable

financings that while highly unattractive were the only alternative to shutdowns in which the vetoing party got nothing.

BRIDGE INVESTMENTS ARE NORMALLY DEBT INSTRUMENTS

Enlightened self-interest suggests that bridge investors purchase a security with minimum risk and maximum reward. Since debt is repaid prior to equity, most bridge financings are designed to provide downside risk protection of a lender but with upside reward characteristics of an equity investor. Financial equipoise between the company and the bridge investor occurs when negotiations focus 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 collateral if specified desirable corporate transactions occur. Any investor is always seeking the first two. In a bridge round, the company is uniquely driven by the third since automatic conversion facilitates a subsequent equity offering or business sale with no further negotiation with the bridge lender.

Most commonly, bridge financings are convertible debt, whether secured or unsecured.[4] All customary debt terms (interest rate, payment schedule, events of default, and default remedies) must be negotiated.

Combining protective debt elements with upside equity features may nonetheless create legal enforceability risks for insiders (but usually not outsiders) such as equitable subordination. Bankruptcy courts have the power to recharacterize debt as equity. This power permits courts to penalize "bad conduct" by insiders. As a consequence, form may not be allowed to prevail over substance.

"Debt" issued to a shareholder or its affiliates in the context of a failing company may be judicially deemed to be equity. If this happens, the court may reprioritize the relative status of claims. The investor could cease having the enviable position of a secured bridge lender and become subordinated to unsecured indebtedness such as trade payables. The extent of this risk can only be evaluated based on the facts and circumstances of a specific transaction.

Different bridge investors 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 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

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.

In optimistic environments, it's less desirable but possible for the bridge loan to be unsecured. With today's pessimism virtually all bridge loans are secured. Secured debt is repaid prior to unsecured creditors and equity holders (either common stock or preferred stock). This relatively simple structure minimizes bridge investors' risks.

If the bridge loan cannot be repaid when due, the bridge lender can exercise the legal rights of any secured lender. It can seize assets, sell them in a secured-party sale, and retain proceeds to the extent of principal and accrued interest. By satisfying legal requirements, including appropriate notice of a sale, the buyer at the sale can include the secured lender. This flexibility permits the bridge investor to determine at a later date what its best and most strategic longer-term option is. Having the company's intellectual property as collateral gives the bridge investor powerful structural protection now and negotiating leverage later.

Foreclosing and selling assets is never the corporate goal. Sometimes, however, it is a bridge investor's goal as a method to gain control of the company and its intellectual property. Many successful companies have

[4] Priority preferred stock is used in rare circumstances where balance sheet considerations dictate that the bridge money must be recorded and reflected as equity rather than debt (even subordinated 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.*

resulted from recapitalizing and re-equitizing management following a secured-party sale. The business was good but the capital structure was bad.

The normal goal of a bridge round, however, is to provide sufficient cash and time to permit an additional favorable equity financing or orderly sale of the business at a higher price that would be obtained in an immediate, time-constrained firesale.

A major negotiating tension between a company and any secured bridge investor is agreeing on what subsequent equity financing will be sufficient to mandate an automatic release of collateral by the bridge lender rather than a voluntary release. If the loan later converts to equity, then the release of collateral occurs automatically.[5] Without conversion, however, the loan remains outstanding, and will either be secured or unsecured. This is clearly undesirable from the company's perspective because debt is senior to any equity.

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 provided by, and the characteristics of, the investor purchasing a subsequent equity financing are therefore critical. Usually the condition precedent to automatic release is an agreed-upon amount of equity financing deemed sufficient by the bridge lender to create "success," as defined by whatever metric the investor employs.

By the same token, to protect the value of its upside equity component, the bridge lender should not release collateral unless: (1) the pre-money value (*i.e.*, the company's presumed value prior to the investment) in the next equity financing exceeds negotiated minimums or (2) the number of shares to be issued increases proportionately to make the investor whole if the pre-money value falls below the minimum. Limitations on the characteristics of an acceptable "next security" itself are also common conditions to releasing collateral. As an example, the next equity cannot be an undesirable non-dividend bearing common stock.

The bridge investor's preference is that collateral is not automatically released. This preserves investor flexibility to evaluate specific future investors and make a more fully informed decision about whether new equity justifies changing the bridge investor's position as a secured lender.

Cash Pay-in Rate

Some crisis bridge investors are unwilling to fund their aggregate commitment in a lump sum. They only provide cash at agreed intervals (frequently weekly or monthly) approximating the projected cash burn rate. This preserves the bridge investor's ability to stop funding if: (1) cash burn is higher or faster than projected, or (2) other adverse events occur (loss of a key customer) dimming the likelihood of the bridge having a successful conclusion.

A condition precedent to the bridge investor's commitment may be the company continuing to meet specified operating and financial goals. Common examples would be personnel reduction, obtaining new customers, or selling non-core assets to generate cash. Periodic funding creates a practical, self-executing, discipline stronger than any contractual covenants. Risk is minimized, again favorably adjusting the risk/reward ratio. If conditions are not satisfied, the investor stops funding.

Valuation and How to Avoid It

Occasionally, bridge financings call for repayment of principal and interest from the next financing. This is hard to negotiate and more difficult to achieve. New investors want their money used exclusively to fund operations and growth; not to "bail-out" existing investors.

By definition, crisis bridge financings occur during bad times for a company, and frequently for capital markets as a whole. The toughest problem is rationally establishing a fixed current price or value for the equity component of the bridge security based on a presumed pre-money value of the company. Prices paid in earlier rounds of financings (internal or external) are wholly irrelevant. There may be no meaningful marketplace "comparables," particularly in a mark-to-market world.

The current valuation issue is completely avoided if the bridge security automatically converts into the next round of financing. The bridge investor will receive whatever security the next outside investor negotiates. Presumably that will happen when valuations are more certain and prospects of corporate survival are greater. This occurs whether the next round of financing is a "down" round or an "up" round.

From the bridge investor's perspective, however, this should be an unacceptable interpretation of risk and reward. As soon as the bridge is funded, the full risk has been taken. Bridge risk is inherently greater than next-

[5] *See* Convertibility, *infra*.

round risk no matter how soon the next round is scheduled to close. Every veteran investor has experienced a "done" 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).

Two common alternatives increase reward: conversion at a discount or warrant coverage. If the bridge security automatically converts into the next-round security at an agreed discount, the discount serves as additional reward. The steeper the discount, the greater the reward. The discount rate can be fixed, or increase over time since longer time equals greater risk.

Through this mechanism, each dollar risked by the bridge investor buys more of the company's equity than the next-round investor's dollars. A practical problem, however, is that the next-round investor sometimes refuses to honor this contractual provision. The next-round investors are unwilling to let someone else get a better deal than they have.

Another practical problem relates to liquidation preferences, and it is structural rather than emotional. If the bridge investor negotiates a 50% discount, then $.50 of bridge security obtains $1.00 of liquidation preference. The new preferred stock investor would have to invest $1.00 to receive a $1.00 liquidation preference. Most importantly, the net effect to the company is that the aggregate cash liquidation preference owed exceeds the cash contributed because the liquidation preference accorded to the bridge investor exceeds the cash invested.

The attraction of discounted notes is that they are simple to negotiate and quickly documented. Because of their disadvantages, if time permits, then warrant coverage establishes a more comprehensive reward that aligns better with subsequent transactions. I discuss this below.

Warrants

The bridge investor is granted warrants to purchase common stock at a fixed price and exercisable at any time during a fixed term. The warrant exercise price may be: (1) nominal, (2) an arbitrarily agreed price, or (3) some agreed percentage of the price paid for new preferred stock.

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

In a common dialogue, the company asserts, "your money is only going to be at risk for a short period, so there should not be much economic reward for such a small risk." Although the company believes in good faith that the risk is small in amount or short in duration, it is never possible to "know" the level of risk being taken. Unfortunately, acts of God occur. In the best case, short-term bridges became longer-term bridges. At worst, short-term bridges became unrepaid losses or get forced into an undesirable equity conversion.

The number of warrants usually increases monthly since the risk taken by the bridge investor likewise continually increases. Time is not the friend of the bridge investor. Another of my maxims is that "like the universe, deals tend toward increasing entropy."[6] This intrinsic bias in favor of randomness and against closure is a universal constant in the deal world.

While a minimum may be appropriate, so may a maximum. Upper limits protect against limitless dilution. Warrant coverage may be better received by subsequent investors than discounted purchase prices. The impact of increased warrants amounts to a rearrangement of the capital structure among the existing shareholders prior to the next investors' purchase. 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, prefer investments that do not involve "cramming down" or rearranging existing investor's relative economic relationships. Simply put, there is less negotiating friction because there is nothing for existing stakeholders to fight about internally. Their relative ownership among themselves is determined by applying an agreed-upon formula. Warrant coverage satisfies a bridge investor's need for increased reward while simultaneously creating a comfortable environment for the next investor.

[6] *See* http://www.bluemesapartners.com/dealmaxims.html.

In good macroeconomic conditions, conventional terms for an early-stage crisis bridge might provide for 3-5% warrants for each month that the bridge investment remains outstanding, a minimum of 10-20% (*i.e.*, 2-4 months) warrant coverage, and maximum of 25-30% coverage. As an example, if a bridge lender funds one million dollars, and gets 25% warrant coverage at $2.00 per share, it is granted 125,000 warrants. In harsh economic environments like 2009, the cost of bridge money tends to be substantially higher, if not verging on confiscatory.

Convertibility

Although convertibility avoids current valuation, the mechanism raises a myriad of other issues. Should conversion be automatic or voluntary? If voluntary, who has the conversion right, the issuer or the investor? What pre-conditions must be satisfied for 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 simply because bridge debt is transformed into equity. A prudent bridge investor, however, may be unprepared to blindly surrender the considerable downside protection of a secured note for unknown equity. The analysis in this article describing when collateral is automatically released applies here as well.

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

Rightly or wrongly, a common perception is that venture investors bring more than capital, so the probability of corporate success is deemed higher. A venture investor is assumed to add management skills, ability to raise or provide additional capital in the future, and competence and leverage to negotiate price, terms, and conditions of a new security that a bridge investor would willingly embrace. Accordingly, the bridge lender is inclined to automatically accommodate investor fund investment.

The self-interest of the bridge investor and a subsequent venture investor are thus harmonized. Automatic conversion is, therefore, usually based on the (1) type of investor providing financing, (2) minimum amount raised, and (3) nature of the security being sold.

Dual Convertibility – The Janus Note

There is a structural approach providing for automatic conversion but not specifying the security into which the bridge loan converts. I created the term a “Janus bridge financing” to describe a heavily investor-friendly bridge note. The Roman god Janus (for whom January is named) simultaneously looked forwards and backwards. In this scenario, the bridge note converts into whichever equity 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,[7] the bridge security converts into either: (1) an existing prior round of preferred stock with a lower pre-money value, or (2) a newly created preferred stock at a specified pre-money value (usually lower than the most recent round). If the next round is a down round, the bridge security converts automatically into the new, better security.

In effect, the bridge holder (like Janus), has the right to look backward into the company’s capital structure as well as forward depending on which view is most advantageous to the investor. Janus Notes provide that the noteholder (rather than the issuer) designates which security the bridge loan converts into. Pre-money valuation alone may not be the sole determinant of a “better” security. There are numerous rights and terms which as a composite could cause reasonable investors to disagree as to what “better” means.

The most important provision from the company’s perspective is simply that there is an automatic conversion. This simultaneously “cleans up” its balance sheet by eliminating the bridge debt and releases the intellectual property held as collateral.

Interest

Like all notes, there is an interest component which is rarely paid in cash. Instead, bridge interest generally accrues, and is payable in kind at the time of conversion. 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 the investor just infused.

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[7] In an “up-round,” the pre-money value of the company reflects an increase from the previous financing round. The corollary is that in a “down-round,” the pre-money valuation of the company has decreased since the previous round.

Consider the end game. The bridge loan has to create a more-than seductive environment for the next investor. Nothing could be less enticing to the next investor than to use growth capital either to pay principal or interest.

While the interest rate is fixed, the rate frequently increases rapidly over time. This both protects and rewards the investor for the time-risk actually taken, as well as encouraging the company to aggressively get the next funds so as to avoid ever-increasing dilution. In many ways, both the company and bridge investor benefit from this escalating penalty for failure to close the next round of equity financing.

Defaults and Remedies

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

Remedies for a noteholder may be more limited than for an equity holder. Customary remedies are: (1) an increased interest rate, (2) an accelerating number of warrants, and/or (3) a decreasing exercise price. Under all of the remedies, each month that the company is in default, the noteholder owns a progressively higher percentage of the company.

Once a bridge note is in default, practical alternatives are limited. Either: (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 foreclose and seize the collateral. There are numerous technical hoops to jump through when the collateral being "seized" is intellectual property. With appropriate notice, the bridge noteholders can conduct a secured-party sale. It is not uncommon for the noteholder to be the only bidder. If the noteholders win the bid, they can then organize a new company based on the intellectual property. 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.

Although unusual, there are occasional equity bridges. A bridge equity holder (preferred or common stock) by contrast to a noteholder might acquire more aggressive default rights more consistent with equity than debt since they are not concerned by the possibility that possessing such rights could jeopardize their position as a secured lender. This might include the right to elect all, or at least a majority, of the board of directors, *i.e.*, gain control of the company. In addition, a bridge equity holder may seek "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. This facilitates the bridge investor's ability to control a liquidity event. These remedies are inconsistent with certain legal limitations distinguishing debt from equity.

Sale of the Business Prior to a Subsequent Equity Financing

There is a variable frequently overlooked by companies and investors. What happens if the company is sold after completing the bridge financing but prior to completing any subsequent equity financing? The note never converts into an identifiable security because the triggering event for conversion never occurs. A convertible noteholder whose upside is limited solely to a purchase price discount to the next round, and who has no warrants, only holds a secured note with accrued interest, *i.e.*, a debt-type reward. 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.

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 noteholder's right to voluntarily convert into a specified series of stock, at a highly advantageous price and terms. By possessing the right to voluntarily convert into a known security, or achieving a substantial rate of return from economically meaningful prepayment penalties, the bridge holder is protected. Otherwise, they would have provided the riskiest money and not obtained any return other than principal and interest.

A distressed sale quickly following a crisis bridge occurs more often than assumed. As soon as it's clear that the bridge is insufficient to create a viable company, a common strategy is to sell the company at a nominal price to management or a strategic buyer. The venture fund's goal may be simply to: (1) avoid 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 does not know the sale price of a private company unless the price is either voluntarily disclosed or mandated because the buyer is a public company and the price exceeds SEC disclosure thresholds. Consequently, venture-backed 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 visible shut-down or liquidation. It is the financial equivalent of President Nixon announcing that the U.S. won the Vietnam War and then unilaterally withdrawing. Reality is not changed but perception may be altered.

PREFERRED STOCK AS A BRIDGE SECURITY

Under unusual circumstances, preferred stock is sometimes issued to bridge holders. The effective business terms mimic those of the secured bridge holder with a notable exception. Preferred stock is equity rather than debt and equity holders cannot secure their position. In the event of a corporate collapse, equity holders receive proceeds only after payment to all company creditors, secured or unsecured. This compares unfavorably to the payment priority and economic protection accruing to a secured bridge noteholder.

When used as a bridge security, preferred stock normally has liquidation preferences senior to existing preferred stock and common stock, and equity features that mirror convertible secured bridge notes. This is best accomplished by a participating preferred. Holders of a participating preferred receive the amount of their investment (like a loan) as first proceeds to shareholders on a sale. Then they participate on an "as-converted" basis with the other equity holders providing the equity reward.

Because preferred stock is equity (whether convertible preferred or participating preferred) the company's balance sheet is "cleaner" than if the bridge financing is debt. Corporate net worth is higher. As a consequence, equity bridges may be potentially useful for Delaware corporations concerned about operating during insolvency (or potential insolvency). It may also 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.

LESSONS LEARNED AND PLANNING

As the capital markets exploded over the last several years, a frequent pattern emerged of multiple rounds of financing, syndicated groups, and different types of institutional investors participating in each round. Unlike historical patterns where different asset classes usually invested only with similar funds, recent activity by hedge funds, private equity funds, and venture capital funds has blurred those lines of demarcation. The result is that different asset classes invested together. While these investors have some financial and operating approaches that are similar, there are at least as many operating and financial goals, tactics, and strategies that are dissimilar. Additionally, high net worth investors sometimes participated along side of these funds.

A diverse investor base inherently slows down a bridge financing and tends to complicate the process as well as the documentation. High net worth angels negotiate differently than institutions since individual investors only need to consult with themselves. Different types of institutional investors have significantly different perspectives and internal decision-making processes.

In 2006,[8] I suggested that thoughtful investors should consider the probability that modifications to charter documents and shareholder rights agreements would be necessitated when over-priced and over-leveraged deals inevitably tanked. Clearly, no documents ever drafted and signed can, or should, anticipate every circumstance in which contractual provisions may need to be relied on.

As an example, at the front end of investments, investors should carefully consider contractual rights that they are acquiring and whether they really want those rights. For example, series voting rights that require unanimity or even supermajority may make desirable changes in a crisis harder than they will need to be. That is a portion of the risk/reward ratio rarely considered when making an initial investment decision. Sometimes the better negotiation may be to accept fewer special voting and consent rights on more issues than is obtainable. Less may ultimately be more.

Another alternative that fulfills institutional investors need for "control," but which eases the way for crisis modifications, is the use of a director elected by a particular series. Presumably, that individual reflects the sensitivities and needs of his fellow series investors. Two approaches should be considered. First, recognizing that individuals make decisions differently than funds, when an original investment is made obtain a

[8] *Supra*, note 1.

proxy from all individual investors or have them agree to vote their shares the same way that the series director does. This is consistent philosophically with a not uncommon tag-along right in favor of fund investors who are investing beside angels. Both eliminate the risk that an individual will make markedly different decisions than an institution.

A second provision permits a series director to vote on certain modifications and bind the entire series for which they are the elected director. This will be much faster than obtaining consents from an entire series. Hopefully the series director is always more current about the business, its needs, and its prospects than the other investors in the same round. Thus, a series director may be a rational (if informal) proxy that can efficiently represent the legitimate needs of its series in any bridge financing.

Investors obtaining "too much" control, including the effective power to veto, may be achieving a Pyrrhic victory. It feels good now, but it is a sword of Damocles in a crisis. Now is the right time for investors to reexamine their long-term philosophies about investment agreements. What was great yesterday may be a disaster tomorrow. Old assumptions may not be valid in 2009 and beyond.

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 facilitating 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 never easy. It is unusually problematic in the tension-fraught environments of crisis bridge financings. The over-arching corporate goal of meaningful and successful survival must be 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.■

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