

What's Next?

A Path Forward in
Uncertain Times



GOODWIN



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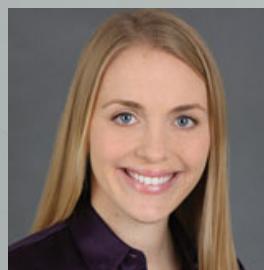
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Life Sciences



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Private Equity



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Partner, New York
Business Litigation

Distressed Companies

Decision Tree



WINDING DOWN

Shut it down



EXIT

There is line of site
(even if vague) on an exit
“Going concern” not the goal



RESTART

Some investors think there is
a way to get long term value
out of company with no clear
line of site

The Restart | “Recap”

This is what most people think of when they say “recap”

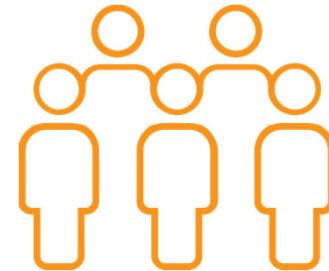
Severe decrease to valuation such that legacy preference is a burden –

- Employees buried under preference
- New money also desires multiples at lower exit valuations
- No single investor wants to be the patsy that keeps the boat afloat and takes on all risk that will reward shares held by other investors/stockholders

Alignment



So we set up some carrots and sticks to ensure alignment – a “pay-to-play.”



We want to give some “credit” for being a legacy investor, but only if you’re pitching in now.

Terminology + Tools | Carrots

“Senior Preference”

New round preferred stock is senior to prior preferred investments. This means the liquidation preference on the senior preferred stock will be paid out in full before the liquidation preference for the prior preferred investments is distributed.

“Structured Economics”

Adding a multiple liquidation preference (e.g., 2x instead of typical 1x) or participation feature.

“Down Round”

New round at lower (sometimes significantly lower) valuation than prior rounds. Questions of whether existing investors receive an antidilution adjustment.

“Cram down” or “washout” financing

Normally refers to *significant* loss of ownership in connection with a financing. Essentially, the severe dilution causes ownership loss. But in some cases, additional mechanics are added to further punish non participating investors – e.g., stock splits or conversion ration modifications. Can also be referred to as a “washout” financing.

The above carrots don't really address legacy preference burdens or may not be sufficient to motivate co-investors to participate.



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Terminology + Tools | Sticks

Classic “Pay-to-Play”

If an existing investor doesn't purchase its full or minimum percentage of its pro rata of the new financing, all or some percentage of its existing investment is converted to common stock. “Pro rata” most typically defined as percentage of preferred ownership. Most commonly achieved via a charter amendment that dictates the terms of conversion to common stock (see NVCA form documents) or via a “pull through.”

“Pull Through”

All preferred convert to common and then participating investors exchange common shares for new preferred stock having substantially the same rights as the converted preferred (i.e., “pulling through” legacy preference to the newly created preferred stock).

Other variations on the classic pay-to-play: “Pull Up”

Participating investors exchange old preferred exchange for new preferred (i.e., no conversion to common as with a “pull through”) with senior liquidation preferences.

More exotic structures could also have non-participating preferred lose ownership in addition to preference. Rare, and increases risk profile of the financing.



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Fiduciary Duties

All board members and officers owe “fiduciary” duties to the corporation and its stockholders – i.e., the **“Duty of Care”** and **“Duty of Loyalty.”** Post financing litigation usually stems from a “breach” of these duties.

Delaware law typically affords Boards the benefits of the “business judgment rule,” by which courts generally defer to the Board’s decision so long made on an informed and good faith basis.

However, insider or “interested party” transactions (e.g., an investor with a Board representative leads a new round of financing) are not afforded benefit of the business judgment rule, and instead burden placed on Board to defend the fairness of the transaction.

Process Matters Here

Investor + company counsel typically collaborate early to ensure the financing is defensible. Particularly tricky when the investor presenting the inside term sheet is on the Board.

Some considerations:

- Disinterested lead investor in new financing (often not possible)
- Disinterested approval by Board – bonus points if it's an empowered disinterested committee
- Disinterested stockholder approval

Above steps often impractical (e.g., insufficient disinterested directors or stockholders). Note that management typically is not considered “disinterested” where refresh grants are contemplated.

- Process of right offering – timing, amount of disclosure, etc.
- Rights offering to all eligible stockholders (typically just preferred stockholders)
- Documented thorough search for new financing or sale (does not require a banker but that helps)

Controlling Stockholder Liability

Controlling Stockholder:

A stockholder could be deemed a controller (and thus take on fiduciary duties) not only based on general control (i.e. majority of board or of stock), but also based on control of just a particular transaction (like an emergency financing).

Improper use of blocking rights:

As companies in distress seek financing, boards and investors should be aware of recent cases allowing liability claims to proceed against investors alleged to have used blocking rights to force companies to forego third party offers and instead enter into allegedly unfair terms with the blocking party.