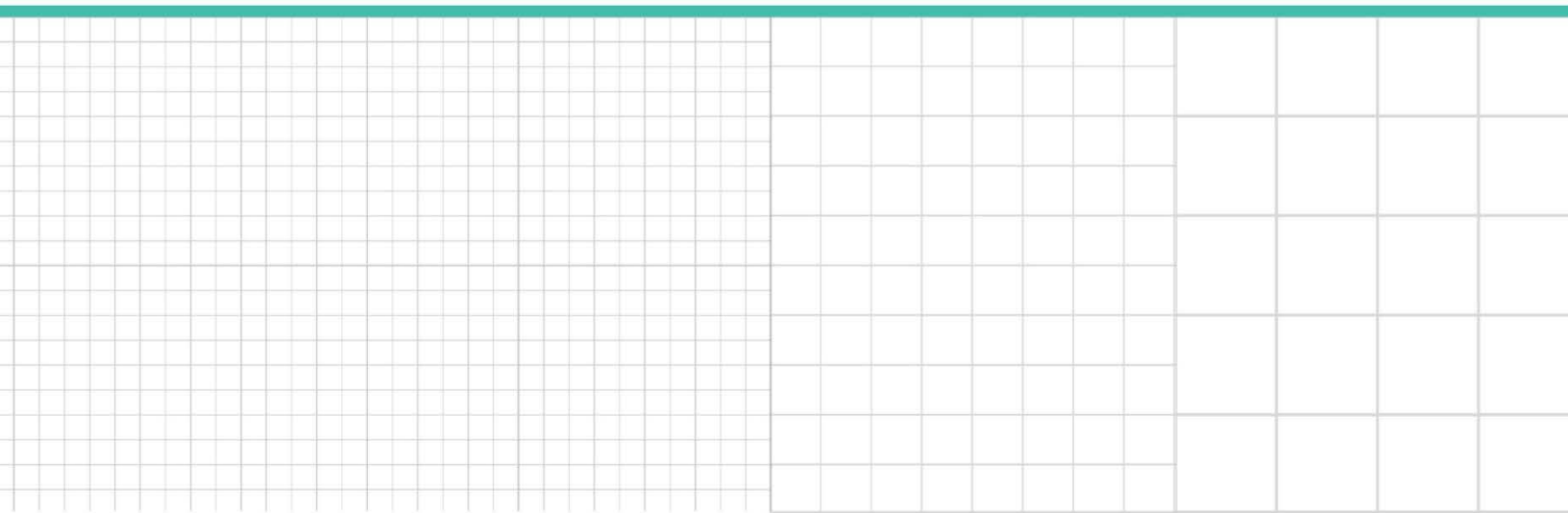


Overview

Investing in Distressed Tech Start-Ups

Derek Liu and Lawrence Lee, Baker McKenzie

Reproduced with permission. Published August 2020. Copyright © 2020 The Bureau of National Affairs, Inc. 800.372.1033. For further use, please visit: <http://bna.com/copyright-permission-request/>



Investing in Distressed Tech Start-Ups

Contributed by [Derek Liu](#) and [Lawrence Lee](#), Baker McKenzie

Most start-ups burn cash in pursuit of creating a product and winning market share rapidly. In an economic downturn, tech investors—as those in many sectors of the economy—may be able to find investments in quality tech companies in need of capital to fund their growth or survival. This second article in a [series](#) on buying and investing in distressed start-ups covers considerations that investors should keep in mind when funding a company in severe need of capital.

Start-Up Capitalization

Perhaps the most important investment decision (other than valuation) is the form of the security that the investor will receive. Seniority, or priority, is a crucial concept here: a senior, or higher-priority, security is entitled to receive proceeds first, whether in a M&A sale or in a liquidation, prior to a more junior security. The typical start-up has the following forms of securities in its capitalization, from lowest to highest seniority: common stock, preferred stock, unsecured debt (e.g., convertible notes), and secured debt (e.g., convertible debt or venture bank debt).

How should an investor decide which securities are preferable in a risky enterprise? Using a process of elimination, investing in common stock can be unwise. This is because in a distressed start-up, if the start-up fails and must sell itself in a firesale, common shareholders are paid out last and thus would likely receive little or no proceeds even where other classes of securities are repaid.

Similarly, investing in a non-convertible debt instrument with no equity upside—no matter how high the interest and no matter the assets pledged as security—is rarely wise, unless the start-up has valuable assets such as patents or unless there are substantial warrants to provide upside benefits. This is because most failing start-ups cannot afford the interest payments and have few tangible assets to liquidate in a bankruptcy. As such, even a high interest rate cannot compensate for the risk.

Senior Preferred and Convertible Debt

With the elimination of these two choices, the choice then falls to either investing in preferred stock, preferably one that is senior to the existing series of preferred stock, or in a convertible debt instrument. The choice is usually a matter of negotiation with the company. Both types of securities are highly customizable and can accommodate a wide range of protections and provisions, although market practice does constrain their use.

Negotiating Dynamics

Any new investor must be aware that a start-up almost always has at least one alternative to new money: its existing investors. Often, distressed start-ups do not solicit outside investments because their existing investors are willing to continue to fund them. Insiders often prefer to continue investing: new investment usually requires a senior level of preference, meaning that previous investors are knowingly diluting their ownership and dropping further down in preference ranking. Further, the unfortunate side effect of accepting new money in a distressed business is that the valuation is most likely lower, so these insiders must also write down their own investments. As such, the existing investors may serve as a natural counterbalance to the new investor's terms to keep them from being too draconian.

Further, the investor also has to be cognizant of preserving management and employee incentives to continue working for the company. Distressed start-ups already must work extra hard to retain employees, many of whom initially sacrificed cash compensation for shares in the company—the equity upside—when they joined the start-up. To the extent that the company's distress makes it difficult for the common shares to be “in the money”(i.e. to have positive economic value) the investor and the board will need to consider additional management carve-out plans or equity pools to continue to incentivize the workforce.

Recapitalization as an Investment Tool

Because of the existing terms of preferred stock, plus favorable terms of new investments, may result in the common stock having no economic value, investors may wish to consider—in truly distressed situations—the need to completely recapitalize the equity structure of the start-up.

A recapitalization of the company can be accomplished in two ways. First, the company converts existing preferred stock into common stock, which removes the preferential rights such as liquidation preference and voting rights, and encourages new investors by giving them the opportunity to purchase senior securities with preferential rights. The conversion into common stock is typically achieved through the auto-conversion mechanics in the company's certificate of incorporation (typically a majority of preferred stock can convert all preferred stock) or by amending the company's certificate of incorporation, which requires a shareholder vote.

Alternatively, the recapitalization can restructure the terms of the existing preferred stock, such as decreasing or removing senior liquidation rights, removing board appointment rights, and other preferential voting rights. Structuring such a recapitalization will typically require the company to amend its certificate of incorporation, which in turn requires majorities of various classes of shareholders as specified in the company's charter.

Given that recapitalizations in this context typically follow a financing round at a lower valuation than prior rounds (a "down-round"), pre-existing anti-dilution protections (as discussed below) would likely need to be waived. The lead investor in a down round will require such a waiver to be effected in connection recapitalization.

Pay-to-play provisions are often coupled with the recapitalization. Through a pay-to-play provision, existing investors must participate in the down round up to their pro rata share (i.e., "pay") in order to maintain the rights on their pre-existing shareholdings (i.e., "play"). If existing investors do not participate, their shares will be subject to recapitalization and either automatically convert into common stock or convert into a "shadow" series of preferred stock that has reduced preferential rights (i.e., reduced liquidation preference, removal of anti-dilution protections, and other special voting rights).

Investors should be aware of the double-edged nature of the terms they negotiate for themselves: anything they are able to extract from the company and existing investors may become the starting point for negotiations in future rounds of distressed financing. So, extra harsh terms in their own round may be used against them by the next investor if the situation does not right itself with the current round of financing.

Convertible Debt

The next question turns to the specifics of the choice of convertible debt versus preferred stock. From a priority perspective, convertible debt—which may be secured by the target's assets—has many benefits. In a bankruptcy, secured debt has priority over the trade creditors of the target, and unsecured debt is at the same level as these trader creditors. As a matter of market practice, the typical convertible debt instrument is straightforward when compared to more sophisticated debt instruments such as a credit agreement. These instruments have relatively few, if any, operating covenants or requirements to maintain certain financial ratios such as leverage ratios, and they do not typically include governance provisions such as the right to one or more board seats.

Upside

The investor's upside is provided for in three main ways. First, the note's conversion feature will provide for a conversion of the principal and accrued interest to equity, typically at the next round of preferred financing and at a discounted valuation. The discount can be negotiated in two ways: either a numerical discount to the implied valuation (e.g., a 10% or 20% discount to the valuation implied by the subsequent round) and/or a valuation cap (e.g., that the valuation will be fixed at a specified maximum regardless of whether the actual implied valuation of the preferred round is higher). Second, some notes, particularly those issued in truly distressed situations, will provide that upon a change of control, the note will be prepaid at a 2x or 3x multiple of the original investment. And third, investors will sometimes obtain additional warrants to purchase equity, which vest if the valuation ultimately recovers.

Security

Whether the investor asks for collateral as security for the convertible note is an option. Having a security interest is preferable, because it ranks the convertible note higher than any other creditors, as a claim to the start-up's assets in a liquidation. And often, particularly in distressed situations, it is hard for a company to marshal compelling arguments against granting such an interest, unless there is pre-existing secured debt.

However, an investor should be realistic that in a true liquidation, the start-up will usually have few assets of value to satisfy the debt. The security interest does have a more indirect benefit, in that it prevents the company from putting any future

debt—including bank debt—ahead of or even alongside the note in question. This gives the investor an indirect veto over future financings.

Speed of Execution

A convertible note can also be the fastest option to get money into an imploding company. A key advantage is that it does not require a prolonged negotiation regarding valuation, because the eventual valuation can be determined by reference to a future round of equity financing. This can be extremely useful at a time when the distress of the business makes it hard to come to a meeting of the minds. The investor has the protection that in the case of any change of control or liquidation, it gets its money (plus interest and possible change-of-control premium) ahead of any other security.

In addition to valuation, the convertible note investor can also opt to be agnostic to governance and other liquidity terms for the time being: by specifying that the note converts into the same security as is sold in the next preferred round, the convertible note holder benefits from all of the various other governance and liquidity rights that will be negotiated in the future. For this reason, during the Covid-19 crisis when start-ups have needed immediate liquidity, convertible notes were a very common option for delivering quick cash into a company.

Size

On the other hand, because of their relative simplicity, convertible notes tend to become less appropriate as the investment size grows. When the investments are substantial, investors do tend to want terms such as valuation and governance to be specified, to be able to both lock in a lower price and provide input and oversight over their investments. Hence they tend to prefer equity investments in such situations. Though there is actually no legal reason why such governance rights cannot be given to convertible note investors, as a matter of general practice, they are only given to equity investors.

Preferred Stock

A preferred stock investment, as equity, does have lower priority of recovery than debt. In practice though, the difference is generally not substantial because start-ups tend not to have substantial debt burdens and trade creditors. This is the case even though start-ups may end up incurring substantial debt as they fall into distress and come to using debt instruments more heavily or falling behind in vendor payments.

It is often the case that the outcome is binary. Either there is an eventual sale at some price, at which time there should be some amount left over for at least the senior level of preferred stock, or there is a complete shut-down of the business, at which time no security is able to recover much. This will obviously require a case-by-case assessment by the investor of the potential assets that could be liquidated (e.g., patent rights, hardware inventory, etc.).

Economic Rights

In investing in a distressed start-up, the investor's main intent has to be upside in two scenarios: maximizing proceeds in an eventual sale to a third party, or maximizing ownership in a recovery of the business. Below are some features of preferred stock that investors should consider as part of their investment terms.

Liquidation Preferences

Liquidation preference refers to the amount of money that the preferred shareholders must recover prior to any junior security. In a healthy start-up, new rounds of preferred typically invest in instruments that are *pari passu* (i.e., at the same level) with prior rounds, and at an equal or “1x” liquidation preference. The effect of those two terms is that they are placed at the same level as all other preferred shares and, if the company is sold for under the total amount invested in the company, they would lose a portion of their investment in the same proportion as all other preferred shareholders.

Conversely, in a distressed situation, investors should ask for at least senior preference so that they rank higher than existing levels of preferred. Further, as a rarer term, the investor with leverage can ask for liquidation preferences that are above 1x, so that in a down-round sale, they will be assured a multiple of their initial investment prior to any other preferred investor taking anything (similar to a change-of-control premium in a convertible note).

Participation Rights

Participation rights are rights to share, or “participate,” in any remaining proceeds that the common shareholders receive in addition to collecting the original investment via the liquidation preference that the preferred shareholders receive. In healthy start-ups, such rights have become relatively uncommon: the preferred stock receives either its liquidation preference or the pro rata portion of proceeds to the common on an as-converted basis. Having a participation right in effect allows the preferred holder to double-dip and get the benefit of both securities. In a distressed company, investors should have more leverage to push for participation rights. In one 2019 law firm survey, investors received uncapped participation rights in 32% of down round financings.

Investors arguing for participation rights may point out that by investing during a troubled time, simply being guaranteed its money back is inadequate compensation. And further, relative to having a liquidation preference greater than 1x (as described above), participation rights operate to properly align the investor and management, since the participation does not kick in until at least the common start receiving proceeds. One method of compromise on participation rights is to cap them at a multiple of the original investment. By this theory, if investors are truly receiving a high return, they should not be further entitled to double dip.

Warrant Coverage

A warrant entitles an investor to purchase additional equity at a pre-specified strike price. Warrants are rare in normal equity financings, and are more common in debt financings where the lenders' upside is otherwise capped. However, warrants can be alternative mechanism to reach a compromise position to either of the options above. Warrants have some benefits to the company relative to either a higher liquidation preference or a participation right.

First, the warrant can be set to only be exercisable in cash (as opposed to allowing for a “cash-less exercise”, where the number of shares issued is reduced to account for the payment of the exercise price), which means that the company could at least be assured of receiving some amount of additional financing in exchange for the extra dilution. Second, the parties have more flexibility to set the exercise price (and type of security), such that the warrant only has value after the company has achieved a sufficiently high valuation. Third, from an optical perspective, because warrants are a separate instrument from the underlying preferred stock, the company may be able to gain more flexibility to not offer them in future rounds of financing.

Protection Against Future Dilution

In making the investment in the distressed start-up, the investor should always be aware that its investment proceeds may not be the last financing the company ever needs. As such, having protections against future rounds of investments becomes advisable to ensure that future rounds do not harm the existing investment.

Veto Rights

The bluntest instrument in the arsenal is to ask for class-specific consent rights that the investor can control (rather than sharing such consent rights with all other preferred holders). In theory, if an investor could obtain consent rights over future amendments to the charter and to issuances of debt, they can basically foreclose any further preferred or debt issuances. A variation would be to ask for a consent right over any senior or pari passu equity or debt, which would allow junior securities only. Such consent rights can be highly contentious because they effectively give the investor leverage to starve the company.

Preemptive Rights

A preemptive right is the right to subscribe for future rounds of financing at the company, with the intent to allow the investor to maintain its ownership percentage through subsequent rounds. One investor-friendly provision to consider is the right to subscribe for any additional portion of a future financing that other investors decline to subscribe for, above the investor's pro rata share.

Such a provision, which is originally intended to keep a company within a small group of existing investors, has a by-product in that a motivated investor can, through multiple rounds of financing, gradually gain control of the company if other investors get tired of funding the company, by continually buying up the leftover shares in each round. A patient investor

may also be able to achieve this end via negotiating for rights of first refusal on any sales by other investors, thereby gradually buying up shares as others exit, though such secondary transactions are rare.

Anti-Dilution Rights

A third common mechanism is an anti-dilution provision, whereby the conversion price of the preferred stock is adjusted downwards (i.e. in favor of the investor, such that the investor would receive more shares of common per share of preferred that it holds) if the company issues a future round at a lower price. The prevailing market formula for anti-dilution is referred to as a “broad-based weighed average,” which looks at both what the new issue price is (relative to the investor’s original investment price) and the size of the new investment relative to the overall capitalization.

In effect, it prevents a small new investment at a low price from dramatically re-pricing all the prior rounds. An investor with leverage might consider pushing for a full-ratchet anti-dilution mechanism, by which its shares are automatically re-priced to the exact same issue price of the new round. A full ratchet is fairly rare for healthy venture-backed companies, but in distressed situations, can be a valuable deterrent against management seeking to issue equity at a lower price without obtaining the investor’s prior consent.

Liquidity Rights

Perhaps the most challenging of these topics is how to increase the chances for a liquidity event such as a M&A exit or an IPO so that there can be an eventual exit of the investment. In most situations, the investor will not obtain control over the board to unilaterally force a sale. However, the investor must keep the fundamental misalignment in incentives in mind: it may prefer a sale at a price that clears its returns hurdle (or at least gets its money back), while management may prefer to run a company itself, with the hope of obtaining more returns for the common.

Drag-Along

A drag-along right is the express power for the investor to force other shareholders to consent to any sale proposed by the investor. In practice, in most situations where the investor is obtaining only a minority of the company, it will be rare for the investor to negotiate unilateral drag-along rights. Management and the other investors would be reluctant to give an investor the ability to force a sale at a point where it benefits, but where other investors and employees are wiped out. Further, in practice, trying to market a company without the cooperation of management can be extraordinarily challenging.

One potential compromise is to specify that the drag-along only applies at or above a pre-specified valuation. Another compromise is a “soft” drag-along by which the investor can force the company to initiate a sales process but cannot force the sale itself. A drag-along may also force smaller minority investors to sell, thus insulating against possible fiduciary duty claims by potentially disgruntled shareholders.

Redemption Rights

A redemption right (like maturity dates on a debt) provides the investor with the ability to force the company to buy back its preferred stock (plus whatever accrued dividends) by a certain date. In practice, an investor will likely not be able to compel the company to fund a repurchase: the start-up at that point in the future will still likely be without the funds to actually pay for the redemption. Instead, the redemption right is a useful tool to force management to consider a sale (or another distressed capital raise), because in effect the investor is making the company choose between a bankruptcy or a sale.

Other Rights

In contrast to the above, certain common rights are likely to have little utility in the situation of a distressed start-up. To begin, registration rights – the right to force the company into an initial public offering – have little value because it is even harder to force reluctant management to go public than to force them into a sale. Further, the chances that a distressed start-up will one day be strong enough to enter the public markets are slim.

Another common right is a tag-along right, whereby the investor has the right to sell on the same terms as other investors. Although tag-along rights are nice to have (and are nearly universal), they may not have much value as there is generally not a robust market for secondary sales of private company stock at scale.

Fiduciary Duties Considerations

Potential Conflicts of Interest for Venture Representatives

Down rounds can raise potential conflicts of interest for board members. Most boards of venture-backed start-up companies include representatives from the company's major investors. Because the major investors of the company may be participating, if not leading, the down round, their interests and priorities may be at odds with the interests and priorities of the minority shareholders. Non-participating minority shareholders face conversion of their preferred stock, losing their negotiated preferential voting rights and waiver of their anti-dilution protections. As such, the representatives of the major investors on the company's board of directors may be at risk for conflicts of interest claims.

Further complicating the matter is the possibility that judicial review of these types of claims of conflicts of interest may not be subject to the "business judgment rule" standard of review, but may be reviewed under the heightened "entire fairness" standard, where the directors bear the burden of proving the transaction was fair.

Down Rounds from the Company's Perspective

While negotiating the down round, the company should take certain steps to ensure an argument for the fairness of the transaction to minimize the risk of conflict of interest claims. These include, among other things, adequate disclosure to existing shareholders and running an independent, arms-length process. Understanding and communicating the structure of the down round is important. The company should understand the amount of dilution existing shareholders will be subjected to, and it should communicate the effects to existing shareholders, particularly employee shareholders.

The terms and effects of the down round, and the process by which the down round was negotiated, should be adequately disclosed to the company's shareholders when seeking shareholder approval. Disclosure should also include the benefits of the down round, whether to existing investors, the participating shareholders, the board, or the management and employees. The disclosure to the company's shareholders should also clearly and adequately detail the adverse effects to any non-participating shareholder.

The process by which the company and its board of directors explores the financing round (and potential alternatives) should be conducted as independently as possible and each step in the process should be documented (including documenting the board's reliance upon legal and financial advisors). Conducting a market check for a new, third-party investor to act as the lead in the down round (as opposed to an existing major investor leading the round) ensures an argument that the terms of the round were negotiated at an arm's length.

Additionally, providing existing minority shareholders with the opportunity to participate in the down round (or conducting a rights offering), and seeking the approval of the minority shareholders, helps demonstrate the fairness of the transaction and stave off conflicts of interest claims.

Conclusion

Investors in down rounds must ensure their downside risks of investing in a distressed start-up are adequately counterbalanced by the potential upside in the structure of the round. Including the mechanisms described above helps to ensure that the lead investor realizes as much upside as possible.

As a lead investor in a down round, it is important to understand the capitalization structure of the company, particularly focusing on the approval rights of existing shares of preferred stock and the liquidation preferences and anti-dilution mechanics, in order to effectively structure the down round. Also, coordinating with the existing major shareholders and the company will ensure that the down round is structured in a way to best achieve maximum upside and limit downside risk. Providing enough "teeth" to the down round (i.e., recapitalization, pay-to-plays), while also rewarding and encouraging investor participation in the round will minimize risk of legal challenges and lead to a smoother transaction.

Investors will benefit from not simply relying on the standardized terms prevalent in venture financing in normal times. Instead, investors should thoughtfully construct their own parameters in order to maximize both upside profits and downside recoveries.