3.2.5 Secured Bridge Loans to Emerging Companies

Original Title: Secured Bridge Loans to Emerging Companies — Overview of Certain Issues in Subordination and Security Agreements [1]

By Kenneth Blohm, Jeffrey Kayes and Haim Zaltzman of Latham & Watkins LLP

Recent initial public offerings bring hope of improved liquidity for venture capital investments. But venture capitalists (VCs) and the companies they incubate continue to face turbulent economic conditions in 2010. IPO activity, which hit its zenith in 2006 and 2007, will remain depressed in the foreseeable future.[2] The debt markets are also unlikely to provide a helping hand, as most banks and small businesses expect lending to remain far below previous levels.[3] Many VCs consequently find no alternatives but to reach further into their funds or to bring in other VCs to support their existing portfolio companies.

Secured bridge loans from VCs have been very common in this new market. We believe that this trend will continue due to increased difficulty in closing equity rounds, limited exit opportunities and the relative benefits that a secured loan may offer in the bankruptcy context.

This *Client Alert* highlights certain legal and practical issues related to making secured bridge loans to emerging companies. In particular, this Alert focuses on issues related to subordination of VC-provided bridge loans to existing and future senior debt and to appropriately structuring security agreements.

Awareness of these legal issues can help the venture community avoid surprises, and hopefully help streamline the negotiation and execution process.

Subordination to Senior Debt

Most emerging companies have outstanding senior secured loans, usually provided by venture bank lenders (Senior Debt). Unless an exception is negotiated, the documents evidencing the Senior Debt typically severely limit the incurrence of other debt. Company's counsel should carefully review any Senior Debt in connection with entering into bridge loan transactions to determine whether any waivers or consents are required. In particular, most Senior Debt documents do not permit any other debt to be secured. Senior Debt lenders customarily waive this requirement, on the condition that the VC bridge lenders enter into a satisfactory subordination agreement that deeply subordinates the bridge loan to the Senior Debt. The required subordination agreements or other similar intercreditor arrangements cover various aspects of subordination and raise numerous issues, two of which are the focus of this *Alert*.

Restrictions on Cash Payments

Senior Debt lenders often do not permit any cash payments under the bridge loan until payment in full of the Senior Debt. Interest can be paid in kind (*i.e.*, capitalized) but no cash payment is permitted. This translates into a complete block on all cash payments, including interest and principal, whether paid periodically or at maturity. Because of these restrictions, the only way the bridge loan can be repaid while the Senior Debt remains outstanding is to make the bridge loan convertible into equity securities of the borrower, and for the bridge loan lenders to exercise this conversion option. It is important to note that subordination agreements often define "Senior Debt" to include any refinancing of Senior Debt, so that the foregoing restrictions will remain in effect until the original Senior Debt, or any refinancing of such Senior Debt, has been paid in full. Some Senior Debt lenders have permitted limited periodic interest payments; but the norm has been a complete block on all payments.

Furthermore, some Senior Debt lenders have demanded that the equity securities into which the bridge loans are converted do not permit any redemption in cash. Many initial rounds of equity financing permit redemption in cash so VCs' counsel should carefully review the company's organic documents to confirm whether restrictions on cash redemptions are workable.

Senior Debt lenders typically insist on these restrictions on cash payments for several reasons. First, the maturity of VC bridge loans is typically significantly shorter than the maturity of the Senior Debt and the Senior Debt lenders do not want the company to make large payouts to the VCs funding the bridge loans before the Senior Debt is paid off. Second, and most importantly, Senior Debt lenders tend to view bridge loans as ultimately an equity investment in the portfolio company rather than another true layer of debt. Senior Debt lenders therefore expect equity-like, complete subordination between their senior loans and VC-provided bridge loans.

Limited Enforcement Ability

The second subordination issue relates to enforcement actions by VC lenders. In more traditional subordination agreements between Senior Debt lenders and junior lenders, junior lenders negotiate certain limits on the ability of the Senior Debt to constrain action by junior lenders if a default occurs. For example, when an event of default occurs, Senior Debt lenders are often only given a certain number of days (90–180 usually) before junior lenders can exercise remedies. But Senior Debt lenders have typically not permitted VC lenders to have any flexibility to bring enforcement actions against the borrower, regardless of how long a default may have existed. This is the case because Senior Debt lenders tend to view VC bridge loans as equity investments and equity does not enjoy such rights. As a result, there is typically an unlimited standstill on the VC lenders' ability to take any enforcement action even if there is a default under the bridge loan.

So that there are no surprises on these fronts, VC bridge lenders need to be aware that their loans will likely be deeply subordinated to any outstanding Senior Debt.

Security Agreements for VC-provided bridge loans

The collateral arrangements for most secured bridge loans are usually set forth in a security agreement between the VCs providing the bridge loan, as secured parties, and the company, as debtor. Security agreements entered into in connection with VC-provided bridge loans involve several unique issues.

For example, most bridge loans are funded by several VCs. This raises the issue as to how to coordinate action under the security agreement, including the exercising of remedies, among the VCs. In a typical lending situation, one lender would act as agent for other lenders. But VCs typically do not have the experience (including back office capabilities) to handle such a task. Nor do VCs customarily agree to take on the possible additional liability that an agent role entails. So often no VC is willing to assume the role of agent. In such a case, the VCs usually agree to act collectively based on a vote.

Fixing the percentage vote required for any decisions then becomes necessary. Otherwise, it is unclear whether remedies may be exercised only by unanimous vote of all VC bridge lenders or by any VC bridge lender individually, even if it funds only a minimal amount of the bridge loan. But voting by various VCs raises the second most common problem — establishing an appropriate voting threshold, particularly to call an event of default and exercise remedies. Unlike with typical venture lenders, one or more of the VCs providing the bridge loan often enjoy a controlling equity position in the company. This complicates negotiations with respect to voting thresholds as a controlling VC may exercise (or not exercise) remedies against the will of minority VCs. There is no simple solution, as a proper threshold may depend on the relationships among the company's VCs and other concerns. But often (and largely to avoid protracted negotiations) VCs settle on either a simple majority or two-thirds super majority voting threshold.

UCC Filing Considerations

Even though filing UCC financing statements to perfect security interests is not onerous, two issues should be kept in mind on this front. First, the UCC financing statements need to account for the numerous secured parties and correctly name such parties on the financing statements. And second, as there is often no single VC that is acting as an agent and the VCs themselves are often not represented by counsel, there is no clear lenders' counsel that will file initial UCC financing statements and if necessary, file UCC continuation financing statements. The VC-provided bridge lenders should consider these issues and discuss the same with their portfolio company and its counsel.

Collateral

The final issue that arises is what collateral should secure the VC-provided bridge loan. VCs often expect that the security grant will cover all assets. This expectation, however, runs into two roadblocks. First, the Senior Debt's security position often does not cover all assets and excludes intellectual property (IP). Assuming that the Senior Debt lenders agree to permit the bridge loans to be secured in the first instance (which they regularly do), the Senior Debt lenders will not agree that the security package for the VC bridge lenders include IP or other property not included in the security package for the Senior Debt lenders. Second, even if there is no Senior Debt outstanding, there may be additional search and perfection costs associated with taking a security interest in IP that the company and its VC investors should consider and discuss with their counsel.

Kenneth Blohm, Partner, ken.blohm@lw.com

Kenneth Blohm is a partner in the Finance Department of the San Francisco office of Latham & Watkins where he specializes in project finance and leveraged finance matters. He also has an active equipment leasing practice.

Jeffrey Kayes, Associate, jeffrey.kayes@lw.com

Jeffrey Kayes is a finance associate in the San Francisco office of Latham & Watkins. His practice focuses on leveraged acquisition finance but includes structured, project, capital markets and real estate finance.

Haim Zaltzman, Associate, haim.zaltzman@lw.com

Haim Zaltzman is an associate in the San Francisco office of Latham & Watkins. As a member of the Finance Department, his practice focuses primarily in general banking, energy and project finance transactions and venture finance-related work. He represents emerging companies in venture financings provided by leading venture lenders and investors.

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[1] This Client Alert does not address issues related to the California Finance Lenders Law or bridge loan structuring issues, including any related notes and warrants. The legal issues discussed in this Client Alert are not exhaustive; other issues do and will arise. The discussion in this Client Alert is only a summary of certain issues and should not be deemed our advice or our opinion on any matter discussed herein.

[2] David Lawsky, "Venture capitalist confidence up, still wary: survey", July 9, 2009 at http://www.reuters.com/article/americasPrivateEquityNews/idUSTRE56813W20090709

[3] Sara Murray and Jon Hilsenrath, "Banks Keep Tightening Loan Standards", August 18, 2009, The Wall Street Journal at http://online.wsj.com/article/SB125051411593936673 9.html. See also Gretchen Morgenson, "Get Ready for Half a Recovery", New York Times, Sunday Business section, November 29, 2009, p 1.