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DEFENSIVE STRATEGIES IN A VOLATILE STOCK MARKET

Stock market volatility during the past few months has created a challenging environment for management, directors, and their advisors. Here are key financing and bankruptcy issues to consider.

Is there any capital out there? Volatile capital markets have led to a dramatic decline in the number of initial public offerings and other registered offerings of both debt and equity securities. Equity raised through IPOs totaled $3.1 billion for October 2000, which is less than half of the $6.4 billion raised in July 2000 and less than one-fifth of the $16.9 billion raised in April 2000.

Companies in need of capital must look to sources other than the public markets. Accordingly, many companies are trying to raise capital through a private sale of equity or debt securities to institutional investors, often in the form of a "bridge loan." If the investment is in the form of a typical venture capital investment in convertible preferred stock, the deal terms are often not what they would have been a few months ago. Leverage in negotiations has shifted back to the investor as valuations continue to go down (which can lead to the problem of "down round" financing, discussed below). Additionally, if the company is seeking debt financing for an acquisition, the lender may not be willing to loan enough to cover the acquisition price.

Bridge Loan Financings. Many companies in need of immediate capital to sustain operations and/or fund acquisitions during the period in which the company is unable to close a larger round of financing are taking "bridge loans," which are typically in the form of short term loans with an equity component (either in the form of a debt instrument that converts into equity or in the form of warrants). In some cases, the lender will require that the debt be secured by some or all of the company's assets, such as its intellectual property. This gives the lender additional protection but requires additional documentation and will slow down the financing process. The equity component can be structured in any number of ways but often is used as an incentive, or disincentive, for the company to repay the debt as quickly as possible by giving the lender the option to buy more of the company's equity the longer the debt remains unpaid. Typically, if the debt instrument is convertible into the company's equity, it will convert into the same securities (at the same price) as the company issues in its next round of financing. Recent bridge loans have included particularly onerous covenants, events of default, and remedies, including, for example, the right for the lender to take control of the board upon a default.

Changing Terms of Venture Capital Deals. Venture capital money is still available, but much of it currently is being used to fund existing portfolio companies and valuations are down. Investors now tend to have more leverage than companies seeking financing, although a hot company may still be able to dictate the terms of the investment. Here are a few examples of recent trends in financing terms:

- ***Liquidation Preference.*** Until recently, many companies successfully resisted granting "participating preferred" stock, which allows the investor on a liquidation or sale of the company to first receive its initial investment and accrued but unpaid dividends before any assets are distributed to the holders of common stock and then allows the investor to participate on a pro rata basis with the holders of common stock in the distribution of the remaining assets. It is now typical for the investors to ask for this. The company should be aware that participating preferred stock effectively lowers the company's valuation.

- ***Antidilution Adjustment.*** It is customary for investors to receive "economic antidilution," which adjusts the number of shares into which the preferred stock converts if the company issues shares at a lower price per share in a subsequent financing than the price paid by the investors in this financing. The "weighted average" formula, which takes into account both the price of the cheaper stock and the number of shares issued, has been the standard. Recently, however, investors have been pushing for the more Draconian adjustment know as the "full ratchet," which adjusts the conversion price to the price of the new, cheaper stock, regardless of how few shares are issued.

- ***Redemption.*** More investors are requiring the right to sell their shares back to the company. In the past, companies have often been able to resist giving investors a right of redemption because the company did not want to be required to use its precious cash to pay off equity investors. Additionally, preferred stock with a redemption right raises accounting issues because it may be treated as debt rather than equity. Nevertheless, many investors now want to make sure they can get their investment back if the company has cash on hand with no reasonable prospect of an IPO or sale of the company.

- ***Staggered Closings and Milestone Fundings.*** Until recently, it was common for a company to sell shares through multiple closings. Now, many investors are not confident that the subsequent closings will take place and may require a single closing at which time the full amount to be raised must come into the company. Conversely, some investors now want to invest in tranches, usually based on the company achieving agreed-upon performance goals. This type of "milestone" funding raises many issues, including defining the milestones that must be obtained and the remedy if an investor fails to fund when obligated to do so.

- ***Veto Rights.*** It is typical for investors to have certain "veto" or "blocking" rights over certain actions by the company, such as (i) authorizing or issuing new securities equal with or senior to the preferred stock; (ii) selling the company; (iii) amending or repealing any provision of the company's organizational documents in a manner that would change adversely the rights and preferences of the preferred stock; (iv) redeeming or purchasing any of the company's securities other than upon conversion of the preferred stock; or (v) permitting any subsidiary to issue or sell stock except to the company or another subsidiary of the company. Recently, this list has grown longer and may include any or all of the following actions as well: (vi) consenting to a voluntary dissolution, re-capitalization, liquidation, or winding up of the company; (vii) changing the nature of the company's business; (viii) incurring debt in excess of a fixed dollar amount; (ix) entering into a contract that obligates the company to spend more than a fixed dollar amount; (x) acquisitions of stock or assets in excess of a fixed dollar amount; (xi) increasing the options reserved for issuance under the option plan; (xii) declaring or distributing dividends; (xiii) increasing or decreasing the size of the company's board of directors; or (xiv) entering into transactions with affiliates or related parties.

- ***Ramifications of "Down Round" Financing.*** If a company is forced to offer its equity securities at a lower valuation than in a prior round of financing, the financing is called a "down round." A down round raises several issues. First, the existing

holders of preferred stock will likely have a right to economic antidilution adjustment (as discussed above) and thus their preferred stock will now be convertible into a greater number of shares of common stock. This dilutes all holders of securities that do not have antidilution protection, such as holders of common stock and options for common stock. Second, the investors in a down round may insist that their "last money in" should be the "first money out" by requiring their liquidation preference to be superior to all other holders of preferred or common stock. They may make similar requests with respect to their priority of registration rights and dividends as well. Finally, the investor in a down round may demand a board seat (or at least the right to be an observer) and veto rights specific to that investor's class or series of stock to give the investor more control than they would typically get in a later round of financing that is not a down round. These requests may complicate obtaining any required consents from existing investors in order to complete the financing.

How has the current volatility changed exit strategies and deal terms?

Sale of the Company As the Most Viable Exit. An investor in a company has several exits from the investment — sale of the company, IPO or other public registration, selling the stock back to the company, or selling the stock to a third party. As noted above, investors cannot rely on the public capital markets as an exit in the current market. If the company is short on cash, a redemption of the stock is not a viable alternative. Accordingly, selling the company is the primary exit currently available to investors.

Buyer Leverage. Buyers, especially those with substantial cash on hand, now have significant leverage in the sale of a company that is struggling in this volatile market. This has led to (i) lower valuations, (ii) more asset deals, and (iii) more thorough due diligence reviews of the company to be acquired.

- ***Lower Valuations***. Selling a company for something significantly less than a "homerun" may implicate the liquidation preferences that preferred stockholders typically have. Selling the company at a very low valuation may mean that after the holders of preferred stock receive their liquidation preference, there is little left to go to the holders of junior preferred stock or common stock.

- ***Asset Deals.*** In a buyer's market, buyers may also insist on a sale of the assets of the company, as opposed to a sale of the company's stock or a merger. Buyers typically like asset sales because the buyer can specifically state which assets and liabilities it will take and can avoid taking on unwanted liabilities of the perhaps financially troubled target.

- ***Increased Due Diligence.*** The market volatility has made buyers less risk tolerant than they may have been in the recent past when the companies being sold had the leverage to push the deal forward quickly and may have had multiple suitors. The timing of many deals has been slowed and the amount of legal, financial, and technical due diligence conducted on companies for sale has increased. Additionally, caps on indemnification are going up so that the buyer can recover more of the purchase price from the seller for breaches in the representations and warranties made by the sellers.

Risks Associated with Delayed Closings. Another consequence of market volatility is that the time between signing the deal and closing the deal will have increased importance, as market shifts during that time can change the value of what is being purchased. Where publicly traded securities are part of the consideration for a sale, parties will likely consider "ceilings," "floors," and "collars" — that is, upper and lower limits on the price or number of securities that make up the consideration for the sale. The language and scope of any "no material adverse change" clause in the acquisition contract (which allows one party to walk away from the signed agreement before closing if there is a material adverse change on the other party)

will need to be carefully considered in light of market volatility.

Absence of Hostile Takeovers. In recent years, the mergers and acquisitions landscape has been characterized by the general absence of hostile takeovers. At first blush, this is somewhat surprising given that some companies are trading at such a low price compared to the cash they have in the bank that they appear to be prime targets for a hostile takeover. Additionally, many companies have not adopted the full range of anti-takeover mechanisms available, such as classified boards (*e.g.*, where only one-third of the total number of directors are up for election in a given year) and "poison pills" (which is a mechanism by which additional shares of stock are issued if a hostile takeover commences). This may be because shares of many new economy companies are largely owned by founders (and other management-friendly investors) who can prevent a hostile takeover.

What about bankruptcy? Whether bankruptcy makes sense for a company facing severe financial pressure depends on whether the company needs or wants to use the tools that are available under the Federal Bankruptcy Code to carry out a restructuring, sale, or liquidation strategy and whether it can afford the costs of operating in bankruptcy.

Liquidation v. Reorganization. A bankruptcy filing protects a company temporarily from the claims of its creditors, but it does not eliminate those claims. Instead, the pre-bankruptcy claims are held in abeyance, and creditors are prevented from taking action to enforce them, until the bankruptcy case is over. In order to reorganize, the bankrupt company must develop a plan to deal with these pre-bankruptcy debts and that plan must be accepted by the creditors and other interested parties. This means that the business must be capable – and the creditors must believe that it is capable — of producing profits that can be paid to creditors in the relatively near future. Without a credible business plan that offers a realistic prospect of near-term profits, a bankrupt company will have a very difficult time avoiding liquidation.

Advantages of Bankruptcy. Even if the company's strategy is to sell its business or simply liquidate, a bankruptcy filing can make sense. Aside from preventing pre-bankruptcy creditors from attempting to collect their claims during the case, the federal Bankruptcy Code allows bankrupt companies to reject uneconomic contracts and leases and to assign valuable ones to third-party buyers even if the contracts and leases are non-assignable by their terms. It also protects buyers of assets by allowing those assets to be sold free and clear of all liens, claims, and interests and eliminating any future challenges to the fairness of the purchase price or terms of the transaction. This greater certainty for buyers can translate into a higher purchase price or reduce or eliminate the need for indemnities and escrows in connection with the transaction, potentially increasing the net proceeds.

Costs of Bankruptcy. There are, however, significant costs associated with using the bankruptcy process to sell the company or liquidate. First, because it is a formal process administered by a federal bankruptcy judge through public hearings in which creditors and shareholders are entitled to participate, bankruptcy sales and liquidations take longer than similar out-of-court transactions. A sale of the company in bankruptcy is unlikely to close for at least 45 days after the case is filed, and it could be delayed well beyond that point. If the business is rapidly deteriorating, a bankruptcy sale may take too long to be feasible. Second, the bankruptcy sale process is structured to encourage competing bids, which may make it less attractive to a buyer than an out-of-court transaction. Third, a bankruptcy sale is only one part of an elaborate and potentially expensive bankruptcy process that must run its course over a period of many months before sale proceeds can be distributed to pre-bankruptcy unsecured creditors. Expenses of the bankruptcy case, which can be substantial, must be paid in full before any funds can flow to pre-bankruptcy unsecured creditors.

Patented Technology. The company should be especially cautious about filing bankruptcy if its business depends upon patented technology licensed to the company on a non-exclusive basis. Non-exclusive patent licenses are not assignable to third

parties without the licensor's consent, and recent court rulings have called into question the ability of a bankrupt company to retain such licenses for purposes of reorganizing. The willingness of the licensor to consent and the ability of the company to operate without the patented technology need to be assessed as part of any decision to seek bankruptcy protection.

Intellectual Property of Licensor in Bankruptcy. As discussed, the Bankruptcy Code allows bankrupt companies to reject contracts that would otherwise be binding. Where a licensee depends on the technology of a licensor in bankruptcy, such rejection can be devastating. Section 365(n) of the Bankruptcy Code, however, enables licensees to retain some leverage in a licensor's bankruptcy. Section 365(n) permits a licensee to "retain its rights" to the intellectual property if the bankrupt licensor rejects the license, whereby the licensor must provide the licensee with the licensed intellectual property in its possession (including any embodiments) and allow the licensee to exercise all rights under the license for the duration of such license. Licensees making this election under Section 365(n) must continue to make royalty payments due under the license for its term, and is deemed to waive "any right or setoff" it may have with respect to the agreement. Section 365(n) does not provide complete protection. Congress failed to include trademarks in its definition of intellectual property under Section 365(n) and thus licensees of trademarks have no right to retain any interest in "rejected" trademark licenses. As a result, it is sometimes a good idea to perfect a security interest in licensed marks, which security interests will survive bankruptcy. Additionally, Section 365(n) does not give licensees a right to compel specific performance, thereby relieving licensors of any obligations for maintenance, training, support, and upgrades. Accordingly, it is a good practice to retain employees who are capable of providing these services in the event the licensor goes bankrupt. To take advantage of Section 365(n), license agreements should ideally contain provisions that characterize all licensed technology as "intellectual property," that obligate licensors to escrow all embodiments of the intellectual property (*e.g.*, the source code), and that obligate licensors to update the escrow account regularly. Finally, licenses should guarantee the delivery of the intellectual property from the licensor to the licensee upon the filing of bankruptcy.

Data Privacy. Another issue that deserves special mention in connection with new economy companies relates to customer lists and related data. For many companies, this information will be among the most valuable and most readily saleable assets. But recent cases have made clear that customer privacy concerns may impede such sales, particularly where the information was collected under a pledge of confidentiality. Accordingly, both sellers and potential buyers of such information need to be cautious in considering such sales. (*See* discussion in inset).

FTC Forces Toysmart to Honor its Privacy Policy. Toysmart, an online toy retailer, posted a privacy policy promising customers that"Personal information…such as name, address, billing information and shopping practices, is never shared with a third party." Toysmart then proceeded to gather such personal information on many of its roughly 250,000 web visitors, accumulating a valuable pool of data. When Toysmart filed for bankruptcy, the company placed an advertisement in The Wall Street Journal offering "intangibles, i.e., URL name, databases, customer lists, marketing plans, [and] Web site content" for sale at auction to pay off its roughly $20 million in outstanding debt. The offer received a great deal of attention from privacy advocates and from the Federal Trade Commission.

When the FTC filed suit to prevent Toysmart from selling its customer information, Chairman Pitofsky stated that "[e]ven failing dotcoms must abide by their promise to protect the privacy rights of their customers." Forty-one state attorneys general also objected to the sale of the information as a stand-alone asset. Eventually the FTC agreed to settle with Toysmart, allowing the information to be sold in connection with a sale of the entire web site to an entity in a related market that was willing to agree to be Toysmart's successor-in-interest as to the customer information. The vote on the FTC settlement was 3-2.

Despite the FTC settlement, Toysmart was unable to sell its customer information. The bankruptcy court set aside the conditions placed on the sale on the grounds that restricting the pool of buyers would be "counterproductive to the interests of the estate." Negative publicity drove away prospective buyers, but when Disney, Toysmart's 60 percent owner, offered to purchase and retire the customer information, creditors balked at the $50,000 price tag as being too low.

Public outcry about the Toysmart case reflects increased consumer concerns about online privacy, and demonstrates that representations made to customers regarding their private information will likely be read by courts to maximize customer privacy, even at the expense of protecting a bankrupt entity and its creditors. For the time being, companies can plan their privacy policies with an eye to maintaining flexibility in a liquidation or reorganization setting, but this issue is likely to be among the privacy issues considered in the upcoming Congress.

Operating Expenses. A bankrupt company must pay its post-filing operating expenses — including its employees, vendors, and landlords — on a current basis during the bankruptcy case while it either waits for approval to sell the business or works out a plan to reorganize and emerge from bankruptcy as a going concern. This means the company must have sufficient funding — either a hoard of cash or current positive cash flow from operations or new loans — to operate in bankruptcy. While the Bankruptcy Code offers special protections for lenders willing to fund a company's operations in bankruptcy, it does not require lenders to make new loans. Without a source of funding, bankruptcy is unlikely to be a viable alternative.

Options Outside of Bankruptcy. It is, of course, possible for a company to reorganize or liquidate without filing bankruptcy. Out-of-court reorganizations make sense when the number of creditors is small and most or all of the creditors are willing to agree on a reorganization plan. The disadvantage of an out-of-court restructuring is that dissenting creditors will not be bound by the deal and remain free to pursue their claims to the detriment of everyone else. If the claims of dissenting creditors are small, the other creditors may be willing to accept this risk, but substantial dissenting claims are likely to make an out-of-court restructuring impracticable. Out-of-court liquidations hold somewhat more promise if they can be completed quickly. Once all funds have been distributed, there is little incentive for creditors to take further action unless they can argue that the distribution scheme was inequitable or contrary to law. Nevertheless, the company's management and directors will not have the protection of a court order approving the transactions, and therefore must assess the risk of such claims before deciding to proceed with an out-of-court liquidation.

What if we're sued by shareholders?

Publicly traded companies are vulnerable to shareholder suits in a volatile stock market. When a company's stock drops in value, especially following a disclosure of bad news, the company may become the target of class action lawsuits — perhaps a large number of cases alleging the same or similar claims under federal and/or state securities laws. The plaintiffs in these cases often bring:

- Claims that the company's prior statements of its past performance were intentionally false and designed to inflate the value of the company's stock (under, for example, Section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5);
- Similar claims against the *individuals* who made or signed any allegedly false statements;
- "Controlling persons" claims against the company's officers and directors, *whether or not* they made or signed any allegedly false statements;
- Insider trading claims against officers, directors, or employees; and,
- Claims against the company's *auditors* if the alleged fraud is based on the company's SEC filings.

Shareholder lawsuits can do considerable damage to a company's image in the eyes of its customers, partners, and investors, especially when the company is young or otherwise untested. A company sued in one of these cases immediately faces a number of strategic decisions: Should we fight the lawsuit, and how aggressively? Should we try to settle the case? If so, how soon and on what terms? These questions can only be answered after an investigation of the facts and

an evaluation of the legal merits of the case. But they often turn, at least in part, on other considerations, such as how well the company can tolerate ongoing litigation. The Private Securities Litigation Reform Act of 1995 ("PSLRA") offers several attractive tactical advantages for a company that elects to pursue an early and aggressive defense:

- Every securities fraud class action must allege specific "facts giving rise to a *strong inference*" that the company knew about or ignored the alleged violations. Such facts might be difficult to ascertain at the outset of litigation.

- A district court generally must stay discovery until it rules on a motion to dismiss. A strong motion to dismiss could delay time-consuming, expensive, and potentially damaging discovery for months.

- Putative lead plaintiffs must compete with *each other* in the first months of the litigation to determine who will be in charge of the case. From the defendant company's point of view, this process helps bring order to the litigation — especially where there are multiple lawsuits — and may give the company extra time to formulate its strategy and defenses while plaintiffs litigate against one another.

- The statutory limit on damages may enhance a company's position in settlement talks.

Preventative Measures. What can a company do to guard against shareholder lawsuits in a volatile stock market? The most important point is that a plaintiff's complaint generally will be built on a company's public statements and actions. Lawyers for shareholders who have experienced significant losses from a stock price drop will pore over the company's public statements and financial reports looking for something they can hold up as misleading. To defang future complaints, therefore, a company should (i) discourage counterfactually optimistic appraisals of its past performance; (ii) ensure that appropriate accounting procedures are followed at all times; and (iii) avoid actions and statements that, out of context or otherwise, may suggest that the company considers securities regulations are of secondary importance. Other things companies might do is make sure all forward-looking statements are labeled in a way that brings them within "safe harbor" provisions of the PSLRA protecting against liability, and carefully consider their list of risk factors they include in their Form 10-K disclosure (for the same reason).

Next month: Directors' duties, maintaining your NASDAQ listing, and attracting and retaining key employees.

Our ECommerce, Business Transactions, and Securities Practice Groups represent a number of emerging growth companies, Fortune 500 companies, boards of directors and institutional investors throughout the U.S., Europe, and Latin America.

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