VENTURES AND INTELLECTUAL PROPERTY GROUP

LETTER

2005 **3rd Quarter**

MEZZANINE FINANCE

HOW'S THE VIEW FROM THE MIDDLE?

What Is Mezzanine Finance?

You are trying to finance the acquisition of a target company or you're looking for growth capital. So far you have lined up the senior bank financing and have investors ready to make an equity investment, but you have come up a little short of funds to accomplish your goals and still have a financing gap to fill. Should you just give up, deciding the deal was not meant to be? No, you have an alternative. You can add mezzanine finance to the mix and close the gap and close the deal.

Mezzanine financings involve risk capital investments which can take the form of debt or equity. This type of investment is referred to as "mezzanine" because it is carried on a balance sheet "in the middle" below the issuer's long-term and revolving senior debt (usually from a bank) but above its common stockholders' equity.

Since various investors and lenders have different risk tolerances, a senior bank may feel it has advanced as much credit to a company as it can within its credit and collateral guidelines, and equity investors may have felt that they have tapped out their resources as well, knowing that they are "last out" behind debt investors/lenders in any kind of liquidity event. That dynamic leaves a gap in the middle where investors willing to take more risk than banks and less risk that common equity investors provide valuable capital to companies. And the mezzanine investors also expect to be "compensated" for that risk by seeking internal rates of return in the 18%-25% range.

What's the Form of a Mezzanine Investment?

Mezzanine investments can take the form of debt or equity or debt that's convertible into equity or has an "equity kicker" such as a warrant to purchase stock. If the mezzanine investment is equity, it typically is preferred stock, and the issuer and the investor will have to negotiate the terms of that stock, including dividends, liquidation preferences, redemption rights, voting rights (determining what matters the investors will have veto rights over) and other investor rights (such as rights of co-sale, pre-emptive rights and drag along rights).

If the mezzanine investment is debt, it is usually subordinated (junior) to the senior bank debt (more on that later), and the issuer and investor will have to negotiate when principal is to be repaid (one balloon payment on maturity or current payments periodically or based on excess cash flows) and what the interest rate is (usually higher than the bank rate) and how often interest will be paid (monthly, quarterly, semi-annually or at maturity). To enhance returns for the investors and address cash flow concerns for the company, there may be a component of interest that accrues and gets added to the principal rather than paid currently, which then also accrues interest. This type of interest is referred to as "payment-in-kind" or PIK interest. Often the mezzanine debt is not secured by any collateral, but in some deals (seemingly an increasing number), the mezzanine investor obtains a lien junior to the liens securing senior debt

Generally, mezzanine investors expect a "kicker" to enhance their return for bearing more risk than the senior debt. In addition to PIK interest, the "kicker" could include some sort of formula bonus payment or detachable warrants to purchase a class of stock, and often the investor has the right to put the warrant or the shares purchased

pursuant to the warrant (i.e., sell the warrant or shares back to the company) at certain times and at a formula price. These formula payments are intended to allow the investors to enjoy some "upside" return if the company has done well (since formulas often include multiples of earnings or share values), but also to provide some "downside" protection (by setting a floor price) to try to guarantee some sort of return going into the deal.

Regardless of the form of the investment, the company and investors will negotiate various covenants, including both negative covenants (things the company is not allowed to do) and affirmative covenants (things the company must do) related to the operation of the business, as well as financial covenants. In addition, investors will expect to receive financial statements and other information from the company on a regular basis. Investors will also often expect to be able to nominate a certain number of members to the board of directors or at least have board observation rights.

Now the Fun Begins

So you've agreed on the basics of the deal – a subordinated note with warrants. You're done, right? Well, not quite. There are many players in a transaction with mezzanine financing, and now you have to figure out how everyone can play nicely in the sandbox at one time.

Interplay with Acquisition

If there is an acquisition involved and the mezzanine lender is financing the acquiring company to provide it with funds to make the acquisition, the mezzanine lender is interested in how the underlying deal is structured (stock purchase, asset purchase or merger) and what impact that can have on the mezzanine investment. For example, will management and other employees of the target company continue to work for the new company or will there be all or mostly new management? If key employees are not going to work for the new company, will they be subject to non-competition agreements to keep them off the playing field so that the new company has a better chance for success? Are there payments to be made over time to the selling stockholders or target company based on set installments or an earnout based on achieving certain milestones? If so, there will need to be discussions and agreements on when and how those payments can be made (regardless of what the buyer and seller agreed to), and generally they will not be allowed by either the holders of senior debt or mezzanine debt except under circumstances agreed to by such holders. Are any of the stockholders or management of the target company also going to become stockholders of the acquiring company? If so, the class of stock that they will own in the acquiring company and how their rights will interact with the rights of other equity and debt investors will have to be determined.

Interplay with Senior Debt

The interplay between the senior debt and mezzanine debt is where a lot of the action is. Consequently, it is important to have senior and mezzanine players that work well together. While the senior and mezzanine holders have negotiated their separate deals with the company being financed, that is only the beginning. The senior and mezzanine players have to agree with each other under what circumstances the mezzanine debt will actually get paid, notwithstanding the terms of the mezzanine documents with the company. Getting to the end of this process can involve some heated negotiations.

The senior and mezzanine lenders have to agree how much senior debt can, in fact, be senior to the mezzanine debt. The mezzanine investors will want to put caps on that amount, usually willing to be junior to credit facilities in place at the closing with some additional cushion to allow for the financing of contingencies. It is in both parties' interest to make sure the company can make payments on its different debt obligations and has enough operating capital to pay its usual bills, so they will want to make sure each is lending a sufficient amount at the outset and that the company's operating projections will support the loans and other payment needs.

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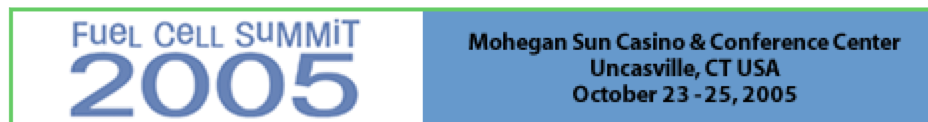
The interplay of covenants – affirmative, negative and financial – is also critical. The parties will need to decide if the mezzanine investor will adopt the senior debt's covenants of all types or perhaps just the senior debt's financial covenants and definitions (albeit with more lenient compliance levels). Since the senior debt tends to be overcollateralized at least at the outset, the senior debt may be less concerned with business operational covenants so investors would want to make sure the covenants as drafted provide sufficient protection to investors that may have no collateral and thus want better controls over general business operations. Regardless, the parties should be comfortable that the covenants are flexible enough to permit the company to operate in the ordinary course without regular waivers. Mezzanine investors would also need to make sure that none of the covenants in the senior debt restrict the negotiated terms of the mezzanine debt, at least not beyond the terms in the subordination agreement.

The subordination agreement is one of the main agreements that ties all of the parties together, and there may, in fact, be multiple subordination agreements to order the various layers of participants. The subordination agreement should address what payments the company can make to whom and when. The payments to be addressed are interest, scheduled principal payments, payment on maturity, and put/redemption payments on equity. The senior debt will want whatever the allowed payments are to be blocked under certain circumstances, such as payment and covenant defaults under the senior debt, and the mezzanine investor will want limits on number and duration of blocks on the payment of the sub debt. There will also be limits on when and how the mezzanine investor can pursue legal action to collect its debt.

Interplay with (Other) Equity Holders

Are we there yet? Not quite. We still need to sort out how the equity holders fit within the overall scheme. Since the mezzanine investor will want to be ahead in the pecking order, we must consider how its equity kicker, put rights, governance rights and veto rights over fundamental transactions stack up against the rights of the equity holders. While it is generally a minority equity holder, the mezzanine investor will often bargain for superior rights to other equity holders, and it is important that these are acknowledged and preserved in the equity structure.

As you can see, these transactions have many layers and are quite complex. Having the expertise of skilled professionals who have experience in the many areas implicated can provide invaluable assistance to the players on the stage. *For more information, please contact Donna L. Brooks at (860) 251-5917 or dbrooks@goodwin.com.*



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VENTURE BRIEFS

IP in Bankruptcy, Beware!: The U.S. District Court for the District of Connecticut recently found that a licensor's decision to file a voluntary petition for bankruptcy under Chapter 11 of the Bankruptcy Code constituted a material breach of a trademark licensing agreement, such that the licensee had no further obligation to perform under that agreement. In *Beckerman v. M. Hidary & Co., Inc.*, the Court, applying Connecticut state law, found that because the licensor (the sports apparel company, Starter) rejected the trademark licensing agreement in its bankruptcy proceeding, and then sold its trademarks at auction, such action constituted a material breach of the agreement because "it deprived the licensee of the ability to sell authorized goods bearing the trademark absent the new owner's consent to the licensee's use of the trademark." In so holding, the Court rejected the contention of the plaintiff (who was an assignee of certain rights and claims of Starter) that the filing of the licensor's bankruptcy petition constituted a termination of the license agreement pursuant to a termination clause in the agreement, which provided for automatic termination in the event either party filed for bankruptcy and provided in such an event for licensee payments for a 120-day run-off period while the licensee continued to sell inventory. The Court further rejected plaintiff's reliance on the fact that the trademark license agreements were not sold as assets in the bankruptcy proceeding. Rather, the licensor chose to reject the licenses and sold the trademarks — including the rights to all royalties for those trademarks — at auction. As a result, the Court found that there was no need for the license agreements themselves to have been sold or transferred. Finally, the Court found that the plaintiff was not entitled to any royalty payments, marketing fees or minimum guarantee payments. Specifically, the Court found, among other reasons, that because all rights to the trademarks, including royalty payments, were sold at auction, and that the plaintiff was not assigned his rights until after the sale of the trademarks, the licensor had no right to royalty payments and therefore could not assign any such claims to plaintiff.
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VENTURE BRIEFS

Underwriters May Owe Fiduciary Duty to Issuers: New York's highest court ruled recently that an underwriter can owe a fiduciary duty to an issuer in certain circumstances. In *EBC I, Inc. v. Goldman Sachs & Co.*, the court dismissed several alternate theories of liability, but found that the plaintiff had stated a valid cause of action based upon defendant's breach of a fiduciary duty. The defendant was hired by eToys, Inc. in anticipation of the company's initial public offering to advise the company regarding the pricing of the IPO and act as lead underwriter on a firm commitment basis. The defendant then syndicated the underwriting, but remained lead managing underwriter for the IPO. The defendant advised eToys to set the IPO price at $20 per share, and the parties agreed to a discounted price of $18.65 per share as the underwriters' price, the difference being the underwriter's commission on the deal. The stock opened at $79 per share on the date of the IPO and sold as high as $85 per share before closing at $76.56. By the end of 1999, the stock had fallen to $25 per share and soon fell below the IPO price, never to recover. In March of 2001, eToys filed for bankruptcy. The plaintiff then brought suit against the defendant and others for their role in the demise of the company. The IPO occurred during the technology bubble at a time when access to IPO's was highly coveted for the chance to make quick profits by run-ups in stock prices. The plaintiff alleged that the defendant made arrangements with the defendant's customers, who purchased the stock at the IPO price, to receive kickbacks of 20% to 40% when those customers subsequently sold their stock, making large profits from the quick turnaround. The New York Court of Appeals recognized the viability of the plaintiff's cause of action for breach of a fiduciary duty. The court reiterated the general rule that "fiduciary obligations do not exist between commercial parties operating at arms' length"; however, it held that an underwriter may owe a fiduciary duty to an issuer, based on a relationship of higher trust, that arises from an underwriter's role as advisor and not from the underwriting agreement itself. The court addressed the impact of its decision on the underwriting industry by restating that the court did not hold that underwriters are fiduciaries in any role other than that of advisor. Notably, the court suggested that the fiduciary duty consisted of the obligation to disclose material conflicts of interest, such as the kickback scheme alleged by the plaintiff. While the court's holding has caused consternation throughout the underwriting industry, the holding is a narrow one and can be dealt with effectively without significant impact on the way underwriters do business. Because the court found that the duty arose *prior* to the creation of the underwriting agreement, disclosing material conflicts in the underwriting agreement, which is executed near the end of the IPO process, may not be enough to satisfy the fiduciary obligations of the underwriter. Whenever possible, material conflicts and potential material conflicts should be disclosed prior to entering into an advisory role with an issuer and restated in any subsequent underwriting agreement. *Kyle Odin, (203) 324-8184 or kodin@goodwin.com*

SEC Adopts Major Reforms to Securities Offering Process: The SEC recently adopted significant changes to the securities offering process under the Securities Act of 1933, as amended (the "Act") that will take effect on December 1, 2005, completing a reform process begun a decade ago. Briefly (the adopting release is over 450 pages!), the SEC relaxed the so-called "gun-jumping" rules restricting oral and written communications prior to the filing of a registration statement and during the offering process, including through the use of a "free writing prospectus" and streamlined the shelf registration process, in each case principally for "well-known seasoned issuers" or "WKSIs." A WKSI is defined as an issuer that has been current in its 1934 Act filings for at least one year and has a worldwide public float of at least $700 million, or has issued at least $1 billion in registered nonconvertible securities (other than common equity) during the prior three years. Additionally, the SEC (i) expanded the exclusions from the definition of "prospectus" to include a broader category of routine communications; (ii) implemented an "access equals delivery" rule for final prospectuses, eliminating the need for physical delivery of a final prospectus so long as the prospectus is filed with the SEC and certain other conditions are met; (iii) made certain changes to 1934 Act disclosure requirements; (iv) addressed the treatment of electronic communications, including electronic road shows and information located on or linked to an issuer's website, under the Act; and (v) modified Regulation FD to clarify that these electronic communications are excluded from that regulation, yet may be subject to filing requirements under certain circumstances. Finally, the SEC addressed and clarified certain liability issues under Sections 11, 12(a)(2) and 17(a)(2) of the Act to provide that

liability is based upon all of the information provided to an investor at the time of the sale only, provided that prospectus supplements filed after the effective date of a registration statement would be considered part of the registration statement for purposes of Section 11 liability and established a new Section 11 effective date for each take down under a shelf registration statement for issuers and underwriters, but not for experts, directors and signing officers. *Clare A. Kretzman,(203) 324-8116 or ckretzman@ goodwin.com*

Dividends on Preferred Stock Not Mandatory: The Delaware Chancery Court recently ruled that the Delaware General Corporation Law does not mandate a corporation to pay dividends on preferred stock. At issue was the interpretation of Section 151(c) of the Delaware code, which provides that preferred shareholders "shall be entitled to receive dividends at such rates, on such conditions and at such times as shall be stated in the certificate of incorporation" or the resolution establishing such stock. In *Shintom Co., Ltd. v. Audiovox Corp*, Shintom, a Japanese corporation and preferred shareholder of Audiovox, claimed that preferred shares were void because they never produced a dividend. Shintom sought return of its $2.5 million investment. In rejecting Shintom's argument, the Court reasoned that the statute expressly gives a corporation the right to set rates and conditions of dividend payments, and "implicit in the right to set the rates and conditions is the ability to choose not to grant dividends at all." In addition, the phrase "if any," is used elsewhere in the code when referring to dividends, suggesting that a corporation may choose not to issue dividends. Finally, the word "shall" in the statute was not intended to be a "command that forces every corporation to offer dividend rights," but rather was meant as a "guarantee that if [the corporation] does offer dividend rights, it must fix the rates, conditions, and terms of payment in the resolution authorizing the stock issuance or the corporation's charter so as to afford stockholders an enforceable contract right." Attorneys for Shintom have promised an appeal, but the case serves as a reminder that the Delaware courts have consistently viewed the rights of preferred stockholders as a contract whose terms must be specifically set forth in the certificate of incorporation and if not so stated, they will not be implied. *Marie Pollio, (860) 251-5561 or mpollio@goodwin.com*

Forced Employee Stock Redemption Must Be in Writing: The Ohio Court of Appeals in *Callos Professional Employment LLC v. Greco* recently held that absent an express provision in the articles of incorporation or in some extrinsic document, like a buy-sell agreement, requiring that stock be redeemed, an Ohio corporation may not require a former employee to relinquish stock in that corporation. In *Callos*, a former Callos employee, Lilian Greco, purchased seven shares of stock in the company prior to her termination of employment. The company, following the termination of Ms. Greco, alleged that as a condition of her purchase, Ms. Greco was required to sell back her shares upon termination of her employment. Convinced that this unwritten buy-sell agreement was supportable by Ohio corporate statutes and/or other extrinsic factors, the company then attempted to compel her to sell back her stock in return for double the purchase price, but Greco refused.

Callos was unsuccessful in its breach of contract action. The first issue considered by the court was whether a buy-sell agreement had to be in writing. The court concluded that pursuant to the Ohio corporate statutes, as they had been interpreted in previous Ohio cases, such a buy-sell agreement had to be in writing. One relevant statute, R.C. 1701.35(A)(5), which Callos used in its effort to prove that it had the express right to redeem the shares from Greco, provided that a corporation may purchase shares of any class issued by it from a person who purchased the shares from the corporation under an agreement reserving to the corporation the right to repurchase. The court countered Callos' argument and concluded that R.C. 1701.35(A)(5) was to be read in conjunction with R.C. 1701.23(A), which provides that "by the express terms of shares of any class or series, such shares may be redeemable, in whole at one time or in part from time to time, at the option of the corporation, or at a specified time or event, in such manner and upon such conditions, price, and notice as are provided in said express terms." Since there were no express terms concerning the redemption, the company did not have the right to require it. The second issue was whether nonspecific language on the stock certificate stating that "THE TRANSFER OF THESE SHARES IS RESTRICTED BY THE AGREEMENT OF THE SHAREHOLDERS AND THE CORPORATION," minutes of a shareholder's meeting indicating such agreement, and compliance with this unwritten agreement by other employees counted as extrinsic evidence of the existence and terms of a stock purchase and sale agreement between Callos and Greco. The court held that since the buy-sell agreement does not comply with the relevant corporate statutes, this extrinsic evidence was irrelevant.

This case demonstrates the necessity of providing employees with written buy-sell agreements at the time of issuing them any shares if the employer wishes to redeem its shares of stock purchased by the employee after the employee's termination. *Rita Graham, (860) 251-5835 or rgraham@goodwin.com*