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Liability for inside bridge rounds?

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Imagine for a moment that you are the CEO of a venture-backed technology or services startup. The company is in the midst of a round of funding, and it is taking longer than anticipated for whatever reason. The cash coffers are unnervingly low, with payroll or other normal monthly expenses right around the corner.

Or maybe the situation is something different. Maybe the company isn't a technology or services company at all. Maybe it is a manufacturing company and the first big order has just arrived. The company needs to lay out a pile of cash to scale up its team or otherwise secure the necessary raw materials to fulfill the order.

Whatever the case may be, who is the first person the CEO typically calls to alleviate the temporary cash crisis? That is an easy one. The CEO almost always reaches out to the member of the board of directors that represents the private equity fund that typically demonstrates the most support for the company. The conversation typically lasts a few minutes, as the pair hammer out standard (or maybe not so standard) terms for a bridge loan, and the cash coffers are reloaded a few short days later.

Problem solved, right? Not necessarily.

The company's short-term cash flow problem is solved. Yet, in at least one part of the country, the venture capital funds funding the bridge loans and the director designees approving the transaction could face liability for a breach of the duty of loyalty, if the transaction does not pass the "entire fairness" test.

Did that grab your attention? It certainly grabbed mine.

The Seventh Circuit issued an opinion that, if adopted by California and Delaware, could turn the common practice of inside bridge loans on its head.

The facts of the case probably sound all too familiar to anyone involved with technology startups during the so-called "bubble burst" in 2000 and the global economic crisis that kicked into high gear in late 2008. Cadant was a technology startup incorporated under the laws of Delaware and backed by an investor syndicate lead by two well known venture funds —Venrock and J.P. Morgan. Cadant was facing dire straits in the fall of 2000. Unable to complete a round of preferred stock financing, Cadant sought a bridge loan from an outside investor group, as well as an inside proposal from

Venrock and J.P. Morgan.

In late January 2001, the VCs funded an $11 million bridge loan at 10 percent interest and 90-day maturity. Cadant burned through those funds in no time, so the company went back to the deep pockets of its investor syndicate and raised another $9 million bridge from the VCs. This time, however, the bridge included a two-times liquidation preference and the published court opinion makes no mention about seeking a competing proposal.

The Cadant board at the time of both transactions consisted of seven directors. Four were designees of the VCs. The other three were “engineers without financial acumen” who were basically “at the mercy of the financial advice” they received from the four VC designees. The board reportedly relied on Eric Copeland, one of its directors and a Venrock principal, to negotiate the terms of the two bridge loans, despite the fact that Copeland had a clear conflict of interest.

The rest of the story isn’t difficult to predict. Cadant ultimately defaulted on both bridge loans and agreed to sell all of its assets for stock then valued at approximately $55 million. That amount was completely consumed by the liquidation preference of the preferred stockholders and the company’s outstanding debt. The common holders received nothing. Bankruptcy ensued and a liquidating trust brought suit against the VC funds and their director designees.

The Seventh Circuit held that a decision by VC representatives on a board to approve a loan was essentially self-dealing that could not be cured by a vote of majority of the disinterested directors where the interested directors set the terms of the deal. The deal, therefore, had to be evaluated under the entire fairness doctrine, which could raise liability questions when distressed companies do not go out and shop the offer to get a market check as to the fairness of the terms. Note also that the VC funds, while not owing a fiduciary to shareholders directly, faced liability under an aiding and abetting theory.

This opinion seems to be at odds with Delaware law that appears on its face to allow a majority of disinterested directors to approve the deal so long as it was fully and fairly disclosed. Note that the court applied Delaware law due to the internal affairs doctrine, since the company was incorporated in Delaware.

Courts outside of the Seventh Circuit are obviously not bound by this decision. But Judge Posner, the man who authored the opinion, is one of the most well respected and widely cited members of any judiciary. If the Delaware Chancery Court adopts a similar position on the issue, it could result in a dramatically change in the appetite for VCs to fund quick inside bridge rounds for distressed portfolio companies hoping to create some breathing room ahead of an equity round or exit.

What's the BIG deal?

Judge Posner’s opinion won’t likely have a chilling effect on inside bridge rounds for Delaware corporations, nor should it. Instead, it should serve as a bit of a wakeup call companies and investors shooting from the hip when it comes to inside bridge rounds.

Two practice points jump off the pages of the opinion. First, directors should think twice before sitting on both sides of the negotiation table when a CEO comes asking for a bridge loan. Had one of the non-VC designees negotiated the terms with the VCs in this case, the case might not have survived a motion to dismiss.

Second, boards should be prepared to defend inside bridges under the “entire fairness” test. Performing some semblance of a market check, if possible, is one way to help avoid liability. You know what they say – the more the merrier when it comes to competing proposals.

It will be interesting to see if Delaware and other jurisdictions ultimately decide to adopt Judge Posner's approach to dealing with inside bridge rounds.

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