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21st Century Workplace	Cybersecurity, Privacy and Big Data	Medtech, Digital Health and Science
Artificial Intelligence and Automation	Fintech	Mobile Tech
COVID-19	Global Commerce	Regulating Tech

Morgan Lewis

DEBT FINANCING FOR EARLY STAGE VENTURES

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May 1, 2020

Morgan Lewis Coronavirus/COVID-19 Resources

- **Global Firm** – 2000+ Lawyers, 700+ Partners, 1100+ Associates,
- **COVID-19 Task Force** – 26 teams consisting of 385+ Lawyers Coordinating With Firm's 15 Areas of Service, 10 Industry Sectors and 31 Offices

- **Practice Teams**
  - SBA/FRB Loan Programs
  - Bankruptcy & Restructuring
  - CARES Act Analysis
  - Controversy
  - Financial Services
  - Intellectual Property
  - Labor & Employment
  - Lender Banking
  - Litigation
  - Retail

- **Regional Teams**
  - United States (CA, CT, FL, IL, MA, NJ, NY, PA, TX, DC/MD)
  - State and Local Orders
  - Asia Pacific / India
  - Asia Pacific / Singapore and Southeast Asia
  - Europe
  - Europe / Russia
  - Europe / United Kingdom
  - Middle East / UAE

Morgan Lewis Coronavirus/COVID-19 Resources

In this time of unprecedented hardship for so many business and investors, we wanted to outline various sources of capital for emerging businesses, including various new Federal loan programs, to help you get through this difficult time.

Overview of Federal Reserve Programs and Paycheck Protection Program

- Purchase **up to $600 billion in loans** through the Main Street Lending Program. The Department of the Treasury, using funding from the CARES Act, will provide $75 billion in equity to the facility – ***Targets Main Street.***
- Provide **up to $659 billion in forgivable loans** to support small businesses and works weathering the economic impacts of the COVID-19 crisis – ***Targets Small Business.***
- The CARES Act previously authorized the Secretary of the US Department of the Treasury (the "Treasury Secretary") to make loans, loan guarantees, and other investments of **up to $500 billion** to support certain eligible businesses – ***Targets Mid-Size Businesses.***

Federal Reserve Programs and Paycheck Protection Program

Given the unprecedented nature of the COVID-19 crisis, the Federal government is taking a number of steps to provide alternative sources of Federal funding to bridge liquidity issues for many types of borrowers, including:

- The **Main Street Lending Program**
- The **Paycheck Protection Program**
- The **Mid-Size Lending Program**.

Main Street Lending Program
Loans and Eligible Lenders

- ***Term loans*** to US companies that either (a) employ 15,000 or less workers ***or*** (b) had $5 billion or less annual revenue in 2019.
- ***Eligible Lenders***: US federally insured depository institutions (including banks, savings associations, or credit unions), a US branch or agency of a foreign bank, a US bank holding company, a US savings and loan holding company, a US intermediate holding company of a foreign banking organization, or a US subsidiary of any of the foregoing.
  - Eligible Lenders may originate new Main Street loans or use Main Street loans to increase size of existing loans to eligible businesses.
- Borrowers with loans under the Paycheck Protection Program can borrow Main Street loans, but may participate only in ***one*** of the ***three*** facilities established under the Main Street Lending Program.

Main Street Lending Program
New Loan Facility

- Originated on or after April 24, 2020.
- Minimum term loan size is $500,000.
- Maximum term loan size is the lesser of (i) $25 million or (ii) an amount that, when added to the borrower’s existing outstanding and undrawn available debt, does not exceed ***four times*** the borrower’s adjusted 2019 earnings before interest, taxes, depreciation, and amortization (“EBITDA”).
- Loans may be secured or unsecured.
- At time of origination or at any during term of the loan, it must not be contractually subordinated in terms of priority to any of the borrower’s other loans or debt instruments.

Main Street Lending Program
Expanded Loan Facility

- Existing term loan or revolving credit facility originated on or before April 24, 2020, and has a remaining maturity of at least 18 months.
- Minimum term loan size is $10 million.
- Maximum loan size is the least of (i) $200 million, (ii) 35% of the borrower's existing outstanding and undrawn available debt that is pari passu in priority with the eligible loan and equivalent in secured status (i.e., secured or unsecured), or (iii) an amount that, when added to the borrower's existing outstanding and undrawn available debt, does not exceed **six times** the borrower's adjusted 2019 EBITDA.
- Loans may be secured or unsecured.
- At the time of upsizing and at all times the upsized tranche is outstanding, it must be senior to or pari passu with, in term of payment priority and security, the borrower's other loans or debt instruments, other than mortgage debt.

Main Street Lending Program
Priority Loan Facility

- Originated after April 24, 2020.
- Minimum term loan size is $500,000.
- Maximum loan size is the least of (i) $25 million, or (ii) an amount that, when added to the borrower's existing outstanding and undrawn available debt, does not exceed ***six times*** the borrower's adjusted 2019 EBITDA.
- Loans may be secured or unsecured.
- At all times the loan is outstanding, it must be senior to or pari passu with, in terms of priority and security, the borrower's other loans or debt instruments, other than mortgage debt.

Main Street Lending Program
Loan Terms

- **Four year maturity**.
- Interest rates will equal **LIBOR** (1 or 3 month) **plus 300 basis points**.
- Principal and interest payments to be deferred for one year (unpaid interest to be capitalized).
- Prepayment of loans is permitted without penalty.

Main Street Lending Program
Restrictions

During the term of the loan (and a year after) under any Main Street Lending Program, borrowers generally cannot do the following:

- Stock buybacks
- Dividends and capital distributions – with tax distributions as an exception
- Executive bonuses

PAYCHECK PROTECTION PROGRAM (PPP) LOANS

- Loans up to **$10 million** with a **1.00% interest rate**.
- Loan amount: lesser of the $10 million maximum and 2.5 times the borrower's average monthly payroll for the past 12 months.
- Excludes compensation over $100,000.
- SBA guarantees 100% of the issued loans during the period of 2/15/2020 through 6/30/2020.
- Loan proceeds can cover: payroll costs; group healthcare benefits; mortgage interest payments, rent, utilities, and other debt interest.

PPP LOANS
CERTIFICATION REQUIREMENTS

The Act requires loan applicants to make a good faith certification:

- that the uncertainty of current economic conditions makes **necessary** the loan request to support the ***ongoing operations*** of the eligible recipient;
- to acknowledge that the funds will be used to **retain workers** and **maintain payroll or make mortgage payments, lease payments, and utility payments**;
- that the eligible recipient does not have an application pending for a loan under this subsection for the same purpose and duplicative of amounts applied for or received under a covered loan; and
- during the period beginning on February 15, 2020 and ending on December 31, 2020, the eligible recipient has not received amounts under this subsection for the same purpose and duplicative of amounts applied for or received under a covered loan

CERTIFICATION OF NECESSITY

QUESTION: *Do businesses owned by large companies with adequate sources of liquidity to support the business's ongoing operations qualify for a PPP loan?*

ANSWER: In addition to reviewing applicable affiliation rules to determine eligibility, all borrowers must assess their economic need for a PPP loan under the standard established by the CARES Act and the PPP regulations at the time of the loan application. Although the CARES Act suspends the ordinary requirement that borrowers must be unable to obtain credit elsewhere (as defined in section 3(h) of the Small Business Act), borrowers still must certify in good faith that their PPP loan request is necessary. Specifically, before submitting a PPP application, all borrowers should review carefully the required certification that "[c]urrent economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant." **Borrowers must make this certification in good faith, taking into account their current business activity and their ability to access other sources of liquidity sufficient to support their ongoing operations in a manner that is not significantly detrimental to the business.** For example, it is unlikely that **a public company with substantial market value and access to capital markets** will be able to make the required certification in good faith, and such a company should be prepared to demonstrate to SBA, upon request, the basis for its certification. Lenders may rely on a borrower's certification regarding the necessity of the loan request. Any borrower that applied for a PPP loan prior to the issuance of this guidance and repays the loan in full by May 7, 2020 will be deemed by SBA to have made the required certification in good faith.

PPP LOANS
LOAN FORGIVENESS

- Up to 100% loan forgiveness for funds used in the first 8-weeks post-disbursement
- Reductions in Loan Forgiveness for:
  - Greater than 25% used toward non-payroll costs
  - Reductions in head count
  - Reduction in salaries greater than 25%
- Forgiveness Process

AFFILIATION RULES

- **Affiliation by Control**
- **PPP Affiliation Exceptions**
  - North American Industry Classification System (NAICS) Sector 72: Accommodation and Food Services
  - Franchises assigned a franchise identifier code by the SBA
  - Businesses that receive "financial assistance" from a licensed SBIC
- **Complicated Cases**
  - Negative control cases
  - "Present Effect" cases
  - Identity of interest cases
- **Ineligible Businesses (120.11 Eligibility)**
  - Private Clubs
  - Non-501(c)(3) Nonprofits
  - Financial Businesses

CERTIFICATION OF NECESSITY
VENTURE CAPITAL FOCUS

Do the SBA affiliation rules prohibit a portfolio company of a venture capital firm from being eligible for a PPP loan?

Borrowers must apply the affiliation rules that appear in 13 CFR 121.301(f), as set forth in the Second PPP Interim Final Rule (85 FR 20817). The affiliation rules apply to venture capital or private equity-owned businesses in the same manner as any other business subject to outside ownership or control. <u>However, in addition to applying any applicable affiliation rules, all borrowers should carefully review the required certification on the Paycheck Protection Program Borrower Application Form (SBA Form 2483) stating that "[c]urrent economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant."</u>

PPP LOANS
RISKS

- **The government will be watching** how these funds are spent. The Act funds extensive oversight mechanisms to prevent and uncover fraud and waste.
- Even if you win, government investigations can be time-consuming, expensive, and intrusive.
- If you are investigated and lose, there are serious risks associated with any fraud in connection with these funds:
  - Criminal fines and imprisonment for making false statements to the SBA to obtain a loan (for yourself or on behalf of any applicant);
  - DOJ can bring other fraud charges as well (wire / mail fraud); and
  - Civil liabilities could be significant; in a whistleblower False Claims Act case, damages would be calculated as **three times** the amount of a loan *plus* civil penalties.
  - A finding of fraud here can leave you excluded / debarred from working with the government for a long time.

Coronavirus Economic Stabilization Act

- **Key features of the Coronavirus Economic Stabilization Act include the following:**
  1. Up to $25 billion for passenger air carriers
  2. Up to $4 billion for cargo air carriers
  3. Up to $17 billion for "businesses critical to maintaining national security"
  4. Up to $454 billion made available as loans or loan guarantees to eligible businesses

- **Mid-Size Banking Program**: Loans, loan guarantees, or other investments provided by banks and other lenders (with an interest rate of less than 2% and no payments due in the first six months) to businesses with between 500 and 10,000 employees that need the loan to support ongoing operations

Mid-Size Business Banking Program Requirements

Certain certifications are required, including:

- It will restore and retain its workforce
- It is a US business
- It is not a debtor in a bankruptcy proceeding
- It will not pay dividends to common stock or repurchase equity security
- It will not outsource or offshore jobs
- It will not abrogate existing collective bargaining agreements
- It will remain neutral in union organizing efforts

Other Financing Options

In addition to the federal programs we discussed, we would like to speak more generally about how you would consider options for financing as an emerging business.

CAPITAL STRUCTURE
RANGE OF CHARACTERISTICS

Common Stock

Preferred Stock
- Dividend Preference (and share with common)
- Voting Rights

Preferred Stock
- Dividend Preference
- Voting Rights
- Redemption Rights

Preferred Stock
- Dividend Preference
- Limited Voting
- Redemption Rights

Subordinated Debt
- Unsecured
- Covenants
- Right to Vote

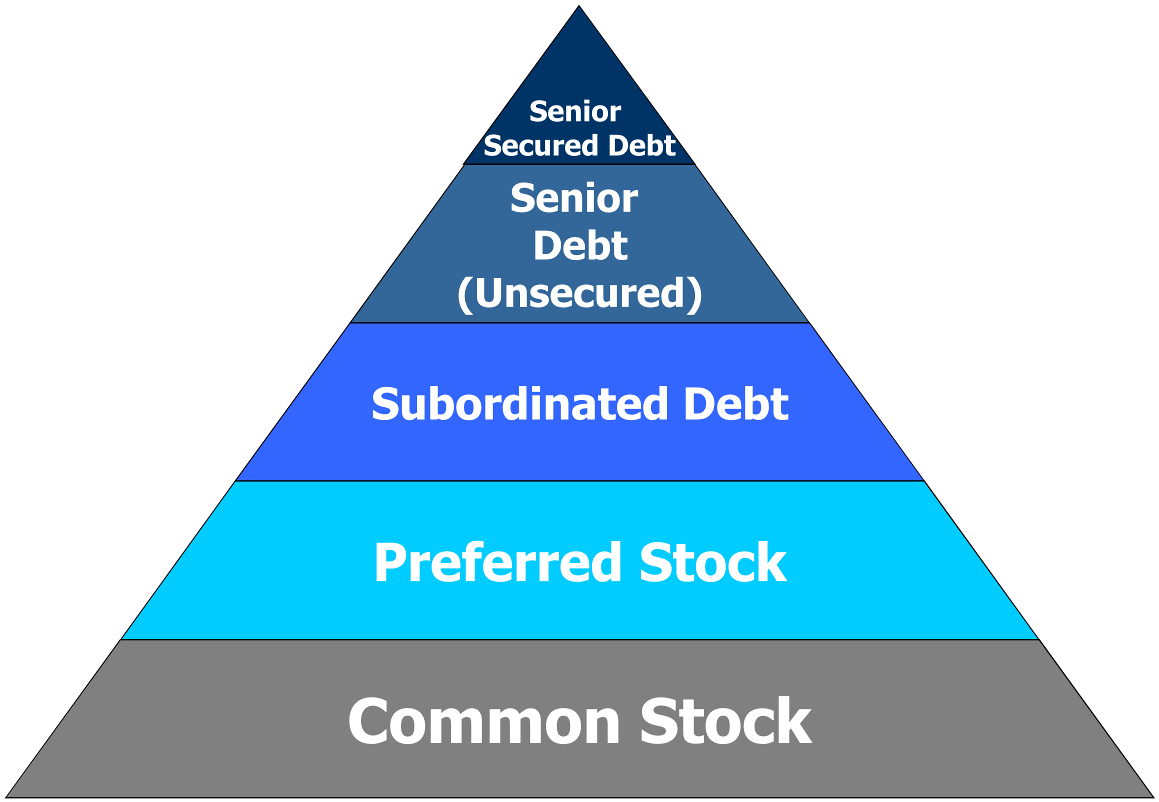
Subordinated Debt
- Unsecured
- Covenants

Subordinated Debt
- Secured
- Covenants

Senior Debt
- Unsecured
- Covenants

Senior Secured Debt

Capital Structure
"Seniority"



Early Stage Debt Financing
Debt v. Equity

Debt Financing	Equity Financing
Debtor/Creditor Relationship	Equity Partner Relationship
Lower Cost of Capital	Higher Cost of Capital
Based on Cash Flow	Based on Expected Future Value
Periodic Interest Payments	"Interest" Accrued, but not Paid
Fixed Maturity Date	Defined Range of "Exit" Dates
Financial and other Covenants; Warrants	Less Restrictions
Retired through Operating Cash Flow	Redeemed through IPO, Recapitalization, or Sale
Board Observer Rights	Board-level Participation
Little to No Governance Involvement	Active Governance Involvement, as appropriate

Early Stage Debt Financing
Debt v. Equity

Key Types of Debt

- Capital Expenditure/Equipment Financing
- Convertible Debt
- Bank Debt Financing/Accounts Receivable/Borrowing Base Credit
- Venture Debt

Early Stage Debt Financing

Key Considerations:

– Size (Dollar Amount)
– Duration
– Pricing of Loan (Fees and Interest)
– Timing of Amortization
– Covenants

Market Players

– Commercial banks with venture-lending arms
– Specialty Finance Firms
– Hedge Funds
– Venture Capital Funds

Early Stage Debt Financing

Why Debt?

- Nominal to no dilution of capital
- Leverage equity raised to reduce the average cost of capital
- Extend cash runway
- Example:
  - Series A round: $5 million at 20% ownership
    - $25 million valuation
  - Monthly cash burn of $500,000
    - Series A provides 10 month runway
  - Debt loan of $1.5 million
    - Even with warrant at 50 bps, provides additional 3 month runway with 1/40th the dilution

Early Stage Debt Financing

Potential Obstacles

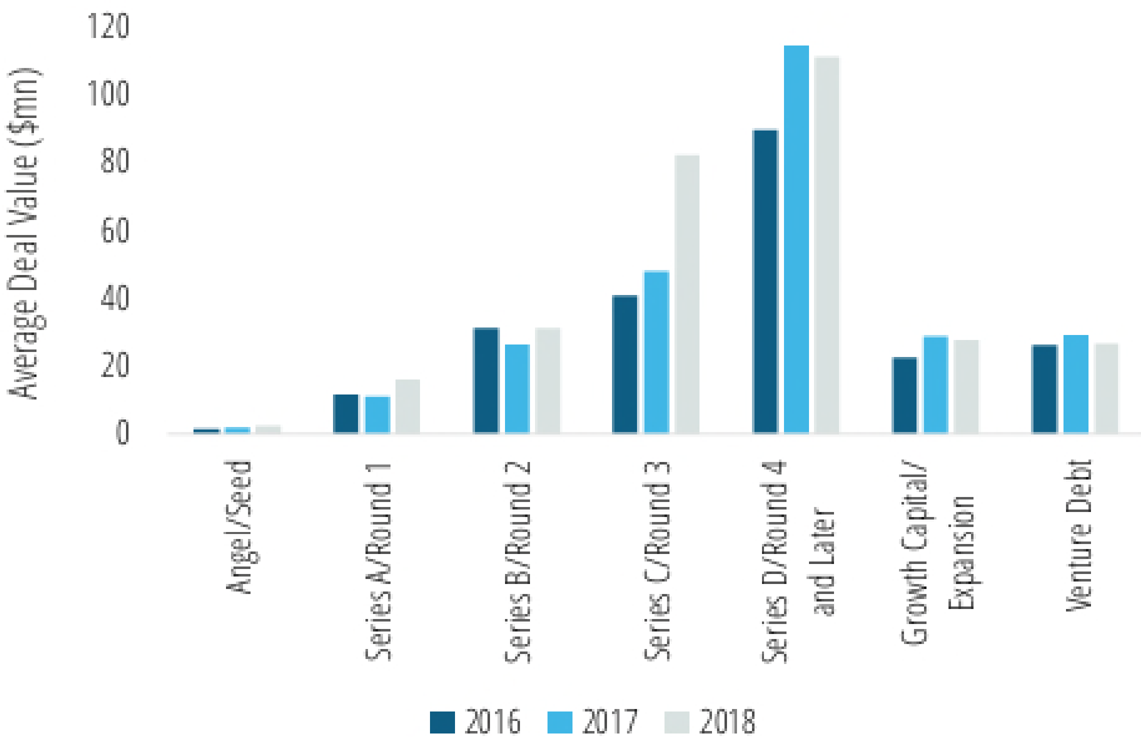
– Lack of track record
– Revenue
– Negative earnings
– Strong competition
– Cash on hand

Mitigants

– Founder’s technical/market expertise
– Well-connected angel and venture investors
– Well-defined business plans

Early Stage Debt Financing
Market Value

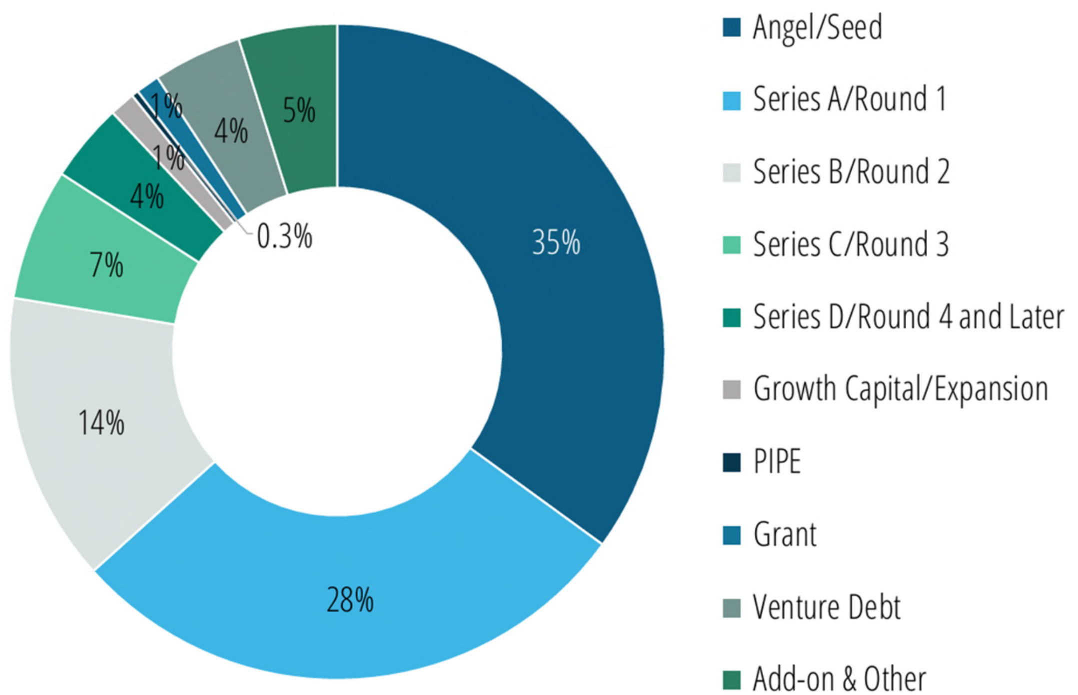
Fig. 5: Average Value of Venture Capital Deals, 2016 - 2018



Source: Preqin Pro

Early Stage Debt Financing
Recent Market Trends

Fig. 3: Proportion of Number of Venture Capital Deals in 2018 by Investment Stage



Source: Preqin Pro

Early Stage Debt Financing
The Term Sheet – Key Considerations

Closing Date

Due Diligence/documentation

Costs

Break Fee

Availability

- Entire Loan at Closing v. Tranched Loan v. Delayed Draw

Maturity Date/Repayment Schedule

- May be interest free for some period to reduce cash needed to service loan
- Bullet payments

Interest Rate

Early Stage Debt Financing
The Term Sheet – Key Considerations (cont.)

Closing Fee

Maturity Fee

– Also known as an "End of Term" Fee; often in exchange for the reduction or absence of warrants

Prepayment Fee

– Make Whole v. Discounted Make Whole v. Percent of Drawn amount

Warrants

– Investor has the option to purchase stock in future at fixed price

Financial Covenants

Affirmative and Negative Covenants are common

Reporting

Early Stage Debt Financing
The Term Sheet – Key Considerations (cont.)

Board Observer Status

Board Seats

Security and ranking

- Negative Pledges over IP

Legal Documentation

“Material Adverse Change” Clauses

Defaults and Events of Default

- Acceleration
- Waivers and Consents

Early Stage Debt Financing
Collateral Issues

Scope of collateral security is often negotiated

- Equity pledges only?
- Personal property only?
- Real estate collateral?
- Intellectual Property only?
- Bank accounts?

Early Stage Debt Financing
IPO Implications

- IPO market was 19% weaker in Q1 2019 than the prior year period
- Longer deals, including deals with debt capital in place, support a longer cash runway
- Debt deals postpone valuation negotiations (avoid down rounds and flat rounds)
- Bank debt working capital facilities evidence positive signals to the market
- Avoid or slow dilution

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Morgan Lewis Coronavirus/COVID-19 Resources

We have formed a multidisciplinary **Coronavirus/COVID-19 Task Force** to help guide clients through the broad scope of legal issues brought on by this public health challenge.

To help keep you on top of developments as they unfold, we also have launched a resource page on our website at

www.morganlewis.com/topics/coronavirus-covid-19

If you would like to receive a daily digest of all new updates to the page, please visit the resource page to subscribe using the purple "Stay Up to Date" button.

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Matthew Schernecke is a partner in the Finance Practice and serves as the New York office local practice group leader. Matthew advises direct lenders, mezzanine investment funds, and venture capital investors on loans and other investment transactions with a wide range of borrowers across industry classes and of all sizes, types, and structures. Matthew also advises private equity clients and corporate borrowers on domestic and cross-border acquisition financings, out-of-court restructurings and workouts, bankruptcy matters, and real estate financings. Matthew leads transactions spanning diverse industries, including media and telecommunications, Internet and technology, food and beverage, real estate, retail, and healthcare.

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Shah Nizami is an associate in the Finance practice. With an undergraduate degree in business administration and a concentration in financial markets, Shah counsels leading financial institutions and corporate borrowers that are involved in US domestic and international commercial finance transactions. He focuses on syndicated debt financings (both secured and unsecured facilities), multinational credit facilities, asset-based financings, and domestic and international debt workouts and restructurings. Shah also works on naming rights and sponsorship rights agreements.

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Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Abu Dhabi
Almaty
Beijing*
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
Moscow
New York
Nur-Sultan
Orange County
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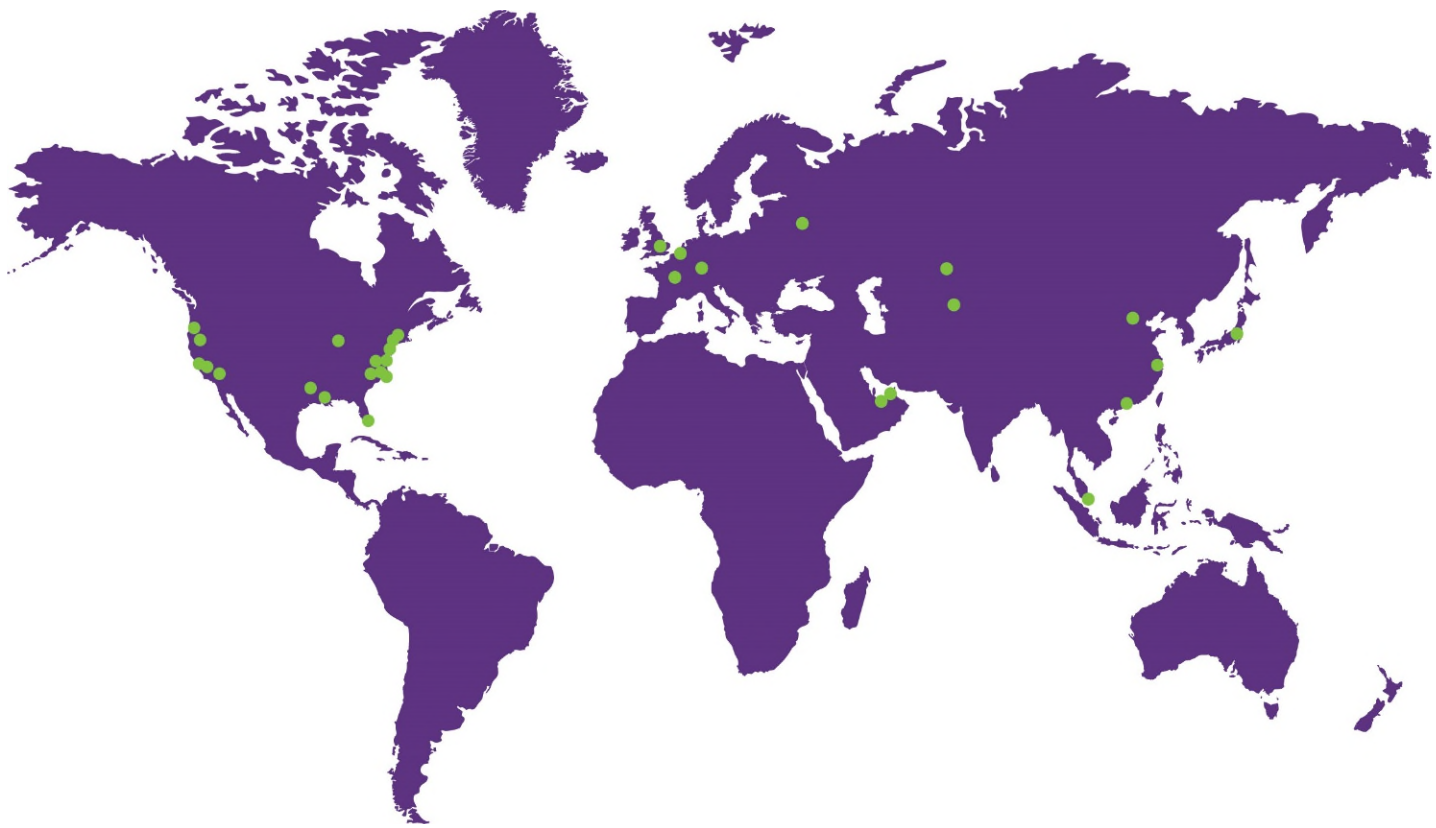

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