

# Bumps on the Road to an IPO: Structuring Provisions to Anticipate Issues in Pre-IPO Convertible Bonds

BY JAMES H. BALL, JR. & ANDREW F. FOWLER

*James H. Ball, Jr. is a partner and Andrew F. Fowler is a senior associate in the New York office of Milbank, Tweed, Hadley & McCloy LLP. The views expressed in this article are those of the authors and do not necessarily reflect the views of the firm. Contacts: jball@milbank.com or afowler@milbank.com.*

Convertible bonds have long been a staple on the corporate finance menu, offering the benefits (and risks) of both equity and debt to issuers and investors alike. Among companies which are preparing to leave the development stage and are considered strong candidates for a lucrative initial public offering (“IPO”) in the next few years, the pre-IPO convertible bond has taken center stage as a versatile financing tool. Traditionally, convertible bonds have blended the characteristics of equity and debt and have been used by issuers to raise capital without immediately diluting earnings or adding leverage to a balance sheet. The pre-IPO convertible bond serves similar purposes but with added benefits to the late development stage issuer which would otherwise be unable to secure financing on acceptable terms.

In many instances, an issuer which has a good chance of making it across the finish

line to an IPO still faces a few significant challenges in its path. In some cases, even aggressive hedge funds specializing in venture capital investments can be unwilling to provide traditional debt financing to private companies in the development stage, which often face regulatory, product development or litigation challenges that can delay their development and, in extreme cases, even threaten their continued operation. When investors are willing to look past the risks to the rewards, and make financing available, they often demand interest rates which are prohibitive and which put a drain on liquidity at the worst possible time in the issuer’s life cycle. For many such issuers, obtaining the financing necessary to sustain the last burst of momentum to get to an IPO may only be made possible through the use of a pre-IPO convertible bond, which will have a significantly lower interest rate than would be

CONTINUED ON PAGE 3

Article REPRINT

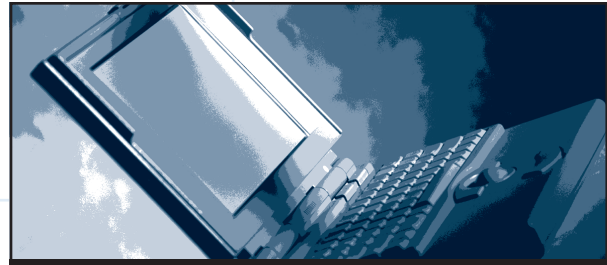
*Reprinted from the Wall Street Lawyer. Copyright © 2007 Thomson/West. For more information about this publication please visit [www.west.thomson.com](http://www.west.thomson.com)*

## Table of CONTENTS

© 2007 Thomson/West. This publication was created to provide you with accurate and authoritative information concerning the subject matter covered, however it may not necessarily have been prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional.

For authorization to photocopy, please contact the Copyright Clearance Center at 222 Rosewood Drive, Danvers, MA 01923, USA (978) 750-8400; fax (978) 646-8600 or West's Copyright Services at 610 Opperman Drive, Eagan, MN 55123, fax (651)687-7551. Please outline the specific material involved, the number of copies you wish to distribute and the purpose or format of the use.

For subscription information, please contact the publisher at: [west.legalworkspublications@thomson.com](mailto:west.legalworkspublications@thomson.com)



### Free Service for Subscribers

#### Online Editions Now Available

West Legalworks is pleased to announce that this newsletter is now available on the Internet to Subscribers of the print edition.

The online version offers additional interactive capabilities that enhance the usefulness of your subscription including Search features for current and archived articles and Links to other information and Westlaw® cases.

To take advantage of this service, please visit [www.glwnewsletters.com/register.asp](http://www.glwnewsletters.com/register.asp) to register or call 800.308.1700.



### Editorial Board

#### CHAIRMAN:

**JOHN F. OLSON**  
Gibson, Dunn & Crutcher  
Washington, DC

#### ADVISORY BOARD:

**BRANDON BECKER**  
Wilmer Cutler Pickering Hale & Dorr, LLP  
Washington, DC

**BLAKE A. BELL**  
Simpson Thacher & Bartlett  
New York, NY

**STEVEN E. BOCHNER**  
Wilson Sonsini Goodrich & Rosati  
Palo Alto, CA

**EDWARD H. FLEISCHMAN**  
Linklaters  
New York, NY

#### ALEXANDER C. GAVIS

Vice President & Associate General Counsel  
Fidelity Investments

#### JAY B. GOULD

Pillsbury Winthrop Shaw Pittman LLP  
San Francisco, CA

#### JOSEPH A. GRUNDFEST

Professor of Law, Stanford Law School

#### MICALYN S. HARRIS

VP, General Counsel and Corporate Secretary  
Winpro, Inc.

#### PROF. THOMAS LEE HAZEN

University of North Carolina – Chapel Hill

#### ALLAN HORWICH

Schiff Hardin LLP  
Chicago, IL

#### TERESA LANNACONI

Partner, Department of Professional Practice  
KPMG Peat Marwick

#### MICHAEL P. JAMROZ

Partner, Financial Services  
Deloitte & Touche

#### STANLEY KELLER

Edwards Angell Palmer & Dodge LLP  
Boston, MA

#### CARY I. KLAFTOR

Vice President, Legal & Government Affairs,  
and Corporate Secretary  
Intel Corporation

#### BRUCE W. LEPPLA

Lieff Cabraser Heimann & Bernstein, LLP  
San Francisco, CA

#### SIMON M. LORNE

Vice Chairman Chief  
Legal Officer  
Millennium Partners, L.P.

#### MICHAEL D. MANN

Richards Kibbe & Orbe  
Washington, DC

#### JOSEPH MCLAUGHLIN

Sidley Austin, LLP  
New York, NY

#### WILLIAM MCLUCAS

Wilmer Cutler Pickering Hale & Dorr, LLP  
Washington, DC

#### BROC ROMANEK

General Counsel, Executive Press, and Editor  
TheCorporateCounsel.net

#### JOEL MICHAEL SCHWARZ

Attorney, U.S. Government

#### STEVEN W. STONE

Morgan Lewis LLP  
Washington, DC

#### LAURA S. UNGER

Former SEC Commissioner and Acting Chairman

#### JOHN C. WILCOX

Senior VP, Head of Corporate Governance  
TIAA-CREF

#### JOEL ROTHSTEIN WOLFSON

Banc of America Securities LLP

#### Wall Street Lawyer

West Legalworks  
395 Hudson Street, 6th Floor  
New York, NY 10014

Please address all editorial, subscription, and other correspondence to the publishers at [west.legalworksregistration@thomson.com](mailto:west.legalworksregistration@thomson.com)

For authorization to photocopy, please contact the Copyright Clearance Center at 222 Rosewood Drive, Danvers, MA 01923, USA (978) 750-8400; fax (978) 646-8600 or West's Copyright Services at 610 Opperman Drive, Eagan, MN 55123, fax (651) 687-7551. Please outline the specific material involved, the number of copies you wish to distribute and the purpose or format of the use.

West Legalworks offers a broad range of marketing vehicles. For advertising and sponsorship related inquiries or for additional information, please contact Mike Kramer, Director of Sales. Tel: 212-337-8466. Email: [mike.kramer@thomson.com](mailto:mike.kramer@thomson.com).

This publication was created to provide you with accurate and authoritative information concerning the subject matter covered. However, this publication was not necessarily prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional.

Copyright is not claimed as to any part of the original work prepared by a United States Government officer or employee as part of the person's official duties.

One Year Subscription ■ 12 Issues ■ \$468.00  
(ISSN#: 1095-2985)

associated with a conventional bond issued by the same company. Especially in the later development stage, investors are more content to trade interest now for the potentially unlimited equity upside associated with the conversion, typically at favorable rates, of the pre-IPO convertible bond into shares of a public company down the road. If all goes according to plan, the issuer will conduct an IPO within the timeline contemplated by the terms of the bond and investors will convert at a favorable premium.

There are many significant legal issues implicated by pre-IPO convertible bonds, including, among many others: the risk of integration of public and private offerings under the federal securities laws; Section 16 short-swing profit and ownership issues; the scope and substance of anti-dilution protections; dealing with the rights of investors in previous financing rounds; and last but not far from least, the overriding need to ensure that the viability of the IPO is never jeopardized. These topics are important, but we wish to focus here on the mechanisms that counsel to the issuer, investors and the placement agent can put in place to address the bumps on the road that a pre-IPO issuer may face.

Because convertible bonds generally, and pre-IPO convertible bonds in particular, tend to be used by companies that are smaller and riskier than those that can finance their growth with straight debt, there is no “one size fits most” prescription for structuring to proactively address the growing pains which these issuers can face. Nonetheless, certain common patterns emerge. Investors often demand and receive protection from potential pitfalls by means of adjustments to interest rates or conversion terms. Common triggers include: failure to meet, or a delay in meeting, development milestones or goals; an inability to acquire necessary patents or secure the rights to key intellectual property; problems with litigation; or a loss of key managerial or creative personnel. The implications of each of these scenarios on the provisions of the pre-IPO convertible bond are discussed below, with the most detailed treatment given to the missed milestone, the most common scenario.

## The Case of the Missed Milestone

For many development stage companies, there are often milestones which, if reached in a timely fashion, will be indicative of a profitable path toward success. Achievement of these goals will increase, and in some cases guarantee, the issuer's ability to complete its IPO within the timeline envisioned by the original deal structure and value proposition. Conversely, a failure to reach such milestones, while not necessarily evidence of outright failure, will delay the completion of the IPO and move back investors' potential exit window.

Some typical milestones for the pre-IPO company include initial regulatory or licensing approvals, which are followed by achievement of a critical mass of subscribers or a certain size of customer base, (or for a manufacturer, production of a certain number of units of its product.) As noted below, counsel should work with bankers and others familiar with the fundamentals of an issuer's business plan, since the synergies of the relevant factors can also define whether or not a company's plan achieves full potential. From the investors' standpoint, the key is to ask what are the most important steps required for the issuer's success and what the effect on the issuer would be if they were not achieved.

In many cases, the importance of including triggers for regulatory milestones, as well as what those milestones are, will be self-evident to investors and their counsel, especially in a highly regulated or specialized industry, or one where the company is dependent on new technology or patents. Nonetheless, when structuring to deal with the fallout of a possible missed milestone, counsel should be careful to ensure both that the material alternative outcomes are addressed by the specified alternatives of the deal terms and that the triggers and associated penalties or adjustments do not tie the issuer's hands unnecessarily. While investors' counsel can and should insist on appropriate adjustments to the interest or conversion rate, care should be taken that the ability of the issuer's management to take remedial action and deal with regulatory authorities is not compromised or limited by clauses requiring consultation or shared decision-making. While such measures may be appropriate in limited circumstances, presumably investors should have faith that the issuer's man-

agement has the capacity to deal with regulatory challenges as part of their general competence in running the business. It is also crucial to provide that adjustments or penalties are proportionate to the actual importance to the issuer's prospects of the milestone, or one step toward the ultimate milestone, being considered. In certain industries, for example, the acquisition of one permit may ensure that other related permits will be forthcoming without difficulty, but counsel should take care to consult with the business people on both sides of the transaction to make sure that the triggers and remedies work as planned in the real world.

**[W]hen structuring to deal with the fallout of a possible missed milestone, counsel should be careful to ensure both that the material alternative outcomes are addressed by the specified alternatives of the deal terms and that the triggers and associated penalties or adjustments do not tie the issuer's hands unnecessarily.**

Similarly, once necessary regulatory approval, patents or licensing approvals have been obtained, the issuer must be able to exploit its innovation by either licensing its product or service to others to develop, or moving into the production phase itself. Here, counsel should consider the necessity of triggers to compensate investors for any delay in achievement of fundamentals such as satisfactory production levels and successful sales, as well as the possible impact of unavailability of supplies, any of which could affect the issuer's ability to sustain momentum into the production phase.

When counsel is focusing on how a variety of factors may come together (or, may not come together, as it were) to impact a company's success, investors may ask why do we need specificity in the triggers at all? Investors in a pre-IPO convertible bond are usually already compensated by an increased interest rate or, less commonly, a general ratchet improving the conversion rate of the convertible bonds, if the IPO is not completed on schedule. Arguably, this mechanism is designed as a "fail safe" to pick up any scenario where success eludes the issuer, regardless of the cause. The adjustments discussed in this article should be seen as supplements to that general mechanism to ad-

dress key areas where investors might otherwise demand a higher interest premium, or decline to provide financing if not otherwise compensated if the contingency occurred.

A practical example of how the conversion terms and interest rate of a hypothetical issuer might be affected by a missed milestone is illustrated by the following hypothetical example.

## Case Study: Cyclops Optics Systems

Hypothetical issuer Cyclops Optics Systems ("Cyclops") designs and develops weapon sighting systems for military applications. After five years of work, and several rounds of venture capital financing totaling over \$300 million, Cyclops has produced two prototype weapon sighting systems which are designed for use on helicopters. Based on analysis prepared by its investment banking advisers, Cyclops has strong prospects to move toward sufficient earnings and capitalization to justify an IPO within the next two years. There are three main areas where Cyclops must meet goals to develop: first, on the regulatory front, it must win a key patent and obtain governmental approval to mass produce its weapon sighting systems; second, it must be able to secure necessary components in adequate quantities and on a timely basis to move into production; and third, it must successfully contract and sell to customers enough of its units to remain viable and generate a profit as soon as possible.

To address these issues, provisions should be added to the conversion adjustments section of the convertible bond terms which compensate investors with a more favorable conversion ratio if these milestones are not reached in time. The adjustments to the conversion rate may also be accompanied by increases in the interest rate which rise in parallel with the severity of the missed milestone. These interest rate increases may fall away if the goal is later achieved.

As a preliminary matter, the mechanics of conversion adjustments must take into account the extent to which there is a quantifiable component to the achievement of a goal as a function of the issuer's enterprise value. For example, if achievement of a given goal will comprise, for sake of argument, roughly 10% of a given issuer's valuation, then a fairly straight forward adjustment

may be made to increase the conversion rate by 10% if the goal is not reached within a specific time. In cases where a product or service must be certified by government or other regulatory body to meet certain performance goals, it may make sense to match adjustments to reflect the ratio to which achieved results bear to desired results, such that if a product meets 80% of its desired performance, the conversion rate will be reduced by 20%. For requirements regarding projected production numbers, sales figures or number of contracts, the percent of actual completion as a proportion of achieved results may be a useful metric. These proportional adjustments can be easier to conceptualize and justify to the company and investors, as there is a sense of inherent fairness if reductions in conversion rate are tied to a proportionate decrease in value or performance metrics. Of the three, adjustments tied to a reduction in overall enterprise value may offer a more accurate change to the conversion rate and be less punitive for the issuer.

For our hypothetical issuer Cyclops, assuming the issuer is required to undertake an IPO within two years of the date of issue of the convertible bonds (the “Required IPO Date”), the provisions could take the form of a series of increasingly investor-favorable adjustments to the conversion rate. Since the patent and the governmental approval process here are being undertaken in parallel, the interplay between the milestones would be especially important here. The other key factor would be the dates on the original timetable by which these goals would ideally be reached to keep the issuer on track as originally planned.

The first general scenario is one where the necessary patents are obtained (the “Patent Event”) within a timeframe that permits the issuer to move to the government approval phase, but the governmental approval (the “Government Approval”) does not occur by the contemplated date under the original plan. Here the adjustment could be tied directly to the reduction of the enterprise value as compared to projections if the goal had been reached as follows:

**[If the Patent Event is reached by DATE 1, but the Government Approval is not obtained on or prior to DATE 2, then the Conversion Price in effect on such date shall immedi-**

**ately be reduced to an amount equal to the product of (x) the Conversion Price in effect immediately prior to such date and (y) .75 (seventy-five percent).](Example 1)**

The reduction posits that a delay in this milestone would reduce the enterprise value by 25%, and effects a proportional adjustment in the conversion price.

The second scenario is one where the necessary patents are obtained within the right timeframe, the issuer moves to the government approval phase, but the product does not perform to full specifications. As noted above, the adjustment in this event could be tied to the extent to which the product performed according to specification, such that if it was 85% effective, then the rate would take this proportionately into account. If tied to a reduction in enterprise value, the adjustment could be structured as follows:

**[If the Patent Event is reached by DATE 1 and the Government Approval is obtained on or prior to DATE 2, but the product is certified only for daytime use and not for nighttime use, then the Conversion Price in effect on such date shall immediately be reduced to an amount equal to the product of (x) the Conversion Price in effect immediately prior to such date and (y) .85 (eighty-five percent).](Example 2)**

The reduction posits that a delay in this milestone would reduce the enterprise value by 15%, and effects a proportional adjustment in the conversion price. If tied to the relative performance of the product when compared to expected results, the adjustment might be more severe for the issuer, depending on the measures and the range of variance between expected and obtained results. Such a provision would work as follows:

**[If the Patent Event is reached by DATE 1 and the Government Approval is obtained on or prior to DATE 2, but the product is certified only for daytime use and not for nighttime use, then the Conversion Price in effect on such date shall immediately be reduced to an amount equal to the product of (x) the Conversion Price in effect imme-**

**diately prior to such date and (y) a fraction, the numerator of which is the number of proposed applications where a daytime-only sight can be used ("Results") and the denominator of which is the number of proposed applications where a dual-capability daytime and nighttime sight can be used ("Plan").](Example 3)**

The relative complexity of such a provision makes it more suitable when approvals involve performance measure that are relatively easy to quantify, such as speed, fuel efficiency or applicability to one or more uses. Because this type of provision may also function more capriciously than an adjustment tied to enterprise value, metrics used should be as clearly identified as possible in the drafting phase to prevent disputes later. A similar mechanic can satisfactorily address deviation from sales or production projections.

The third scenario, where neither the relevant patents or the required government approvals are obtained, could typically be addressed by a variant of the first scenario but with a greater reduction of the enterprise value.

The attendant increase in interest rate is conceptually much simpler, and typically would simply call for an incremental accretive increase in interest rate upon each missed milestone noted above, with additional penalty increases if the situation is not remedied subsequently. These additional interest provisions would typically fall away upon the attainment of the relevant goal.

## **Litigation Pitfalls: The (Multi) Million-Dollar Nightmare**

Similarly, a pre-IPO issuer may face litigation that can hamper its ability to make use of technologies or resources on which its success depends. In essence, the favorable settlement of litigation is treated as a milestone, and an issuer that cannot end litigation is penalized by an increase in the interest rate and/or adjustments to the conversion terms which are favorable to investors.

There are certain special considerations involved with structuring triggers around litigation which do not apply so clearly in the context of regulatory approval. It is important for counsel to design provisions addressing the existence of litigation to

function without the litigation counterparty being aware of them, since if the litigation counterparty discovers that the outcome of their case also may relieve the issuer of a penalty provision, their leverage over the issuer will be increased. Counsel should note that documents embodying the terms of pre-IPO financings will nearly always constitute material contracts which will be required to be filed publicly as exhibits to the issuer's registration statement in connection with an IPO. Applications for confidential treatment to prevent disclosure will be appropriate for such provisions. However, these provisions may be deemed material to investors' decision to purchase shares in the IPO and therefore confidential treatment may not be permitted. In any event, it is likely that litigation would be resolved prior to commencement of the IPO for marketing reasons.

Pre-IPO adjustments to address negative results in an ongoing litigation would often track Example 1 above, and investors would be compensated by the reduction in value with a favorable reduction in the conversion rate. One possible way to protect investors in the period following the IPO is by using a weighted average of the trading prices -- after the negative litigation outcome ("Negative Litigation Event") is disclosed -- as the lower end of the adjustment. This would help guarantee investors' conversion optionality is not "out of the money" in the wake of an expected stock price drop following the negative news disclosure. Such a provision could work as follows:

**[Upon the occurrence of Negative Litigation Event, the Conversion Price then in effect shall be reduced to an amount equal to the lower of (x) the Conversion Price in effect immediately prior to such Negative Litigation Event and (y) the share-volume weighted average of the Weighted Average Price of the Common Stock for the 20 Trading Days beginning on the first Trading Day following such Negative Litigation Event.]**

A similar approach can be taken for post-IPO adjustments for any material negative event.

## **Loss of Key Executive**

Another scenario where investors may require protection is in the event of the loss of certain key

managerial or technical employees, on whom the success of the business is perceived to depend. The adjustment here would track Example 1 above, with the variation that (arguably) the adjustment should be removed if a suitable replacement for the key executive was located. In such a case, investors would presumably have to be provided with some input into the determination as to whether or not the replacement was comparable, perhaps through giving investors one of three votes on a panel (with the other two being independent of the company). Issuers and their advisers can be understandably sensitive about the key executive issue, but if one or more members of the management team are really indispensable, there is no reason why investors should not be compensated for any decrease in value associated with their departure, regardless of the cause.

**Another scenario where investors may require protection is in the event of the loss of certain key managerial or technical employees, on whom the success of the business is perceived to depend.**

## Some Final Thoughts

Although coverage of all the scenarios where adjustments or other provisions could be appropriate is beyond the scope of this article, some other considerations are worth noting in brief. In appropriate cases, counsel should consider if in addition to interest rate and conversion adjustments, that investors should seek springing board seats, whereby investors may appoint board members only if certain events occur. One such event might be the loss of key personnel discussed above. Such springing board seats could be temporary or permanent depending on the underlying issue which gives rise to the right.

Adjustments to interest rates and conversion terms can often mean the difference between a deal getting done on terms that are commercially viable for the issuer or not done at all. Some attentive drafting and close consultation between the lawyers and business people can yield constructive, creative solutions that both protect investors while allowing the issuer the financing it needs to bring its business plan to full fruition through a successful IPO.