GOWLING WLG

FINANCING IN UNCERTAIN TIMES: RAISING PRIVATE CAPITAL IN CHALLENGING CIRCUMSTANCES

Down rounds, pay to play scenarios and bridging to better

Visit our COVID-19 resource centre

25 May 2020

The uncertainty unleashed by the pandemic has lead to challenges for businesses and their investors. Financings are being delayed or cancelled, valuations reduced and the size of investment rounds are down. There are opportunities too. Creative businesses and investors are getting deals done. Gowling WLG is hosting a series of webinars designed to explore, analyze and help our clients and friends understand some of the alternate sources of financing available and how to access them.

While provinces are in the first phase of reopening, many startups are determining the impact of COVID-19 on their business operations and what the "new normal" may look like. For many founders and entrepreneurs the pandemic has lead to the possibility of declining revenues and increased costs which result in an even greater challenge to obtain early stage funding for their innovative businesses. Our panel of experts will provide insight into the resulting financing implications for companies experiencing downward pressure on valuations including discussion on down rounds financings, pay to play scenarios and considerations for directors.

CPD/CLE Details

LSO: This program is eligible for up to 1 hour of Substantive content
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LSBC: This program is eligible for up to 1 hour toward the LSBC's CPD requirement
LSAB: This program is eligible for up to 1 hour of credit toward the CPD program

Transcript

Viona: So I think we're going to get started and I just want to thank everyone for joining us. People will continue to join as we move forward. For those who don't know Gowlings has been running a series of webinars and they've been called Financing in Uncertain Times. These is the second installment of that webinar series. Everyone knows we're living in unique times right now and that's resulted in companies being faced with a lack of capital. We thought it would make sense to discuss today some of the issues resulting from the current and post-COVID-19 environment and share some of those insights with you today. During today's presentation our panel will talk about what we're seeing here in some companies and investors on the financings that we're currently doing and also discuss some of the impacts of lower valuations on early stage companies. For those that may have attended the first session of the series which was last week, you may recall that my colleagues spoke about some of the government programs that are available to the ... with the cash crunch that companies are feeling right now. Today's session, however, is intended to deal with the investor in the company and founder perspective and the impacts of doing deals at a lower valuation, which we talk about down arounds, we're going to be talking about pay to play per visions, anti-dilution implications and some of the key aspects of financing during these economic times. I think some of these down arounds and some of these provisions are going to be a reality and a trend going forward. I note this webinar is being recorded and it will be available, in addition to the previous webinar in this series, on demand on our website. Before we get started there are just a couple of housekeeping items we wanted to raise. To view the

presentation and all of the speakers you can click the speaker view and that's in the upper right hand corner of your screen. For questions, at the very bottom of your screen, there's a Q&A tab and at the end of the formal session of this webinar we will absolutely addressing as many questions as we can get in. The presentation, as I previously noted, is recorded and is going to be posted probably within a few days on our website. For lawyers, I just want to note that this program does count for about an hour of CPD, and in the case of lawyers in Ontario it's an hour of substantive credits for the annual mandatory CPD requirements. I think everyone can see we have a legal disclaimer up. Today's session is really going to be a high level. As you're aware the situation is extremely fluid and it tends to change on a daily basis. We ask people to, if they need specific advice, please each out to your legal counsel often.

Today we have a panel, which you can see on your screen, a number of the key professionals who are doing these types of deals and doing financings. We have Marc Tremblay who's a partner in our Montreal office. We have Daniel Scott, partner in our Ottawa office. Todd Bissett is a partner in our Waterloo office and Garrett Hammel is an associate in our Ottawa office and all of the panelists are part of our corp finance group and do a lot of financings. My name is Viona Duncan. I'm a partner in the Waterloo office and I'm also the co-leader of our global tech sector for the firm and I'm going to be the moderator today. In terms of the agenda for today, the plan is going to be give you a brief overview of the market conditions, just very briefly and then we're going to examine flat rounds and down rounds and some of the structural considerations that come from that. As most people are aware, with financings generally, both shareholders and the board have to be cooperating and be involved in order to get these types of deals done, and that brings up some important factors. So we're also going to touch on some of the board issues, fiduciary duties and conflict of interest that arise during these type of down around financings. Then we're going to look at key terms and conditions for these type of down around financings and how also some of, what we would call typical conditions in all financings, tend to be modified in down arounds. I note that all of the panel members, including myself, we've been fielding a number of calls with some frequency lately to walk through some of these issues and to provide guidance to our clients on the implications of down around financings. I think it's important to look at that today and, I guess to be frank, I think some of these issues are certainly issues that we've seen during previous down turns. As I said before we want this to be a open discussion and so please do feel free to share the questions that you have using the Q&A feature. To the extent that we don't get to some of the questions, we can go a few minutes over the allotted time, but also do feel free to reach out to myself or any of the panel members with any questions that you might have. We may as well dig right in. As noted, we're going to have our panelists talk both

from the investor perspective and as well as the company and the founder perspective, where applicable. I think to start it off I'm going to turn it over to you, Marc, to discuss the pre-COVID market sort of environment for financings.

Marc: Thank you, Viona. Well, I'll be brief because I think most of this information is well known to you but I think it's important to all be on the same page. The market for financing, as you know, was very good for companies and founders, from the founders perspective, pre-COVID. There was a lot of cash in the system. Some investors were aggressively looking for companies to invest in, at least in certain industries, and particularly for instance, here in Montreal in AI and in the fintech industry investors were aggressively looking for that type of companies. So the valuation in those type of industries were very high, well, depending on how you look at it but it's certainly, it would be called interesting, from the founder's perspective. There were a lot of examples just to illustrate that in the few months leading to the COVID crisis. As some of you may know Visa announced in January that it entered into an agreement for the acquisition of Plaid, a fintech company, and they have bought it for $5.3 billion dollars. What is interesting is that 3 months earlier Visa participated in a $250 million dollar financing round in that company. Based on the valuation of $2.3 billion dollars. So in a short span of 3 months the valuation for that company doubled. It just shows that at least until the last couple of months the market in certain industries was very optimistic about the expected growth in the next couple of years. Obviously certain industries, like fintech, you are looking at between 5% growth, according to certain analysts, on a regular basis so the next 5 years. As we know also the Dow Jones reached like almost 30,000 points, 29,000 in February or something like that. The market and the investors were rather optimistic and that's what was driving valuation and therefore creating a good financing environment from the founder's and company perspective.

Viona: Excellent. Thanks, Marc for that. Sounds like it's been a particularly busy time prior to COVID. Todd, obviously we know deals are still happening but wondering whether you want to chime in on sort of the current deal environment and what companies might expect.

Todd: Certainly. I'm happy to. The deals are indeed still happening. There are still plenty of activity in the market but I would say that it's characterized primarily by uncertainty. Everyone's looking around trying to determine what's coming next, obviously case by case, looking at the deals. But there is not the sense of everything will be up and to the right. There is much more uncertainty around the market and that is impacting the way the folks that are approaching their deals and their transactions. So written large, when I look at it from an industry or market perspective, and we have those conversations

with investors and founders and folks watching the market, there is some pessimism, or at least as compared to the prior market, there's pessimism about the types of valuations that companies will be able to ask or achieve and the amount of cash that's going to be available to be brought in to the market. But I would emphasize that those are sort of market industry level views and I think that's informed by the uncertainty. The reality on the ground is that those broad views have very little to do with the actual deals that are being done because it's such an uncertain time. It's such a unique time that broad views aren't just in generally applicable and you have to look very specifically at a case by case basis. So we're seeing a large number of deals happen that I would call opportunistic. Deals dealing with companies that are pivoting or adjusting their market trends in the current environment or that have an anticipation that their business plan might be accelerated or moved forward long term. Now we're even seeing deals for companies that aren't necessarily directly related to the current market but where there's a long time view of the direction that will go. Those comments that we're used to hearing in the market, well this term is important because it's standard and all the deals are doing that, I hear less of that. I think it's less relevant in the current market because of that uncertainty. My message to the group would be deals can happen. Don't pay too much attention to the broad trends. Look at the very specific details of the opportunity in front of you and focus on what can be pulled out of those opportunities.

Viona: Thanks, Todd. I think that kind of sums up the market conditions for where we are today. We all know there's a number of factors in today's economy that weighs down a company's valuation, even with the large number of government programs that we're seeing that have been rolled out in the last few weeks and months. A large number of companies still require additional financial support. Garrett, I'm wondering if it makes sense for you to just walk us through the financing options that a company's board should be looking at during this challenging economic environment.

Garrett: Sure thing, Viona. In these more challenging times that we find ourselves in and if a company is in need of raising capital in the more short term environment there's a couple of options that the board should be considering. One option is conducting a down round financing. The mechanics of which is going to be the focus of most of this presentation. So I guess for those of you who may not be familiar with the term, a down round financing is simply where a private company raises funds at a valuation that's lower than the previous financing round. In challenging environments, such as the one that we currently find ourselves in, it's not uncommon for these down around financings to become the new flat rounds, and for flat rounds to become the new up rounds. However, the reality is really going to be different for every company as we've seen first hand. The

impacts of the pandemic have varied greatly across different sectors and portions of the economy. As one might expect raising funds at a lower valuation then a previous round introduces a number of specific issues that a board will need to address as part of that process. Those specific issues are really what me and my colleagues will attempt to cover over the next 40 minutes or so. Another option that the board should be considering and exploring is some sort of bridge or interim financing. This is more or less exactly what it sounds like in the sense that it's intended to bridge the gap between the time when a company's money is set to run out and when it can expect to receive an infusion of funds at a later date. If you want to say this another way, it's a smaller round of funding used to solidify company's short term position until a longer term financing option can be arranged. Bridge financing usually comes from sources such like an investment bank or venture capital firms that are existing investors in the company. The financing can come in the form of a loan, or an equity investment or some kind of combination of the two, like a convertible debt. One of the benefits of bridge financing is that it's largely an internally led process as opposed to a down round financing. So typically requires fewer consents and approvals along the way. While we're not going to focus too much on bridge financing in this presentation, just when deciding between these two options, a company's board may prefer the bridge financing option if they anticipate more of a V-shaped recession. Since a return to strong post-pandemic numbers is going to bolster their negotiating position. Based simply on the argument that the pandemic period is not going to have a long lasting effect on the business and should be downplayed in any kind of valuation process. On the flip side, investors may prefer the bridge financing option if they anticipate more of a U-shaped recession or some kind of a different longer recovery V-shaped. That is becoming more and more likely as things progress. Since pegging a valuation too soon may result in setting a value before the company's value has really stopped falling as a result of the pandemic. Viona.

Viona: Thanks, Garrett. Evidently the decision to pursue a down around would involve not just the board but also the current investors and shareholders, in most cases, and I think as Garrett has noted there's often some tension between the interests of the company and those of the investors, especially when considering down rounds. Dan, I was wondering if you can maybe talk a little bit about how an existing investor can protect themselves when the company doing is a down round.

Daniel: Thanks, Viona. Existing investor's options are going to be largely dictated by whatever rights they were able to negotiate when they originally made their investment. Their rights will be embodied in the company's articles and shareholders agreement, and in the applicable corporate legislation, and will generally include things like specific end

resolution provisions, preemptive rights, consent rights and shareholder votes. Any dilution provisions will be discussed in greater detail later in this session so I won't spend time on them here. Preemptive rights give investors the right to maintain their existing proportionate interest in the company by allowing them to participate in the new round by subscribing for such number of new shares as maintains their existing fully diluted interest. Consents are typically set out in the shareholders agreement. There's generally a whole list of items that cannot be done without a specified level of consent and the consent that is required is from the existing preferred shareholders, generally speaking, and the threshold will vary from one company to the next. It could be, for example, a simple majority of those prefs or a super majority, 2/3, 3/4, unanimous. Or it might be a specific majority but requires that the majority include a specific investor, who would typically be the lead investor from the last round, which then gives that investor, in effect, veto. In addition, there are almost always be an amendment to the articles of the corporation to, if nothing else, create the new class of shares that is to be issued in the new financing. Being that this is not specifically included in the list of actions requiring consent, which it probably would be, the corporate legislation requires the amendments to be approved by special resolution which requires a 2/3 majority vote or unanimous written resolution. In addition, depending on the specific terms of the new articles there could be a class vote requirement where beyond the other required approvals the holders of a specific class would be required to approve separately as a class. For all of those reasons, and the main take away from this I think, is that the company's existing shareholders or investors must have a seat at the table when you're talking about a new round. It's not possible to impose a down round, or any other financing round on them, without navigating their existing rights. That may mean offering them some concessions or tempering the expectations of the new investor group. Viona.

Viona: Thanks, Dan. I'm going to put you on the spot and I'm also going to ask you to speak about the issues from the company founder side and what issues they should be aware of as they sort of manage the tension between the two groups and the interest between company, founders and shareholders/investors.

Daniel: No problem, Viona. As economy slow, investors caution and risk aversion increases. While investors will continue to seek out appropriate investments, and in some cases bargains, they do not want to miscalculate and investment in the company that may already be fatally wounded. One result of this more cautious approach is, of course, scaling back valuations. This can simply be a result of doing the math on the metrics used by the investors in valuing potential investments. Such as multiples of earnings. Earnings, for many companies, have necessarily decreased over the past several months. Which I

don't think is a surprise to anyone. Or it could be a result of investors being more conservative in pegging their numbers. Lower valuations will mean that existing shareholders will have to suffer greater dilution in order to secure the same amount of capital as compared to what could have been achieved previously. That said, that may be a necessary evil in order to give the company additional runway to allow it to right the ship. Another possible impact is just a smaller pot of money being made available. As investor caution increases they are more likely to keep the proverbial patter dry and look to cut smaller cheques. That allows them to get into companies that they believe are attractive and perhaps invest more later, either as a follow on investment or in a subsequent round. That can result in companies obtaining less money in the immediate term, meaning that they may be back in the market sooner than they would like. Investors may wish to structure deals with tranche closings as a tool to help manage their risk while still giving the company some comfort that the additional runway is there. This is another keep your patter dry strategy. In such deals the company must achieve certain metrics, or satisfy certain conditions, in order for subsequent tranches to actually be advanced. But that may at least give the company the ability to stabilize its business in the short term and receive the additional funds in the medium term. Pay to play provisions and stronger anti-dilution provisions have also tended to be more popular with investors in tougher economic environments. But pay will be discussed more fully later. Finally, I should add that the relationship will not necessarily be adversarial. Investors will seek to manage their risk but on many fronts their issues are aligned with the company. The better the company ultimately performs the better the return for the investors. For that reason a savvy investor will remain mindful of the need to keep the founders and management incentivized and engaged of the possibility that overly draconian terms that the company is saddled with now may hinder its ability to raise capital if it becomes necessary later. Viona.

Viona: Thanks, Dan for touching on both sides of that issue. As we've seen, while the boards considering some of the options with respect to structure, there's also additional consideration that they should be thinking about in terms of how they're going to conduct themselves, and also in terms of the process they should be using in walking through the down round. Garrett, I was wondering whether you can discuss some of the key issues that a board should consider when a down round is something that's on the table.

Garrett: Thanks, Viona. There's a number of other things procedural wise that the board should be considering as part of the down round process because, generally speaking the down round, when you're raising funds at a lower valuation, it comes with a heightened risk of litigation, for obvious reasons. A down round raising funds at a lower

valuation can have a clear negative impact on shareholders and other stakeholders. To mitigate against these heightened risks and protect the company, there's a number of simple actions and strategies that the board can adopt and implement, based on the circumstances. First and foremost, having a clear understanding of their fiduciary duties as directors of the company, is always going to be helpful. As a brief overview, without getting into too much detail here, a director's fiduciary duty is to act honestly, in good faith and in the best interests of the company and it's stakeholders. That obligation to act in the best interest of the company stakeholders is a more recent corporate law development that broadens the scope of the directors fiduciary duty. Such that they also need to consider the interests of shareholders, and not just majority or those who control the voting rights, employees, retirees, pensioners, creditors, governments, the environment as well as the long term interests of the corporation. So that's that. Second, the board may want to consider establishing an independent committee to review and negotiate the down round. This strategy may not be applicable in all cases, as it's really intended to be a mechanism to cleanse the process from any kind of potential conflicts of interests that may arise at the board level, which is something that I think Dan is going to cover later on. The board is going to want to consider the timing, the makeup, the potential powers of this committee which should include the ability to appoint their own counsel and experts as they need. At the end of the day, by simply adopting the recommendation of the independent committee, the board is going to greatly increase the availability of Canada's business judgment rule as a defense to any stakeholder litigation. Third, the boards going to want to ensure that they have a really strong record keeping practices in place. Making sure that proper board minutes are being taken and really just other documentation that is part of the process. While this may seem like it's pretty common sense, and it is applicable in all cases, I'm sure most of us on this panel can speak that it's not always done in practice. So it is something to keep at the top of mind for board members. In essence, they're just going to want to be able to show that they had a clear deliberation at the board level with rep to the negotiation and the terms. They had a thoughtful approach to the valuation as well as perhaps the consideration, if any, the impact of the down round on management benefits. Fourth, the board is going to want to consider whether it's an option to have the transaction approved by disinterested shareholders. Obviously this may not be applicable in all cases because it may simply just not be obtainable in all cases. But to the extent that it can be obtained it certainly provides a great defense against any future stakeholder litigation. Lastly, the board's going to want to make sure that it's making the appropriate disclosures throughout the process. Again, this is a strategy and approach that's applicable in all cases and simply means that it's going to be provide all relevant and material information to the various stakeholders, in a timely manner, so that

they can make a proper and fully informed decision. This is also going to cover disclosure of conflicts of interests, which again, I think Dan is going to cover.

Viona: Thanks, Garrett. We all know when issues arise the board has to ensure that it's taking appropriate steps and that they're fully documented in the minutes. I know probably everyone here on the panel's had situations where the board's decisions have been questioned, after the fact and the company wishes, and the board wishes, that the minutes were better documented. I think there's another issue that we could expand upon, as it relates to the board, and that's conflict of interest for board members and that specifically includes your investor appointed director. Dan, wondering if you can briefly touch upon some of the issues surrounding that and where these conflict of interests arise as a it relates to the board.

Daniel: No problem, Viona, and you're right. The conflict of interest issues that Garrett mentioned can become highlighted in companies that have VC representation on the board. The VC representative may see him or herself as being there to represent the VC's interest at the board level and, while it's fine for the VC representative to provide the VC's perspective during board level discussions, the representative is not permitted to prefer the interests of a VC over other stakeholders within the corporation when making board level decisions without breaching his or fiduciary duties to the corporation. Shareholders are of course permitted to act in their own self-interest. That self-interest is the lens through which the VC's perspective, as presented by the VC representative, should be evaluated by the board. Rather than creating corporate value, which can be imagined as growing the size of a pie, shareholder source suggestions can be more focused on shifting value between stakeholders. Such as from employees or creditors to shareholders thereby reallocating the pieces of the same sized corporate value pie onto the plates of shareholders. In the Canadian context, such value shifting initiatives may be properly criticized as prioritizing the interests of shareholders over other stakeholders, which may not result in corporate actions that are in the best interest of the corporation. This can be contrasted with the US where directors might not be faulted for increasing shareholder value in such a manner. In Canada, as long as a board's decision can be justified as being in the best interest of the corporation as a whole, the decision may be protected by Canada's business judgment rule which Garrett has already outlined. Even if it fails to maximize short term or even long term shareholder value. In short, directors who also own fiduciary obligations to a specific existing shareholder, as in the VC representative director example, are likely to be in a conflict of interest position when trying to help navigate the next investment round. Particularly if that shareholder who appointed them is also looking to participate in that round.

Viona: That's great, Dan. I want to turn and discuss some of the other practical implications of down round financings. As we know down rounds involve a lower valuation and, in some cases, the unforeseen result of that is you end up with the common shares being under water. As well, one of the implications there is that you are using options, which are usually common shares, to incentivize your current employee group as well as bring in new talent. Understanding that, with the potential for your options and your common shares to be under water, I was wondering, Garrett, if you can just discuss some of the implications and what companies do in this type of situation.

Garrett: Thanks, Viona, and you're absolutely right. One of the big tactical implications to consider of this down round process is the effect that it may have on the company's ability to retain and attract high level talent. No matter what stage the company finds itself in talent is always going to be a critical factor in the success of the company going forward. So when negotiating the terms of the down round the company really needs to consider the impact that those negotiated fruitions may have on the various incentive plans that they have in place. A broader perspective, as part of this consideration managing the messaging to those key employees and management is going to be a really crucial part of that process, as it's easy to see why employees may perceive a down round as a signal that there's blood in the water, so to speak. Or now may be a good time to jump ship to greener pastures. So, when negotiating the terms of a down round the company's going to want to consider the need to top up its option pool. Obviously to allow the company the flexibility it needs to grant further options to properly incentivize key talent to stick around. In some cases this request may be met with pushback from investors who are going to resist it on the basis that they don't want the dilution to come out of their share. So there may need to be some discussion around where the dilution ultimately comes from in terms of the option pool top up. But at the same time the investors should also be able to realize that the company really does need to be able to retain and attract those key talent in order to protect and preserve their investment as well. Another practical consideration is that as part of the negotiation is the repricing of outstanding options to reflect the new lower valuation. Again, managing the communications with the existing option holders is going to be a key piece here, as there's going to be tension between the option holders, who are naturally going to be upset that investors may be participating in the down round and receiving shares at a price that is below their current strike price. The company, on the other hand, who may believe that the new lower valuation is really only just temporary as a result of the pandemic, and not truly reflective of the company's long term value.

Viona: Thanks, Garrett. We're going to move on from implementation

considerations and I think we're going to get right into the nitty gritty of down round financings and we're going to talk about the terms and conditions. I think we've alluded to, earlier today, that there's certain specific provisions which tend to be associated with down round financings. One of those terms that people may have heard about are pay to play provisions. They are typically complicated provisions and also tend to cause a bit of heartburn, for both the company and the investors, from a negotiation perspective. Todd, I know you, like the rest of us, are getting calls regularly on these type of provisions and it'd be excellent if you could talk about the advice you're giving your clients as it relates to pay to play provisions.

Todd: Sure, Viona. Happy to, thanks. Talking about pay to play is an interesting thing to be asked to do. I find them a really fascinating topic. Part of the reason for that is because they always come up in a down round context. They always come up in a tough market environment and they're viewed in the market largely as being this extremely powerful tool as a mechanism to get a deal done. But due to their nature, they're actually very difficult to take advantage of in practice, and often they're not nearly of as much practical use as you might think. If I was trying to describe a pay to play to my kids I'd probably use the metaphor of a dragon. Like they're this really scary powerful tool but awfully hard to find when the time comes to try to bring one to bear. Let me unpack this a little bit. First, let's explore what a pay to play action is. At base a pay to play is a mechanism that removes or reduces the rights that an existing investor has, vis a vis shares, if it fails to invest in the future or subsequent round of financing with the same underlying company. As you can see here from the slide the mechanism typically shows up in one of two ways. One is if an investor fails to invest then their preferred shares that they already own will be forced into common shares. As a consequence of that they'll lose all of their preferred share rights, including some of the most important economic shares with designation preferences, anti-dilution rights and similar rights. There is also less aggressive mechanisms where, instead of converting into common some of the rights of the investors have negotiated into their shareholder agreements, simply fall away. The most notable one might be preemptive rights which is the right of investor to participate in the current and any future financings of the company. All of these can be brought to bear there. It's a different level of application but it's all the same pay to play concept. The idea being that existing investors penalized for not participating in a new round. That's the problem. By their nature, in order to be effective, a pay to play right has to already be in place. It has to already be baked into the company's documents when that new financing, where it's going to be brought bear in, arrives. That in turn creates an enormous tension in the market. The company's founders are always in favour of pay to play as they would like to impose a pay to play in every round of financing. Up rounds and down. But for investors

it's not so simple. For investors it's a case by case analysis. If I represent an investor who is investing in a current round financing, particularly a down round, I have a very strong incentive to have a pay to play. Have a mechanism to force other investors to co-invest with me or be penalized. But the same investor that I'm speaking for has very little incentive to box themselves up and impose a pay to play on themselves, forcing themselves to invest in the next round of financing that might come later, and might be in a different market environment when the same investor doesn't want to invest. That creates the tension here. When times are good, and even when times are not so great, the investors who are actually around the table writing cheques, they wish to cause others to invest but they have very little incentive to impose a pay to play on themselves in the future. But that can be very, very difficult to convince investors to agree to one. As a consequence, you very rarely see one actually existing in company documents except in an unusual circumstances. So when a down round actually arrives, more often than not in practice, there is no pay to play already existing in the documents. There's no dragon around to scare the investors to participate. So what you turn to is instead of trying to enforce an existing pay to play, to force investors around to invest in the company, you shift into this conversation where you're trying to convince your investors to proactively agree to a pay to play, even though it might not benefit them in the current or future rounds. That is an awfully tough conversation to have.

Viona: Thanks, Todd. I think that was very well said. If we consider this, what Todd said, in the context of falling valuations, cash strapped companies and even potentially bankruptcies, the question that comes to mind is whether pay to play provisions are even a possibility for companies? Marc, it make sense for you to provide some insight as to the difficulties faced by the company, or the founders, when they try to ask for such a provision, in light of the current context.

Marc: Well, I would say that as Todd alluded to, right now I think it's certainly not impossible but it certainly is very difficult and specific conditions are required in order for founders to be able to convince the current investors or future investors to swallow that pill. I'd add that at the same time it might be also risky in certain cases to raise this issue for founders if it was not already in the documentation. It's sort of a judgment call so let me maybe expand a bit on that because obviously in a down round, there's a lot of pressure on the company and on the founders, for obvious reasons. The existing investors do not like down round. It's all so obvious. So the pressure is huge. But it's not necessarily crazy to, obviously also, for founders to ask for those particular provisions or ... to be included but my advice would be that to be very careful, as I said earlier, because if your position is to say, "Well, I'm going to ask for it.", and if they say, "No.", that's fine. Are you

ready to live without that provision? My advice is if one of the investors decides that it's a good idea and that given the current context you may even have convinced that investor that it will be a condition precedent to have that such type of provision. So to ensure that you know the co-investors will invest money in the future if there's new needs within the next 6 or 12 months. In other words, may be investors will decide that, at least investors are looking at their portfolios and are deciding right now, at least in the current condition, whether they are open to invest or they'll just drop the company. They may end up decide that they just prefer to withdraw now rather than being stuck alone in the next round because the others are not investing. So, I think it's certainly possible but I'd be very careful before asking that in the current context. I think that most founders right now would be more concerned on the short term rather than jeopardize or be very concerned about limiting the risk of a future potential round.

Viona: Thanks, Marc. I'm wondering if you could also expand on what happens if a company has a pay to play in their agreements right now. What are the impacts of that?

Marc: Well, I think as Todd explained, it's the dragon that make or break the law of fear and, to a certain extent, when it's there it certainly creates an incentive for current investors to participate in that new round. Because as you now even if the anti-dilution provision were weighted that based instead of full ratchet or something but if the round is significant or important relative to the previous ones it could have a very significant ... effect. So the consequences are clear and that's the intent of those pay to play provisions. But again, I would add that it's there or it's not but if it's there I think it will be very interesting in the current conditions to see what the impacts will be in the context of the COVID-19. As I mentioned earlier I think some investors will look at it and say, "The solution, I'm just going to try to sell my shares at a very discounted value.", and basically to a certain point to be able to live with your write off therefore creating down spiral effect on the valuation of the company. The pay to play provision will not necessarily create that situation but it will be one of the factors that could lead the company to facing such a problematic scenario. That's what I think.

Viona: Thanks, Marc. I guess if I'm an existing investor I guess what I want to know, and I know we've bee asked this question, is if pay to play consequences can in fact be imposed upon me, such that they will apply to a current financing or what are my options? Todd, might make sense for you to comment on that.

Todd: Yeah, absolutely. As Marc was saying, if there's an existing pay to play baked into the documents, then sure. It's there. It can be imposed. These are generous speaking enforceable rights. They'll have some parameters, some rules, for how they're

implemented but as long as you follow those parameters based on the documents in place, they're enforceable. But absent that, if you don't have a pay to play already existing in the documents then the short answer, and this is a little too simplistic so I'll unpack it, but the short answer is, no. You can't just impose a pay to play on existing investors. They bought shares. They negotiated rights that are prior financing and you can't impose new rights or change those rights just because the company happens to be in financial distress or down round situation. Now, that being said, I'm talking at that point about sort of an investor as a group. When we look at individual investors there can be situation. Most notably rights of existing investors usually can be amended or modified by some sort of a majority vote. Dan and Garrett talked about this quite a bit earlier in the presentation about various levels of consent to amend the articles or change the rights of the investors in the documents. So there are scenarios where a majority of investors might agree that imposing a pay to play on themselves, in the current round, is in the best interest of the company, and a minority of investors who might not agree and who may not wish to it, could in fact in that scenario, be dragged into it and it could be imposed on them without their consent. In practice that very, very rarely happens and that's because the investors who would be willing to impose a pay to play on themselves, usually are the same investors who are writing new cheques in the new round of financing. If you have investors who are writing new cheques and therefore won't be hurt by the pay to play, you have those investors approving a pay to play on behalf of their peer investors who are not writing new cheques and will be damaged, you create some real significant issues. Some real legal issues here. There are pressure rights, there's soft dealing arguments and so very difficult to impose in that context. Unless you have a scenario where a majority or a super majority of your investors who, in fact will be damaged by the pay to play, nevertheless are going to agree to impose it on themselves, it won't be possible to impose pay to play. It will be very difficult to get there and as a consequence the only scenarios where you typically see it, or where you most typically see it if it's not already in the documents, is when new external investors, and sometimes internal investors, come in and they just said as a rule, "We will not close this deal unless you agree to pay to play.", and you end up in that scenario where the investors are forced to a choice where they can agree to accept the pay to play and get the deal done, or refuse the pay to play and risk the company going down and getting essentially nothing. Nothing return on their investment. Even then it's a forced choice but technically it's a voluntary choice that they make.

Viona: Thanks, Todd. I'm cognizant of the time. We have about 10 or 12 minutes left. I know we've been talking a lot of doom and gloom at the moment and negative aspects of pay to play. I know there are some advantages to pay to play provisions and

I'm wondering, Todd, if you want to touch just briefly on a twist sort of on the pay to play provision, which we often call a pull up provision, and how that compares just briefly to a pay to play.

Todd: Sure. Happy to and absolutely, as you say Viona, a down round is not all doom and gloom. It's not all bad things which we'll get into in a moment. Quickly on the pull up, because it's a very rarely seen right, so I don't want to spend a lot of time on it. But essentially a pull up is the polar opposite of a pay to play. A pay to play is designed to penalize investors who fail to invest in the new round. A pull up is designed to reward investors who do participate in the new round. It does it by saying if you're an existing shareholder, and you invest in the new round, then we're going to take your old shares that you already own and we're going to pull them along into the new realm, and you're going to get the benefit of those new round rights and preferences. So that might mean that those old shares, bought at a higher price, actually convert into a larger number of new shares at the lower price. Or it might function a little bit more like a most favoured nation clause where you keep the old shares as they are but you get the benefit of whatever new rights and preferences you've negotiated in the new deal. Pay to plays and pull ups can be used one or the other, or both, in a transaction based on the leverage of the parties around the table. But fundamentally they're imposed in the same way. You can't simply create a pull up without consent of the parties. It needs to be negotiated and implemented as part of the new round unless it already exists in the old documents. So many of the same constraints around imposing them exists as we just talked about in the pay to play context.

Viona: Thanks, Todd. As folks know there's a lot of moving parts with pay to play provisions and obviously there's no one size fits all so obviously getting the appropriate advice to help you through those is key. I want to move quickly to another provision which is common. Not just in down rounds but I wanted Dan to touch very briefly on anti-dilution provisions in the context of a down round. Just sort of what we're seeing and some of the tweaks or implications to these provisions as it relates to down rounds. Dan.

Daniel: Sure thing, Viona, and you're right. Anti-dilution is not unique to down rounds and like pay to play provisions there's no one size fits all approach. What has been typical through most of the last decade and during rosier economic periods, generally, has been an approach commonly referred to as a broad based weighted average anti-dilution protection approach. Under this model, the conversion priced used to determine the number of common shares that preferred shares can convert into, is decreased when the company subsequently issues shares at a price lower than the price at which those preferred shares were issued. This approach has an element of fairness to others on the

cap table in that it factors in the overall size of the down round. In other words, a down round with an aggregate value of a million dollars will result in less than adjustment to the conversion price in a down round that raises ten million dollars. What has been seen in theory is where down rounds are more prevalent, and what we may see more of now, is the much more draconian full ratchet anti-dilution protection. The full ratchet affords the most downside protection to the investor and is the most detrimental to the existing shareholders in that it is the most dilutive protective measure. The full ratchet reduces the conversion price of any convertible securities held by the investor to the point where it equals the issue price in the securities issued in the subsequent down round. It effectively recalculates the number of common shares that the investor's preferred shares can convert into but the ... original price per share by the current common share price implied by the down round. Unlike the broad based weighted approach it only considers the price per share and ignores the aggregate amount of the financing. The full ratchet can have a chilling effect on a company's ability to obtain additional financing in the subsequent down round, or on the existing shareholders willingness to consent to a subsequent down round, because of the dramatic effect it can have on the cap payable.

Viona: Thanks, Dan. As we know, anti-dilution provisions have a impact on both shareholders and the company itself and the founders. Garrett, wondering if you can talk about the company looks at when they're negotiating down round provisions.

Garrett: Yeah, I think Dan's actually done a pretty good job in terms of summarizing a little bit from both sides, actually. It's just really important to remember from the company's perspective that, again, there is no one size fits all. These provisions are going to be negotiable on a case by case basis. What's appropriate in one case may not be totally off base in another. So the company is just going to have to keep that broader picture in mind, and be able to recognize when the investors may be pushing a little bit too far, and when to push back because the company's going to want to make sure that whatever gets baked into the terms of the down round financing doesn't become problematic in later rounds of funding, and doesn't act a disincentive to founders or key employees going forward as well. I think Dan's done a pretty good job of summarizing that. The company really, at the end of the day, just needs to work really closely with their legal counsel to ensure that whatever the agreed upon terms are at the end of the day, that they're probably reflected in the company's articles and shareholder agreements and any other relevant transaction documents.

Viona: Thanks. I know we've look now at down round pay to play provisions. We've looked at the implications of anti-dilution provisions on down rounds. One of the things I think is also important with these type of financing rounds, is to look at some of

the typical terms, and understand how some of those typical terms are modified in the context of a down round deal. Todd, wondered if you could walk us through just a few of those.

Todd: Sure. Thanks, Viona. You see on the slide here a number of items that come up in a down round financing and all of these are items that come up. I'm not going to go through the individual items. I think they probably speak more or less for themselves as to where the market is. Little bit more high level what I would comment on is that when you're dealing with a down round financing sometimes you can find investors end up with this kind of kid in the candy store mentality. Where they recognize that there's a lot of leverage. They recognize that the company is in a tough spot and they can start picking off a lot of rights and just asking for everything. So there are some big ones and we've talked about them today, including most notably what Dan and Garrett were just talking about with anti-dilution. But really, almost anything else that get's negotiated in a financing can be re-cached or re-presented and imposed in a new deal in a more aggressive way. Some of the bigger ones we'll see in a prior round, you might have had a 1x non-participating liquidation preference. In a down round you might find investors looking for a 3x or a 5x participating round. You might see investors trying to take over the board or expand their protection provision such that they have an enormous amount of control over all the material decisions of the company going forward. You can see entirely new rights get presented, like redemption rights, which give the investors an exit opportunity to properly use that. Really, anything can be there and so all of that will be negotiated case by case, based on the folks around the table. Where I would end this is really by pointing out that investors, company, everyone really should be thinking about more than just the current round and recognizing that enough can be enough. You don't want to go too far down this road of recasting everything in a down round financing. First of all, the down round financing sets the precedent for the next round of financing of the company. So if the rights are too aggressive in a down round then the investors and the founders and the company will have to deal with the next version of those same rights when you get to the next financing. That might not be even in the investor's best interest. You have to make sure that your founders and your other stakeholders remain incentivized. So if you run too aggressive a deal, and there's too much dilution, you might really lose some of the secret sauce in the incentivization that makes the company a success that you wanted to invest in in the first place. Finally, I note that relationships matter. These are financings. Financing transactions, even down rounds, are deals where at the end of the deal everyone is sitting around the table trying to grow something together. If you run a down round financing that's too aggressive some times those relationships can get broken and you'll lose that ability to really work together to grow something great in the future as the market

advances. So that's really how I would say you should take the mindset coming into any financing but particularly in a down round.

Viona: Thanks, Todd. I think that's a really good place to end it and we can move to some of the questions that we have. I think ending it, and saying relationships matter, that talks a lot about the tension that we're seeing between shareholders, investors and the company, and really, the goal is sustainability of the company and financing of a company and I think that when everyone's sitting around the table, when we keep that in mind, and realize that everyone's in it together, I think that goes a long way. So thanks, Todd, for that. Thanks to the panel as well. I just want everyone to know that there are some additional webinars coming up as part of this series. I think you'll see them on the screen there but we have on May 28th, Emergency Capital Raising for Public Companies. June 4th, we have Equity Crowd Funding Development and as well, Development and Blockchain Financing on June 11th. With that, I am going to go ahead and move to some of the questions that we have.

The first question which talks about the Canadian government has been making signals about blocking investment from Chinese companies. However, China is a potential good partner as they are seeking more modern Western technology and have a longer investment horizon than North America investors. So the question is do you see any risk of the government blocking Chinese investment and what should boards consider when taking on foreign investment? I thought, Todd, I'd pass that question off to you, as I know you do a lot of work in that area.

Todd: Thanks, Viona. Yeah, for those of you who don't know me, I practiced in China for about 10 years as a technology lawyer before coming back to Canada a few years ago. Nobody knows. I don't have a crystal ball on this so I'm going to try to give a relatively quick answer and there's really two sub questions here. Do I see a risk of the Canadian government blocking investment? In theory, yes, but based on the trends and what I'm hearing so far, I would say the risk is pretty low. Investment from China is already not the easiest thing to bring in, as many of my clients and I'm sure many of others of you have experienced, those deals are already a little bit difficult to close. There's not a massive flow of those deals and I think the Canadian government has a pretty strong incentive in making sure that Canadian companies are still are able to raise money from as many sources as possible. So based on current relations between the countries, I don't anticipate that that will happen. I've been wrong before and if relations deteriorate then all bets could be off. But that's my current view of the market is that that's more signaling that there's some discomfort but more a of political signaling and not something that's likely to be implemented in aggressive way. The second question is what

should boards consider when taking on foreign investment? I mean we could do three webinars on this so I don't want to belabour the point too much. With respect to China, specifically, we just talked about the fact that politics matter to. We just said relationships matter. Politics also matter. It matters at a government level. It matters at a peer to peer level within the market. So when boards are taking investment from foreign investors, you need to have an eye on why are those investors making the investment? Do they have the same incentives as you have? Are they as aligned as you are? Will they be as flexible and as accommodating going forward as a local investor would be? Will they be more flexible and accommodating than a local investor would be. Are there upsides and downsides? So, I would really just say there are additional issues that are grafted on when you deal with a foreign investor but you're basically asking the same questions. Is this a good partner? Will I be able to count on them in the future and how confident am I of those conclusions such that I'm willing to go forward with this deal?

Viona: Excellent. There's a few other questions. Some have been sent privately but one of the questions that I have is that it sounds like some of these down round provisions and understanding what happens and working your way through them can get complicated. The question is who manages the process when you're trying to raise capital? Should it be the management team, existing investors? What do you recommend? Should the company hire an investment advisor to help? I don't know. Dan or Marc, do you want to take that question?

Daniel: It really depends a little bit on the stage of the company. A really early stage company is probably not going to go and engage an advisor. They may have an advisor on the board. Someone who has got some acumen that they can access or tap but they probably won't hire somebody. It would more fall to the CEO to go out and hustle and find the investors and then the CEO and CFO together would kind of drive the ship on the deal. Marc, do you have anything to add to that or a different view?

Marc: No. You're right, Dan. Early stage, at least that's my experience as well. It's very specific for it. I'm not sure there's really a rule that is followed by every company in terms of who should manage the process but it's sure that once, as a certain size, the management is very involved and CFO and everything. That's my experience.

Todd: Viona, do you mind if I make a quick comment on that?

Viona: Absolutely. Go ahead, Todd.

Todd: Just really quickly, I agree with everything that Dan and Marc were saying. One caution I would put in, from an investor perspective, is I would very strongly

suggest that management not hire an external manager unless they have first consulted with their existing investors. That should be a decision that's made with full disclosure just in case the investors have thoughts on the idea. Investors can be quite upset if they're not consulted about that decision.

Viona: Another question for Marc and Todd. It says you referred to market conditions. We know they're deteriorated in general but for those companies who survive any insight into what the current conditions will be? Maybe over the next 6 to 12 months, perhaps.

Daniel: Marc. Dan.

Todd: Marc.

Marc: Yeah. Well, you know what? I think it's a good point. We're talking about down round but we've got to keep in mind that a lot of companies continue to perform well and that investors may look at those companies also so that I think, hopefully, we've not kind of conveyed the message that all financing rounds will be down round in the next future. I think the economy alarm just increased the likelihood that it will occur but if you look at the stock market that I was referring to, yes, in February the Dow Jones, for instance, was at 29,000 but it fell to 19,000. But if you look at today's, it's around 24,500 and some companies, I was working on several deals at the time, and some of the potential acquires, within a couple of weeks they found that their stock fell by more than 40 or 50% but now they are back at -10 so hopefully if the economy is doing that bad in the next couple of months, then their stock might be in those areas, high growth areas, they might be back to what there were previously. Nobody knows, obviously, but I think even those companies that were very affected, some of them in certain areas will perform well and they're not going to necessarily face a down round.

Viona: Thanks, Marc. I think we're out of time. I don't want to keep people past the allotted time. I want to thank everyone for joining us. We do have article coming out on this topic which should be out in the next day or so. That'll be posted on our website as well, through social media, for those who'd like to read it. I just wanted to say thank you to everybody for joining us today and I guess until next time, stay positive and stay healthy. Very best everyone. Thank you.

Todd: Thanks everyone.

Garrett: Thank you.

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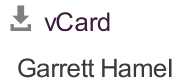

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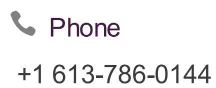

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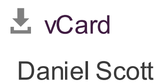

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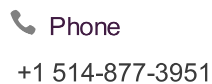

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