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# Navigating a distressed fintech market



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*This piece was co-authored by Sunay Radia, partner, McDermott, Will & Emery.*

Fintech encompasses a broad spectrum of emerging businesses operating at the intersection of financial services and technology including neobanks, digital brokers, e-money institutions, crypto businesses and more.

While the sector has outperformed the general market for the past several years, like Icarus, fintech's flight into the valuation stratosphere has made for a steep fall. The market downturn since May 2022 has had a disproportionately negative impact on companies in this sector. Shares in most of the major fintech firms have fallen by an average of 50% so far in 2022, almost twice as much as the drop in conventional markets. The general market downturn has also combined with the onset of a new 'crypto winter' that has further steepened the negative trend for crypto businesses.

Many fintech businesses are start-ups or scale-ups that are dependent on investor funding to continue operations rather than organic cash flows. The negative market backdrop has made it difficult for these businesses to raise new funds, slowed growth, and pushed emerging businesses further away from profitability.

As the average start-up has between twelve and twenty-four months of cash runway between funding cycles, it is widely expected that a protracted downturn will give rise to numerous distressed situations in the fintech sector. The issue is particularly pronounced for business that were towards the end of their prior cash runway cycle when the May downturn hit, but can be expected to impact a greater scope of businesses if the current conditions continue into 2023.

In this article, we aim to consider fundraising, cash management and restructuring strategies for fintech businesses in the United Kingdom and Europe. In particular, in the restructuring context, we examine some of the English insolvency processes which are available to fintech businesses and consider the benefits of restructuring under English law.

### Fundraising considerations

Before the market downturn, the fundraising climate for most sectors was hot and in the fintech market, it was red hot and incredibly



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The current market has shifted the dynamic dramatically, and the balance of power now lies with investors rather than companies and their founders. Both valuation metrics and revenue drivers have fallen in the past several months, dealing a severe blow to the sector. Businesses in this space now face raising at lower multiples and with headwinds to revenue drivers.

As a result, it has been increasingly common for fintech businesses, particularly those that last raised in 2021, to have to raise 'down rounds' with valuations below their last fundraise. The specter of a down round has caused many businesses to defer fundraising in the hopes that the market will recover. As time progresses and cash runways narrow, this last-resort option becomes increasingly necessary.

Raising a down round requires extensive communication with existing shareholders, particularly any classes of preference shares that may have anti-dilution protections. Where the choice is between insolvency or continuing operations—albeit with some sacrifice to economics—most shareholders will accept that the logical outcome is to allow a down round to go forward. However, protracted negotiations with existing investors can be expected, and the time to accommodate this should be factored into plans.

Founders should also expect demands from investors for additional control rights, enhanced reps and warranties and a protracted due diligence process. The era of easy money for fintech is over (at least for now).

### Cash management

Disciplined cash management has become more important given the increasing barriers to getting new money. fintech businesses going into this phase of the cycle should do everything they can to conserve cash.

This is a particular challenge for fintech businesses in the scale-up phase of growth that may be seeking to experiment with new product lines to find new sources of revenue. While this can be a successful strategy and, in some cases, leads to a flash of genius pivot that is more successful than the company's original business model, it works best in a cash-flush environment. Scale-up fintech businesses would be well advised to focus on the areas that are working and iterate to make them profitable as quickly as possible, rather than diversifying into new products. This challenge is made more pronounced by the significant costs of capital and regulatory compliance associated with entering into new business lines in the fintech space. When cash is drying up, diversification is not a recommended strategy.

In addition to focusing on core strengths, fintech businesses, particularly those providing consumer-facing products and services, should be cautious about marketing spend. This is an easy cost driver to trim or eliminate. It may not always be possible, as for some businesses marketing is the only way to establish name recognition; however nice-to-have marketing spend can and should be eliminated, resulting in significant cost savings. Where possible, organic word-of-mouth advertising can be emphasised instead, e.g., participation at industry events that already are getting press coverage.

New hiring and geographic and other expansion should also be paused unless it is possible to readily convert the spending on employees and expansion into profits. While there will always be exceptions, the current climate calls for a more conservative outlook, until the economic environment normalises.

### Restructuring

A last resort for fintech businesses where fundraising and cash management strategies have failed is to consider a formal restructuring process.

There is a broad suite of businesses in the fintech universe, each with its own unique circumstances and challenges. While it is difficult to generalise, we consider here some restructuring-related issues that are common to many fintech businesses and unique to this sector. We also explain the restructuring process under English law and explain why an English restructuring plan or administration may be a preferred means of restructuring for a European fintech.

#### 1. Regulatory and consumer protection issues

As previously mentioned, the fintech sector encompasses a broad range of actors that have very different profiles, including in an insolvency context. One aspect that is common to several types of fintech businesses that hold client funds and other assets but are not regulated as banks (including neobanks, e-money institutions, crypto exchanges, and others) is that those funds and assets may not be treated as secured assets of the depositor in the event of insolvency and furthermore do not benefit from protections under the Financial Services Compensation Scheme in the United Kingdom (government insured up to £85,000) or Deposit Guarantee Scheme protection in Europe (government insured up to €100,000). This means that account holders may be treated purely as unsecured creditors and find themselves at the back of the queue for recovery purposes.

Furthermore, fintech businesses tend to be highly regulated. An insolvency proceeding of a regulated business will require the involvement of the regulators, particularly where a distressed sale is being pursued as an option. Regulatory sign-offs on restructuring plans can be expected along with heightened scrutiny.

#### 1. Restructuring plans



or if an English company has obligations that are to be restructured, this may be enough to satisfy the “sufficient connection” criteria and establish jurisdiction.

A restructuring plan will generally require approval of 75% in value of each class of a company’s creditors. Creditor classes are determined by reference to the rights which creditors have vis-a-vis the company. The creditor class approval requirement is subject to the ability to cramdown dissenting creditor classes via a “cross-class” cramdown mechanism. The English court has the discretion to

approve a plan which is opposed by a particular class of creditors (*i.e.*, one where less than 75% vote in favour of the plan) if it considers that the dissenting class is no worse off under the restructuring plan than it would be in the “relevant alternative”— *i.e.*, the insolvency process which the business will be subject to in the event the restructuring plan is not approved.

Key takeaways and benefits of fintech businesses using a restructuring plan are:

- The restructuring plan is a company-led process where the founders, subject to third-party scrutiny and sign-off, retain control of the business and process.
- The approval thresholds to amend fundamental terms of investor and financing documents under the restructuring plan can be lower than those set out in the contractual investor and financing documentation.
- Fintech businesses can use a restructuring plan to impose their plan on dissenting creditors if the conditions to a “cross-class cramdown” are satisfied.

Restructuring plans are typically used by more established companies with a diverse and large set of stakeholders. However, the process has recently been used by an SME tech business (Houst Limited)[\[1\]](#) and may be a viable process for fintech businesses. Companies will need to enter into early negotiations with their main stakeholders prior to the process in order to ensure the support of the requisite majorities and minimise the risk of not receiving creditor approval of the plan in court.

#### 1. Administration

An alternative insolvency process that European fintech businesses may consider is an administration. Administration is an English insolvency process that fintech companies can consider using to implement a restructuring by way of a pre-pack sale.

A pre-pack sale is a process by which a company and administrator pre-negotiate a transaction before the company’s administration which completes on or shortly after the administrator’s appointment. Pre-pack sales seek to ensure minimal business interruption and are often used where the administrator considers that a going concern sale will result in best value for creditors but there is insufficient liquidity for the company to trade through an administration.

Founders with expertise or importance to a business may remain involved in the business post ‘pre-pack’. As with any restructuring process, the transaction is only viable where a company is able to raise liquidity or investment to provide the newly restructured entity with enough runway to trade through the distressed period.

#### 1. Contingency planning

Founders and management teams of fintech companies facing financial distress will often be concerned with business and operational efficiencies during a downturn and will not have the bandwidth to consider restructuring options. However, early contingency planning and engagement with advisors and creditors is key to ensure that companies have sufficiently well- formed restructuring proposals should they not be able to weather turbulent times. Choosing the appropriate restructuring process will require an assessment of the company’s capital structure, creditor population and potential impact on integrity of operations, customer and supply contracts. This is often a labour intensive process but one which may be the key to ensuring survival for fintech businesses which are unable to raise financing in a market downturn.

### Conclusion

While the European fintech market is in the midst of a cyclical downturn, the sector remains full of promise for better days to come. In the meantime, the strategies presented in this article could be of use to parties looking for options to remain solvent or restructure where there are no alternatives. In the event restructuring is needed, an English restructuring plan or administration may be a preferred means to resume operations, provided the bankrupt company can establish jurisdiction in the UK.





*Sunay Radia, partner at McDermott, Will, & Emery and co-author of this piece.*

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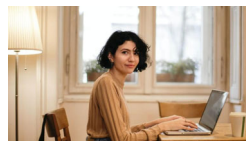
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