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WEBINAR

QuickLaunch University: Down-Round Financings

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Speakers: Glenn Luinenburg, Jenna Ventorino, Daniel Zimmermann

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WEBINAR

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Agenda

- Update on Fundraising Environment
- Current Market Conditions
- Typical Down-Round Considerations
- Fiduciary Duty Landscape
- Recent Litigation
- Lessons from the Recent Case Law
- Process: What Should You Do?
- Structuring Down-Rounds
- Alternatives in Structuring Pay-to-Plays
- Takeaways

Update on Fundraising Environment

A combination of factors resulting in the perfect storm will likely contribute to an increase in down-round financings

- 2019 marked record-setting VC deal activity and valuations continued to be on the rise
- Longest bull market in history
- High volatility in public market equity valuations

Reemergence of more onerous provisions in priced venture capital financing rounds

Consider bridge financings as a strategy of deferring valuation negotiations

Current Market Conditions

Deal Term Changes

- Valuation decreases
- Investments being tranched and/or reduced
- Staggered sign and close
- Structure changes
- Liquidation preference multiples increasing
- Full ratchet anti-dilution adjustments
- Increased representations and warranties
- COVID-19 related disclosures
- Investor withdrawals

Current Market Conditions

Other Observations

- Longer diligence processes
- Debt facility draw-downs

Typical Down-Round Considerations

Delicate and Important Issues. Down rounds raise a number of delicate and important issues for companies, directors, investors, and employees, with a heightened risk of stockholder litigation

Fiduciary Duties vs. Investor ROI. Many venture-backed companies lack significant independent presence on the board. The investor-heavy board composition can lead to challenges as the investors and management have economic motivations that may conflict with the interests of the other unaffiliated stockholders.

Typical Down-Round Considerations

Employee Equity Implications.

- Most venture-backed companies attract human capital using stock options.
- Raising capital at a declining price can signal to such employees that the company may be unable to achieve a favorable exit event.
- The resulting dilution can substantially reduce the retention value of the outstanding equity awards for employees

Stockholder Considerations

- Depending on how the down round is structured and which stockholders participate, the financing may also be dilutive to existing stockholders

Fiduciary Duty Landscape

Generally, litigation relating to down round financings center on a breach of a fiduciary duty by the company's directors, particularly when the down-round financing is led by existing stockholders of the company.

All directors owe fiduciary duties of care and loyalty to all stockholders

- The duty of care focuses on process and whether a board acted in an informed and deliberate manner
- The duty of loyalty requires all members of the board to act for the purpose of advancing of the interests of the company and its stockholders as a whole, rather than separate interests or allegiances
- This is true even if a director is appointed by a particular class or series of stock or a particular stockholder

Down rounds frequently involve actual or potential of conflicts of interest, which increases the pressure on the board and its process

Fiduciary Duty Landscape

Two common conflicts for startups:

1. Majority of Board has special interest in financing transaction:
   - Directors who are principals of venture funds
     - Viewed as "dual fiduciaries"
     - May be viewed by courts as having a conflict in some situations, such as:
       - A financing or recapitalization led by directors' funds
       - A sale that benefits preferred stockholders more than common stockholders
   - Other types of conflicts
     - Directors who are beholden to a fund through economic and business relationships
     - Members of management receiving a special benefit in a transaction
2. Controlling stockholder participates in down round or receives special benefits in a transaction

Litigation Implications

Standard of review considerations

- Business judgment rule baseline: Courts defer to directors under the business judgment rule when directors act with due care, in good faith, without a disabling conflict, and with a rational business purpose
- But where at least half of the board has a conflict and the board is not viewed as majority independent, the "entire fairness" standard applies; same result where a controlling stockholder leads a financing or receives a special benefit
- Entire fairness standard is the opposite of business judgment rule deference; examines fairness of both the process and deal terms and changes the presumption/burden of proof

Litigation Implications

Standard of review considerations

- Fundamental theory in an entire fairness claim is that the board and others breached their duty of loyalty and should be personally liable for damages
  - Members of management are often sued as well
  - Venture funds can be sued as controlling stockholders or for aiding and abetting directors' breaches of fiduciary duties
- Entire fairness litigation are fact intensive and tend to be protracted, expensive and difficult to dismiss at an early stage

Litigation Implications

Recent litigations involving private companies

- ***In re Trados Inc. Shareholder Litigation* (2013)**: Sale of company where preferred stockholders received all of the stockholder proceeds and 90% of their liquidation preferences. Common received nothing. Majority of board was found to be non-independent, so entire fairness applied. Over four years of litigation.
- ***In re Nine Systems Corp. Shareholders Litigation* (2014)**: Insider financing and recap followed by a sale of the company. Diluted stockholders challenged the financing and recap when the sale was announced. Entire fairness applied because of conflicts. Six years of litigation. Plaintiffs awarded $2M in fees against directors and their funds.
- ***Carsanaro v. Bloodhound Technologies, Inc.* (2013)**: Similar facts as in In re Nine Systems regarding challenges to insider financings that occurred before a sale. Entire fairness applied. Directors' motion to dismiss denied. Parties settled.
- ***Good Technology* (2018)**: Sale of company where preferred stockholders received majority of the proceeds and VC-affiliated directors constituted a majority of the board. Entire fairness applied. Parties settled for more than $50 million.

Litigation Implications

- ***Calesa v. American Capital* (2016)**: Private equity fund that held 26% of a company's voting power found to be a controlling stockholder given relationships with a majority of the board, such that a recap financing it led was subject to entire fairness.
- ***New Enterprise Associates* (2018)**: Insider financing in which fund became majority stockholder, followed by issuance of warrant by which third party obtained option to purchase company. Warrant was conditioned on third party acquiring another company in which fund was invested. Certain directors dismissed because plaintiffs did not allege material tie to fund. Litigation against remaining directors and NEA as alleged controlling stockholder and aider and abettor settled.
- ***DealerSocket (2020)***: Majority stockholder (the PE fund Vista) led a financing round, in part to fund the acquisition of another company. A rights offering was conducted for the other 20 stockholders. Two founder directors claimed that they had been frozen out of board discussions, with the other directors acting as a "shadow board" and Vista sending heavy-handed texts to the founders. The company's valuation was $500M in June 2019 and the valuation used in the round was half of that. The Court noted that the plaintiffs had stated a "strong claim," was critical of the rights offering, and granted a TRO. The parties settled.

Lessons from the Recent Case Law

Criticisms from the courts in these recent cases

- Board members did not understand their fiduciary duties
- Venture directors unfairly excluded an independent director from board deliberations
- Disclosures to stockholders were inadequate and did not identify how insiders benefited from a financing
- Stockholders were asked to approve financing documents, but were not provided with final copies of the documents
- Directors relied on informal valuations, and earlier 409A valuations suggested a higher value for common stock than what was ultimately ascribed to common stock in the transaction at issue
- Management incentive plans (1) rendered management directors conflicted, and (2) in sales of the company, were viewed as taking proceeds away from the common stockholders

Practical Process Suggestions: What Should You Do?

Consider certain big-picture mechanisms, which could restore the business judgment rule

- Negotiation and approval of transaction by an independent committee of directors
- Approval of a transaction by a majority of disinterested stockholders
- Rights offerings - offering the financing on equal terms to all stockholders
  - securities law concerns
  - recent skepticism from judges relating to whether stockholders have the financial ability to participate and have adequate time and information to participate on equal terms

Practical Process Suggestions: What Should You Do?

Build the best Board process and record possible — important under any standard of review and helps avoid criticisms from the recent case law

- Assess likely litigation risk
- Understand your fiduciary duties and to whom they run
- Understand and discuss conflicts
- Include all directors in board deliberations as appropriate (although recusals may occur)
- Consider all reasonably available information and alternatives — including possible buyers or financing sources and the standalone plan
- Make appropriate use of advisors to extent possible; if a company cannot afford a financial advisor, document that

Practical Process Suggestions: What Should You Do?

- For valuations, carefully consider bases for valuation; be aware of prior valuations the company has used that may come up in litigation and document basis for valuation
- Make appropriate disclosure to stockholders and properly obtain stockholder approvals
- Carefully consider size, nature, and negotiation of management benefits or incentive plans
- Build a good record of deliberation and options, and create good board minutes

Structuring Down-Rounds

Down-rounds may involve a recapitalization

- Typical goal in a recapitalization: to right-size or flatten the capital structure
- May involve:
  - converting classes/series of preferred stock to common stock (reducing liquidation overhang)
  - a reverse split of outstanding stock (creating a "fresh" cap table)
  - reclassifications of existing stock into new classes or series of stock (preserving some of the existing economics)

Equity awards and pool may need to be refreshed

Structuring Down-Rounds

Anti-dilution adjustments

- Down-rounds often trigger anti-dilution adjustments
- Possible approaches:
  - Let anti-dilution adjustments occur
  - Make use of charter waiver provisions to prevent adjustments
  - Amend charter to avoid effects
    - Consider whether class or series votes are required for waivers or amendments

Structuring Down-Rounds

Use of pay-to-play provisions

- Purpose of a pay to play:
  - Incentivize preferred investors to participate in a financing
- General concept:
  - Investors who participate at required level continue to hold preferred stock in some form
  - Non-participants' preferred stock is converted to common stock or another junior security, sometimes at a punitive ratio
- Only addressed in a limited manner by the Delaware case law
  - Key authority: 2004 WatchMark case (WatchMark Corp. v. ARGO Global Capital)

Alternatives in Structuring Pay-to-Plays

When are pay-to-play provisions implemented?

- Some companies have existing pay-to-play charter provisions providing that in a future financing, non-participants will be converted to common
- In other cases, pay-to-play provisions are implemented in connection with a financing

Alternatives in Structuring Pay-to-Plays

Flavors of pay-to-play provisions

- Provisions come in many forms, depending on the situation
- Variations you may see:
  - Convert all preferred stock into common stock by way of a preferred stock vote; then permit participants in the financing to exchange some of their common stock into preferred stock,
  - File a charter amendment on the eve of a financing providing that non-participants' preferred stock will instantly be converted to common stock (approach from WatchMark case) or into some other shadow/junior series with lesser rights, or
  - File a charter amendment providing that at some future time, non-participants will have their shares converted into common stock or a shadow/junior series
- Sometimes preferred stock is converted into common stock or a new series of preferred stock at a 1:1 ratio and sometimes at a much more punitive ratio

Takeaways

1. We may continue to see more down-rounds, given macro-economic trends
2. Companies and investors can significantly mitigate risks of a down round with proper planning
3. Fiduciary duty and process concerns may be significant, given potential insider involvement and limited time and resources
4. Consider process steps that may prevent the "entire fairness" standard from applying (high bar, but worth exploring)
5. Pay-to-play provisions may be, but are not always, involved

Takeaways

6. In any event, regardless of standard of review, run the best process possible:
   - Appoint a special committee of disinterested board members to review, negotiate and approve the transaction;
   - Start looking for alternative funding sources early and carefully document those efforts;
   - Find an outside third-party investor to lead the round if possible;
   - Engage in a rights offering;
   - When feasible, obtain a third-party valuation or fairness opinion;
   - Disclose the terms of the financing to the stockholders as well as any potential conflicts of interest and obtain the approval of a majority of the disinterested stockholders; and
   - Carefully document the deliberations of the special committee and the board with respect to valuation of the proposed transaction.

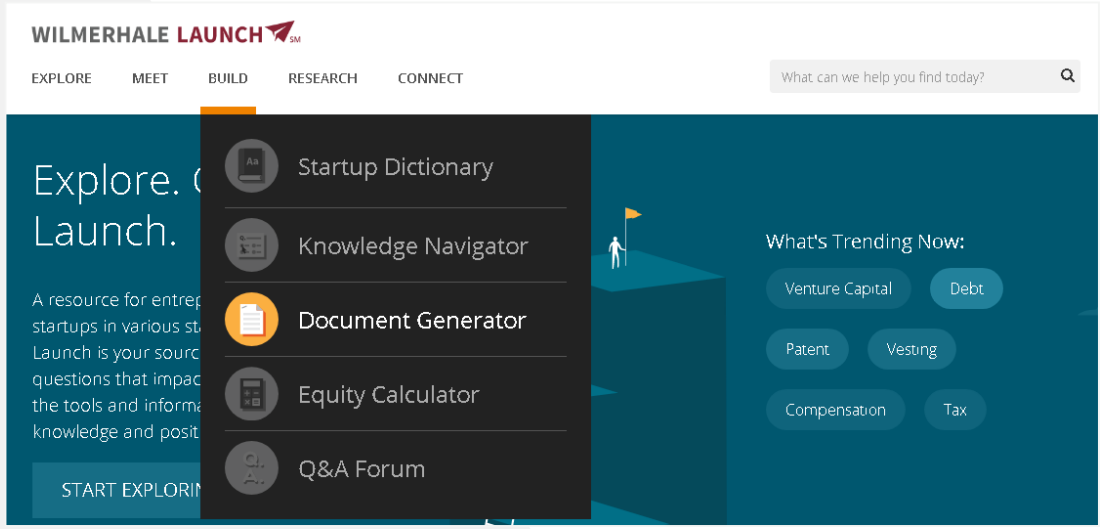
Takeaways

7. Consider employee equity structure going forward
8. When down-rounds occur, a company may not be a worthwhile litigation target — but if the company turns itself around, litigation may arise in the future
9. Down-rounds can introduce a host of technical issues — and a need for savvy counsel/advisors

Additional Resources

For more information visit WilmerHaleLaunch.com

- A website full of vital information, tools and connections needed to position entrepreneurs and startups for success
- Draws on expertise of WilmerHale's extensive team of lawyers practicing in areas critical to emerging companies in various stages of growth
- Features a growing library of video insights from lawyers, investors and other experts
- Allows entrepreneurs and investors to build knowledge, research topics with everyday impact and connect with dedicated lawyers
- Contains Document Generator



Questions

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