Late Stage Investment Rounds:

Identifying and Navigating the Issues

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As the time frame to liquidity continues to extend, investors are now routinely considering and making investments in private equity-backed portfolio companies that have already been through multiple rounds of institutional financing. In many cases, plain vanilla Series A or B investments are a thing of the past. There are a number of complex business and legal issues that investors should consider when making investments into companies that have already been through numerous institutional investment rounds. This article identifies and discusses many of these issues and offers some guidance on navigating through them.

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Whether to Compress the Equity Structure or Add to the Complexity?

One of the most important and threshold issues that needs to be addressed in connection with any new later series investment is to determine whether the investment should be structured as a new series of preferred stock layered on top of the existing equity or whether the existing equity should be recapitalized and compressed. While recapitalizing and compressing the existing equity is a complicated and potentially contentious short-term task, doing so can minimize or eliminate a number of the difficult and complex issues described herein. If a recap and compression is the selected approach, the company and investor groups must decide whether it should occur prior to, or concurrently with, the new investment round.

A lean, straightforward capital structure generally simplifies exit scenarios and maximizes exit opportunities. As a result, most investors prefer to invest capital into simple and clean equity structures. After going through multiple rounds of institutional financing, companies often end up with relatively complex capital structures. When those companies find themselves in need of additional capital—especially those where the aggregate liquidation preferences dwarf the underlying value of the equity and/or there are already three or more series preferred stock—many of the early discussions center around whether to recapitalize and compress the company's equity structure. If the board of directors and the existing investor reach the conclusion that a recapitalization is necessary, the next discussion usually focuses on whether to self-execute a recap or wait until a new outside investor requires it. Many practitioners believe that an internally driven recapitalization prior to going into the market to seek additional capital results in more favorable outcomes for existing investors. However, certain investors may not be willing to self-administer a recapitalization on the belief that it is more palatable to have an outside third party dictate the terms of the recapitalization. Based on our experiences, there is no single right answer on whether a self-administered recapitalization is preferable to one driven by an outside investor. When existing investor groups make this decision there are a number of determining factors. These factors include:

- The extent of the disparity between existing aggregate liquidation preferences and anticipated pre-money value. Larger disparities weigh in favor of self-administered recapitalization, as many investors consider the recap inevitable in these circumstances and prefer to try and set the terms of the recapitalization.
- The cohesiveness of the existing investor group. Greater cohesiveness favors a self-administered recapitalization because the terms of the recapitalization may end up being less harsh from an economic and governance perspective on the existing group, as a whole.
- The size of the new round. Larger fund raisings tend to act as an impetus for investor groups to organize themselves and act collectively.

Most outside investors prefer pre-financing recapitalizations that compress the equity structures because it simplifies the negotiation and analysis of proposed investments. Even so, in many cases, a pre-financing recapitalization is not realistic, as internal investor groups often lack the motivation or organization needed to recapitalize and compress themselves. In addition, the time frame in which new investments needs to be made is often too short to complete an internal recapitalization prior to beginning the external fundraising efforts.

Deciphering and Structuring Liquidation Waterfalls

Typically, the most recent money invested is senior to all earlier invested capital. Unfortunately, the analysis is often not this simple for companies that have been through multiple rounds of institutional financing. In many late series investments, the liquidation preference analysis is influenced by factors other than the relative seniority of a series of stock. If the company has undergone up rounds followed by down rounds, the analysis can be overwhelming. Investors need to be aware of the challenges posed by complex liquidation waterfalls when structuring their investments.

Consider the following example:

- Management owns 10 million shares of Common Stock
- Series A investors acquired 10 million shares of Series A Convertible Preferred Stock for $3.00 per share (implied post-money value of $40 million)
- Series B investors acquired 10 million shares of Series B Convertible Preferred Stock for $4.00 per share (implied post-money value of $120 million)
- Series C investors acquired 10 million shares of Series C Convertible Preferred Stock for $3.00 per share (implied post-money value of $120 million).

Based on these facts, if the company were sold for at least $160 million, a stockholder's choice would be simple – each would be best served by taking its "as-converted" value (the CSE Value) as, in each case, the CSE Value of $4.00 exceeds each series' original issue price[1]. However, if the company were sold for $120 million, the evaluation would become slightly

1 All calculations in this section assume that each series of preferred stock sold is senior to the earlier series and that all applicable anti-dilution provisions are waived.

more complicated (but still very manageable) as the CSE Value is below the Series B investment price of $4.00.

If the company were to complete additional investment rounds without any corresponding compression to its capital structure, the waterfall analysis could become incredibly complex depending on the terms of, and participants in, each investment round. In particular, two issues commonly arise in these situations. First, most charters do not provide guidelines as to the order in which investors are entitled or required to make preference decisions as between series of preferred stock (the "Sequencing Issue"). Second, in situations where one or more investors owns multiple series of preferred stock in a non-pro-rata fashion, the decision as to whether to take each series' original issue price or its "as converted" value upon liquidation can be influenced by the potential impact of those choices on each investor's other equity holdings (the "Overlapping Investor Issue").

Sequencing Issue. The Sequencing Issue arises where preferred stockholders have the right, but not the obligation, to convert their preferred stock into common stock immediately prior to a liquidation or deemed liquidation event. In certain situations, a particular series' economic return can be greatly impacted by the conversion (or non-conversion) of another series of preferred stock. In the vast majority of situations, the choice between receiving the original issue price or the "as-converted value" is obvious and easily determinable. However, where a company's capital structure features multiple series of preferred stock, all with varying terms (such as one series that carries a participation right, and others that have standard, convertibility features) and non-sequential issue prices, the permutations can result in a stand-off among multiple series of preferred stock. In one representative transaction, the Series A investor would receive its highest value if the Series B, Series C and Series D all elected to convert, but the Series C would receive its highest return only if the Series B and D converted. Likewise, the Series B investor would receive its highest return if the Series D elected not to convert, while the Series A and C converted. Not surprisingly, the charter in this transaction was silent (as the vast majority are) on the order in which a particular series of preferred stock may, or is required to, make its election. In certain situations, the language of the charter attempts to be self-executing by stating that if a holder were to receive a greater amount through conversion, it need not actually convert, but rather is entitled to receive such greater amount in all cases. Even these provisions can break down if the capital structure is sufficiently complicated and non-sequential. From a practitioner's perspective, the most successful solutions have been either to (a) include specific language in the charter that sets forth the sequential rights of each series to make a decision (i.e., the most junior security must make a definitive election first, followed by the more senior series of preferred) or (b) avoid the potential issue entirely by recapitalizing and compressing the company's equity structure.

Overlapping Investor Issue. As a practical matter, the Overlapping Investor issue can never be entirely avoided. This issue arises when an investor (or group of investors) holds multiple series of capital stock with different terms and sale prices. In every case where there is a distribution of proceeds to the equity holders, the amount available for distribution is a fixed amount. If the amount payable to one series or class increases, the amount payable to the other capital stock must be reduced by a corresponding amount. Usually, one can easily identify the most economically rational distribution of proceeds from the perspective of each class or series, viewed as a whole. This simple analysis can become much more complex, however, when viewed on an investor by investor basis. Consider the following situation and assume that a vote of at least two-thirds of the holders of the series of preferred is required to convert that series into common stock:

- Management owns 10 million shares of Common Stock
- Series A investors acquired 30 million shares of Series A Convertible Preferred Stock for $1.00 per share (implied post-money value of $40 million)
- Series B investors acquired 10 million shares of Series B Convertible Preferred Stock for $4.00 per share (implied post-money value of $200 million)

- Company is sold for $400 million
- Investor A owns 35% of Series B and all of Series A.

Under normal circumstances, all of the preferred would convert into common and receive its portion of the CSE Value of $8.00 (Series A would receive $240 million and each of the Common Stock and the Series B would receive $80 million). In that case, Investor A would receive $266.7 million. However, if Investor A refuses to consent to the conversion of the Series B into Common Stock, his return would actually increase to $283.3 million because all of the incremental value that would have been paid to the holders of Series B (all shared among all holders of the series) shifts to the Series A and the Common Stock.

From a practitioner's perspective, making sure all parties are aware that certain investors have the ability to alter the payoffs to an entire series of stock in a self-interested manner to the detriment of others can help the parties try to minimize the potential impact of the Overlapping Investor Issue. Once all the constituents are aware of and consider the potential incongruence, approval thresholds can be adjusted accordingly or specific provisions can be inserted into the company's charter that mandate that maximum returns go to the most senior series of stock.

Magnified Down Round Issues

While down rounds often present many of the most challenging legal issues and contentious negotiations, the issues and negotiations are especially difficult for companies that have been through multiple institutional investments rounds. Typically, the potential challenges increase based on the greater magnitude of the disparity between the aggregate outstanding liquidation preferences and the pre-money value and the greater the number of earlier investment rounds. Given that in most down rounds, the company has an immediate need for cash, new investors are often able to use leverage to get significant new investor rights. The amount of a new investor's leverage can sometimes be mitigated by the participation of existing investors in the new financing round. Ironically, however, in many cases where certain existing investors are participating and others are not, the participating existing investors (as opposed to the new investors) are the strongest proponents of very favorable investment terms or very punitive consequences for non-participation.

The conflict-of-interest issues between participating and non-participating investors are often magnified in companies with multiple rounds of equity financing because the parties must balance disparate treatment concerns with the necessity of getting a financing consummated. A larger number of existing series of stock means (1) greater complexity in sorting out the mechanics of the transaction (including potential participants) and (2) a greater number of potentially disgruntled stockholders and a greater chance that one of them might challenge the fairness of the transaction. While acting in a protective and conservative manner is always advisable in down rounds, it is imperative that companies and investor groups are as careful as possible in these particular circumstances. These magnified conflict issues are best addressed by a combination of full disclosure of the transaction's terms to all the impacted constituents (directors and stockholders) and a rights offering to allow all stockholders to participate on a pro-rata basis. While not ideal, as a practical matter, the rights offering is often done after the initial closing of the financing.

Down rounds in companies with multiple rounds of institutional investments spread over a number of years often result in difficult internal conflict situations for fund managers who are controlling investment decisions of affiliated funds that are at different stages of their investment cycles. For example, a family of funds may have invested in the Series A-E rounds of a particular company. When the company raises its Series F round, all of the funds controlled by the common fund manager may not be in a position to invest additional funds—whether due to a failure to reserve sufficient funds, the termination of the fund or otherwise. The inability of certain affiliated funds to invest capital puts the fund manager in a precarious situation with respect to approving a proposed transaction. Approving the transaction might result in significant adverse economic consequences to the non-participating funds while providing significant economic windfalls to the participating funds. In many cases, fund managers seek to have affiliated funds (those under common control) aggregated for purposes of measuring "participation" as it relates to pay-to-play provisions or preemptive rights. Under these circumstances, the fund manager can avoid adverse results to certain funds by having newer funds invest a disproportionate amount of the aggregate capital. However, even this solutions presents potential conflicts among related funds as certain funds are arguably taking disproportionate risks for the benefit of other funds—some of this potential unfairness may be mitigated at a practical level if the impacted funds have overlapping limited partners.

Rubik's Cube Anti-Dilution

Anti-dilution provisions are designed to protect investors from the negative economic impact of future issuances below certain negotiated prices. Typically, investors implement some form of weighted average anti-dilution formula that is based on the original issue price of each series of preferred stock. Unfortunately, standard weighted average anti-dilution provisions were not designed to deal with multiple series of preferred stock issued at non-sequential prices. The problems are exacerbated when past issuances were made at varying prices, some of which are above and some of which are below the price of the contemplated new issuance. The basic premise of all anti-dilution provisions is that the number of shares of common stock issuable upon conversion of a series of preferred stock is adjusted upward in the event of an issuance at a lower price, in an effort to compensate the holder for the economic dilution that it would otherwise suffer from such an issuance. However, anti-dilution is a zero sum game. When an anti-dilution adjustment is triggered for a series of preferred stock, the number of common shares issuable upon conversion of that series is increased. The result of this adjustment is that the relative number of common equivalents (or common shares) held by other stockholders is decreased. As such, when anti-dilution adjustments are triggered, one stockholder's gain is another stockholder's loss. Unfortunately, when multiple series of preferred stock are outstanding, the adjustment equation can become circular and sometimes impossible to solve because the theoretically correct allocation of common stock equivalents to holders of preferred stock cannot be achieved. In situations where the anti-dilution provisions cannot work as intended, the only solution is negotiation at a business level.

In order to eliminate the potential for future chaos, many new investors demand a re-setting or adjustment of the anti-dilution trigger prices for a company's existing preferred stock in connection with a late series financing. For example, if an investor in a Series F round acquires securities at a price of $1.00 per share and earlier rounds were issued at a price greater than $1.00, the investor group might avoid future anti-dilution issues by requiring that the earlier series' trigger prices be decreased to $1.00. This change not only simplifies future anti-dilution calculations, but also substantively protects the Series F investor from disproportionate dilution in future rounds where equity is issued at a price that would have been below the trigger prices of some or all of the existing series prior to their downward adjustment.

Impact of Pay-To-Play Provisions

As recently as three or four years ago, "pay-to-play" (PTP) provisions were rarely negotiated into the original investment documents. However, over the past few years, PTP provisions have become an increasingly common feature of preferred stock rounds—especially those issued in later rounds. PTP provisions cause the holders of preferred stock who do not participate in future financing rounds to lose certain rights with respect to their stock. In most cases, the consequence of non-participation is either a loss of anti-dilution protection or a conversion into common stock.

When PTP provisions are in effect, the existing investor group is bifurcated into two divergent interest groups—participants and non-participants. In those situations, the consequences of non-participation are often very harsh as the participating investors tend to use the PTP provision as a stick (or club) against non-participants. As a practical matter, even if a PTP provision was not put into place as part of an earlier investment round, the participating investors very often put one into place as of immediately prior to the closing of the new

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round. From a practitioner's perspective, it is imperative that the PTP provision reflect the business intentions of the parties. One common error in many PTP provisions is to have "participation" or "non-participation" based on a particular investor acquiring its full "pro-rata share" of the newly offered amount. These formulations often track the language relating to preemptive rights provisions—sometimes even cross-referencing the definition of pro-rata. PTP provisions of this type result in very anomalous results because if any money is raised from an outside third party, there have to be "non-participants". Consider the following example: (a) four investors each own 25% of the outstanding capital stock of the company, (b) "participation" is defined as acquiring its pro-rata share of the financing determined on the basis of each stockholder's relative ownership of outstanding stock, (c) the failure to fully participate results in a conversion of a holder's preferred stock into common stock, and (d) the proposed financing at a business level consists of $20 million of new capital—$10 million from an outside investor and $10 million from the existing investors. Based on the definition of "pro-rata" used above which is the definition currently found in at least half of the applicable provisions in the marketplace each existing investor would be obligated to invest $5 million (an aggregate of $20 million) in the new round. This is definitely not the business intention—if each investor put in $5 million, there would be no room in the round for the outside investor who is slated to put in $10 million. In order for the outside investor to be able to invest as contemplated, an existing investor would have to be washed into common stock. The critical practitioner mistake in this example was to base the definition of "participation" on the size of the aggregate financing. The formulation for determining participation should be whether an existing investor acquires its pro-rata share of the portion of the financing which is offered by the company's board of directors to the existing investors. Under a correct formulation, each investor would be obligated to invest $2.5 million (25% of the $10 million allocated to the insiders).

Governance Intricacies

One of the most important negotiations in later round investments relates to governance and voting rights. While the discussions relating to board control and/or participation are relatively straightforward, the analysis relating to voting thresholds can be very complicated. The decision points are numerous and come in various permutations:

- Should each series of preferred have a separate set of negative covenants?
- Should each series of preferred have a separate set of affirmative covenants?
- Should all existing series of preferred stock vote as a single group?
- How should a "majority interest" be defined (majority, two-thirds, etc.)?
- What should the relative rights of the existing investor group be as compared to the new investor group?

As with most issues described in this article, there is no universally correct answer. When the decisions are being made, there are a number of market trends that merit consideration:

- Assuming that the investment amount is significant on an actual and relative basis, the most senior series of preferred stock typically contains the most complete set of negative covenants (limits on material actions such as sale events, senior or pari-passu stock issuances, liquidations, redemptions, payment of dividends, etc.). In situations where the existing investor group is participating in a material manner (40% or more) and has a significant amount of capital already invested in the company, the existing investor group is sometimes able to negotiate having the package of rights controlled by the entire investor group as a whole (vs. controlled by the new investor alone). The outcome of these negotiations depends entirely on the relative leverage positions of the various investor groups.

- All series of preferred stock typically have covenants in place that prohibit their terms from being adversely amended without the consent of the particular series.
- Each series votes on a separate basis to have its shares converted into common and/or redeemed, as applicable.
- It is not typical for junior series to have the right to consent to issuances of senior equity securities.
- Due to fiduciary constraints and issues, investors should always avoid having control rights effected through board representation in lieu of negative and/or affirmative covenants.

Special Transfer Restriction Issues

Most institutional investment rounds include transfer restrictions on sales of stock by founders and management. In early institutional rounds, it is not typical for the investors to subject themselves to transfer restrictions such as rights of first refusal or tag along rights. The market standards begin to shift when there are a number of institutional investors in an early round. It is not unusual for a club deal (multiple institutional investors in a single round) to include transfer restrictions that apply to all of the institutional investors. In later rounds of financing, transfer restrictions on earlier round investors are becoming more common as the later investors want to have more control over the institutional investor base. As earlier investors actively seek liquidity, transfer restrictions allow investor groups to actively determine their going forward partners and to align themselves with other investors that are equally committed to the future success of the company.

One of the challenges for new investors is to attempt to get the benefit of transfer restrictions without becoming subject to them. In many cases, later round investors are forced to compromise on their initial position of wanting one-way restrictions. One of the compromises that appears to work effectively and be palatable to most sides is for only the old investors to be subject to rights of first refusal, but that all investors have the benefit of tag-along rights on sales by all other investors.

Conclusion

As portfolio company investments take a greater amount of time to mature to liquidity, later series investment rounds are becoming more and more common to support the cash needs of portfolio companies. In structuring and negotiating late round financings, investors and companies need to consider the issues that arise in these transactions. Ultimately, as described above, many of them cannot be avoided, but they can be managed in an effort to avoid anomalous results. ◎