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Down Round Financings –
Key Considerations for Asset Managers

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The Bottom Line

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Introduction

The COVID-19 pandemic and the related US government actions taken to-date in order to combat the spread of COVID-19 has caused an unprecedented economic downturn of companies in the US and globally, including companies sponsored by growth-equity funds and venture capital funds (the "**Sponsored Companies**"). Consequently, in certain cases, in order to address the current/pending liquidity needs of a Sponsored Company, a down round equity financing may be the only alternative source of liquidity funding.

In light of the foregoing, today we will be discussing the items below (under the context of the laws of State of Delaware):

1. expected trends in down round financings in the next 12 months;
2. liability risk in down round financings;
3. procedures to mitigate potential liabilities in down round financings; and
4. practical considerations for a new investor (i.e., not a pre-existing stockholder prior to the down round financing) investing in a down round financing.

What is a down round financing?

A down round financing is an equity financing based on a valuation of a Sponsored Company lower than the valuation of such Sponsored Company that was the basis of a prior round of equity financing of such Sponsored Company, which, unless existing investors participate in such down round financing, will result in a dilution of their ownership interest of such Sponsored Company. Note, down round financings have been consummated during periods of a healthy economy, as liquidity needs of a Sponsored Company may arise for different reasons; however, due to the impact of the COVID-19 pandemic we expect to see a material increase in volume of down round financings.

Expected Trends

What are expected trends that will arise out of the magnitude of down rounds anticipated to be consummated in the next 12 months?

1. Increasing stockholder litigation (as compared to stockholder litigation post the 2008 financial crisis).
2. More aggressive "pay to play" structures
   - conversion at punitive multiple
   - pro rata based on "money in" vs. shares
   - exceptions for certain stockholders
   - two-step ("pull-thru") with sweetener
3. Increase in issuance of "participating" preferred stock (as opposed to "greater of")
4. Increase in granting redemption rights, coupled with forced sale provisions

What lessons did we learn from the down round financings that were consummated post the 2008 financial crises?

1. Flexibility in structuring;
2. Beware of series votes; and
3. Fiduciary exposure (e.g., rights offerings are not a panacea)

The Bottom Line: Great flexibility in structuring, but risk of fiduciary/fairness claims by non-participants, particularly if 50% or more of board has conflicts of interests.

Potential Liabilities: Directors

What are the potential liabilities in respect of down round financing?
A claim by a stockholder of a Sponsored Company against a director(s) of such Sponsored Company for breach of fiduciary duties in connection with the consummation of a down round financing, which resulted in dilution to such stockholder's ownership interest of such Sponsored Company as of immediately prior to the consummation of such down round financing. As a practical matter, the risk of any stockholder litigation claims generally arises when the valuation of a Sponsored Company increases following a down round, coupled with a liquidity event by such Sponsored Company (e.g., a sale or an initial public offering).

Fiduciary Duties of a Director.

- **Duty of Care**: directors are required to be thoughtful, deliberate and well informed when undertaking decisions on behalf of the applicable Sponsored Company (i.e., process when making a decision)
- **Duty of Loyalty**: directors are required to act in good faith and in the best interest of the applicable Sponsored Company – and not act on behalf of his or her own self interest (i.e., conflict of interests of a director).

Which class of stockholders do the directors owe fiduciary duties to?
Holders of common stock. The Delaware courts have ruled that the benefits and protective terms of shares of preferred stock held by holders of preferred stock are contractual in nature; as such, fiduciary duties are only owed to preferred stockholders in respect of matters that are not based on contractual protections.

Potential Liabilities: Directors

- **<u>The Bottom Line</u>:** Anyone serving as a director on behalf of their growth equity fund or venture capital fund should understand, in consultation with their in-house or outside legal counsel, his or her fiduciary duties and to whom such fiduciary duties are owed. As a practical matter, we would suggest minutes of board meetings indicate that directors were made aware of their fiduciary duties.

- **<u>The Bottom Line</u>:** A majority of down round financings do not result in a stockholder litigation claim; however, there has been a noticeable increase in claims recently. Also, if a stockholder makes a claim, such litigation is expected to be costly and lengthy because the claim is mostly based on facts; as such, we have observed judges deny the motion to dismiss and move to discovery (i.e., costly/lengthy process).

Potential Liabilities: Directors

What are the legal standards for review of board determinations in connection with a down round financing?

- **<u>Business Judgement Rule</u>**: a court generally will defer to the "business judgment" of a board approving a down round, <u>unless</u> 50% or more of the directors were "interested " in the transaction, or the transaction was with a "controlling" stockholder".

- ***<u>"Entire Fairness"</u>***: to the extent that 50% or more of the board or a "controlling stockholder" has a conflict of a interest, then the court will **<u>not</u>** give deference to the board of directors determination and all aspects of such determination will be reviewed by the Delaware court, including review of whether there was sufficient (1) "fair dealing" (i.e., process under which the down round financing was consummated); and (2) "fair price" (i.e., terms and valuation are fair in the particular context of the down round financing). As such, the burden of proof is on the **<u>directors</u>** or **"<u>controlling stockholder</u>"**, as applicable, to establish that both the process under which the down round financing was undertaken and the price and terms of the down round financing security were both sufficiently "fair".

Why would a director be deemed an "interested" director in the context of a down round financing?
A director would be deemed an "interested" director if he or she has a particular interest in the down round financing transaction.

The following is a list of the more common scenarios in which directors of a Sponsored Company could be deemed "interested" directors:

- Director is designated by a sponsor stockholder (unless the designee is truly independent), and such sponsor stockholder participates in the down round financing;
- Director is a member of management and such member of management will derive a benefit that other stockholders won't receive in connection with the down round financing; and
- Director, in his individual capacity, invests in the down round financing

Potential Liabilities: Directors

<u>The Bottom Line</u>: When preparing to undertake a down round financing analysis should be conducted to determine whether any directors could be deemed "interested" directors, including review of contractual terms and side letters that were entered into in prior financing rounds.

<u>The Bottom Line</u>: Review the directors' and officers' insurance policies of the Sponsored Company, the director indemnification agreements and, if a fund, also review the applicable insurance policies of your fund to ensure there are no conflicts that would prohibit coverage.

Potential Liabilities: Controlling Stockholder

Do any stockholders of a Sponsored Company owe fiduciary duties to any other stockholders of such Sponsored Company?

As a general matter, stockholders may act on their own behalf and do not owe fiduciary duties to other stockholders. However, in the context of a down round financing, a stockholder (or a group of related stockholders) may be deemed a "controlling stockholder" by virtue of (1) its level of percentage ownership of a Sponsored Company (i.e., owning a majority of the outstanding shares of a Sponsored Company); and (2) its indicia of "control" (whether through contractual terms or otherwise), in which case such "controlling" stockholder(s) will owe fiduciary duties to the other existing stockholders.

What if our fund owns less than majority of the Sponsored Company (e.g. 25%), could our fund be deemed a "controlling" stockholder?

Yes, ownership is only one factor when analyzing "controlling" stockholder status. As noted above, if your minority interest is coupled with other indicia of control, then your fund may be deemed a "controlling stockholder".

Potential Liabilities: Controlling Stockholder

The Bottom Line: When preparing to undertake a down round financing analysis should be conducted to determine whether stockholders could be deemed a "controlling" stockholder, which will require analysis of the capitalization table, review of applicable equity documents, charter and additional diligence regarding the relationship of a stockholder to any other stockholder.

The Bottom Line: If your fund could be deemed a "controlling stockholder", it should be careful in how it participates in the negotiation and in the overall process in respect of the down round financing in order to avoid any claims that such fund exercised its "control" in deriving benefits for itself at the cost of other stockholders. Also, if your fund has a board representative, such individual should be expressly cognizant of (and make clear to other individuals he or she is speaking to) under which capacity (director or stockholder) such individual is taking such actions.

Liability Mitigation

What actions can be taken by a Sponsored Company in connection with a down round financing, particularly if there are "interested" directors and/or "controlling stockholder(s)", to mitigate litigation liability and to potentially avoid the "Entire Fairness" standard of review?

There are a number of substantive and procedural tools that can be deployed, which we have listed below, to mitigate liability and to shift the burden of proof to the stockholder plaintiff challenging the merits of the down round financing. However, in the context of the real world, it may prove challenging to actually implement some of these tools, in which case, the importance of creating a detailed record of all matters discussed and deliberated by the board becomes even more important as the minutes of such meetings may be your only mitigating factor.

Liability Mitigation: Substantive and procedural tools to mitigate legal risk arising out of a down round financing

1. **Independent Committee.** Form an independent committee of disinterested/independent directors to negotiate the terms, manage the process and vote to approve the down round financing. However, this independent committee needs to be granted sufficient authority and independence to make determinations in connection with the down round financing.
2. **Majority Vote of the Disinterested Stockholders.** Obtain stockholder approval of the disinterested stockholders. However, in order for the vote of such disinterested stockholders to be effective, such disinterested stockholders must be provided with all material information (including, among other material information, descriptions of the conflicts of interest and the details of the process that led to the down round financing).
3. **Rights Offering to all Stockholders.** Whether or not a stockholder is entitled to preemptive rights, offer the down round securities to all stockholders. If there is a timing urgency, a Sponsored Company could offer the down round securities to its stockholders following the consummation of the down round financing in order for them to maintain their respective percentage ownership immediately prior to the closing of such down round financing.
4. **Market Check.** The board of directors of a Sponsored Company may solicit outside investors to determine whether there are other financing options at better terms than those being offered in the down round financing. In certain situations, there may not be enough time to actively solicit outside investors; as such, a Sponsored Company may issue short term bridge notes that would convert into the equity of the down round financing if alternative financing is not obtained by prescribed time.
5. **Valuation/Fairness Opinion.** The Sponsored Company may obtain an independent fairness opinion prepared by third party valuation firm.
6. **Necessary Terms**. The terms of the down round financing equity should be only those that are necessary to obtain sufficient financing.
7. **Deliberate**. The board (or independent committee) should deliberate on key issues, often via a board meeting (or telephonic board meeting) in lieu of executing written consents, especially in terms of the valuation of the down round financing. Beware of comments in emails, texts or other mediums that could be obtained in litigation.
8. **Exigency Documentation.** Record in the minutes of meetings of the board (or independent committee) the exigency of the financing that is required (e.g., Sponsored Company needs to fund payroll by end of week) and the context around such exigency of financing, including timing concerns, detailing the lack of alternative sources of funding in the relative context of the exigent circumstances that require this funding.

Liability Mitigation

The Bottom Line: As a practical matter, due to timing issues, constitution of the board of directors, constitution of the stockholder base and other matters, it may be impracticable to implement some of the tools listed above. However, often many will be feasible, and the final three will almost be advisable in all events. As such, efficient planning should be undertaken with your counsel to determine the best path forward, and to assist in the documentation of the minutes of the deliberation of the board (or independent committee).

Liability Mitigation: Pay to Play

What if the down round financing is structured such that if an existing stockholder does not participate in the down round financing, it would suffer certain negative consequences (e.g. existing preferred shares converted to common, change in priority in liquidation, etc.) (more commonly known as "Pay to Play")?

A material segment of down round financings are structured in some form of a "pay to play". If 50% or more of the board is "interested" or the round is led by a "controlling stockholder" the same analysis in respect of "fair dealing" and "fair price" would apply (i.e., the terms of the "pay to play" will be reviewed in the context of the particular circumstances in which the down round financing was consummated, and whether the punitive consequences imposed upon non-participating stockholders in the down round are necessary to induce other stockholders to participate in the down round financing). In most cases, while there may be certain technical issues you may need to resolve to give effect to the "pay to play" benefits and consequences (e.g., amending charters, obtaining sufficient stockholder approval, etc.), in most cases, there are structural solutions to these technical issues.

What are common negative consequences in a "Pay to Play" down round financing?

- Conversion of preferred stock to common stock on a 1:1 basis or different ratio
- Conversion of non-participating stockholders preferred equity into a new series
- Change to preference and priority in connection with a liquidation event or dividends
- Disparate application of the "pay to play" among stockholders
- Full conversion even if partial participation (below pro rata)
- Required participation based on % of shares vs % of liquidation preference
- Post-conversion stock split

Liability Mitigation: Pay to Play

<u>The Bottom Line</u>: Aim for "market" – a "pay to play" combined with an "inside round" (50% board conflict or "controlling stockholder") may be especially scrutinized for fairness.

Mitigating Risk in a "Pay to Play"

Hypothetical:
Sponsored Company facing a liquidity crises, but has optimistic "upside case" forecast. Due to shortness of time, market check is minimal and informal. The existing lead investors (three of five board seats) agree to lead the financing round, but only if (a) significant decrease in valuation, and (b) pay to play converting all non-participating preferred stock into common stock at a 10:1 ratio.

Assessment in terms of key potential risk mitigators:

- independent committee or majority of disinterested stockholder vote
- rights offering
- market check
- valuation/fairness opinion
- necessary terms
- documentation

The Bottom Line: Every situation will be different; as such, one needs to properly strategize and take into account the specific facts of the down round financing in order to properly balance and asses the best approach. One size does not fit all!

Practical Considerations for a New Investor in a Down Round Financing

What matters should be considered by any "new investor" (i.e., not an existing stockholder prior to the down round financing) in connection with a down round financing?

1. **Governance/Capitalization Diligence**: Diligence the governance process in respect of such down round financing to assess any litigation risk against the applicable Sponsored Company, and also the capitalization following the consummation of the down round financings in order to determine where such new investor may be exposed by votes of a majority or similar voting thresholds in respect of corporate matters.
2. **Adjustment to Prior Round Conversion Price**: Holders of shares of preferred stock are generally entitled to anti-dilution protections, which adjust the conversion price in the event of an equity issuance at a price below fair market value or the applicable conversion price. Taking into account that the shares of preferred stock held by the existing stockholders prior to a down round financing would have a higher conversion price than the conversion price of the stock issued in connection with the down round, if the conversion price of the preferred stock held by such existing stockholders is not adjusted downward, there could be subsequent issuance at a valuation that exceeds the down round preferred stock conversion price, but is less than the conversion price of the preferred stock held by such existing stockholders that results in only such existing stockholders being entitled to the anti-dilution protection.
3. **Tag Along Rights – Allocation Adjustment**: Consider in connection with any existing stockholder tagging along on a sale initiated by a new investor whether to allocate the number of shares that can be included in the transaction not based on number of shares, but rather based on allocation of proceeds in connection with a liquidation event (with the presumed preference of the down round financing securities upon liquidation effectively reducing the number of shares existing stockholders can include in such transaction).
4. **Waiver of Anti-Dilution Rights**: Require existing stockholders to waive their existing anti-dilution protections.

Practical Considerations for a New Investor in a Down Round Financing

What matters should be considered by any "new investor" (i.e., not an existing stockholder prior to the down round financing) in connection with a down round financing?

6. **<u>Veto Rights</u>**: As interests may not be aligned between existing investors (who have invested at higher valuations) and any new investor (who invested at a lower valuation), a new investor should negotiate for certain veto rights over material matters, including, without limitation, future down rounds, "pay to play", any forced conversion rights, block on affiliate transactions, redemption rights of existing stockholders and amendments to terms of the shares of preferred stock issued in such down round financing.
7. **<u>Rights in connection with a Sale</u>**: Require that in connection with any sale of such Sponsored Company (or the sale of all or substantially all of the assets of such Sponsored Company) all proceeds are required to be paid pursuant to the priority waterfalls set forth in the certificate of incorporation of such Sponsored Company; consider the vote required to waive such payments.
8. **<u>Management/Key Employees</u>**: Human capital being a key consideration for continuation of the business of such Sponsored Company, consider what, if any, actions need to be taken to benefit certain members of management and key employees because such down round financing may have severely impacted the value of any incentive equity held by such members of management and key employees.

<u>The Bottom Line</u>: Any new investor in a down round financing needs to carefully analyze the capitalization table, governance documents and related equity documents (including requests for all side letters) to assess where and under which circumstances it needs to insert protections in order to maintain the negotiated features of the shares of preferred stock issued in such down round financing. DON'T GET SURPRISED!

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