CORPORATE

CAPITAL RAISING

Down round and cramdown financings: a guide

Gibson Dunn lawyers run through the basics of capital raisings for troubled companies

In the first three months of 2020, the US economy suffered its sharpest decline since the 2007-8 financial crisis. Venture-backed companies are not immune. According to a white paper recently published by the National Venture Capital Association, investment in the US startup ecosystem is expected to drop significantly. In this turbulent period, companies may exhaust (or face difficulties obtaining) funding available under government stimulus programmes. Venture-backed companies in need of capital may have trouble finding new investors or convincing existing stockholders to inject additional capital. They may then be forced to decide between strategic alternatives such as a merger, a partial or complete liquidation, or a down round or cramdown financing.

What is a down round or cramdown financing?

A down round is a capital raise in which the company valuation is lower than the company's valuation in its prior financing round. As a result of the lower valuation, the equity outstanding immediately prior to the down round may suffer significant dilution. A cramdown is a term often used to describe a down round in which existing investors lead a new financing that includes terms that may be severely dilutive to non-participating investors, and that may include other features such as forced conversions, pay-to-play mechanisms, super-priority liquidation preferences, drag-along rights and special voting rights, that may have the perceived effect of punishing non-participating stockholders.

Because the need for capital in these situations may be urgent, venture-backed companies and their investors often want to move quickly. However, the special circumstances inherent in a cramdown, including conflicts of interest among directors and stockholders, require that any such financing be carefully considered and that the board take precautions to ensure the fairness of the transaction.

What are the potential conflicts?

Most venture-backed companies have a board consisting largely of management and representatives of the major investors, who in many cases may control the board. This board composition can lead to challenges, as investors and management have economic motivations that may be at odds with the interests of other stockholders. The investors leading a down round financing are justifiably looking to maximise the return on their investment – but that motivation and the desire to incentivise other existing stockholders to participate may drive them to propose transactions that severely impair the rights of the capital stock held by non-participating stockholders. Management will be concerned with maintaining an equity stake following any financing, and any additional equity that management receives in the transaction will also dilute non-participating stockholders. In either situation, representatives of the lead investors and management on the board of directors have a conflict of interest.

The composition of a company's stockholder base also generates potential conflicts. In a venture-backed company, the stockholders typically include the lead venture investors, members of management and, often, a number of small investors who contributed early seed money. However, the lead investors often own shares that give them actual or de facto voting control. Minority stockholders may argue that the lead investors' board designees are wearing two hats (as both stockholders and directors).

The concern is that these conflicts may result in a transaction that is characterised as unfair to minority stockholders, and that non-participating minority stockholders may challenge through litigation.

For a non-participating stockholder that has been heavily diluted, there may be little downside to bringing a lawsuit. Minority stockholders sometimes sit quietly following a cramdown financing and only bring suit if the company reverses its fortunes and is poised to achieve a successful exit. So, even if the cramdown financing is successful and the company experiences a turnaround, the litigation risk from a cramdown financing can cast a permanent shadow over the company – potentially even impairing a company's ability to achieve an exit.

What legal issues should the board and lead investors consider?

Generally, decisions made by the board are protected under the business judgment rule. The business judgment rule is a presumption that board decisions made on an informed basis and in good faith will not be second-guessed by a court. In order to qualify, directors must satisfy a duty of care, which requires that a board be careful, thoughtful, deliberate and well-informed in connection with any decision, and a duty of loyalty, which requires that directors act in good faith and in the best interests of the corporation – not for their own personal interest at the expense of stockholder interests.

In a dilutive financing involving the conflicts of interests described above, the board's decision to approve the transaction will generally not be protected by the presumptions of the business judgment rule. Rather, in such legal challenge, the directors will likely have the burden of proving the entire fairness of the transaction. The entire fairness standard encompasses both the negotiation process (fair dealing) and the economic terms of the transaction (fair price). Importantly, shifting the burden of proof to the directors approving the transaction effectively lowers the bar for potential plaintiffs considering a legal challenge.

How can the board and investors minimise the risk of litigation?

There are a number of precautions the board (and investors leading a financing) can take to reduce the litigation risk.

Disinterested directors take the lead; establish a special committee If any board member is an interested party, such as a representative of a participating investor or a member of management receiving additional equity in the deal, then they should recuse themselves from any vote on the transaction. If a majority of the directors are interested parties, then the board should appoint a special committee of only disinterested directors to evaluate, negotiate and approve the terms of the transaction. The delegation of authority to such special committee may provide significant legal protection by shifting the burden of proof on the subject of fairness to any stockholders challenging the transaction.

Seek approval of non-participating stockholders The company should consider seeking the approval of disinterested stockholders, particularly if the company does not have disinterested directors able to serve on a special committee. Approval by a majority of the non-participating stockholders helps demonstrate the fairness of the transaction and can also shift the burden of proof to plaintiff stockholders challenging the transaction. If the special committee approach is combined with a requirement that the transaction be approved by a majority of disinterested stockholders, the special committee's approval of the transaction may attract the protection of the business judgment rule (rather than the tougher entire fairness standard).

Actively explore other alternatives The board should explore and consider all viable funding alternatives in a timely manner, including whether financing is available on alternative terms or from outside investors and, if not, whether strategic alternatives such as a merger, asset sale or other business transaction might be the best course for maximising stockholder value. Investors with representatives on the board should encourage their representatives to assist in this effort.

Conduct market research The board should familiarise itself with current market terms for similar transactions and use this understanding as a foundation for determining what terms will be fair to the company and its stockholders.

Document each step The board should keep a detailed record throughout the process. The record should reflect the board's thinking and analysis, the guidance sought and received from legal and financial advisors, and all material considerations taken into account.

Conduct a rights offering Regardless of whether preemptive rights exist, the board should consider giving all existing stockholders (perhaps limited to all accredited stockholders in order to achieve a valid private placement) the right to invest in the financing on a pro-rata basis to maintain their existing ownership stake. Note, however, that a rights offering is not a cure-all for a transaction that is otherwise unfair or that is approved in a flawed board process.

Carefully disclose the terms of the financing The board should fully disclose the terms of the financing to stockholders if seeking stockholder approval. Disclosure should include not only the financial and legal terms, but also the benefits, both inherent and potential, to any participating stockholders and to management and employees. Particular emphasis should be placed on the benefits received by lead investors or management that are represented on the board and any terms that may adversely affect non-participating stockholders.

Engage a financial advisor; obtain a fairness opinion If it is economically feasible, the board should consider engaging a financial advisor and ultimately obtaining a fairness opinion to support not only the valuation used in the transaction, but also the steps taken by the board.

While there is no single course of action that will neutralise the threat of legal challenges to the transaction, the guidance above provides a brief roadmap for the board to demonstrate that it satisfied its legal obligations and negotiated a transaction that was in the best interests of the company and its stockholders under the circumstances. The key takeaway for the company and lead investors is this: don't rush the process or use your board representation to force the transaction through. Instead, encourage the disinterested board members to assess the transaction and consider alternatives in a thorough and well-documented process.

Bradford Weirick
Partner
Gibson Dunn & Crutcher, Los Angeles

Mark Goldman
Associate
Gibson Dunn & Crutcher, Los Angeles