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Down Round (and Cram Down) Financings in Today's Market

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Venture-backed companies typically raise multiple rounds of financing, but the impetus for raising additional funds and the circumstances surrounding each round can vary dramatically. In strong economic times when a company is thriving, it may have little trouble finding new partners or convincing existing stockholders to invest additional capital. However, leaner periods can present significant challenges for companies lacking sufficient capital reserves or a business model that generates investor excitement. The current economic downturn has created such an environment.

The first half of 2009 was the slowest two-quarter stretch for the venture capital markets since the mid-90s. According to a July 2009 study conducted by PricewaterhouseCoopers and the National Venture Capital Association, fewer venture capital deals closed in the first two quarters of 2009 than in any two consecutive quarters since the period covering the last quarter of 1995 and the first quarter of 1996. On a dollars invested basis, the first half of 2009 saw less money invested by venture capital firms than any two-quarter period since the first half of 1997. In tight times such as these, many venture-backed companies in need of capital will be forced to decide between strategic alternatives such as a merger, a partial or complete liquidation or a "down round" or "cram down" financing.

What is a "Down Round" or "Cram Down" Financing?

A down round financing is a capital raise that is based on a company valuation that 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 will suffer dilution. A "cram down" is a term that is often used to describe a down round financing 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 and "pay-to-play" mechanisms, that may have the perceived effect of punishing non-participating stockholders. In a severe cram down, existing stockholders who do not participate in the round may end up with little or no meaningful ownership stake in the company. In addition to further consolidating ownership of the company, investors willing to participate in a cram down may often also receive ancillary deal terms and preferred stock rights and preferences (such as super-priority liquidation preferences, "drag along" rights and special voting rights) that are superior to the prior rounds.

Because the need for capital in these situations may be great and the timing may be tight, too often venture-backed companies and their financial sponsors want to move full speed ahead without adequately considering the myriad of issues inherent in a cram down financing. However, the special circumstances inherent in a cram down, including conflicts of interest among directors and stockholders, require that any such financing be carefully considered and that the board of directors take appropriate precautions to ensure the fairness of the transaction.

What Conflicts Can Arise?

There are several fact patterns typical to venture-backed companies that give rise to issues and risks in the context of a down round financing where existing stockholders are leading the financing. Most venture-backed companies have a board consisting largely (or solely) of management and representatives of the major investors, who in many cases may control the board. Few venture-backed companies have a significant independent presence on the board. This board composition can lead to challenges as the investors and management have economic motivations that may be at odds with the interests of outside minority stockholders. The investors leading a down round financing are clearly not just motivated by a desire to save the company. They are justifiably looking for transactions that provide them with the best opportunity for return for their investment — but that motivation and the desire to incentivize all existing stockholders to participate may drive them in some cases to propose transactions that wipe out the equity of non-participating minority investors. Management will be concerned with maintaining an equity stake following any financing, and any additional equity that management receives in connection with the transaction will also dilute non-participating minority stockholders. In either situation, representatives of the lead investors and management on the board of directors have a conflict of interest. Often as not, there may not be anyone on the board who does not have a conflict.

The composition of a company's stockholder base also generates its own conflicts. The stockholder base typically consists of the lead venture investors, members of management and, often, a number of small investors who contributed seed money in the very early stages. However, the lead investors generally own a substantial majority of the equity and may have outright voting control, often giving them the power to effect any changes to the company's charter documents that they see fit. From a minority stockholder's perspective, controlling investors may have little incentive to play fair, and they may perceive that the lead investors (who, they will argue, are wearing two hats as stockholders and directors) are only concerned with terms of their investment and not necessarily with what is best for investors at large or the company generally.

The concern is that these conflicts may ultimately result in a transaction that is perceived as (or is characterized as) unfair to minority stockholders and one that represents merely a compromise between the interests of those in power. The end result is that minority stockholders not participating in a down round or cram down transaction may believe that their interests are not adequately represented by the board and that litigation is the only meaningful way of asserting their rights.

Cram down financings are inherently prone to legal challenge because, from the perspective of a non-participating stockholder that has been heavily diluted, there may be little downside to bringing a lawsuit. Minority stockholders sometimes simply sit on their rights following a cram down financing and may only bring suit if the company reverses its fortunes and achieves a successful exit — and the plaintiff law firms are often more than willing to bring a case on contingency at little cost to the complaining stockholders. In other words, even if the financing is successful and the company experiences a turn-around, the litigation risk from a cram down financing can create a permanent cloud over the company, which can sometimes scare off acquirors and spoil a potential exit event.

What Are the Legal Issues for the Board and Lead Investors to Consider?

The issues, conflicts and risks outlined above trigger a number of important legal considerations for the board and lead investors proposing and approving a down round financing.

Generally, decisions made by a board of directors are protected under the "business judgment rule." The business judgment rule is a presumption that the decisions of a board made on an informed basis and in good faith will not be second guessed by a court in any subsequent legal challenge. In order to qualify for the protections of the business judgment rule, 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 down round or cram down financing involving the types of conflicts of interests among directors and stockholders described above, where directors or controlling stockholders have a financial interest that is not shared equally by all stockholders, the transaction will be subject to heightened legal scrutiny. The decision by the board to approve the transaction will not be protected by the presumptions of the business judgment risk — rather, in any legal challenge the directors will 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"). Perhaps most importantly, the shifting of the burden of proof to the directors approving the transaction effectively lowers the bar for potential plaintiffs considering a legal challenge.

What Can Investors and the Board do to Minimize the Risk of Litigation?

There are a number of precautions the board (and venture capital investors leading a financing) can take as negotiations on a down round financing progress that will reduce the risks of any legal challenge.

- *Let 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 receive additional equity in connection with the deal, then the director should recuse himself or herself from any vote on the transaction if it would not frustrate the presence of a quorum. 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 a special committee of disinterested directors may provide significant legal protection for the board by shifting the burden of proof on the subject of fairness to any stockholders challenging the fairness of the transaction.
- *Actively Explore Other Alternatives*. The board should thoroughly explore and consider all viable alternatives to any dilutive down round or cram down financing. The board should make every effort to determine if 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 maximizing stockholder value. Venture capital investors leading a cram down financing should instruct their representatives on the board not to obstruct this effort and, ideally, to assist in this effort. The board should explore strategic alternatives before its too late to consider any offer besides a dilutive cram down transaction. In any legal challenge, the board won't have the ability to defend its decisions on the basis that it had no viable alternatives if the board waited too long to explore alternatives.

- *Seek Approval of the Non-Participating Stockholders*. If the company does not have disinterested directors able to assess and approve the transaction, the company should consider seeking approval of disinterested stockholders. If a non-participating stockholder approves the transaction on the basis of proper disclosure, then generally it has waived its right to challenge its terms. Approval by a majority of the non-participating stockholders helps demonstrate the fairness of the transaction and can also shift the burden of proof in any legal challenge to the plaintiff stockholders challenging the transaction.
- *Conduct Market Research*. The board should familiarize itself with current "market" terms for similar transactions. To the extent feasible, the board should understand the terms of other cram down rounds and venture financings recently completed by similarly situated companies and use that understanding as a foundation for determining what terms will be fair to the company and its stockholders. Again, the lead investors should facilitate and encourage this effort.
- *Document Each Step*. The board should keep a detailed record throughout the process, not only in the board minutes but also as to other developments and steps taken to pursue alternatives. The board should conduct, and properly document, multiple meetings at which any dilutive financing is discussed and considered. 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.
- *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. Any expert third-party advice strengthens the board's ability to determine what is fair under the circumstances and strengthens its defense to any legal challenge.
- *Carefully Disclose the Terms of the Financing*. The board should fully disclose the terms of the financing to stockholders in connection with obtaining stockholder approval. This disclosure should include not only the financial and legal terms, but also the benefits, both inherent and potential, to any participating existing stockholders and to management and employees. Particular emphasis should be placed on the benefits received by lead investors that are represented on the board and any and all terms that may adversely affect non-participating existing stockholders.
- *Conduct a Rights Offering*. Regardless of whether mandatory preemptive rights exist, the board should consider giving all existing stockholders the right to invest in the dilutive financing on a pro rata basis to maintain their existing ownership stake in the company. Bear in mind, though, 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.

- *Maintain Civility*. All parties, including management, the lead investors and the board should remember to maintain a level of civility throughout what may often be a difficult process. The situation is likely already tense if the company is facing a cram down financing, and adding emotion or hostility will only compound the issues inherent in these types of transactions. Lead investors, in particular, must avoid the temptation (overtly or otherwise) to push for provisions designed to "punish" non-participating stockholders because, quite simply, any obvious punitive motive will only bolster a plaintiff's case.

Because, by definition, a down round financing only arises after a company has hit troubled times, it is unreasonable to expect that a company will not encounter a few bumps in the road in the course of negotiating a down round financing. There is no single course of action that will eliminate the issues that may arise or the risks of a legal challenge to the transaction after the fact, but the guidance summarized above provides a road map 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 message for the lead investors in a cram down financing is simple — don't rush the process or use your board representation to force the transaction through. Instead, foster and encourage the disinterested members of the board to assess the transaction and consider alternatives — because that's the lead investor's most important protection against a disgruntled minority stockholder.

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