Down-Round Financing Risks and Mitigating Solutions

With venture capitalists tightening their investment protocols and company valuations beginning to fall, the market is likely to see an increase in down-round financings. A down-round occurs when a company raises additional funds at a valuation lower than in previous rounds. Down-rounds typically carry adverse consequences for earlier investors, founders, and employees, such as dilution and reduced value of their holdings. But when companies need equity capital to continue to operate in the face of economic downturns, subpar performance, or increased competition, down-round financings may be their only chance of survival. Although the punitive financial effects of down-rounds are widely known, the legal landmines and litigation risk are often overlooked.

I. Director Conflicts and Anti-Dilution Provisions

One concern for directors of companies contemplating down-rounds should be the effect of anti-dilution provisions contained in agreements between the company and certain classes of investors. Assessing the effect of dilution on shareholders, and whether anti-dilution provisions exist and should be maintained, is complicated by the fact that the interests of the company may conflict with the interests of its individual directors or their nominating entities. Venture capital funds typically obtain anti-dilution rights when investing in a start-up.[1] Such rights protect their investment value against the dilution that would otherwise occur in a down-round by permitting them to convert their preferred shares into a sufficient number of increased shares in the next round to maintain their ownership percentage of the company's total equity.[2]

Companies have taken different approaches to address anti-dilution provisions in the context of down-rounds.[3] The simplest is to honor and implement them, but that is rarely acceptable to the new investors or feasible as a practical matter. Some companies have sought to amend their charters to avoid anti-dilution provisions. Under Delaware law, however, any charter amendment that will negatively impact preferences or special rights of a class or series of stock requires approval of a majority of the class or series.[4] Another approach is to offer existing preferred series holders the opportunity to exchange earlier preferred shares for newly issued preferred shares in the down-round (which captures the benefit of the anti-dilution provisions), provided they agree to invest pro rata. Under this "pay-to-play" approach, prior investors with dilution rights must purchase shares in the new round or face dilution.

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[1] *See generally* Joseph L. Lemon, Jr., *Don't Let Me Down (Round): Avoiding Illusory Terms in Venture Capital Financing in the Post-Internet Bubble Era*, TEX. J. BUS. L., SPRING 2003, at 1, 13; *see also* Samuel C. Louderback, *Anti-Dilution Provisions*, 17 TRANSACTIONS: TENN. J. BUS. L. 375 (2016).

[2] They do this using agreements containing two types of formulas to increase their shares—a full ratchet formula or a weighted average price formula. Full ratchet provisions compensate for the entirety of the economic dilution the earlier investor would otherwise face. Weighted average price agreements compensate diluted investors more modestly by formulating a weighted average share price prior to and after the dilutive round, granting price reductions equal to the difference between the original and the newly calculated average.

[3] Spela Prijon, *Anti-Dilution Provisions: Which One Is Better for Founders?*, LEDGY (July 16, 2019), https://ledgy.com/blog/anti-dilution-provisions/.

[4] *See* Del. Gen. Corp. L. § 242; *see also* Nate Emeritz and Adrian Broderick, *Delaware Guidance on Approval of Charter Amendment*, BLOOMBERG LAW (Dec. 2020), https://www.wsgr.com/a/web/30860/Delaware-Guidance-on-Approval-of-Charter-Amendments.pdf.

II. Director Duties in Down-Rounds

Given the adverse consequences of a down-round for a company's employees and investors, down-round financings can create litigation risks. To avoid the stigma of a down-round, companies sometimes get new investors to agree to a flat or slightly increased valuation, but typically must offer onerous terms that structure future economic returns so the new investors disproportionately benefit over earlier investors by many multiples. Though not technically a "down" round, this is functionally the same and leads to the same litigation risk. Directors owe fiduciary duties of care, loyalty, and candor to stockholders, and in some jurisdictions may owe fiduciary duties to creditors when companies are experiencing financial distress.[5] Similar duties exist for senior management. In some cases those duties may extend to controlling shareholders. Although most down-round financing does not result in litigation, it is important to review these situations with an eye toward possible litigation risk and avoiding pitfalls.

1. Duty of Care

The duty of care requires directors to be prudent in decisions to take on new financing. Directors must properly inform themselves of all material information reasonably available to make informed decisions while acting in good faith.[6] Down-round financing decisions are often made urgently, with the company's survival hanging in the balance. Yet directors and management must ensure that any decision making takes all pertinent information into account.

2. Duty of Candor

Under Delaware law, directors and management owe a duty of candor to disclose fully and fairly all material information to shareholders.[7] Delaware courts have extended this duty to all public communications. The duty applies to a down-round financing because most state laws require stockholder consent to establish privileges and rights of any preferred stock that will be issued in the down-round. In that context, a company must provide all information that is material to a shareholder's decision to consent to the new round of financing. This includes accurate information about the financing and the extent to which existing shares will be diluted.

3. Duty of Loyalty

The duty of loyalty comes into play in the context of conflicts of interest that commonly arise in down-rounds. The duty of loyalty requires directors to put the interests of the company and its stockholders ahead of their own or their nominating entity's interests.[8] The presence of conflicts of interest calls for a heightened standard of scrutiny and potentially increases the risk of liability for directors, because it may eliminate the protections of the business judgment rule and other safe harbors.

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[5] *See, e.g.*, *In re AWTR Liquidation Inc.*, 548 B.R. 300 (Bankr. C.D. Cal. 2016) (explaining how corporate directors of insolvent corporations owe creditors the same fiduciary duties of care, loyalty, and good faith to creditors as they owe to their shareholders). For further information on a director's fiduciary duty in the "zone of insolvency," *see generally* Brad Scheler, et. al., *Director Fiduciary Duty in Insolvency*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Apr. 15, 2020), https://corpgov.law.harvard.edu/2020/04/15/director-fiduciary-duty-in-insolvency/.

[6] *In re Bridgeport Holdings, Inc.*, 388 B.R. 548, 566-72 (Bankr. D. Del. 2008). For a deeper analysis of directors' duties of care, see Gregory Markel, et al., *A Director's Duty of Oversight After Marchand in "Caremark" Case*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Jan. 23, 2022) https://corpgov.law.harvard.edu/2022/01/23/a-directors-duty-of-oversight-after-marchand-in-caremark-case/.

[7] Shannon German, *What They Don't Know Can Hurt Them: Corporate Officers' Duty of Candor to Directors*, 34 DEL. J. CORP. L. 221 (2009).

[8] *Guttman v. Huang*, 823 A.2d 492, 506 n. 34 (Del. Ch. 2003).

III. Business Judgment Rule and Entire Fairness

The presence of a conflict increases the liability potential for directors. Delaware courts have established the business judgment rule as the default standard of review for assessing whether a board has breached its duties. The business judgment rule is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[9] This deferential standard presumes directors have acted in good faith. However, the presence of a conflict may allow disgruntled investors and other plaintiffs to overcome the business judgment rule's protections and result in courts applying the heightened "entire fairness" standard.

Under Delaware law, "entire fairness" is the most exacting standard for judicial review; courts determine whether the decision was entirely fair to the stockholders, necessitating an intensive factual inquiry into both the economics of the transaction (the fair price test) and the process leading up to the transaction (the fair dealing test).[10] Actions reviewed under the "entire fairness" standard are unlikely to be susceptible of resolution on a summary judgment motion, which grants leverage to plaintiffs.

Nonetheless, there are instances where courts have found down-round financings met the "entire fairness" standard. In *In re Trados Shareholder Litigation*, for example, the Delaware Court of Chancery ruled that, despite a board's failure to adopt any protective processes or expressly to consider the interests of common shareholders, a down-round recapitalization and merger liquidation of a company was entirely fair, even though the common shareholders received no value for their holdings.[11] Under Delaware law, the "proper test of fairness" is whether "the minority stockholder shall receive the substantial equivalent in value of what he had before."[12] The down-round recapitalization in *Trados* met this standard because the fair market value of the common stock at the time of the transaction was zero; it was thus fair for the common shareholders to receive no value from the financing and sale of the company.[13]

Importantly, fair price alone may not carry the day. For example, the court in *In re Nine Systems Corp. Shareholder Litigation* found that, although fair price and fair dealing support a "unitary conclusion" of fairness, showing only that the price is "in the range of fairness" does not "necessarily satisfy the entire fairness burden when fiduciaries stand on both sides of a transaction and manipulate … the process."[14]

IV. Safe Harbors

The majority of states provide at least some procedural mechanisms—known as safe harbors—to protect companies and their directors who have conflicts of interest arising from a down-round transaction. In Delaware, three safe harbors can be used to address a conflict and return the transaction to the business judgment rule presumption: (1) majority disinterested director approval, (2) approval by an independent special committee, and (3) stockholder approval. These safe harbors are found in both Delaware common law and in Section 144 of Delaware's General Corporation Law.[15] Section 144(a)(3) also contemplates that the

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9 *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). For further background information on the business judgment rule, see generally The Business Judgment Rule, DEL. L. CORP AND BUS. ORG.§ 4.19, 2006 WL 2450349.
10 *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 44 (Del. Ch. 2013).
11 *Id.* at 56.
12 *Id.* at 76.
13 *Id.*
14 *In re Nine Systems Corp. S'holder Litig.*, 2014 WL 4383127 (Del. Ch. 2014).
15 For further background on the interplay between the common law and statutory tests, *see generally* Blake Rohrbacher, et al., *Finding Safe Harbor: Clarifying the Limited Application of Section 144*, 33 DEL. J. CORP. L. 719 (2008).

"entire fairness" standard may be met in other ways even when a transaction does not meet any of the safe harbor requirements.

One safe harbor—having the transaction approved by a majority of disinterested directors—may apply when all material facts regarding conflicts of interest that relate to a down-round financing are disclosed to the board. Once this information is known by all disinterested directors, the board may in good faith authorize the down-round through a majority vote of the disinterested directors. For best practices, the transaction should be approved during an in-person or telephonic meeting rather than by written consent, as Delaware courts at times have noted that important board decisions should be discussed in person.

Applying Delaware law, the Pennsylvania Superior Court in *Rock v. Rangos* explored the intricacies of the disinterested director safe harbor of Section 144(a)(1) arising from Texas Instruments' acquisition of Akustica.[16] The former CEO and director of Akustica alleged that some of his fellow directors had breached their fiduciary duty by withholding information regarding the transaction. The term sheet had proposed a sale of "all Akustica's assets for an initial offer of at least $80 million."[17] The former CEO argued that the directors negotiating the down-round purchase had withheld information regarding how interested Texas Instruments was in acquiring the company to expedite negotiations. The court did not accept that argument. First, the court found that the interested directors had informed the board of all pertinent information concerning the term sheet and what Texas Instruments was willing to pay. Second, because the board consisted of a majority of disinterested directors, all of whom had approved the term sheet, the transaction was entitled to safe harbor protection under Section 144(a)(1).

A second safe harbor under Section 144(a)(1) recognizes the ability to cleanse conflicts through use of an independent special committee. If all material facts are disclosed to an independent committee comprised of disinterested directors, and the committee in good faith authorizes the down-round through a majority vote of those disinterested directors, then the business judgment rule presumption may be applied.

Courts may of course inquire into the independence of the special committee and the sufficiency of its review. The Delaware Court of Chancery rejected the independent special committee safe harbor in *Salladay v. Lev*.[18] The court found that a majority interested board had failed to follow the proper procedure for independent special committee approval and that their conflicts were thus not cleansed. The court stated that a fully constituted, adequately authorized, and independent special committee can overcome conflicts relating to a transaction. But the committee must be constituted *ab initio*, before "substantive economic negotiations."[19] This was not the case in *Salladay* because pre-committee discussions had already created a "price-collar" for the financing and thus the "entire fairness" standard had to be applied.[20]

The third safe harbor is stockholder approval, reflected in Section 144(a)(2). A transaction such as down-round financing may qualify for this safe harbor if it is approved by a majority of stockholders acting in good faith and on an informed basis. This does not, by its own terms, require that the stockholder vote be by only disinterested stockholders, although certain cases have required that.[21] The Delaware Court of Chancery found in *Corwin v. KKR Financial Holdings* that the stockholder approval safe harbor can apply only if no controlling stockholder exists.[22] This effectively had "widened the gulf between transactions that involve a controlling stockholder and those that do not."[23] If a controlling stockholder does exist, the company must

16 *Rock v. Rangos*, 2013 Pa. Super. 13, 61 A.3d 239 (2013).
17 *Id.* at 253.
18 *Salladay v. Lev*, 2020 WL 954032 (Del. Ch. 2020).
19 *Id.*
20 *Id.*
21 *See, e.g.*, *Solomon v. Armstrong*, 747 A.2d 1098 (Del. Ch. 1999).
22 *Corwin v. KKR Financial Holdings*, 125 A.3d 304 (Del. 2015).
23 Ann M. Lipton, *After Corwin: Down the Controlling Shareholder Rabbit Hole*, 72 VAND. L. REV. 1977, 1979 (2019).

operate within the *Kahn v. M&F Worldwide Corp.* framework.[24] The *MFW* framework contemplates that the court will review a transaction involving a controlling stockholder under the business judgment rule when the transaction is conditioned on approval by both: (1) an independent, fully empowered board committee that fulfills its duty of care, and (2) the uncoerced, informed vote of a majority of the unaffiliated stockholders.[25]

A separate statutory section, applicable only when the other safe harbors do not apply, allows for fairness of the transaction to be demonstrated in other ways. *See* 8 Del. C. § 144(a)(3). In *Marciano v. Nakash*, the Delaware Supreme Court noted that "a non-disclosing director seeking to remove the cloud of interestedness would appear to have the same burden under section 144(a)(3), as under prior case law, of proving the intrinsic fairness of a questioned transaction which had been approved or ratified by the directors or shareholders."[26] The decision to participate in down-round financing may receive Section 144(a)(3) protection if it is fair to the corporation at the time it is authorized, approved, or ratified.

V. Common Down-Round Conflicts of Interest

In down-round financings, there are two areas where directors frequently encounter conflicts of interest. The first is when a majority of the directors are deemed "interested" in the transaction.[27] Such scenarios commonly arise when the director plans to invest in the down-round financing, the director will derive a personal benefit from the financing that other stockholders will not receive, or the director is designated by a stockholder and that stockholder has an interest in the financing. The second common source of conflicts of interest is when the transaction was engineered "by a controlling or dominating shareholder."[28]

1. Interested Director Litigation

The court in *In re Trados Inc. Shareholder Litigation* considered what makes a director "interested" in a down-round.[29] In *Trados*, six of seven directors were deemed sufficiently "interested." Two of them, both members of management, were deemed conflicted because they had received "material" benefits in the recapitalization of the company from a management incentive plan that paid a bonus to individuals who signed a non-competition agreement. Another director was deemed interested for obtaining employment with the acquiring party.[30] Three other directors, who were principals of venture capital funds, held preferred stock in the company. The court determined that these three directors were "dual fiduciaries" who were inherently divided in their loyalties and faced "competing duties" to the company and their funds, which wanted to sell the company.[31] "Dual fiduciary" conflicts are a fact of life for "designated directors," who are partners of private equity firms that have been designated to serve as a director of one of the firm's portfolio companies.[32] Finally, the sixth director, who had been appointed by a fund, was deemed conflicted because of his relationship with the appointing fund, which the court found created a sense of "owingness" to the fund.[33] Because the majority of directors were conflicted, the court applied the "entire fairness" standard to the down-round transaction.

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24 *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).
25 *Id.*
26 *Marciano v. Nakash*, 535 A.2d 400 (Del. 1987).
27 *See, e.g.*, *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 37-38 (Del. Ch. 2010).
28 *See, e.g.*, *Kahn v. Lynch Communication Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994).
29 *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 54 (Del. Ch. 2013).
30 *Id.*
31 *Id.*
32 *Duty of Loyalty Issues for Designated Directors and the Boards of Portfolio Companies*, QUINN EMANUEL URQUHART & SULLIVAN CLIENT NOTES (May 26, 2020), https://www.quinnemanuel.com/the-firm/publications/duty-of-loyalty-issuesfor-designated-directors-and-the-boards-of-portfolio-companies/.
33 *Id.*

The duties of care and loyalty were applied to a down-round financing by a California court in *Kalashian v. Advent VI Limited Partnership*.[34] In that case, the founders of Alantec saw their ownership stake drop from 8% to 0.007% through a series of down-round financings. Adversely affected shareholders alleged that the directors had breached duties of care and loyalty because the venture capitalists sitting on the board had purposely diluted the founders by issuing themselves new stock at valuations below fair market value and by issuing common stock to new management to allow them to vote in favor of the new financing. Although the Alantec board countered that the new financings were critical because the company was on the verge of bankruptcy, the plaintiffs were nonetheless able to withstand summary judgment and to use that as leverage to settle with the company and its directors for a reported $15 million.

More recent cases have highlighted the importance of preparing a strong record to document the process leading to a down-round. *In re Nine System Corp. Shareholders Litigation* concerned the recapitalization of a company through a down-round financing and sale that economically diluted existing stockholders.[35] The court found that a majority of the directors were conflicted because they were standing on both sides of the transaction, and thus were dual fiduciaries with conflicting obligations, and the "entire fairness" standard thus applied. The court focused on "fair dealing" and found that, even with a transaction price near the low end of fairness, the "grossly inadequate process" applied by the directors supported the conclusion that the deal was not entirely fair.[36] The directors had relied on an unsubstantiated valuation of the company, took no input from an independent director or outside financial advisors, and concealed material terms from the stockholders.[37]

Similarly, the court in *Carsanaro v. Bloodhound Technologies* faced the issue whether a company's issuance of stock during a down-round had violated duties to existing investors.[38] In *Carsanaro*, the founders of a software corporation, who owned common stock, sued the company's directors and venture funds who had initiated two down-round financings before selling the corporation. The corporation was sold for more than $82 million, with members of management receiving a transaction bonus of $15 million, whereas the founders received less than $36,000.[39] The court found that the company's directors were "interested" in the transaction because they were standing on both sides of the deal, as both the directors of the company and as fiduciaries of the funds pursuing the down-round financing. The directors' competing interests were sufficient to subject the transaction to an "entire fairness" review. The court found that the challenge to the fairness of the down-round financings was sufficient given their unilateral nature and because the directors had approved the financing without any market canvass or third party input.[40] The court denied the defendants' motion to dismiss, which led to a settlement.

The financing and sale of Good Technology Corporation drives home just how expensive settling down-round-related issues can be. Good Technology shareholders challenged the transaction, based on the directors' affiliation with venture capitalist firms. The Delaware Chancery Court found that "entire fairness" applied, after which the parties reportedly settled the case for more than $50 million.[41]

The Delaware Chancery Court also addressed breaches of fiduciary duties in connection with down-rounds in *Basho Techs. v. Georgetown Basho Invs*., 2018 WL 3326693 (Del. Ch. 2018). The court found that directors had breached their fiduciary duties by forcing the company to enter into a down-round financing. The court found that two directors had taken the self-serving actions of hiring employees without input from other directors and paying them above market salaries to secure loyalty in connection with financing

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[34] *Kalashian v. Advent VI Ltd. P'ship*, 1996 WL 33399950 (Cal. Super. Ct. App. Dep't 1996).
[35] *In re Nine Sys. Corporation Shareholders Litig.*, 2014 WL 4383127, at *1 (Del. Ch. 2014).
[36] *Id.* at *34-35.
[37] *Id.* at *46-47.
[38] *Carsanaro v. Bloodhound Techs., Inc.*, 65 A.3d 618 (Del. Ch. 2013)
[39] *Id.* at 628.
[40] *Id.* at 639.
[41] *In re Good Technology Corp. Stockholder Litigation*, 2018 WL 3649449, at *1 (Del. Ch. 2018).

decisions.[42] The court further criticized the directors for approving loan financing from investment vehicles owned by the directors, instead of seeking other financing options. Interestingly and possibly because of bad lawyering, the directors made no effort to show the entire fairness of these transactions, thus resulting in liability.[43] The defendant directors were found jointly and severally liable for more than $17 million.

In *Carr v. New Enterprise Associates, Inc.,* New Enterprises Associates (NEA), one of the largest venture capital firms in the United States, became the controlling stockholder of Advanced Cardiac Therapeutics, Inc. (ACT) through a series of preferred stock offerings that valued ACT at $15 million.[44] The founder was not allowed to participate in this series, so he brought a claim asserting that the board had violated their fiduciary duties in approving the offerings. The founder alleged that the board was inherently conflicted and had deliberately undervalued the company. The argument was premised on ACT's board selling a warrant to Abbot Laboratories stipulating that Abbot would purchase two companies each funded heavily through NEA. The founder argued that the board had purposely undervalued ACT in the down-round to incentivize Abbott Laboratories to take on the warrant transaction because the purchasing of the two other companies would maximize their value for NEA. The court found these allegations were sufficient to survive a motion to dismiss, and the parties settled.[45]

2. Controlling or Dominating Shareholder Litigation

In addition to conflicts that may apply to directors and officers, most states recognize actionable conflicts can arise against controlling shareholders. Recent cases have made clear that control is not confined to stockholders who own more than 50%. In *Calesa v. American Capital*, for example, the Delaware Court of Chancery held that a private equity fund holding 26% of a company's voting power was sufficiently influential to be a controlling stockholder, given its relationship with the directors.[46] The fund's conflict subjected the down-round to "entire fairness" review. Similar conflicts may exist when a fund or other stockholder has a meaningful equity stake or has other forms of control and participates in a transaction.[47]

The Delaware Court of Chancery addressed this situation in *ACP Master, Ltd. v. Sprint Corporation*.[48] The minority stockholders of an acquired corporation sued the acquiring corporation, alleging an unfair down-round recapitalization. They maintained the acquiring corporation had breached its fiduciary duties as a controlling stockholder because it had valued the company at $5.00 per share, which they claimed was too low. The court undertook an intensive review of the company's resources, with the record including over 2,500 exhibits, 29 depositions, and pre- and post-trial briefing of 766 pages. The court concluded the "fair value" of the common stock was $2.13, and $5.00 per share was entirely fair to the stockholders.

VI. Protection from Shareholder Litigation

Many of these cases reflect criticisms of down-round processes that can be avoided. One recurring criticism is that directors lack awareness of their fiduciary duties and potential conflicts of interest, particularly in the face of competing obligations. Another is failure to employ proper safe harbor procedures or other

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42 *Basho Techs. Holdco B, LLC v. Georgetown Basho Invs., LLC*, 2018 WL 3326693, at *19 (Del. Ch. 2018).
43 *Id.*
44 *Carr v. New Enter. Assocs., Inc.,* 2018 WL 1472336 (Del. Ch. 2018)
45 *Id.*
46 *Calesa Assocs., L.P. v. Am. Cap., Ltd.*, 2016 WL 770251, at *1 (Del. Ch. 2016).
47 *See, e.g.*, *id.*; *see also In re Tesla Motors, Inc. Shareholder Litigation*, 2018 WL 1560293 (Del. Ch. 2018) (finding Elon Musk was a controlling stockholder even though he held just 22% of Tesla Motors' voting power, given his ability to "dominate the corporate decision making process").
48 *ACP Master, Ltd. v. Sprint Corp.*, No. CV 8508-VCL, 2017 WL 3421142 (Del. Ch. 2017), *aff'd*, 184 A.3d 1291 (Del. 2018).

hallmarks of fairness to protect minority stockholders. Companies can take multiple approaches to avoid or overcome such shareholder claims.

1. Pay-to-Play Provisions

Pay-to-play provisions are used to incentivize existing investors to participate in future down-round financings. These provisions require preferred stockholders to continue to invest in further financing rounds or face conversion of their preferred stock to common stock or a more junior security. This may even be done at a punitive ratio.[49]

Pay-to-play provisions are used in down-round financing in several ways. Many companies have existing pay-to-play charter provisions that provide for conversion of preferred stock to common stock for nonparticipants in a down-round. A common way that these existing provisions operate is to convert all preferred stock of non-participating stockholders while allowing participating stockholders to exchange their existing common stock for preferred stock. This can be an effective carrot-and-stick approach to incentivize stockholders to participate in the down-round and forego any litigation claims.

Companies without existing pay-to-play provisions may consider a charter amendment or other means of implementing such provisions for a down-round, assuming they comply with the applicable Delaware or other-state statutes governing charter amendments. One approach, seen in the limited case law addressing these provisions, is to file a charter amendment just before the financing and have the provision specify that non-participating parties will have their preferred stock immediately converted to common stock or a series with lesser rights.[50]

2. Rights Offerings

A rights offering provides all stockholders with the equal opportunity to participate in the down-round. There are some indications that this may cleanse any conflicting interests. But some Delaware courts have expressed skepticism, questioning whether stockholders will actually have a fair opportunity to participate, whether they have financial ability to participate, and whether they have been given adequate time and information. Rights offerings have also been scrutinized as imperfect solutions, given that they are often limited to accredited investors to avoid securities law complications.[51]

A 2020 rights offering was at the center of the *DealerSocket* litigation before the Delaware Court of Chancery.[52] The majority stockholder (a private equity fund) had attempted to lead a down-round financing to fund the acquisition of a new company. A rights offering was offered to all stockholders. However, the founders alleged that they had been frozen out of board discussions and that the other directors were acting as a "shadow board" that attempted to persuade the founders to join the round. The company's valuation was $500 million in 2019, and the board was attempting to use a valuation that was one-half of that in the new round. The court was critical of the rights offering and found that the plaintiff founders had asserted a "strong claim" for breach of fiduciary duty, leading to a settlement between the parties.[53]

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49 *See generally* Constance E. Bagley & Craig E. Dauchy, *The Entrepreneur's Guide to Business Law* 212-18 (1997).

50 *WatchMark Corp. v. ARGO Glob. Cap., LLC*, 2004 WL 3029915, at *1 (Del. Ch. 2004); *see also* Yochiro Taku, *What is a pay to play provision?*, STARTUP COMPANY LAWYER, http://www.startupcompanylawyer.com/2007/08/04/what-is-a-pay-to-play-provision/.

51 Sebastian A. Bacon, et al., *INSIGHT: Minimizing Risk in Down-Round Financing During Covid-19,* BLOOMBERG LAW (June 8, 2020), https://news.bloomberglaw.com/securities-law/insight-minimizing-risks-in-down-round-financing-during-covid-19.

52 *Perry v. Sheth*, No. 2020-0024-JTL, 2020 WL 3400176 (Del. Ch. 2020).

53 Brian Womack, *Vista-owned DealerSocket Settles with Co-founder After Lawsuit – and Announces Key Acquisition Has Closed*, DALLAS BUSINESS JOURNAL (Feb. 11, 2020) https://www.bizjournals.com/dallas/news/2020/02/11/dealersocket-suit-automate-acquisition.html.

3. Building a Supportive Record

When considering down-round financing, companies and their directors can take multiple steps to avoid, or prevail in the face of, an "entire fairness" review. One key step is to create a supportive record.[54] A company should maintain a record of all deliberations of its board and any special committees that concern a down-round financing. The record should be detailed enough to memorialize key events and provide context explaining why the financing was necessary, including (as is often the case) the need to ensure the company's survival. As discussed above, courts have been critical of directors who cannot show they were aware of their duties to stockholders. Creating a detailed record of when and how the board was apprised of its duties and how those duties were properly considered and fulfilled is critical. Records that courts have viewed as positive are, for example, slide decks that memorialize key points of the financing and that were provided to the board in advance of the meeting. The further in advance such materials are provided, the better. Courts have also viewed reliance on outside experts, such as financial advisors, as further evidence of "fair dealing."

Courts also consider business exigencies to be an important factor in assessing any claim for breach of duty. Evidence that a company was taking on a new round of financing to keep the company afloat will favor defendant directors. When possible, a company should record its cash flow needs and the consequences of failing to meet them. Courts have shown they are more likely to accept that a financing was necessary if it is shown that a true liquidity emergency existed and if the financing is commensurate with evident cash flow needs. Such facts can be particularly powerful when presented alongside evidence of meetings with independent financial consultants and investment banks concerning the company's solvency and possible financing alternatives. All consultation regarding alternative financing and the dire financial condition of a company should be documented.

To give a broader sense of what courts are likely to consider in assessing a financing, two corporate lawyers compiled eight factors that boards should memorialize in their records. These are: (1) the quality of decision making, (2) an understanding of the board's fiduciary duties and possible conflicts, (3) input from legal and financial advisors, (4) appropriate reliance on officers, employees, and advisors, (5) consideration of all plausible alternatives and the board's conduct during negotiations, (6) consideration of valuation bases and methodologies, (7) proper handling of management incentive plans, and (8) appropriate disclosures to stockholders.[55]

VII. Conclusion

Down-round financing presents litigation risks that are often overlooked but that can be avoided. Companies contemplating down-rounds should create a supportive record that documents steps taken to ensure a deliberate and even-handed process. With courts willing to criticize boards that fail to show an understanding of their fiduciary duties or potential conflicts of interest, applying a litigator's eye in advance can help minimize litigation risk and create the strongest record possible.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to reach out to:

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[54] *Id.*

[55] For a deeper dive into the different ways in which a company can build a supportive record in connection to a down-round financing, *see* Steven E. Bochner & Amy L. Simmerman, *The Venture Capital Board Member's Survival Guide: Handling Conflicts Effectively While Wearing Two Hats*, 41 DEL. J. CORP. L. 1 (2016).

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