

Publication

06/24/2020

Client Alert: Down-Rounds and Other Insider Financing: How to Minimize Your Fiduciary Risk

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The United States and the world are in the midst of a pandemic and a resulting economic crisis of massive proportion, with most businesses, including many venture capital and private equity backed companies, experiencing shocks to their revenue lines. For many of the smaller of these companies here in the U.S., however, this situation is aggravated by their ineligibility to tap into the federal government's forgivable loan program created by The CARES Act, known as the Paycheck Protection Program, due primarily to the application of its affiliation rules. And mid-sized companies have largely spurned the Federal Reserve's Main Street Lending program, finding it generally too late, too costly and too restrictive. So we can expect that there will be a wave of equity financing transactions among the country's financial sponsor backed companies to shore up their balance sheets and keep them afloat.

By virtue of their status as fiduciaries, the directors of these companies may be exposed to a significant degree of risk in connection with these equity financing transactions, particularly since in many instances the existing financial sponsor may be the only party willing to step up with the fresh capital. For insider financing transactions such as these, the risk of claims may be

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especially great if the financing is a “down-round” and the ownership interests of the company’s other common equityholders are being materially diluted or even eliminated[1]. In referring to a “down-round” we mean an equity financing transaction in which the pre-money valuation of the company for its current round is less than the post-money valuation determined for its immediately prior financing round. A director who serves on the board as a representative of an equityholder which is a venture capital or private equity fund may also have fiduciary obligations to the fund’s own limited partners or members, which should also be carefully considered when assessing the financing transaction.

To be sure, the fiduciary liability issues described and considered in this article may arise in a variety of contexts—perhaps when a private equity firm holding a majority interest provides additional equity to its portfolio company, or preferred stockholders of a closely-held corporation offer to make a further investment, or even in an un-sponsored company where any deeper-pocketed equityholder proposes to expand its position. All of these insider financings may give rise to assertions of undue influence and the transaction’s unfairness to founders, management equityholders, early friends and family investors, or other common equityholders, leading to claims against the directors for approving them. However, for ease of discussion this article will focus on insider financing involving venture capital backed companies, and the application of the ideas presented here to related contexts should be readily apparent. And, while these fiduciary risks exist with any insider financing, whether the transaction is a down-round or not, we emphasize down-round financing transactions here because the likelihood of claims is particularly acute in the current environment as values decline, independent capital is not readily available, invested capital is at risk, and tensions run high.

An existing equityholder that doesn't participate in a new financing round on a proportionate basis, whether due to a lack of opportunity, a lack of ability or a lack of interest, will have its ownership interest diluted. When the financing involves an insider, often with a representative serving on the board, this can lead to claims that the price is unfairly low (resulting in excessive dilution) or that the ancillary pro-investor provisions commonly found in these transactions are unduly favorable to the insider which is offering to invest additional capital. The dilution may also cause other equityholders to fall below ownership thresholds so as to lose certain voting and control rights, such as the ability to block extraordinary actions, and may even render other equityholders vulnerable to involuntary redemption. Thus, particularly when viewed in hindsight, the transaction may be challenged as economically unfair to some equityholders, and the board's approval of the transaction attacked as a breach of the directors' fiduciary duties. In some cases the investing equityholder may itself also be deemed to have fiduciary duties to the other equityholders. And even if an investing equityholder isn't itself deemed to be a fiduciary, it may be found to have "aided and abetted" the board members' breach of their fiduciary duties. As a result, down-round financings are substantially more likely to give rise to claims by disaffected equityholders, who will focus scrutiny of the actions of the board members and the investing equityholders. Any indemnification rights granted to the directors by the company may offer protection, but may prove difficult to enforce in any particular case. And while the existence of a directors and officers liability insurance policy may provide the directors with some comfort, there can be no assurance that any such policy will provide a defense and adequate coverage to any particular claim.

The applicable Delaware law is particularly relevant to this discussion, because many of these companies have been formed under Delaware corporation, limited liability

company or limited partnership statutes, and even for those governed by the laws of other states, the Delaware law is frequently a point of reference. And under Delaware law, these cases often will not be reviewed under the “business judgment rule” but will instead be reviewed under the “entire fairness” standard, the most stringent analysis of the board’s actions which may be applied by the court in these types of cases. In many of these cases, the defendant directors or investing equityholder will bear the very difficult burden of proving that the transaction was “entirely fair”. To manage this considerable risk, there are a variety of actions that the boards of venture capital backed companies can be taking right now as they prepare for and implement a down-round equity financing transaction.

Confirm that Fiduciary Duties Apply

The board members of sponsor backed companies that are contemplating an insider financing should start by considering whether they and the proposed insider investor do, in fact, have fiduciary duties that run to the company and to the equityholders. These duties will generally exist in cases where the sponsor backed company is organized as a corporation, and will frequently also exist in cases where the company is organized as a limited liability company or a limited partnership. In addition, under the law of Delaware and various other states, a controlling equityholder has a fiduciary duty not to use its power of control to derive a benefit from a transaction to the detriment of the other equityholders. But under Delaware law, the fiduciary duties of managers and members of limited liability companies and of general partners of limited partnerships may be waived if there is an express provision to that effect in the applicable governing document, so a preliminary review of that document is warranted. If such a waiver exists, the managers, general partners and insider investor will have considerable latitude in what they may do in a down-round financing,

limited by their duties of good faith and fair dealing and whatever contractual obligations may be described in the applicable governing document.

"Business Judgment Rule" or "Entire Fairness"?

Assuming that the sponsor backed company's directors and any prospective insider investors are determined to be fiduciaries, the facts and circumstances of the particular case will determine the applicable standard by which the actions of the board and investors will be subject to review. As a general rule, directors will be protected by the "business judgment rule", which extends wide deference to the decisions of directors who are not "interested" in the subject of the decision so long as they do not commit a breach of a fiduciary duty of care or loyalty. So in all cases the board will want to be scrupulous in its discharge of these fiduciary duties. With regard to its duty of care, the directors will want to gather information as to the company's current and projected working capital and its expected capital requirements, ask questions of management as to potential alternative sources and costs of capital, and compare the costs, timing, likelihood of successful consummation, and other relevant factors for each of its various financing options. And all of these efforts should be appropriately documented in the minutes of the board's meetings or in its written consent documents. If less than a majority of the board is "interested" in the transaction, then the affirmative vote of disinterested board members comprising a majority of the board will likely be sufficient to resist a claim of a breach of the duty of loyalty and allow the transaction to remain under the umbrella of the business judgment rule, so that the action of the board acting in accordance with its duty of care will likely be respected.

But if a majority of the board is "interested", then the business judgment rule is unlikely to apply. Instead, under Delaware law, the transaction will be reviewed

under the more stringent “entire fairness” standard, which itself consists of two inquiries—a “fair dealing” analysis, which considers whether the process of the transaction was fair to the equityholders, and a “fair price” analysis, which considers whether the economic terms of the transaction were fair to the equityholders. A director will be deemed “interested” if the director receives a personal benefit from the transaction not enjoyed by equityholders generally, or if the director appears on both sides of the transaction. Note also that in the context of a down-round equity financing transaction, a director will be deemed “interested” if the director is a representative of a fund that is participating in the transaction.

The “fair dealing” component of the entire fairness analysis will involve a review of a variety of factors relating to the board’s decision-making process, some of which may be unique to the particular financing transaction. It is likely to focus on such things as the nature and quality of information considered, the scope of deliberation and debate undertaken, the extent to which equityholders were afforded the opportunity to participate in the financing transaction, and the independence of the parties who ultimately considered, recommended and approved the transaction on behalf of the company. The “fair price” component involves a review of the fairness of the economic terms of the transaction—price, payment terms, and associated financial considerations—from the perspective of the equityholders.

Since both components of the “entire fairness” standard require a thorough review of the factual record, litigation based on this standard rarely results in a relatively prompt resolution through the court’s issuance of a summary judgment. This reduces the chance that the dispute can be settled or resolved early and makes for more expensive and time-consuming litigation.

The Critical Importance of the Burden of Proof

The general rule for the “entire fairness” standard imposes on the board the burden of proving that the financing transaction was entirely fair to the equityholders—and this is frequently an insurmountable burden. But Delaware law provides that the burden shifts to the plaintiff equityholders, requiring them to prove that the transaction was not entirely fair, if either (i) the transaction was approved by a special committee of the board, consisting solely of independent and disinterested directors, or (ii) the transaction was approved by a majority of disinterested equityholders. While this may seem like a mere procedural issue, in practice the allocation of the burden of proof may well determine which side is able to prevail in the litigation.

A Few Techniques for Minimizing Your Risk

In light of all of these risks and concerns, what precisely should the board of a sponsor backed company, and the inside investor’s board itself, be thinking as the prospect of a down-round equity financing looms on the horizon? Here’s a summary of a few things to keep in mind in order to limit the risks of fiduciary liability.

1. **Make a Record of the Board’s Careful and Thorough Consideration of the Company’s Financial Situation and its Alternative Paths Forward.** First of all, to discharge its fiduciary duty of care, the sponsor backed company’s board should have strong evidence that it fully investigated the company’s financial situation and its available alternative sources of capital, and explored the implications of each option. This should include evidence that it gathered all relevant facts as to the company’s capital requirements, reviewed the accuracy and reliability of the facts as presented, inquired of management as to the alternatives for raising capital, and assessed the benefits and detriments of each of these

alternatives. The record should clearly show that the board has carefully reviewed and complied with the terms of the company's existing equityholder agreements and credit agreements, and considered the impact of the proposed transaction on any existing options, profits interests or other management incentives. The record should also clearly indicate the time-sensitive aspect of the company's capital needs and the likely consequences of its failure to obtain such needed capital, since courts appear to be more solicitous of board action approving a down-round financing when the board is viewed as having little choice but to do so. Minutes of board meetings should indicate that the board engaged in meaningful deliberations with regard to all of these matters.

2. Have Interested Directors Recuse Themselves. In Delaware and most other jurisdictions, the fiduciary duty of loyalty generally requires a director who has a conflict of interest of whatever nature to avoid participating in decisions that benefit the director's own interests at the expense of the company. A director in a conflict position is therefore well advised not to attend any meeting where the subject of the conflict is raised, avoid participating in any deliberations of the matter, and have the minutes reflect that the director was recused and did not vote on the matter. This is true for an interested director in an insider financing no less than for any other conflict of interest. But recusal may not be an option in all cases, such as when most or all of the directors are interested in a transaction.

3. Form a Special Committee of the Board. In any circumstance where interested directors might otherwise be voting with respect to a transaction, and certainly in cases where the "entire fairness" standard is likely to be applied, consider whether it is possible for the venture capital backed company to establish a special committee, consisting of independent and disinterested directors, which can be empowered to evaluate, negotiate and

approve the down-round financing and its material terms. If such a committee can be constituted in light of the company's particular situation and it evaluates and approves the transaction, the burden of proof in any litigation applying the "entire fairness" standard will shift to the party challenging the transaction, greatly reducing the risk of an adverse outcome by forcing the challenger to prove by a preponderance of the evidence that the transaction was not "entirely fair".

4. Obtain Approval From a Majority of the Disinterested Common Equityholders. If the "entire fairness" standard is likely to be applied and it's not possible to establish a special committee that consists solely of independent and disinterested directors, perhaps the board can arrange for the transaction to be reviewed and approved by a majority of the company's disinterested common equityholders—which is the other way to shift the burden of proof to the party challenging the transaction.

5. Grant Existing Equityholders the Right to Participate in the Down-Round. If all existing equityholders are given the right to participate in the down-round financing, whether or not they have preemptive rights, and they all receive full and proper disclosure of all material information regarding the financing and its context, the board and its inside investor will have a powerful argument to add to their defense against any challenge of the "entire fairness" of the transaction—although this is no guarantee that the transaction was in fact entirely fair. Such a rights offering would be subject to applicable federal and state securities laws, so it may become difficult to implement if any of the other equityholders fails to qualify as an accredited investor. And to be fair, in many cases the other equityholders will not have the ability to participate in the financing, even if they desire to do so. But at a minimum the offer for the equityholders to participate and preserve their percentage holdings will eliminate one

strong argument that could otherwise have been made by those who might challenge a down-round financing.

6. **Make Reasonable Efforts to Secure Outside**

Investors. The company's solicitation of an equity investment by an independent third party investor can help establish the terms and conditions available to the company in the marketplace, which can then either be accepted by the company in place of an interested party transaction with a current equityholder, or used to demonstrate the fairness of the terms of the down-round financing actually entered into with an insider investor. The company's inability to obtain an offer for an alternative financing within the required timeframe, despite good faith efforts to do so, will also be an important fact supporting the defense of any challenge to the transaction.

7. **Get a Fairness Opinion.** If time allows and the venture capital backed company's budget can support it, the board or special committee should consider engaging an independent financial advisor to review the proposed down-round financing and deliver a formal opinion on the fairness of the process, price and terms to the common equityholders. If a fairness opinion has been prepared by a respected financial advisor allowed a reasonable timeline for its due diligence and its delivery of the opinion, it can greatly enhance the defense of any challenge to the transaction.

While there can be no assurance that the performance of any or all of these actions would inoculate the board or the inside investor in a sponsor backed company from liability in the event of an inside financing transaction, each of these actions would bolster the defense of a claim of fiduciary breach and consequently reduce the risk of a finding of liability. A careful board of directors or inside investor would do well to implement these



methods to the extent possible when contemplating an inside financing, particularly in a down-round.

If you have any questions regarding inside financing or any other board governance issues, please contact Bruce Fox, Michael Gray, Josh Klein, Cristina DeMento, Seth Pritikin or your Neal Gerber Eisenberg attorney.

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[1] Note that we focus here primarily on the transaction's impact on the common equityholders, since under recent interpretations of Delaware corporate law directors owe fiduciary duties to the holders of "permanent capital" as residual claimants, which generally consists of the holders of the common stock but also includes the holders of preferred stock solely to the extent that their rights are the same as those of the common. The fiduciary duty does not extend to the protection of those rights of the preferred stockholders which are unique to the preferred, such as a liquidation preference. We have assumed that this principle will be applied in a similar manner in the context of Delaware limited liability companies and limited partnerships, subject to the possibility of a waiver as described below.