



DOWN ROUNDS, PAY TO PLAY
AS WE ALL KNOW THE LAST MONEY IN SETS THE RULES.
HOW TO PROTECT YOURSELF AND TAKE ADVANTAGE OF
THE CURRENT MARKET CONDITIONS FOR ANGEL
INVESTING

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INTRODUCTION

- Current Economic Environment
 - Credit Crises
 - Depressed Real Estate
 - Increased Unemployment
 - Drop in Stock Prices
 - Bankruptcies

- Result for Venture Environment
 - Less early funding available
 - Down Round Terms, including Pay to Play

- Potential Litigation - Duties of Directors
 - Duty of Care
 - Duty of Loyalty



DOWN ROUNDS - TERMS

- Down Round – Lower Valuation/Price
 - Economic Interest Dilution
 - Voting Interest Dilution
- Senior Liquidation Preference
 - 1-5x
 - Paid Before Common & Other Preferred on Exit/Liquidity Event
 - Participation Right – After liquidation preference, share pro rata
- Full Ratchet Antidilution
 - May switch to Weighted Average after 6 mos. to 2yrs.



DOWN ROUNDS – TERMS (CONT'D.)

- Alternative Structure - Senior Secured Convertible Debt
 - Downside Protection
 - Multiplier paid on Exit
 - 2-5x paid on Exit; may increase over time
 - Warrants or Discount to Next Round
 - Warrant Coverage/Discount to next round may increase over time
 - Covenants
 - Negative Covenants
- Tranche/Milestone Based Financings
- Additional Equity Incentives for Management/Employees
 - Common Stock may be too far underwater
 - Liquidation Preferences far exceed potential exit
 - Phantom Stock
- Pay to Play



PAY TO PLAY

- Non-participating SHs Penalized – Incentivize Existing Investors
 - If not, no incentive to invest – free rider problem

- Potential Deal Terms for Existing Preferred Who Don't Participate
 - Convert to Common
 - Loss of Liquidation Preference and other rights
 - Convert to Shadow Preferred
 - Lower or no Liquidation Preference
 - No Antidilution protection
 - No board representative
 - Conversion ratio of less than 1:1 to reduce dilution to management and others (e.g., 2 for 1)
 - Treated as if invested at a higher valuation or invested less money

- Positive Incentives – Pull Forward Preferred
- Alternative – Outside Investors - Full Cramdown of all Existing Preferred



DIRECTOR LIABILITY - BUSINESS JUDGMENT RULE

- Presumption that, in Making a Decision, Directors of a Corporation Acted on an Informed Basis and the Action Taken was in the Best Interests of the Corporation and its Shareholders
- Unless the Presumption is Rebutted by a Plaintiff, the Board's Decision will be Upheld and the Directors will not be Liable



BUSINESS JUDGMENT RULE (CONT'D.)

- Plaintiff can Rebut the Business Judgment Rule Presumption if it can Demonstrate that the Board Violated one of its Fiduciary Duties in Connection with the Challenged Transaction.
- If the Presumption is Rebutted, the Burden Shifts to the Defendant Directors to Prove the Entire Fairness of the Transaction
 - Fair Price
 - Fair Dealing



DUTIES OF DIRECTORS

- Duty of Care
- Duty of Loyalty



DUTY OF CARE

- Duty of Care – Use Due Care in Making Decisions as a Director and in Performing Oversight Responsibilities.
- California Corporation Code Section 309(a):
 - Good Faith
 - Reasonably Believe in Best Interests of Corporation and Shareholders
 - With the Care, Including Reasonably Inquiry, a Prudent Person in a Like Position Would Exercise in a Similar Situation



DUTY OF CARE (CONTINUED)

- Meeting the Duty

- Time Commitment, Attendance at Meetings - More Material Requires More Time and Diligence
- Be Adequately Informed
 - Don't Act Without All the Facts
 - Don't be Afraid to Request More Time to Deliberate
- Make Due Inquiries
 - Look for Red Flags – transactions with little business purpose, related-party transactions, unusual accounting changes, unusual one-time expenses
 - Question Management
- Reliance on Experts
 - Must Exercise Due Care in Choosing Experts



DUTY OF LOYALTY

- Duty of Loyalty
 - Good Faith
 - Act in a Manner Reasonably Believed to be in the Best Interests of the Corporation
 - Not in Separate Best Interests of Director or Related Person

- Duty owed to:
 - Corporation
 - Shareholders
 - Creditors if Insolvent



DUTY OF LOYALTY (CONTINUED)

- Situations in Which Duty of Loyalty is Implicated:
 - Conflict of Interest Transactions
 - Usurping a Corporate Opportunity

- Conflicts of Interest Transaction
 - Types
 - Financial Interest
 - Personal Interest
 - Approval of Interested Transactions (Cal Corp. Code Section 310)
 - Material Facts Concerning Director's Interest Disclosed; and
 - Approved by Shareholders without Counting Interested Director's Shares; or
 - Approved by Disinterested Board and Transaction was Just and Reasonable (compare Delaware – Does not require fairness)
 - Alternatively, Can Prove the Transaction was Fair.



DUTY OF LOYALTY (CONTINUED)

- Controlling Shareholder Fiduciary Duties
 - Generally controlling shareholders can act and vote their economic interests
 - Have fiduciary duties to other shareholders when on both sides of a transaction or when receive something to the exclusion of the minority
 - Self-interest precludes application of the business judgment rule of the board even if directors are unaffiliated with controlling shareholder
 - Transaction must be entirely fair to the minority
 - Fair Price
 - Fair Dealing
- Example – Down Round Financings
 - Conflict of Interest – VC Board Member interested because fund is investing in round
 - Those who don't continue to invest are “washed out” while those who do participate are buying on more favorable terms than prior rounds



DIRECTOR DUTIES IN DOWN ROUNDS (GENERAL)

- Typical Protections
 - Create Independent Committee
 - Offer Participation to All Shareholders
 - Secure Disinterested Shareholder Approval
 - Independently Validate Terms (at least one)
 - Offer terms to third parties and fully negotiate
 - Full deliberation by independent board
 - Fairness opinion



PAY TO PLAY - WATCHMARK

■ Facts

- Watchmark (wireless co.) intended to acquire Metrica Service Assurance (software co.)
- Potential to double sales
- ARGO's BOD member involved in BOD deliberations re: acquisition
- BOD simultaneously negotiated preferred stock financing to finance acquisition
- Negotiated pay-to-play where Preferred of non-participating stockholders converts to Common
- ARGO decided not to invest
- Charter protective provisions – each series of Preferred must approve any adverse charter amendment & no impairment clause
- Watchmark formed wholly-owned sub, merged with it, and eliminated ARGO's ability to block
- Watchmark sued ARGO in declaratory action validating financing and merger

■ Claims

- ARGO claimed Preferred terms prevented financing w/o consent and other VC BOD members violated fiduciary duties



WATCHMARK (Cont'd.)

- Was Charter Violated? No.
 - Subsidiary merger not prohibited - Charter didn't contain magic phrase "whether by merger, consolidation or otherwise" to clarify that adverse changes to Preferred also blocked if effected through a merger.
 - Since the narrow protective provision didn't prohibit a subsidiary merger, no impairment of ARGO's rights occurred
- Did BOD Violate Fiduciary Duties in Approving Actions Which Forced ARGO's Preferred Stock to be Converted to Common? No.
 - Even though the other investor directors participated in the financing, all investors treated the same.
 - All Preferred SHs lost vetoes as a result of merger, not just ARGO's Preferred class
 - All Preferred SHs, including ARGO, could participate in financing and avoided conversion to Common; so it was ARGO's own volitional act of not participating that caused its shares to convert
 - BOD had deliberate process in deciding on subsidiary merger and merger with Metrica in Company and SHs best interests
- No Violation, Even Though not Approved by a Majority of Disinterested Directors (the other Directors' funds invested), Separate Committee or Fairness Opinion



WHAT IF CA LAW APPLIED?

- California Corporations Code provides for class vote for each voting class of stock
 - Watchmark result would likely have been different in CA
- California Corporations Code Section 2115:
 - CA law applies if (both):
 - >50% of business activities in CA (payroll, property, sales)
 - >50% of voting stock held by CA persons
 - DE Supreme Ct. says DE law trumps 2115
 - Vantage Point Venture Partners 1996 v. Examen (2005)



CONCLUSION

- Expect More Down Rounds, including Pay to Play
- Properly Draft Charter
- Best Protection is Keeping Funds Available for Future Rounds
- We can Also Benefit From this Environment
 - Lower Valuations
 - Investor-favorable terms