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Navigating the "Cramdown" Round: A Director's Roadmap

Except for a few hot sectors (notably, SaaS and AI), the U.S. venture capital market has been in something of a free fall since the euphoric market of the immediate post-COVID period. Valuations for companies seeking venture funding have plummeted from their record highs in 2021 by approximately 25% for Series A rounds to as much as 75% for Series E rounds, while overall deal volume of VC investments dropped by 61.8% in Q4 of 2023 from the high-water mark set in Q4 2021.[1] The four horsemen of (i) moribund IPO and M&A markets, (ii) geopolitical turbulence, (iii) limited availability of cheap debt financing (exacerbated in no small part by the demise of SVB in March 2023), and (iv) fears of recession have combined to cast a pall over the venture capital market, chilling investor interest in would-be unicorns that demand inflated valuations while pushing growth at all costs over profitability.

This dismal market for emerging companies has contributed to a spate of down rounds (defined as any financing round in which the pre-money valuation is less than the post-money valuation of the preceding round) on a scale not seen for more than a decade.[2] Down round financings can be taxonomized on a spectrum, ranging from the relatively mild version in which existing investors either do not have or are willing to waive their price antidilution protections while the new investors buy senior preferred stock with typical broad-based weighted-average antidilution protection and a 1x liquidation preference, to the most draconian type, sometimes referred to as a "cramdown, pull-up" round, in which the terms can include full-ratchet antidilution and the implementation of a "pay-to-play" provision that forces investors who fail to purchase their pro rata share to convert their existing preferred into common stock pursuant to a "Special Mandatory Conversion" charter provision at the existing conversion ratio (generally, on a 1:1 basis) or – in the case of the most aggressively punitive version of a cramdown financing – into a smaller number of common shares in what amounts to a de facto reverse stock split (e.g., one share of common stock for every five outstanding preferred shares).[3] The pay-to-play provision at the heart of any cramdown round can be implemented before the financing by participating investors if they already control the requisite majority of the outstanding voting stock.[4]

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[1] Carta VC market dataset, Oct.11, 2023.
[2] Id.
[3] As noted in footnote 67 to the National Venture Capital Association ("NVCA")'s Certificate of Incorporation template, "[i]n order to avoid the punitive conversion, Preferred Stockholders may have an incentive to voluntarily convert their Preferred Stock on a 1:1 basis prior to the automatic Special Mandatory Conversion." The footnote goes on to note that, to avoid this outcome, the board may want to consider prohibiting optional conversions during the pendency of any Special Mandatory Conversion.

[4] In *WatchMark Corp. v. ARGO Global Capital, LLC, et al.*, Civil Action No. 711-N (Del. Ch. Nov. 15, 2004), ARGO, a preferred stockholder, sued WatchMark unsuccessfully to try to block a subsidiary merger that the company and a lead investor planned as the first step of a cramdown financing. The company sought to replace its existing charter (which required separate series voting by the preferred stock on any charter amendment that would "impair" the preferred stockholders' rights) with the charter of its newly formed subsidiary, which would eliminate the separate series voting rights and lower the consent requirement for the preferred stockholders. In holding for the company, the Delaware Court of Chancery noted that the "no impairment" provision in the company's charter did not specifically prohibit impairment via a subsidiary merger. The court held that the phrase, "whether by merger, consolidation or otherwise" (or words to that effect) had to be included in the charter to enable the existing preferred

In some particularly aggressive cramdown rounds, an investor's failure to "pay to play" can result in loss of its preemptive rights, rights of first refusal, co-sale rights, and registration rights, while participants in the cramdown round may be offered, following the forced conversion of all series of preferred to common stock, a new series of preferred on significantly more favorable terms than were offered in prior rounds (hence the "pull-up" part of the cramdown round), including senior liquidation preference at 2x or more, a veto on M&A exits that would return them less than some multiple of invested capital (e.g., a minimum of 2x or greater MOIC), drag-along rights, special voting rights, redemption rights and registration rights. Management may also be granted equity in the form of options after the closing of the financing at the post-closing price to offset the dilutive effect of the round and keep them incentivized, while outstanding options may be "repriced" down to the post-closing price so that employee equity maintains some of its value and does not get wiped out in the round.

Financing structures that dilute the equity of minority stockholders are often subject to challenge under Delaware law. This is especially true when the board is conflicted or the financing is at the behest of a controlling stockholder, in which case the board's actions will generally not be protected by the business judgment rule but rather will be reviewed under the strict entire fairness standard. In cases where the entire fairness standard applies, the board bears the burden of proving that both the negotiation process and the economic terms of the transaction were fair. The burden of proof can be shifted back to the plaintiffs if the board demonstrates that the financing was approved by either (1) a well-functioning committee of independent directors, or (2) a fully informed vote of a majority of the disinterested stockholders.[5]

Guidelines for the Board in a Down Round Financing

There are various precautionary measures that the board (and lead investors in the round) can consider implementing to show that the down round (especially of the cramdown, pull-up variety) was entirely fair in terms of both price and process, if later subjected to challenge by the company's stockholders. Some of the possible prophylactic measures that the board can take are described below.

Establishing a Fair Price

- **Obtain a 409A valuation.** Obtaining a 409A valuation close in time to the round from an independent, reputable third party that is in the business of preparing 409A valuations can be key to support the company's position that the pricing of the round was entirely fair.

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to block the subsidiary merger. See also *SBTS, LLC, v. NRC Group Holdings Corp.*, 2019 WL 4306967 (Del. Ch. Sept. 19, 2019) (transcript) (finding protective provisions of preferred stock did not apply to a merger that converted it into common stock in a new holding company inserted above the company in question), *Benchmarket Capital Partners IV, L.P. v Vague* 2002 WL 1732423 (Del. Ch. July 15, 2002) (Del. Ch. July 15, 2002) (protective provision in charter that required a series vote where a proposed amendment would adversely affect the rights of the preferred does not apply if the adverse change is effected through a subsidiary merger, unless the charter expressly prohibits it), and *Elliot Assocs., L.P. v. Avatex Corp.,* 715 A2d 843 (1998) (preferred stockholders had a right to a separate series vote on a proposed subsidiary merger where the charter expressly prohibited charter amendments "by merger, consolidation or otherwise" that would impair their rights).

[5] Depending on the outcome of the appeal process in *In re Match Group. Derivative Litigation*, C. A. 2020-0505-MTZ, 2022 WL 3970159 (Del. Ch. Sep. 1, 2022), the employment of either one of these cleansing devices may be sufficient to convert the entire fairness review standard to the business judgment review standard.

- **Consider obtaining a fairness opinion**. If it is economically feasible, the board should consider engaging a financial advisor and obtaining a fairness opinion to support not only the valuation used in the transaction, but also the procedural steps taken by the board to establish a fair price.
- **Research comparable transactions**. The board should familiarize itself with current market terms for similar transactions and use this understanding as a basis for determining not only a fair price but other key financing terms.

Establishing a Fair Process

- **Create an independent committee of the board.** 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, they should recuse themselves from any vote on the transaction. If a majority of the directors are interested parties, the board should appoint a special committee of only disinterested directors early in the process to evaluate, negotiate and approve the terms of the transaction. The delegation of authority to a special committee may provide significant legal protection by shifting the burden of proof of fairness to the 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. As noted above, 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 be sufficient to bring it under the protection of the business judgment rule (rather than the stricter 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 bridge financing through a SAFE or convertible note offering, merger, asset sale or other transaction might be the best course for maximizing stockholder value. Investors with representatives on the board should encourage their representatives to assist in this effort.
- **Keep complete and accurate records**. The board should keep detailed minutes throughout the financing process. The record should reflect the board's thinking and analysis, the guidance sought and received from legal and financial advisors, and all related material considerations.
- **Conduct a rights offering**. Regardless of whether preemptive rights exist, the board should consider giving all existing stockholders the right to invest in the financing on a pro-rata basis through a rights offering to maintain their existing ownership stake.
- **Disclosure, disclosure, disclosure.** The board should make every effort to disclose the terms of the financing fully and accurately to its stockholders. 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. 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.

While there can be no guarantee that taking any or all of the foregoing steps will immunize the board from the threat of litigation, the measures described above may provide a useful roadmap for the board to navigate the corporate governance minefield in connection with the cramdown round and help establish that it conducted the financing at a fair price and based on a careful, deliberative, and fair process.

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Pierson Ferdinand attorneys are knowledgeable and experienced in advising boards of directors and investors on the legal issues that can arise in private equity and venture capital financings. For additional information or assistance, please reach out to us or to your regular Pierson Ferdinand contact.

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