

## Venture Capital Advisory: When Low Prices Happen to Good Companies

### What to Do in Preparation for a Down-Round Financing

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As we are now firmly entrenched in a challenging economic environment, many private companies will find it very difficult to raise capital on acceptable terms. For private companies, the sealed IPO window continues to place downward pressure on valuations as the opportunity for liquidity through a public offering is likely to remain closed for investors for the foreseeable future. Coupled with the present liquidity crisis and the recession, these pressures are likely to result in lower valuations for many companies in the capital markets (even promising, well-managed companies). In light of all this sobering news, senior managers and directors should anticipate the possibility of a down-round financing. Complicating the situation is that the only capital available may be from insiders and, under such circumstances, directors need to be particularly careful so that they do not subject themselves to lawsuits from other shareholders and potential liability. In order for directors to mitigate against potential liability and to protect themselves against fiduciary claims, process and good corporate governance procedures are important. Here are a few practical tips for how to prepare for a down-round financing.

#### Start Early to Establish Fair Price

Finding capital in this market will likely take longer than anticipated so you need to plan ahead to give yourself plenty of time to test the market for outside investors. In order to limit potential liability, we recommend that your company establish an investment committee with the independent members of your company's board of directors to screen and hire an appropriate placement agent and other experts to start the process of raising money. Further, make sure this process is clearly documented in the minutes of the board. A systematic process for raising capital is more likely to produce the best price possible and shows a record of diligence that is protective from a fiduciary standpoint. Additionally, if you make a good faith attempt to find outside financing and it is not available, it will allow you the flexibility to proceed with an insider round of financing.

#### Have a Plan B and a Plan C

If there were ever a time for parallel tracks, this is it. While trying to raise money from a new outside lead, confer with existing investors about the possible terms of an insider-led round. Start to hammer out the terms of an alternative Plan B. At the same time, engage with strategic partners, make sure they know the positive news about developments in your company's business and inquire about investment opportunities from those sources as a potential Plan C.

#### Document the Process

It is critical that the minutes of the meetings of the board of directors and its committees reflect all updates on the financing, the number of avenues tried and the results or lack of results from trying those avenues. All too often, companies skip over the creation of a verifiable record. The better documentation of the process, the more protection available to directors from potential lawsuits should the company be forced to take an alternative that is dilutive, particularly if the round is led by insiders. We also recommend that you engage your legal counsel in the process at the start. In the long run, this will save you money rather than cost you money.

#### Pay Attention to Fair Dealing

In a market this difficult, most companies will fall short of their fundraising goals. The terms will likely be more dilutive than hoped and the company may fail in its attempt to locate a new outside investor group to set the valuation and lead the round. With an insider-only investment round, particularly one in which investors are represented on the board, special care must be taken with regard to the approval of the transaction and the establishment of fair dealing. Under Delaware General Corporation Law, Section 144, transactions in which directors have an interest are not voidable solely because of that interest; *provided, however* that the interest is disclosed or known (to the voting parties) and either the independent directors of the board or the stockholders of the company approve the interested transaction. For an insider-led round, disinterested directors, if any, of the board should approve the transaction or a majority-in-interest of the stockholders unaffiliated with the insider investors.

#### Consider a Rights Offering

Even with respect to an insider-led round, it is difficult to argue that members of the board of directors have breached their fiduciary duties to the company and its stockholders if all stockholders are offered the opportunity to invest on the same terms as other insiders. If it is a situation where the company needs funds immediately, insiders can fund an initial closing, and the company can then follow up with a subsequent rights offering to all stockholders for a second closing to occur, for example, thirty days, after the initial closing. Be mindful of U.S. securities laws about offering to unaccredited investors; it may be prudent to limit the rights offering to only accredited investors.

We hope this provides you with some practical advice for preparing for a down-round financing. If you would like any additional information, please contact your Mintz Levin attorney or any of us listed on this client alert.

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