

## Pay-to-play or no way

In the wake of the dot-com implosion in 2001, "pay-to-play" provisions, requiring a company's existing investors to make an additional investment in the company or suffer severe consequences, began to appear with increasing frequency in private equity investment term sheets.

The justification for pay-to-play provisions is that in a difficult capital-raising environment such provisions are necessary to raise capital and, in some cases, avoid bankruptcy. In the current economic climate, such provisions have been reappearing with significant consequences for the unwary.

While there is considerable variation among pay-to-play provisions, they all share the common characteristic that prior-round investors in a company are being asked to participate on a pro-rata basis in a "follow-on" round of financing or suffer adverse consequences. The participation is most often in the form of a cash participation but can also take the form of an exchange of equity held by earlier round investors for the newly offered round of equity. Frequently, more junior Series A, B or C preferred stockholders are faced with the prospect of buying into a more senior round of financing.

The adverse consequences of nonparticipation may include the

loss of the liquidation preference held by the nonparticipating preferred stockholders, the automatic conversion of such preferred stock into common stock and the loss of company board seats associated with the earlier round preferred stock. From a bottom line perspective, nonparticipation results in potentially heavy dilution of the equity positions held by earlier-round preferred stockholders. This dilution is most apparent where the preferred stock is converted or exchanged for common stock, resulting in the loss of favorable conversion ratios that had been previously bargained for.

The traditional justification for pay-to-play provisions is that without the new cash infusion, the company in question will be at risk of going under. As such, the argument goes, the very survival of the company as a going concern ought to trump the nonparticipating stockholders' pre-existing rights as well as any sense of loyalty that the company ought to have toward the original supporters of the venture. This argument resonates well in a more depressed private equity investment environment but less convincingly in a strong private equity market such as the one that existed in the U.S. from approximately 2003 through the summer of 2007.

Delaware case law on this issue

has taken a somewhat formalist approach to pay-to-play. The Delaware courts in *WatchMark Corp. v. Argo Global Capital LLC, et. al* ("WatchMark") and *Benchmark Capital Partners IV LP v. Vague* ("Benchmark") each upheld the applicable pay-to-play provisions by focusing on procedural fairness and strict contract construction principles, rejecting equitable arguments rooted in the notion of substantive unfairness, and rejected the notion that a fiduciary duty was owed to the early round minority stockholders to not impair their rights.

In *WatchMark*, the fact that **Argo Global Capital LLC**, an earlier-round Series B preferred stockholder, was incapable of making an additional investment when presented with the pay-to-play, was not a concern of the court. The focus of the court was rather on whether there was an "equality of opportunity" and freedom of choice for Argo to participate in the new round based upon whether the terms of participation were equal for each investor. It should be noted that the inability of a pre-existing fund investor to participate at the specific time that a company might propose a pay-to-play is a common phenomenon, as fund investors may be in excellent economic health but may simply be, from an

internal fund cycle perspective, unable to dedicate cash to an additional investment.

In WatchMark, Argo had negotiated a fairly extensive "nonimpairment" clause in WatchMark Corp.'s charter. A nonimpairment or "no adverse change" clause requires the consent of a particular series or class of security holders prior to amending the company's certificate of incorporation or certificate of designation if the proposed amendment impairs or adversely affects such security holders' rights. Without delving into the details of the case, by entering into a merger agreement, WatchMark was able to avoid violating the technical language of the nonimpairment right held by Argo, although in doing so it circumvented the clear intentions of the parties and impaired Argo's rights.

In WatchMark, the court implicitly stated that more lawyering would have solved the problem for Argo. To borrow from the Chancery Court, more "sophisticated contract draftsmen hired by sophisticated financiers" may have closed the loophole that WatchMark slipped through.

From a company's perspective, to best immunize a pay-to-play based round of financing from judicial challenge, procedural fairness should be paramount. Both current and prospective stockholders in the company should be afforded the identical opportunity to participate in the pay-to-play round of financing. The establishment of an independent committee of directors to speak to valuation and whether the round is in the best interests of the company's stockholders is also a wise safeguard. Early-round series of preferred stockholders' certificates of designation should provide that automatic conversion of the preferred stock into common stock and may only occur upon a majority class-based vote, as

opposed to a series-based one. Finally, nonimpairment provisions in the certificates of designation should be as narrowly drafted as possible to allow wiggle room for the company to structure creative ways to compel prior round investors to invest additional capital.

Conversely, a pre-existing fund investor, to the extent feasible, would be wise to set aside sufficient cash reserves for future rounds of financing when he or she makes an original investment. Delaware case law suggests that investors should focus on the absence of any of the procedural protections noted above, such as whether there is an equality of opportunity to invest and whether there is an independent valuation of the company at the time of the proposed investment.

A real-world scenario in which these factors played out resulted in a nonparticipating investor threatening to sue a company for breach of its fiduciary duties based on the terms of the proposed pay-to-play term sheet. The term sheet treated the new money investors more favorably than the pre-existing investors, an independent committee of directors of the company had not been established to determine (in concert with an independent investment bank), the fairness of the premoney company valuation and the pre-existing investors were given an unreasonably short period of time to make their investment decision. The new money refused to fund its investment with such a threat of suit looming over the company, especially as this round was contemplated to precede the company's IPO later that year.

The mere threat of suit was sufficient for the company to resubmit a considerably less dilutive term sheet to all investors. While the fund investor was not able to obtain internal finance committee approval to participate

in the follow-on round, the result was that the fund investor withdrew its threat of suit, and the new money came into the company with significantly less dilutive effect on the fund investor's equity position in the company. TD

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