WINSTON & STRAWN LLP

CLIENT ALERT

Tips to Navigate a Down Round Equity Financing

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Over the past six weeks, control-oriented private equity funds (Sponsors) have been hunkering down with their portfolio companies in light of the COVID-19 pandemic. Any and all tactics have been considered and implemented in order to preserve liquidity, including drawing under existing revolvers, working with lenders for relief, taking advantage of loans and tax relief opportunities under the Coronavirus Aid, Relief, and Economic Security Act (the CARES Act) (if and to the extent available or even implemented at this time) and operational cash management with customers, landlords, and suppliers.

Despite these efforts, if the global pandemic continues and/or if business does not bounce back quickly enough, many portfolio companies may need additional capital to keep operating. After exhausting all other remedies, Sponsors with dry powder may have to inject additional capital in order to protect their investments at a time when valuations are lower than prior financings.

Sponsor-led down round equity financings come with particular risks that need to be considered, especially in situations where the Sponsor controls a portfolio company with many minority investors. If proceeding down this path, we recommend Sponsors keep in mind the following:

Fiduciary Duties. First and foremost, review the governing documents to confirm whether fiduciary duties apply to directors and controlling equityholders. Although fiduciary duties always apply in the context of a Delaware corporation, Delaware law provides that fiduciary duties of managers, general partners, and members of limited liability companies and limited partnerships may be waived if such waiver is expressly made in the applicable governing documents. When such waivers exist, managers, general partners, and controlling equityholders will have broad discretion relating to a down round equity financing (subject, of course, to any contractually imposed limitations/duties in the governing documents and the implied covenant of good faith and fair dealing).[1]

In situations where such waiver is not made (or such waiver is not otherwise permitted as a matter of law), controlling Sponsors and their appointed directors must be aware of their fiduciary duties. Where a majority of a portfolio company's directors are appointed by a Sponsor, and the new round of equity financing is led by such Sponsor, such directors will be considered "interested" directors and will not be protected by the business judgement rule unless certain of the steps discussed in the next paragraph are adopted. Instead, the entire fairness standard of review will apply to the approval of such equity financing and the directors must prove that the process was fair and that the transaction was done at a fair price.

If interested directors exist, a portfolio company's board can take one or more of the following steps in order to create a record that will support the fairness of its decision-making process and the price, and even potentially obtain business judgment rule protection:

- Form an independent committee
- Obtain a fairness opinion/engage a financial advisor
- Take the deal to market
- Obtain disinterested/minority stockholder approval
- Document the process

Combining an independent committee approach with a requirement for disinterested/minority stockholder approval from the outset can result in the transaction being evaluated under the more forgiving business-judgment rule instead of the exacting entire fairness standard. However, for a Sponsor with a middle-market portfolio company, some or all of the above steps may not be practical or cost-effective. As such, a Sponsor should consider the right approach given the facts (*e.g.*, the amount of minority investors, the dynamics among equityholders, the immediacy of the liquidity need, timing, the existence of preemptive rights) with its counsel in order to pave the most protective and commercial path.

Rights Under Equityholder Agreements. Sponsors and their counsel should review the applicable governing documents of the portfolio company (whether that be the limited liability agreement, stockholder's agreement, or charter) to evaluate possible restrictions or consents required in order to facilitate a new equity financing. Focus should be on the following:

- Minority consent rights
- Amendment provisions
- Preemptive rights

If any of these minority protections exist, Sponsors should carefully abide by the terms in order to ensure compliance and avoid any post-transaction disputes.

Impact on Credit Documents and Lender Relationships. If no event of default under applicable credit documents exists, a new Sponsor-led equity financing is unlikely to give rise to a mandatory prepay under a portfolio company's credit documents. That said, down round equity financings are most often tied to financial distress and covenant defaults and as such, keeping the line of communication open with lenders and understanding rights and obligations under the applicable credit documents is key during this process. A Sponsor should take a holistic approach, considering not only the current liquidity needs to be satisfied by the equity financing, but how and when to communicate to lenders and whether to ask for certain accommodations under the existing credit documents in order to achieve liquidity and prevent a future event of default. Such requested relief could include:

- Material loosening or "holidays" for financial maintenance covenants
- Permitting some or all of interest and fees payable to be capitalized rather than cash pay
- Deferring required amortization payments
- Carveouts and exclusions from certain financial definitions and representations for COVID-19 and its effects

During the COVID-19 pandemic, we have found lenders to be generally willing to make accommodations and work with Sponsors during this difficult time (particularly those lenders that work closely with Sponsors on many different portfolio companies). Relationships matter—and we believe lenders that are more willing to work with Sponsors will come out of this crisis stronger, having forged stronger partnerships with its Sponsors.

Communication with Key Co-Investors. Often times, the equity capital stack includes co-investors and rollover investors. These relationships often run deep with Sponsors and are often meaningful, especially if the co-investors are also limited partners in the Sponsor's fund or if the rollover investors are existing management. Sponsors should therefore approach key co-investors and management equityholders in advance of making the investment and ask whether they want to participate contemporaneously and on the same terms as the Sponsor. Such partners will likely have protective preemptive rights; however, we believe that socializing this move early will pay dividends later in respect of future partnerships.

Impact on Management Incentives. Excessive dilution of the management team's equity may neuter existing incentives that would otherwise have been critical to the company's success in trying times. Sponsors should consider alternative or supplemental options to supplement the compensation package (*e.g.*, repriced options or additional cash solutions) to ensure that the management team's incentives are appropriately aligned. Addressing this early and communicating with management will be important as the team navigates through distress.

The question is not whether this pandemic will end, but when. Those portfolio companies with liquidity will be the ones that survive this distressed environment. As Sponsors continue to monitor the liquidity needs of their portfolio companies as well as liquidity options (including other loan programs to be announced under Title IV of the CARES Act), they should be prepared to pull the trigger and provide equity financing if the situation calls for it.

View all of our COVID-19 perspectives here. Contact a member of our COVID-19 Legal Task Force here.

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[1] If such waiver is provided—and in the absence of other express contractual provisions imposing additional duties or limitations—managers, general partners and controlling equityholders are only held to the implied covenant of good faith; establishing a breach of that duty is subject to a high standard and it rarely can be invoked to provide minority equityholders with protection that is not expressly set forth in the governing documents. The governing documents may, however, include, among other things, restrictions on and/or mandatory procedures for interested-party transactions.

5 Min Read

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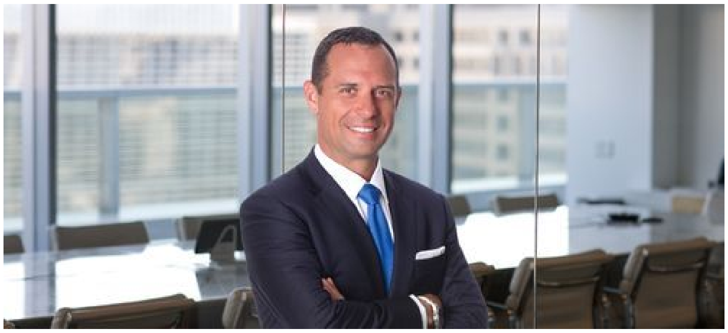

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