



June 2005

ARTICLES IN THIS ISSUE

HOME

- Changing Pharma Fundamentals Promote New Marketing Models
- Mortgage Industry Gets Squeezed
- Recent Delaware Decision Endorses "Pay-to-Play" Technique and Offers "Down-Round" Protection to Insider Investors

Industry Articles

- Mirus In The News
- About Us

NEWSLETTER ARCHIVES

- January 2005**
January 10, 2005
Vol. 1 Issue 25
- July Newsletter 2004**
July 7, 2004
Vol. 1 Issue 22
- May 2004**
April 18, 2004
Vol. 1 Issue 21
- February Newsletter 2004**
January 29, 2004
Vol. 1 Issue 20
- November Newsletter 2003**
October 31, 2003
Vol. 1 Issue 19

[MORE]

TELL A FRIEND

SUBSCRIBE

To subscribe to our quarterly E-newsletter, please enter your email address in the box below.

Add Remove

Send as HTML

Recent Delaware Decision Endorses "Pay-to-Play" Technique and Offers "Down-Round" Protection to Inside Investors

by Dimitry Herman, Andrew Rogovin & Fritz Hammond of Hinckley, Allen &

Worried about legal liability for cramdowns and pay-to-play provisions? A recent Delaware Chancery Court decision, WatchMark Corp. v. ARGO Global Capital, LLC, is the latest in a series of cases that supports investors who undertake dilutive "down round" financings. These cases demonstrate that courts are likely to interpret literal the express provisions of a company's charter and stress the importance of carefully drafting provisions intended to protect existing investors.

WatchMark is a venture-backed company that sought to raise a Series F round of financing for an acquisition that was critical to its business. The terms of the new investment, among other things, contained a commonly used "pay-to-play" provision which penalized any existing investor failing to participate in the financing by automatically converting their existing shares of preferred stock to common stock. To effect this transaction, WatchMark needed to amend its corporate charter, which would have required the consent of 80% of its Series B preferred stock for any amendment that would "adversely affect" the rights and preferences of the Series B shares. Significantly, the charter required only a 70% vote of all preferred stock, voting as a single class, to approve a merger. The Company's board consisted of six directors, five of whom were representatives of investors in prior rounds, including one director from ARGO. The investment was offered to all of the Company's investors and, unlike others, ARGO declined to participate. Because ARGO held enough Series B stock to block the charter amendment, but not enough to block a merger, WatchMark proposed to circumvent ARGO's veto by way of a parent/subsidiary merger. Specifically, WatchMark proposed to merge with its wholly-owned subsidiary and to adopt a new charter that would be identical in all respects to WatchMark's existing charter except for the 80% charter amendment provision, which would be eliminated.

In line with prior cases, the WatchMark court found that ARGO was not entitled to a separate series B vote on the merger and concluded that WatchMark's board did not breach any fiduciary duty in approving this transaction. Notwithstanding WatchMark's intent to use a merger to avoid ARGO's supermajority consent rights, the court held that where the charter language relating to amendments was clear and unambiguous, it would not expand the meaning of such provisions "even if such a reading would deny the protective provision's 'apparent purpose of assuring a class vote if adverse consequences flow from a merger.'" The court pointed out that while the protective provisions list a number of other transactions that would require an 80% vote, mergers were specifically not incorporated in that provision. With respect to ARGO's fiduciary duty argument, the court noted that duties owed to preferred stockholders are "primarily contractual in nature" and that if any fiduciary duty is owed to preferred stockholders, "it is only in limited circumstances."

Submit

The *WatchMark* case is the latest in a series of cases in Delaware and other jurisdictions that support strict construction of investment documents, particularly those involving sophisticated parties that relied on the advice of legal counsel. For example, in *Benchmark Capital Partners (2002)*, the Delaware Chancery Court upheld the use of a parent/subsidiary merger to indirectly effect an amendment to the Company's charter to authorize a new series of preferred stock, notwithstanding a protective provision granting junior preferred stockholders a vote on actions that would "adversely change their financial or economic rights."

Similarly, a recent Massachusetts Superior Court decision, *Triumph-Connecticut Ltd v. Ascent Pediatrics*, involved a protective provision that prohibited the company from selling its business by way of a sale of stock or assets or a merger, but which excepted mergers where the company was the surviving entity. Emphasizing the sophistication of the parties involved, the court refused to expand the express language of the contract and held, as a matter of law, that a reverse triangular merger effected without the consent of the investor was not a breach of the protective provision by the company.

Practical Considerations

Given *WatchMark* and other recent decisions, investors and companies should consider the following:

§ In general, careful and clear drafting of contractual language and charter provisions is absolutely critical. Given the sophistication of parties in this business context, courts are likely to interpret any ambiguity against the drafters.

§ *WatchMark* endorses the use of pay-to-play provisions and the technique of using a parent/subsidiary merger to effect a charter amendment for which consent cannot otherwise be obtained.

§ To avoid the specific result in the *WatchMark/Benchmark* cases, investors may wish to draft charter provisions to require their consent to an adverse change of the "rights, powers and preferences" of a series or class of stock, however effected, e.g. "directly or indirectly, by means of a merger, consolidation amendment or otherwise.

§ Pay-to-play provisions may be more likely to stand up where, as in *WatchMark*, (1) all investors have an opportunity to participate in the financing, (2) are similarly treated by the provision and (3) the provisions affect a party's pre-existing investment only to the extent of that party's non-participation in the new round.

§ Providing all investors the opportunity to participate in the financing on the same terms also reduces the risk of self-dealing or breach of fiduciary duty claims.

§ As always, a clear record of discussions and deliberations and an informed and deliberate process of structuring the new financing can further insulate directors and officers from shareholder claims.

About Hinckley, Allen & Snyder LLP

Hinckley, Allen & Snyder LLP, with over 110 lawyers in three New England states, provides a broad range of legal services to regional and national clients throughout the Northeast. Our transactional practice specializes in venture capital and private equity deals, mergers and acquisitions, commercial lending, intellectual property, health care, corporate and securities law, real estate and tax. Our clients include major New England commercial banks, hospitals and health care institutions, technology start-ups, private equity funds, broker-dealers and a variety of publicly and privately-held companies.

About the authors

Dimitry Herman, Andrew Rogovin and Fritz Hammond are partners in Hinckley Allen's corporate area. Our practice concentrates on venture capital and private

equity transactions, mergers and acquisitions, and other transactional corporate and securities matters, with a focus in information technology, telecommunications, network systems, wireless, health care, life sciences and consumer product sectors. *We wish to express a special thanks to Bradford Crevier for his research and assistance in connection with this article.*

For more information on this article or Hinckley, Allen & Snyder, please contact Dimitry Herman at (617) 378-4156 or dherman@haslaw.com.

[PRINTER FRIENDLY VERSION]

Powered by **IMN™**