WatchMark Ruling Clarifies Pay-To-Play

By John R. LeClaire, Michael J. Kendall and Kingsley L. Taft

Recent times have seen a surge in the use of “pay-to-play” techniques in private company financing rounds. In a typical scenario, existing investors that fail to participate in a current financing lose certain preferred stock rights, such as their liquidation preference or anti-dilution protection, or even forfeit all preferred stock rights through forcible conversion of their preferred stock into common stock.

In 2003, about a third of all preferred stock financings are reported to have included some pay-to-play consequences for non-participating investors. And this trend is increasing—as compared to 2002, more deals in 2003 contained pay-to-play provisions written into the company charter in anticipation of future financings, and the consequences for failing to play grew more severe, with a larger percentage resulting in forced conversion to common stock. This trend is occurring even as financing conditions improve, as investors continue to be influenced by recent down markets.

Venture investors and commentators have offered a number of reasons for the increasing frequency of pay-to-play. First, investors generally are not as likely as in the past to recover any of their capital from an unfavorable investment. Consequently, investors demand that fresh capital be given the greatest chance to earn a high return by eliminating the hurdle of repaying prior investors. Indeed, investors find themselves both the beneficiaries and the victims of pay-to-play. As they face pay-to-play as an existing investor in one company, they often look to enforce pay-to-play when they are the new investors in another. Also, with more funds doing multi-stage investing, early stage investors are no longer the primary source of deal flow and often do not receive “kid glove” treatment. Finally, today’s serial entrepreneurs will often move on to their next endeavor if their equity becomes buried beneath a mountain of preferred stock.

Against this backdrop, a recent case in the Delaware Chancery Court, WatchMark Corp. v. ARGO Global Capital, LLC, et. al., tested the fairness of pay-to-play techniques. By holding that the company’s board did not breach its fiduciary duties when a non-participating investor’s preferred stock was converted into common stock, the court has provided a roadmap on how to execute pay-to-play successfully.

The WatchMark Story

WatchMark is a wireless networking software company based in Bellevue, Wash. In early 2004, WatchMark sought to acquire the Metrica Service Assurance Software Group, an acquisition that could double WatchMark’s sales. WatchMark’s board consisted of six directors, five of whom were nominated by venture investors. The board representative of ARGO Global Capital and its related fund, GSM Capital Limited Partnership, the eventual contesting parties, was actively engaged in considering and negotiating the Metrica acquisition. The board approved the merger in October 2004.

While the Metrica merger was being negotiated, WatchMark’s board also began negotiations for the sale of a new series of preferred stock to finance the acquisition. All of the company’s investors were invited to participate in the negotiations. By August, a number of WatchMark’s investors had agreed on the key terms of the financing, including the conversion of the outstanding preferred stock of non-participants to common stock. Each of the investors was asked how much it would invest in the new round, and in response, ARGO informed WatchMark it would not participate.

Due to an apparent concern that ARGO might challenge the transaction, WatchMark sought a declaratory judgment validating the proposed financing and merger. ARGO counterclaimed against
WatchMark and the four other investor board members alleging that WatchMark did not have the right to consummate the deal without ARGO's consent under the terms of ARGO's preferred stock and that the board had breached its fiduciary duties. In its ruling, the court upheld the actions of WatchMark and the board on both counts.

Pay-to-play places increased pressure on preferred stock protective provisions, which can be used by investors to hold off or at least mitigate adverse pay-to-play consequences. Indeed, in WatchMark, ARGO could have thwarted the pay-to-play treatment with a better-drafted provision.

The WatchMark charter contained protective provisions requiring the consent of each series of preferred stock to any adverse charter amendment, as well as a related “no impairment” clause. It did not, however, include certain magic words that Delaware courts have previously said must be present to provide an investor with complete protection. The absence of these words allowed Watchmark to form a wholly owned subsidiary, merge with it, and thereby eliminate ARGO's ability to block the financing transaction.

ARGO also tried to rely on a broadly drafted no impairment clause to argue its consent to the transaction was required. The court, however, refused to let ARGO use the no impairment provision to overcome the flawed “no adverse amendment” provision the court had already ruled did not protect ARGO. Since the narrow protective provision did not prohibit the subsidiary merger, there was no impairment of ARGO's rights and, thus, no charter violation.

A Matter of Fair Play

After concluding that ARGO could not block the subsidiary merger or the subsequent financing, the court next considered whether the WatchMark board had breached its fiduciary duties by approving those actions, which would result in the forced conversion of ARGO's preferred stock into common stock. The court concluded that the WatchMark board had not. The key to the court's reasoning was the fact that all preferred stockholders were treated the same with respect to the pay-to-play. As nominees of investors that participated in the financing and whose preferred stock survived, the four investor directors other than the ARGO representative might have been guilty of self-dealing had ARGO been treated differently from others. That was not the case here:

First, all series of preferred stock lost their separate series voting rights as a consequence of the merger. The court's reasoning suggests that its ruling may have been different if only the separate vote of the preferred stock series held by ARGO had been eliminated. However, by terminating all separate series votes on charter amendments, and instead having all preferred stock vote together, ARGO was no worse off than any other preferred stock holder with respect to the protective provisions implicated by the subsidiary merger.

Second, all preferred stockholders, including ARGO, could have participated in the financing and thus avoided the conversion of their preferred stock. The court emphasized that only by a preferred stockholder's own decision not to participate in the financing would its preferred stock be converted into common stock. Thus, the structure of the pay-to-play was even-handed, and punishment a self-imposed consequence.

Third, the court made much of the fact that no one, including ARGO's director nominee, disputed that the Metrica merger was in the best interests of WatchMark. Indeed, the court complimented the WatchMark board on its informed and deliberate process of recommending the subsidiary merger as a precondition to the preferred stock financing. These facts appear to have substantially influenced the court's view that the WatchMark board exercised due care.

Finally, WatchMark and its board did not rely on techniques often used in down-round financings to protect insiders against claims of fiduciary breaches, such as approval by a majority of disinterested directors or by a separate committee of disinterested directors or obtaining a fairness opinion. In WatchMark, notwithstanding the fact that the merger and financing were approved by a majority of interested directors, the court held the pay-to-play structure valid.

One last factual tidbit: The court reported that ARGO had indicated a willingness to participate if the new financing terms were sweetened, undercutting ARGO's argument that it was being discriminated against and making it a less sympathetic victim.

Life After WatchMark

So how do you put WatchMark's teachings into practice? There are two critical elements:

Provide all preferred stockholders with an equal opportunity to participate in the pay-to-play financing. The punishment for failing to participate should be voluntary and self-inflicted, thereby avoiding any perception that the loss of preferred stock rights was not in the affected investor's control. In practice, an investor may not be able to participate in a financing because it
lacks sufficient funds, but the court did not consider this real-world concern and was solely concerned with how preferred stockholders were treated by the financing terms. Having all the preferred stockholders participate in negotiating the terms of the pay-to-play financing should further strengthen this position.

Process, process and more process. Always critical in these situations is the extent to which the company’s board engaged in an informed and deliberate process. Courts take comfort in knowing that a board was fully informed and exercised its independent judgment, and further that the board concluded that the proposed financing was in the company’s best interests. Unwavering attention to process will protect a company and its board when using pay-to-play.

Living with Pay-To-Play

In light of the increasing use of pay-to-play, what are investors doing to protect themselves? The most obvious measure centers on the protective provisions. At the very least, make sure those protections are done correctly to avoid, for example, the subsidiary merger loophole used in WatchMark. Consider their scope. Do they prohibit all company events that could be used to strip preferred stockholders of their preferences? Also, count votes. A block is only effective if you have the necessary votes to put it in place.

Those legal protections, when properly drafted and applied, may still not be enough. Even with veto power, it may not be possible for venture investors to prevent all financing events that could potentially diminish their returns. For example, a newly issued junior preferred stock with a liquidation preference multiplier can be used to reduce the amount payable to a senior participating preferred stock upon a company sale, even though the issuance of such junior preferred may not necessarily be prohibited by the “no adverse amendment” provision discussed above. And there are other novel ways to structure around favorable preferred stock charter provisions. Even if those structures are not used, the threat of such work-arounds can diminish investors negotiating leverage on future financing terms.

About the only certain protection is additional funds to invest and the willingness to do so. Even with bulletproof protective provisions, investors may disagree among themselves over new financing terms, and minority investors may not be able to block the resulting pay-to-play. In response, funds are reportedly reserving extra dollars to protect their investments against unwanted and undesirable loss of their preferred stock preferences. WatchMark exemplifies a trend toward aggressive and dilutive treatment of investors who cannot or will not continue to fund an enterprise, a trend that we believe will continue to grow. Savvy investors would be wise to take the risk and reward of pay-to-play into account in their deal terms and fund management.

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Footnote 1: In the November 2002 issue of VCJ, we discussed the Benchmark Capital Partners IV, L.P. v. Vague case and its predecessor, Elliott Assocs., L.P. v. Avatex Corp., and the limits of preferred stock protections. Those cases held that the magic words “whether by merger, consolidation or otherwise” were required to clarify that adverse changes to preferred stock were intended to be blocked not only if the company’s charter was amended, but also if the adverse changes were effected through a merger.