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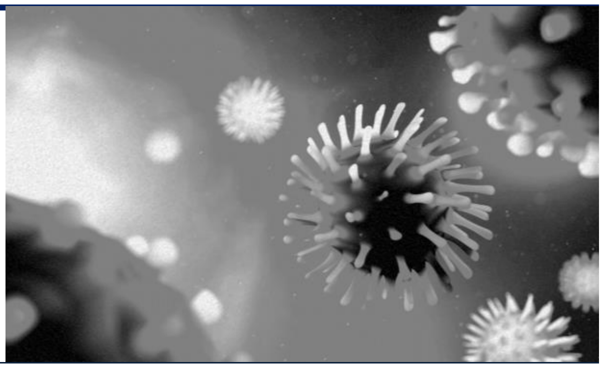

Cram Down Financings in the Era of Covid-19

By Shahram Safai | 1 June 2020

We are in unprecedented times. The Covid-19 pandemic has swept the globe like a tsunami and it continues to wreak havoc on countries, people and economies. The effects of the pandemic are evident now. For example, the US unemployment rate is presently at 14.7%. In the peak of the financial crisis of 2008, the unemployment rate was 10%. This rate is predicted to rise to 25% at the peak of the Covid-19 pandemic – equivalent to the unemployment rate of the US Depression of the 1930s!

Given the backdrop of the cataclysmic economic effects of the Covid-19 pandemic, it has also become increasingly harder to find willing investors for startup companies. Such a scenario will give rise to "cram down" financings. In such a cram down financing, only one or a few investors are willing to put any new money into a company. However, such money usually comes with a much lower valuation for the company (down round) and forced conversions from luxurious preferred shares to plain vanilla common shares which generally punish non-participating shareholders who end up 'crammed down' to a small ownership stake of the company in common shares.

Generally, such a cram down financing involves a few controlling venture capital investors increasing their control and ownership stake at the expense of the crammed down remaining investors who did not participate in the financing. In such circumstances, courts have held that controlling venture capital investors must satisfy the "entire fairness test" by proving that the transaction was fair to the minority crammed down shareholders. This means that a controlling venture capital shareholder may have a fiduciary duty to minority shareholders.

In such circumstances, controlling venture capital investors should insist on a broadly worded indemnity from the company to protect them against potential claims by the minority shareholders based on the entire fairness test and breaches of fiduciary duty.

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The Covid-19 pandemic has resulted in a significant shortage of venture capital financing for companies. Such shortage can result in unique investment opportunities for those venture capital investors who are willing to invest in such uncertain times. However, such opportunities can result in potential liabilities that may be so significant as to wholly undermine such investment unless specific investor protections are negotiated. ■

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