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Pay-to-Play Provisions – Traps for the Unwary

In today’s difficult economic climate, venture investors must make tough decisions about which of their portfolio companies to continue funding. The IPO market has been virtually non-existent for two years and many private companies have had a great deal of difficulty attracting capital from new investors. In many cases, existing investors are the only available financing alternative, and down rounds (a financing at a lower price than the most recent round) have become commonplace.

Unfortunately, existing investors are not always willing to put additional capital into their portfolio companies, and investors who are willing to risk additional capital expect their co-investors to share the risk. Pay-to-play provisions (which might be more aptly named “play or pay” provisions) are designed to encourage existing investors to support a company, especially in down rounds.

Investors who are willing to support a company in a down round (the “players” in the financing round) generally want the other existing investors to support the company as well. If all investors pitch in to support the company, less capital is required from each investor. The players also do not want the non-players to get a “free ride” on the benefits of that support without putting up any additional capital. Absent pay-to-play provisions, the non-players will benefit in several ways. First, the capital from the players is often the capital of last resort. If they do not invest, the company is likely to be shut down. Second, if some investors do invest, all existing holders of preferred stock with anti-dilution protection will benefit from an increase in the conversion rate of their stock as a result of the sale of securities at a lower price. The increased conversion rate will immediately increase the voting power of the preferred shares and will result in higher returns in the event of the subsequent sale or IPO of the company.

Pay-to-play provisions are designed to encourage support of the company and address this potential free ride dilemma. With pay-to-play provisions, everyone pays, one way or another. If existing investors subject to pay-to-play provisions do not purchase their pro-rata portion of the down-round securities (or "play" in the down-round), the price they "pay" will be to lose some of their existing rights.

There are a variety of ways that pay-to-play provisions can be implemented. Typically, the non-player's existing preferred stock is converted into a new series of preferred stock, often referred to as the "shadow series". The shadow series is usually identical to the existing series except it may not have (1) price anti-dilution protection, or it may have less favorable price anti-dilution protection (such as weighted average price anti-dilution protection instead of full ratchet protection), (2) voting rights, (3) a liquidation preference or (iv) some combination of the foregoing. In more extreme cases, the non-player's existing preferred stock is converted into common stock, thereby losing all of the advantages of preferred stock.

While pay-to-play provisions are becoming increasingly prevalent, they can have unintended consequences if not crafted properly. This article highlights a number of issues that should be addressed when instituting pay-to-play provisions.

Beware of Unintended Veto Rights. The provisions describing the rights of the existing series will often state that certain actions, such as the sale or liquidation of the company or the authorization of additional securities, requires the approval of a certain percentage of the voting power of the existing series. In drafting pay-to-play provisions this fact is sometimes overlooked, with the unintended effect of creating a series of preferred stock, held only by the non-players, with separate class voting rights – i.e., veto rights for those same actions. To prevent this outcome, the charter should state that the existing series and the shadow series will vote together as a single class on all matters except as otherwise required by law.

Prepare Investor Contracts Carefully. Other investor rights and obligations, such as registration rights, preemptive rights, rights of first refusal/co-sale and voting rights and obligations, are usually set forth in contracts among the company, founders and other investors. Each of these contractual provisions should be carefully drafted to make certain that they anticipate the possibility that the existing series may convert into a shadow series without unintentionally divesting the holders of rights or freeing them from obligations upon conversion. One should also consider how the creation of a shadow series will affect the waiver and amendment provisions of investor contracts. If it is intended that the rights and obligations of the holders of the existing series and the shadow series are to be the same, then the investor contracts will need to make it clear that the existing series and the shadow series will vote as a single class on all amendments and waivers. Other alternatives may need to be considered if the rights and obligations are not intended to be the same.

Consider "Pro-Rata" Calculations. The manner in which an investor's "pro-rata portion" is calculated for purposes of determining whether the pay-to-play provision is triggered for that investor must be considered. As a result of changing market conditions, it is frequently the case that a company's earlier series of preferred stock will not include pay-to-play provisions but that a pay-to-play provision will be included in later rounds (meaning that only the series of preferred stock issued in the later round will be forced to convert into a shadow series if the holder does not participate pro-rata in a subsequent financing). This leads to the issue of whether an investor's "pro-rata" portion of the future down-round financing should be calculated based on its total ownership of all classes of preferred stock of the company or only its ownership of the series containing the pay-to-play provision. While there is not necessarily a correct answer to this issue, some investors view the inclusion of prior series, without a pay-to-play provision, in the calculation as unfair, since it effectively imposes pay-to-play obligations on the prior series.

To the extent that the pro-rata calculations are based on an investor's total ownership of all series of preferred stock, another consideration that needs to be addressed is the anomaly that could result if different venture funds from the same family of funds participate in each financing round. For example, if ABC Fund I purchased Series A preferred stock without a pay-to-play provision, and ABC Fund II purchased Series B preferred stock with a pay-to-play provision, the pro-rata portion that ABC Fund II must purchase to protect its Series B preferred stock will be based solely on its ownership of Series B preferred stock unless the calculation of pro-rata ownership is drafted to include shares owned by affiliated venture funds. Conversely, if XYZ Fund I owns shares of both Series A and Series B preferred stock, XYZ Fund I is going to have to purchase a greater proportion of the offering to protect its Series B preferred stock.

Be Aware of Dissenters' Appraisal Rights. If the terms of one or more series of existing preferred stock are going to be amended to implement pay to play provisions retroactively, be certain to check the law of the company's state of incorporation. If such an amendment is approved, the statutes of some states (including Massachusetts, but not Delaware) will entitle dissenting stockholders to have their shares repurchased by the company at their appraised fair value.

These issues highlight the need for care in preparing venture financing documents with a pay-to-play provision.

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