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Private Equity 2011 - Caveat Investor: What to Consider and What to Watch Out For When Investing Additional Capital Into A Portfolio Company

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In a distressed market, it can be difficult for a portfolio company to obtain additional debt or equity capital. In such times, or when capital is needed in short order, portfolio companies often turn to existing stockholders (whether private equity funds, venture capital or other investors) to provide the necessary funding.

These "follow-on financings" can be structured in several ways: (i) a follow-on financing at the same valuation as the previous round, (ii) a down-round financing, (iii) convertible promissory notes or promissory notes with warrant coverage, (iv) a bridge loan into a future round of financing, or (v) a more extensive restructuring. The exact form of the follow-on financing will depend on the specific facts and circumstances of the company, including the company's financial situation and outlook, the status of the equity and debt markets, the constitution of the company's shareholder base, the objectives and perspectives of the company's investors and input from the company's lenders.

At first blush, a follow-on financing with inside investors that does not involve a material capital restructuring can appear to be a very straightforward exercise. Typically, the investment documents from the prior financing are used as a template and revised to effect the additional financing. Very few third party consents are generally required and the lenders are usually fine with additional equity capital being raised. However, it comes as no surprise that even the simplest follow-on financing will require board consent and will require the company's directors to exercise, and fulfill, their fiduciary duties that run largely to the common stockholders of the company. This is equally true of the director designees of the private equity investor who, when making decisions as a director, may not categorically prefer the interests of the preferred stockholders over the common stockholders. This basic fiduciary duty analysis is well settled Delaware law.

What may come as a surprise is that recent case law, primarily Delaware, has increased the risks and pitfalls of follow-on private equity investments. This article will discuss these recent holdings and suggest "best practices tips" to minimize potential liability and litigation exposure. Moreover, an investor and its counsel should not merely have the goal of prevailing should a dispute with other shareholders arise, but should seek to avoid litigation and arbitration altogether. After all, a court holding that an investor and/or its director designees are not liable is not much to celebrate if the victory resulted in significant litigation expenses and poor publicity. The tips below should help to minimize the likelihood of these situations with better planning, structuring and, importantly from the perspective of recent Delaware case law – "process."

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