More Than You Ever Wanted to Know About Pay-to-Play Provisions
Lessons from Texas Hold’em?

By Jeff Harris and Ken Maready

Introduction

Spectators of high stakes poker routinely witness card players “raise the ante” to force other players at the table to either financially prove their commitment to their respective hands by investing new funds or to fold and immediately lose all of the money they previously put into the pot. In venture capital circles, investors can raise the ante with co-investors by means of a “pay-to-play” provision, requiring that all investors in a portfolio company continue their pro rata financial commitment to the company, or else lose certain rights with respect to their original investment.¹

This article discusses the basic forms, drafting issues and enforceability concerns of the pay-to-play provision and touches on the related “pull-through” or “exchange offer”. We have solicited comments from a number of law firms and VCs in different parts of the country, and have attempted to incorporate their guidance into this article.²

Background

Although the exact origins of the pay-to-play are debatable, several sources suggest Sevin Rosen Funds has played a significant role in bringing a strong version of this term to the institutional mainstream. Most practitioners believe the concept of pay-to-play has been around since at least the 1980s; however, many note seeing it more frequently in term sheets beginning around 2000.

¹ Unlike the game of poker where the goal is to be the last player standing at the end of a round, the primary goal of a pay-to-play provision is to encourage other investors to continue to contribute needed capital so that all investors will see the company through to the end.

² The authors would like to thank and acknowledge many people for their time and thoughtful comments, and particularly note the helpful guidance of: Eric Finseth of Wilson Sonsini Goodrich & Rosati, Carmelo Gordian of Andrews Kurth LLP, John Jaggers of Sevin Rosen Funds, Jason Mendelson of Mobius Venture Capital, Pat Mitchell of Goulston & Storrs, a professional corporation, Sarah Reed of Charles River Ventures, Jolie Siegel of Testa Hurwitz & Thibeault, LLP, Mark Weakley of Holme Roberts & Owen LLP, Eric Weshelblatt of Holland & Knight LLP, Bud Whitmeyer of Research Triangle Ventures, and Rich Zamboldi of Accel Partners. The views stated herein are not necessarily the views of any of the foregoing or their respective firms or funds.
Use may vary by geography, stage and other factors, but several prominent venture firms (including early stage investors such as Sevin Rosen and Mobius Venture Capital) confirm the term is now in virtually all of their term sheets. There are various reasons investors are now including pay-to-play provisions. For example, Sarah Reed of Charles River Ventures indicates “CRV generally advocates pay-to-play provisions in its deals, because we believe that the investing syndicate should play together as a team in supporting the company through future rounds.” Many of these funds are including the provision up-front to avoid uncertainties and legal claims if needed in a future financing round.

Many practitioners attribute the rise of the pay-to-play to two factors: (i) the explosion in the number of VC funds, and the number of funds making investments outside of their primary geographic location (and sphere of influence), which has led to a lack of intimate knowledge about, and influence over, co-investors; and (ii) the abundance of down rounds and capital market uncertainties since the latter half of 2000.

Today, firms are not only being more aggressive in putting the pay-to-play in their term sheets, but are also more aggressively using the term to clear out non-participating investors. As noted by John Jaggers of Sevin Rosen, “in the old days you would walk into the room and lay this term on the table like your .45 caliber, but never use it…now, we’ve used this at least a half-dozen times over the last few years and have several successful companies as a result.” Predictably, larger venture funds are more likely to require a pay-to-play as a condition of their investments and companies are more than willing to allow a lead investor to self-impose this on the entire syndicate.

Very early rounds of financing (such as angel rounds and smaller seed-stage funds) typically do not include pay-to-play provisions for obvious reasons (e.g., rounds may involve the sale of common stock only, and many early-stage investors have no intention to continue funding multiple future rounds of financing). On the other end of the cycle, pay-to-play terms may become less important in later rounds of funding for maturing companies in which investors feel they have enough visibility as to the future funding needs required to reach an exit event.

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3 Early stage investors, which typically do not include pay-to-play provisions in their standard term sheets are increasingly likely to accept a pay-to-play in tranched or difficult financings.

4 In addition to enforceability concerns when attempting to adopt a pay-to-play that would apply to smaller, early-stage investors, later-stage VCs may want to consider the policy of regularly implementing pay-to-play provisions against seed investors who lack the funds or authority to invest in later rounds. Regularly punishing angel groups or seed investors for not investing in later stages of companies they have seeded may be tantamount to killing off the VC’s own farm team.

5 Some practitioners view anti-dilution (e.g., full-ratchet) more objectionable in later rounds due to the impact on management and feel pay-to-play serves as a necessary balance.
Structure

There are two basic components to a pay-to-play provision: (i) the triggering event and (ii) the consequence. There are a number of varying approaches to both – here, we describe the most common.

The Triggering Event

The event triggering the application of a pay-to-play is the failure of an investor to participate as required in certain issuances of stock (“qualified financings”). There are often limitations on what kinds of financing will have potential pay-to-play consequences. Most commonly, qualified financings only encompass down rounds.\(^6\)

In addition, pay-to-play provisions are sometimes drafted to include limitations applicable on an investor-by-investor basis – such as a provision that the pay-to-play will not apply to an investor if such investor has invested at least a certain dollar amount, either within a stated period of time or in the aggregate (with such threshold stated either as a fixed dollar amount or expressed as a multiple of such investor’s original investment). Certain types of investors (such as strategic investors or government-affiliated entities) may also require that they be exempted from application of the pay-to-play.\(^7\) Although these types of limitations can make sense in certain circumstances, many of the experienced attorneys with whom we spoke expressed a clear preference for keeping the provisions as simple as possible. In addition, having limitations which treat investors holding the same class or series of stock differently than others can raise enforceability concerns.\(^8\)

The determination of whether an investor has participated to the full extent required to avoid the pay-to-play is typically a more straightforward matter. The required amount of investment is based upon some level of the investor’s pro rata ownership – some pay-to-play provisions require only investment of the investor’s pro rata ownership of the total fully-diluted capitalization of the company, and others require investment of the investor’s pro rata amount of preferred stock outstanding or a specific subset of preferred stock.

The Consequence

\(^6\) Also, investors may agree to carve out specific financings -- e.g., financings in which the requisite percentage of specified holders elect to waive the application of the pay-to-play; no required holders purchase shares in such financing; the financing occurs less than a specified period of time (such as 6-months) after the closing of a prior qualified financing; or financings in which rights of first refusal otherwise do not apply.

\(^7\) Strategic investors with whom we spoke were prohibited by policy from providing comments on this topic, but as a general matter, corporate strategic investors aggressively fight pay-to-play and drag-along provisions. Jason Mendelson of Mobius Venture Capital noted that negotiations with strategic partners ultimately involve a balancing of the corporate partner’s importance to the company and the degree of control it is looking to exert going forward. From our experience and anecdotal evidence, despite initial resistance, strategic investors will agree to a pay-to-play provision in many cases.

\(^8\) See the discussion under Enforceability, below.
The consequence common to nearly all pay-to-play provisions is that the non-participating investor will lose the benefit of anti-dilution adjustments for such investor’s preferred stock going forward. Mechanically, this is typically achieved through the automatic conversion of the non-participating investor’s shares of preferred stock into shares of a new series of preferred stock (referred to as a “shadow series” or “shadow preferred”) substantially similar to the original series of preferred, but lacking price protection anti-dilution adjustments.9

Some venture funds feel that the loss of anti-dilution protection, without more, does not provide the proper level of incentive to co-investors. As a result, a more draconian version of the pay-to-play emerged over time (referred to by some as a “strong-man pay-to-play”) providing that the non-participating investor’s shares of preferred stock are automatically converted into common stock at the time of the qualified financing (and, if applicable, that the non-participating investor lose any rights to designate a director to be elected to the company’s board of directors). Therefore, the non-participating investors not only lose the benefit of anti-dilution adjustments, they also lose their liquidation preference. This has the added benefit of reducing the preference overhang which can help a company’s management remain incentivized. Anecdotal evidence suggests VCs strongly favor the added motivation provided by the strong-man variety.10

Most pay-to-play provisions we have seen are on an “all-or-nothing” basis – in other words, an investor participating in a qualified financing to some extent, but less than its full pro rata amount (a “partially participating investor”), would still suffer the consequences of the pay-to-play with regard to all of its preferred stock. However, we have seen some use of a modified version providing that the pay-to-play would only apply to a fraction of the partially participating investor’s preferred stock. This still provides incentive for investors to participate to the full extent possible, and some practitioners feel that this version might be looked upon more favorably by a court asked whether the pay-to-play were enforceable, as is more fully discussed below.

Drafting Concerns

With regard to the basic question of where in the financing documents to include the pay-to-play provision, we believe that most practitioners currently include pay-to-play provisions in the company’s charter. Some draft pay-to-play provisions as a provision of the Stock Purchase Agreement11 – in which case, rather than providing for conversion of the investor’s stock, the

9 In order to increase the potential impact of this term, lead investors may prefer structuring the pay-to-play provision so that mandatory conversion occurs at the original issue price, which has the effect of causing non-participating investors to lose anti-dilution protections retroactively.

10 See for example, Fenwick & West quarterly surveys of Bay Area financings (approximately 75% since ‘02). Presumably, this is due to the increased incentive to participate; however many practitioners prefer this because it is a simpler approach (noting drafting issues as a primary concern).

11 See for example, the draft pay-to-play provision in VENTURE CAPITAL & PUBLIC OFFERING NEGOTIATION (3rd EDITION), Michael J. Halloran, et al, Aspen Law Books, (through 2003 supp.) pp. 8-42 through 8-45. As noted in the commentary to these model provisions, if using this “waiver” model of pay-to-play, it is best practice to include: (i) a provision in the charter expressly allowing a holder of preferred stock to waive antidilution rights prospectively for such holder and for future holders of the shares, and
provision is drafted as a prospective conditional waiver by each investor of future anti-dilution protections, which waiver is triggered by the non-participation of such investor in a qualified financing. (With regard to strong-man pay-to-play provisions located outside of the charter, these contractual provisions would provide that an investor’s stock will be “voluntarily” converted under the terms of the charter if it does not invest the required amount in a qualified financing.) Many attorneys prefer to keep ongoing rights or requirements of this type out of the Stock Purchase Agreement and include them in the charter or at least an investor rights or voting agreement.\textsuperscript{12} Note that including pay-to-play provisions in the charter could raise enforceability issues where the terms of the pay-to-play provision would treat different shares of the same class of stock differently (i.e., a pay-to-play which allows certain investors to be exempt from its application).\textsuperscript{13}

As company counsel, the chief concern when drafting or reviewing a pay-to-play provision is the clarity of the application of the pay-to-play, due to the possibility that it may be heavily contested if exercised. Particularly, company counsel will want to ensure that:

- triggering events for the pay-to-play are objective and simple to measure;
- similarly, any carve-outs are objective and simple to measure;
- pro rata calculations are spelled out clearly (based upon fully-diluted capitalization overall or among preferred stockholders only\textsuperscript{14}; include warrants or other exercisable securities held by the investor? held by others? include affiliates of the investor?\textsuperscript{15});

(ii) a legend on the stock certificates putting future holders on notice that anti-dilution adjustments may have been waived for shares evidenced by the certificate.

\textsuperscript{12} This is not true with respect to a round-specific version of the pay-to-play we refer to as a “\textit{mini pay-to-play}” involved in some tranched investments. This provision is to help enforce investors’ obligations to invest in a second or third tranche of an investment once the milestones or conditions for such tranche have been met. This type of pay-to-play is best located in the Stock Purchase Agreement for that investment. Because the application of the mini pay-to-play is limited in scope and it is the reasonable expectation that all investors in the financing will meet their obligation with regard to additional tranches, the mini pay-to-plays, as far as we have seen, are all of the strong-man variety, causing the shares purchased by an investor in the initial closing and other prior tranches to all be automatically converted into shares of common stock if the investor doesn’t meet obligations in a future tranche.

\textsuperscript{13} See the discussion under \textit{Enforceability}, below.

\textsuperscript{14} In this regard, counsel should consider whether the pro rata amounts which drive the pay-to-play may conflict with pro rata rights located in other documents providing investors and other stockholders with rights of first refusal to purchase securities of the company in new offerings. In many instances (including, for example, the National Venture Capital Association model venture capital documents, which can be found at www.nvca.org), the pro rata calculation for the pay-to-play is based upon ownership of preferred stock only, while the preemptive-type rights to participate in future financings only provides the investors with the right to participate pro rata based upon the entire fully-diluted capitalization of the company. If many stockholders are awarded the preemptive-type pro rata rights of first refusal, the company may not even be able to offer each investor a sufficient number of shares to
- notice provisions that will drive the pay-to-play are clear and easy to comply with; 
- if the pay-to-play would result in conversion of non-participating investors’ stock into a shadow series of preferred stock, the company obtains, as part of the initial adoption of the pay-to-play, the requisite board and stockholder approval to authorize, create and issue the shadow preferred; and

allow them to avoid the pay-to-play provisions (this should obviously be considered by investor’s counsel as well). The NVCA model documents get around this issue by defining “Pro Rata Amount” in the pay-to-play provision as (i) the lesser of the investor’s pro rata amount of the preferred stock or (ii) the maximum amount of offered securities the investor is offered to purchase by the company in the qualified financing, subject to cutbacks applied by the board of directors equally to all investors.

Including the concept of affiliates in the pay-to-play is highly recommended, as otherwise some investors may be able to avoid the full effect of a pay-to-play by transferring a portion of the shares to an affiliate immediately prior to the qualified financing and participating only with respect to the shares still held by the investor itself. We have seen this happen, and participating investors were not pleased with the drafters of the pay-to-play provisions.

Specifically, we believe the notice provisions should not be the same as the typical notice provisions required in connection with stockholders’ rights of first refusal to participate in new issuances of stock. Whereas those notice provisions often require that the terms of the offering be sent to each such stockholder a certain number of days prior to the new issuance of securities, in practice this is often difficult to comply with since terms of the financing are often negotiated up until the eve of the initial closing. Strict compliance with such a notice provision is often waived or overlooked in the context of a right of first refusal as long as the stockholder ultimately gets the chance to participate – but where a pay-to-play is involved, an investor may be less likely to waive strict compliance and may use such failure as the basis for a challenge to the pay-to-play. Therefore, many recommend a more company-friendly notice provision structured so that, for example, the pay-to-play would apply to an investor if that investor fails to invest its pro rata amount within 20 days after having been offered the right to purchase such amount by the company. This allows for even post-initial-closing notice if necessary to make sure that all of the terms of the financing are properly given to the investor to make its decision.

Some practitioners advise including all of the rights, preferences and privileges of the new shadow series of preferred stock in the charter at the time of adopting the pay-to-play. Other forms of pay-to-play provisions do not include the entire series of shadow preferred in the charter, but rather provide instructions and authority to authorize, designate and issue the shadow preferred, including more or less detail on what the shadow preferred will look like – typically, this is expressed as having the same rights, privileges and preferences as the original series of preferred stock, except (i) the conversion price will be the same as the conversion price immediately prior to the qualified financing, (ii) the shadow preferred will have no provisions to adjust the conversion price for dilutive issuances, (iii) the shadow preferred will be named, e.g., “Series A-1” or “Series A-prime” and (iv) some accommodation for the definition of “original issue price” or other such terms will be made so that it is clear that such terms are based upon the original price paid for the original preferred stock which is converted into the shadow preferred. It is advisable in such cases to prospectively provide the board of directors with authority to adopt blank check preferred, or at least to adopt the shadow preferred substantially as described in the pay-to-play provisions.
it is clear that the conversion price at which non-participating investors' preferred stock will be converted into common stock (or, in a non-strong-man pay-to-play, the conversion price for the resulting shadow preferred) will be the applicable conversion price in effect immediately prior to the qualified financing.

Legal Issues

Enforceability

Some practitioners disfavor pay-to-play due to the potential uncertainty it may inject into the deal – e.g., can pay-to-play be forced on prior rounds absent unanimous consent or will it simply lead to litigation? Will inside directors be charged with self-dealing and breach of fiduciary duty? Will washed-out investors bring an “impairment” clause claim? Pay-to-play provisions and down-round-financings typically go hand-in-hand – should there be enforceability concerns?18

Interestingly, Delaware counsel notes enforceability issues are fairly settled in Delaware and appear to receive more attention in other jurisdictions.19 The recent Watchmark decision,20 in addition to confirming the ability of the defendant corporation to consummate a Benchmark-type merger, confirmed the enforceability of properly drafted pay-to-play provisions in certain situations.21

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18 Implementing up-front should minimize potential claims and many VCs elect to do so in early rounds for this very reason. It is particularly important that boards of directors and investors pay special attention to their duties to the corporation and its stockholders in a situation where a pay-to-play is to be adopted immediately prior to a financing in which the pay-to-play will be triggered (an ”eve-of-financing pay-to-play”). As such financings are typically significantly dilutive and either inside-led or have heavy insider participation, the financings in general are subject to charges of violations of fiduciary duties, including self-dealing, by the investor-designated members of the board of directors. The pay-to-play provision can be seen as particularly self-serving if adopted at a time when it is clear which investors will be participating investors and which will not.

19 This article does not address the enforceability of pay-to-play provisions under the law of any jurisdiction other than Delaware, but we note that practitioners in California have voiced additional concerns regarding the enforceability of pay-to-play provisions in that state as a result of California case law surrounding poison pill provisions which some consider to be analogous in some respects. In Delaware, courts are inclined to recognize the deal that the parties negotiated – as one practitioner explained, you had better contract for a specific veto right if that is what you want.


21 The Court again held that general impairment clauses provide no independent rights – which will hopefully lead to their discontinued use as recommended in the NVCA’s model charter, see www.nvca.org.
Among other facts, the Watchmark opinion noted the following: (i) that the pay-to-play applied to all series of preferred equally, (ii) that the pay-to-play allowed partially participating investors to avoid the effects of the pay-to-play with regard to some portion of their stock, (iii) the deliberate and detailed discussions and analyses by the Watchmark board of directors in approving the mergers and the terms of the financing and (iv) the challenging investor’s apparent ability to invest its full pro rata amount and attempts to negotiate better terms for itself.\(^{22}\)

Although Delaware counsel appears to be comfortable with the enforceability of pay-to-play provisions, the following common concerns emerged during our conversations with practitioners (some clearly based on Watchmark):

- A pay-to-play provision put in place on the eve of a qualified financing may raise more enforceability questions than a pay-to-play put in place in connection with a financing prior to the financing in which the pay-to-play is used.\(^{23}\)

- The board of directors should carefully consider the likely effect of pay-to-play provisions on the corporation and its current stockholders, and such consideration should be well-documented in the corporate documents.\(^{24}\)

- A pay-to-play is more likely to be enforceable against an investor if such investor had the opportunity to participate in, or at least was very well-informed during, the negotiations of the terms of the qualified financing.

- A pay-to-play which does not convert all of the shares of a partially participating investor may be more likely to be enforced than an “all-or-nothing” pay-to-play.\(^{25}\)

- A pay-to-play invoked by venture capital funds against smaller investors who did not expect to be responsible for later stages of funding (and who do not have the funds or

\(^{22}\) The Court noted “[n]o conversion to common stock can occur unless a preferred shareholder voluntarily opts out of the proposed Series F financing,” “alteration of ARGO’s Series B rights will be a function of ARGO’s own economic interests, a decision of its own making,” and “only if a preferred stockholder chooses, of its own volition, not to participate in the new Series F issuance will its shares be converted to common.”

\(^{23}\) Note that notwithstanding this general sentiment, Delaware counsel does not view enforceability issues to exist assuming the requisite votes are obtained, a rational business purpose exists and the record demonstrates these terms are the best available.

\(^{24}\) If the board of directors believes that the pay-to-play may be detrimental to the corporation’s current stockholders, it should try to negotiate the term out of the financing if possible. Fairness opinions are occasionally sought, but not perceived as common.

\(^{25}\) This concern is raised by some practitioners as a result of dicta in the Watchmark case.
authority to make such later-stage investments) may be subject to challenges not covered by Watchmark.26

Prior to Watchmark, one of the main concerns with regard to the enforceability of pay-to-play provisions in general was that the provision could be read as treating shares of the same series of stock differently – shares of stock held by participating investors could be treated differently in the future (at the time of a qualified financing) than shares of the same series of stock held by non-participating investors. Although Watchmark has alleviated these concerns with regard to a basic pay-to-play provision, in cases where the provisions of the pay-to-play provision go further and expressly provide for the pay-to-play to apply differently to different holders of the same stock – i.e., a provision that certain named investors, or investors holding less than a set number of shares of preferred stock, are specifically excepted from the consequences of the pay-to-play – there remain concerns with respect to a “different treatment” challenge.27 In these cases, many counsel advise their clients to include the pay-to-play provision as a contractual agreement among the investors in an investor rights or voting agreement, rather than in the charter.28

Legal Opinions

Due to concerns regarding enforceability, some law firms are now including specific qualifications or limitations in their legal opinion letters relating to the pay-to-play provision. For example, a form of opinion letter developed among several firms with well-recognized venture capital practices now includes the following:

“In connection with each of our opinions expressed herein, we call your attention to the fact that the validity and enforceability of mandatory conversion provisions such as the “pay to play” provisions set forth in [insert section reference] of the Restated Certificate have not been specifically ruled upon by Delaware State courts, and therefore any opinions herein that relate to those provisions of the Restated Certificate or that rely on such validity and enforceability are not free from doubt.”29

All practitioners with whom we spoke had considered whether a pay-to-play would be enforceable when giving opinions. Those who did not include specific limitations as set forth above rely upon: (i) the likelihood that any finding of unenforceability of a pay-to-play

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26 Although it is not clear that this was a determinative factor, it is worth noting that the Watchmark opinion makes reference to the fact that the suing stockholder had the capital available with which to maintain its position.

27 In fact, some advised us that a charter with this type of provision is likely to be rejected by the Secretary of State of California for this reason.

28 See the discussion under Drafting Concerns, above.

29 This qualification was added to the form opinion letter pre-Watchmark and it may be subject to removal or modification as a result of this case.
would come under equitable principles, which are already excepted out of legal opinions and/or (ii) express ‘down-round’ assumptions that the board of directors had not violated their fiduciary duties and that the transactions were not interested transactions under Section 144 of the Delaware General Corporations Law.⁴⁰

**Conflict of Interest of Investors’ Counsel**

In many venture capital transactions, the lead investor will select one law firm upon which other investors in the financing will rely to conduct due diligence, negotiate the terms and documents for the financing and close the transaction. In most cases, the interests of the investors as a group are aligned; however, when a pay-to-play is involved, it may be important for investor’s counsel to (i) make it clear to the investor group that it is representing only the interests of the lead investor which may differ from other investors within the syndicate, and (ii) disclose the potential conflict (divergence of interests) among the investors caused by the existence of the pay-to-play, particularly where smaller or less-sophisticated investors are involved.

**The Pull-Through or Exchange Offer**

The pull-through or exchange offer is an alternative method of allowing participating investors to avoid heavy dilution in a down round if a pay-to-play has not been put in place in prior rounds. Some practitioners feel that an exchange offer mitigates challenges which might otherwise be brought against a pay-to-play provision on the grounds that the pay-to-play provision might be read as treating shares of the same series differently. In any event, as an exchange offer can be substantially similar to an eve-of-financing pay-to-play and is typically adopted at the time of a dilutive financing, fiduciary duty and self-dealing concerns should be considered by the board of directors and any inside investors participating in negotiations for the financing.

The pull-through is effected in connection with a new financing, typically a down round (for purposes of this discussion, a **“Series B financing”**), by having the corporation offer participating investors the right to convert shares of preferred stock they hold from prior rounds of financing (**“Series A Shares”**) into, depending on the structure, either shares to be issued in the new financing (**“Series B Shares”**) or shares of a new series of preferred stock (**“Series A-1 Shares”**) which are not as beneficial as the Series B Shares, but are better than the Series A Shares in various ways. If the financing is a cram-down or recapitalization, the Series A-1 Shares are typically substantially the same as the Series A Shares, except that the Series A-1 Shares will not be converted into common stock, while the remaining Series A Shares will. If the financing is not a cram-down, the Series A-1 Shares are typically substantially the same as the Series A Shares, except that the conversion price of the Series A-1 Shares is lower (reduced in some cases as low as the price of the Series B Shares).

Because those “left behind” in an exchange offer are not likely to look upon the company and/or the financing favorably, when implementing an exchange offer it is very important that

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³⁰ Non-Delaware practitioners voiced more concern regarding the need for specific carveouts than Delaware counsel (which noted it has not been asked to give specific enforceability opinions regarding pay-to-play) – possibly due to the perception that the cost may outweigh the perceived value.
certain votes, consents or waivers of the Series A Shares are obtained *prior* to the exchange for a new series of preferred stock. For example, if the non-exchanged Series A Shares are to be converted into common stock at the time of the financing pursuant to an “automatic conversion” provision in the charter which is triggered by the consent of the holders of some majority of the shares of Series A Shares, it is important to obtain such consent prior to the exchange. Similarly, if the vote or consent of the Series A Shares is required in connection with the Series B financing (i.e., to allow the designation or issuance of senior preferred stock, to amend the charter, to waive anti-dilution adjustments, etc.), such consent must be obtained prior to the exchange. For similar reasons, if the non-exchanged Series A Shares are *not* to be converted into common stock, it is wise to amend the terms of the Series A Shares to reduce blocking rights (protective provisions) to the minimum required by Delaware law and, where possible, to make it clear that such shares will vote or consent as a single voting class with the Series A-1 Shares.

In those cases where there exists a series of preferred stock entitled to anti-dilution adjustment in connection with the financing in which a pull-through is involved, it is wise to add clarifying provisions to the applicable weighted-average anti-dilution formulas in the charter prior to conducting the financing. Without such clarification, the treatment of shares being exchanged or being issued in the exchange could be ambiguous under some weighted-average formulas.\(^{31}\)

There are also some interesting accounting effects that occur as a result of the exchange of shares in connection with the financing. The company’s accountants should refer to Emerging Issues Task Force D-42: “The Effect on the Calculation of Earnings per Share for the Redemption or Induced Conversion of Preferred Stock.”

**Conclusion**

Pay-to-play provisions can materially influence behaviors and provide the additional runway for companies to ultimately become successful where they otherwise may have failed. Large investors often believe that their co-investors should be willing to fully support a deal or be washed out and pay-to-play provides a contractual mechanism to achieve this.\(^{32}\) Funds cannot deliver desired returns unless they have successful companies – most are hoping to hit a few home runs and some view portfolio management as a numbers game. Those in favor of pay-to-play believe it helps get a few more deals to the finish line – or in Texas Hold’em terms, past the initial “flop” and all the way through “fifth street” -- which increases the odds for a winning hand.

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\(^{31}\) We suggest adding a statement that the shares exchanged in the financing be considered as outstanding immediately prior to the financing at the conversion price in effect prior to such financing, and that the *incremental* shares of common stock issuable upon conversion of the Series A-1 Shares issued in exchange therefor (if such shares have a more beneficial conversion price than the Series A Shares, as is often the case) be considered to be shares issued in the financing. This can be negotiated, but the point here is that it should be considered and included in the charter prior to the financing.

\(^{32}\) Many venture capital firms, such as Sevin Rosen Funds, strongly believe in the well-known mantra “Lead, Follow or Get out of the way!” In theory, pay-to-play should help prevent non-contributing investors from simply standing in the way of a deal.
From a lawyer’s perspective, it seems fairly settled in Delaware that properly adopted pay-to-play provisions will be enforceable. It is clear that the provision, and the circumstances surrounding its adoption, may be subject to the same fiduciary duty claims as any other term of a financing, particularly in down-round situations. Company counsel should advise his or her client’s board of directors to consider the effects of a pay-to-play provision on the corporation’s stockholders when determining whether the overall terms of a financing are in the best interests of the corporation and its existing stockholders. If the pay-to-play provision is adopted, company counsel should very carefully review all provisions of the financing documents which bear on the triggering event or the consequences of the pay-to-play to make sure that they are clear, as simple as possible and are consistent with other provisions of the financing.