Down Round Financing

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PRACTICES Corporate, Emerging Companies and Venture Capital

Although the data for San Francisco Bay Area remains encouraging for the first quarter of 2020*, given the economic instability brought by COVID-19, we might see more down rounds going forward. Down rounds are financings where the company is valued less than in a previous round. In practical terms this means that the new investors are buying shares of the company at a lesser price than the previous investors. If your company is in a position where it needs funds to survive, but cannot secure financing at the previous valuation or higher, there are a few things regarding the decision-making process and the substance of the financing documents to watch out for.

Process considerations

First, have the management of the company document and implement a very thorough process of deciding a down round. A good practice is to have directors deliberate over all the available sources of liquidity and circumstances of the company. Document why those sources are not as good alternatives as a down round. Document why a down round is in the best interest of the company even though it may not be in the best interest of individual stockholders. Not being thorough may result in a costly derivative lawsuit.

Moreover, if the company's board of directors is dominated by one or several stockholders that control the board of directors and they are leading the current down round, then it will be wise for the board to form a committee of independent directors to review the down round or to have a vote by disinterested stockholders on the matter. This will make sure that the minority stockholders are treated fairly in the process, that the board of directors is not breaching its fiduciary duties and the controlling shareholders' liability is minimized. Worse than having a down round is having a contested down round.

Finally, identify all the slow-moving parties that will need to participate in the down round. Typically, corporate investors will require longer turnaround times than other venture capital firms. Prepare the conversation with your corporate investors well in advance, whether they have participated in your previous round and will need to executed documents related to the current down round or they are new investors. Otherwise, the risk is that your company will run out of liquidity before the round is raised.

Down round terms and related documents

In a down round, even more than in a regular round, it is important to review and understand the incentives of your previous investors. Update the company's capitalization table and model several scenarios to understand how conversions, anti-dilution protections or participation rights previously granted would play out with the terms of the new financing. Also, previous investors will not automatically enforce their anti-dilution provisions, and instead use them to negotiate other things with the company, such as pivoting or changing the management. The company and the founders could engage in a conversation with the investors to understand where their priorities are and what they can negotiate for themselves.

In a down round, the new investors are more likely than not to ask for one or several of such protective terms as enhanced liquidation preference, participating preferred stock, redemption rights, cumulative dividends, full-ratchet anti-dilution protection, “pay-to-play” provisions, consent rights, and others.

Beside the deal terms, the company will have to look out for the morale of the management and employees. Often times, a company raising a down round will be viewed as a “sinking ship” by its management and employees unless the company finds a way to incentivize them. The company can grant equity compensation awards, structure retention plans and management “carve out” plans, offer cash pay-outs to select employees or have a combination of these and other retention strategies.

To conclude, a down round will be a trying time for a company, but with a good process and understanding of the interests of various involved stakeholders, the down round will help the company continue its activity and support the various constituencies around it. A good counsel can help make sure that the process and terms of the round conform to company’s goals and help avert unnecessary risks.

For questions regarding this content, please contact the lawyers below or the Haynes Boone’s Emerging Companies and Venture Capital Practice Group.

* https://www.bizjournals.com/sanfrancisco/news/2020/04/01/lowered-valuations-for-11-bay-area-startups-could.html