

Considerations for Startups and Emerging Companies: Down Rounds

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PRACTICES Emerging Companies and Venture Capital

Startups and emerging companies often secure funding from investors in equity financing rounds. In an up round, the company raises funding in a subsequent round at a higher valuation than it had during the previous round of funding. Up rounds are viewed by investors as a positive indicator that the company is growing and that its wealth is increasing. As a result, up rounds boost investors' faith in the company and can often lead to market confidence and positive publicity. On the flip side, down rounds are when the company raises funding at a lower valuation in a later round of financing than it had during the previous round. Down rounds are viewed negatively by investors as they often indicate that a company is in trouble. There are a variety of factors that can lead to a down round, some of which include a slowing economy, a change or pivot in the company, or a shift in the market. It's important to note that down rounds are common in startups and emerging companies, and even more so in tech startups.

For that reason, there are a few key issues that these companies should be aware of in case they find themselves in this situation. During a down round, investors often ask for greater liquidation preference, anti-dilution protection, and tranche funding.

Liquidation Preference

Liquidation preference determines the payout order in the event of a Deemed Liquidation Event (most commonly a merger, consolidation, sale of control, or winding up of a company). In short, a liquidation preference is meant to protect investors (the preferred shareholders) by providing them the right to get their investment in the company back before common shareholders (often the founders) can receive any returns. Founders of startup companies must be aware of this when negotiating liquidation preference to investors during a down round, as the investor will typically have more bargaining power and may push for a larger multiple. The multiple is the amount the company must pay the investor before the common shareholders can receive any of the proceeds. If the multiple is too high, founders may be left with little to no payments for themselves when the company is liquidated.

Further, this risk is even greater if the investor negotiates for participating preferred shares. Participating means that in addition to its stated liquidation preference the investor has the right to share (by "participating") on a proportional basis in the distribution of liquidation payments from the Company that would otherwise be paid exclusively to the holders of Common Stock. Contrast this with non-participating liquidation preference where the investor can either exercise their liquidation preference and receive their initial investment back, or convert their preferred shares into common shares while receiving proceeds based on their equity ownership in the company, but not both. If possible, founders should avoid agreeing to participating liquidation preferences for investors. Alternatively, they may want to consider negotiating a liquidation preference cap in the event that a Deemed Liquidation Event were to occur. A cap sets a maximum payout the investor can receive for their participating liquidation preference, which is typically around 3x their investment amount.

Dilution

When companies issue new shares in subsequent rounds of financing, the existing shareholders' ownership in the company gets diluted. During a down round, the dilution is greater for the prior investors as the new investors are paying less per share than the prior investors. An anti-dilution protection provision is a way for investors to protect themselves during a down round (or other certain events specified in the provision). Typically, during a triggering event, the conversion ratio increases so that the investor receives a greater number of common shares for each preferred share they convert during a down round. It is important for startups and emerging companies to understand the events that can trigger this protection to avoid any surprises when financing at a lower valuation. Another option is for the company to grant the investor pro rata rights (see "[What Are Pro Rata Rights?](#)").

Tranche Funding

Lastly, tranche funding limits the amount of financing an investor will put into the company until specified milestones are met. This type of financing is beneficial to investors as it helps mitigate their risk and exposure in the company. However, this can put extra pressure on the company and its employees to reach the next milestone in order to secure an additional investment. Startups and emerging companies need to set these milestones carefully and ensure they are attainable should they negotiate tranche funding with an investor.