The Down Round Financing

What Every Officer, Director and Investor Needs to Know

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The Cause

Clearly, the deteriorating economic environment has worsened in the last six months of 2008 as evidenced by the credit crises, manufacturing slowdown, drop in real estate prices, and rise in unemployment. The market for venture capital has not been immune from the effects of this slowdown, which has resulted in decreasing valuations of companies seeking venture capital and caused certain companies to contemplate the consummation of a down round transaction. This article discusses the down round financing mechanism and the practical realities and legal considerations and protections that companies should understand during the planning process of such a transaction.

A Down Round Defined

A "down round" can generally be defined as a venture capital financing in which new investors place a lesser value on the company prior to their investment than was placed by prior investors in previous financing rounds. This (i) translates into the new investors paying a lower price per share, and (ii) receiving certain rights and preferences that are superior to the rights of the previous rounds' investors.

Dilution

The most evident and economically painful consequence of a down round is the dilution experienced by existing investors/stockholders. The goal of every initial investor at the time of its investment is for the company to continue to achieve its business objectives such that, as additional future capital is raised, the value of the company increases over time and fewer shares are sold. This limits dilution to existing stockholders. However, in a down round, the company must sell more shares than in the previous rounds in order to generate the same amount of cash. This erodes the existing stockholders' equity position.[1]

Why Consummate the Down Round?

In light of the significant financial pain that the company and existing stockholders experience as a result of the down round, the obvious question is why would a company consummate such a transaction? The answer is quite simple: without additional working capital there will ultimately be no company and the total investment will be worthless. One alternative to a down round might be the potential merger or sale of the company to a third party but, depending upon the stage of the company's development, such a sale would most likely be premature and also consummated at a deep discount to what the founders, investors and board have targeted as an optimal exit value. Consequently, the theory behind a down round is that it provides the company sufficient cash to weather the current economic storm long enough to achieve additional business milestones thereby increasing its potential value either for the next round of financing or an ultimate liquidity event. There are historical examples to which many such companies undoubtedly look for inspiration where early stage companies survived economic downturns and subsequently rose like a phoenix from the economic ashes to become stalwarts within their respective industries: those that quickly come to mind are Dell Computer and Microsoft Corporation in the mid to late 1980s during the PC maker and software company crashes, and Google and Apple at the beginning of the current decade during the Dot Com bust.

What Provisions Will Likely Be Negotiated As Part of the Down Round?

The following constitute the most relevant legal provisions that will be negotiated as part of any potential down round:

• **Tranche Financing.** Investors may be inclined to invest just enough working capital to provide management and/or the board sufficient time to (i) seek the sale of the company, or (ii) achieve a particular business objective or milestone that increases company value so that a future "flat" or "up" round becomes more feasible.

• **Liquidation Preference.** The liquidation preference, which in a more favorable economic environment would typically be equal to a 1x return (i.e., the investors receive their entire investment back upon a liquidity event before there is any distribution of sale proceeds to other stockholders), may be more favorable for the investors in the down round and lead to a 2 or 3x multiple. Moreover, depending upon each party's leverage during the negotiations, the deal could involve the issuance of participating preferred stock (a double dip) with senior liquidation preferences at multiples of the purchase price, which investors would presumably value more if the possibility of a relatively worthless common stock is considered likely.

• **Anti-Dilution Protection.** Investors in down round financings, which by definition are viewed as riskier, may request full ratchet anti-dilution protection against additional down round financings. This is significant because, under normal conditions, a broad or narrow based weighted average anti-dilution protection would be deemed the reasonable alternative and would result in less dilution to existing investors were a future down round consummated. One common compromise with respect to anti-dilution protection is to include a full ratchet provision that remains in effect for only a certain period of time (i.e., six months or a year) with the anti-dilution protection thereafter converting into a weighted average formula.

• **CramDown/Pay-to-Play.** In extreme financing situations, as a precondition to the consummation of a down round, the new investors may require the conversion of all existing series of preferred stock into common stock in order to (i) decrease the aggregate liquidation preference, and (ii) make the realization of a liquidation preference for the new investors more feasible upon a liquidity event. Such a "cramdown" can lead to the resulting common stock having little to no real value. Additionally, many dilutive financings implement a pay-to-play mechanism whereby existing stockholders not participating in the new round of financing are penalized by being forced to convert into common stock or a shadow preferred stock with lesser protections than what they originally enjoyed as a preferred stockholder upon their initial investment. Finally, new investors in a down round may require existing investors to waive any anti-dilution protections they may enjoy as a result of the down round thereby experiencing unanticipated additional dilution.

• **More Favorable Terms.** As an alternative, or in addition, to modifications to the rights of those existing investors who do not participate, current participating stockholders may receive additional benefits over current non-participating stockholders. For example, they may (i) have their preferred stock repriced via an adjustment to the conversion ratio thereby giving them a lower valuation for their original investment, (ii) be given the opportunity to exchange their existing preferred stock for new, more favorable preferred stock (i.e., a senior liquidation preference), or (iii) receive more protective representations and warranties, broader indemnification rights, or other similar investor-favorable protections.

• **Management Retention/Incentive Plans.** Finally, some financings may involve large stock option grants to offset the dilutive effects of the financing to management and employees. But where the practical economic effect of the down round is to make the company's common stock (and by extension stock options) worthless, the new investors may require the company to implement cash retention plans for management and employees that enable them to receive a certain percentage of sale proceeds upon a liquidity event regardless of the value of their common stock at the time of sale.

• **Convertible Debt.** While a "down round" typically connotes an equity round at a reduced price per share, in an environment in which value is decreasing, investors might, for a variety of reasons, propose convertible debt over equity securities. The most obvious reason would center on the fact that in a risky investment environment, voting control, as reflected by percentage ownership and valuation, may be deemed secondary to the return of capital upon a liquidity event or, more importantly from a down side perspective, protection in the event of the company's bankruptcy. This financing mechanism could involve the issuance of secured convertible debt that is senior to other company debt and might require the payment of a multiple of the principal amount upon a liquidity event or conversion into equity at a higher multiple of the principal.

The Problem of the Interested Director Transaction

Most down rounds involve an interested director transaction. This generally means that one or more directors has a material financial interest in the outcome of the deal that isn't shared by the company, the other directors, or the shareholders generally (such as a VC director). This potential conflict is exacerbated when such directors constitute a majority of the board and/or exercise material control over the board's actions.

The Applicable Standard

Most board financing decisions are subject to the Business Judgment Rule (BJR), which assumes that the board acted in the best interest of the company and its shareholders. Normally, such decisions are upheld by courts, if challenged, provided that the decisions were made in good faith and with due care, which obviously gives the board broad discretion regarding the underlying terms of any down round of financing.

BJR versus Entire Fairness Test

However, due to the significant likelihood that a down round will be either substantially or entirely led by insiders, a board's decision to proceed with such a transaction runs the risk of losing the presumptive protection of the BJR and being subject to the Entire Fairness Test (EFT). The EFT states that the actions of the board will only be upheld if the entire transaction is fair, with the primary determinative criteria being the adequacy of the (i) purchase price achieved, and (ii) the process utilized to arrive at the negotiated price and applicable terms. This is significant because a finding by a court that a board did not satisfy the EFT, if deemed applicable, can result in personal liability to the director(s), raises questions about whether the transaction was properly authorized, and can be determinative of whether the deal should be voided in its entirety.

Recommended Steps for a Down Round

In light of the foregoing, the following steps should be taken for a company to complete a down round that is an interested director transaction without exposing the deal or the directors to unreasonable legal risks:

• Create a committee of independent and disinterested directors to evaluate and approve the proposed terms of the financing.

• Alternatively, obtain a majority approval from the disinterested directors or stockholders after full disclosure of all material facts regarding the deal. As part of this process, obtain an independent third valuation from an investment banker, if possible, or outside investor that leads, or at least participates in, the financing.

• In connection with the down round, consider making a rights offering to all existing stockholders including founders, management, and employees so that they will have the opportunity to (i) try to maintain their relative respective equity percentages that existed prior to the down round, or (ii) at least limit the down round's dilutive impact. However, also be cognizant that this mechanism will raise a set of additional legal issues pertaining to each offeree's accredited investor status as well as both federal and state securities laws requirements and/or applicable exemptions.

Conclusion

One cannot predict when the current economic environment will improve nor when the necessity and occurrence rate of down round financings will dissipate. Although each company's situation will vary, the requirement to effectively negotiate acceptable terms and conditions in a down round will be paramount. Moreover, although down round financings will present many business and legal challenges, the recommendations above should serve to limit the likelihood of unanticipated and unnecessary legal problems.

If you would like to discuss aspects of a down round of financing, or to learn more about Morse's venture capital practice, please contact **Mary Beth Kerrigan**.

Footnote:

1. There are certain protections typically afforded to initial venture capital investors to limit the effects of such down rounds (i.e., anti-dilution protection in the form of either broad or narrow based weighted average protection or the more onerous full ratchet mechanism) but, as a condition to the consummation of most down rounds, the new investors may require existing investors to waive such anti-dilution protections thereby mandating dilution. In any event, even if such anti-dilution protection were permitted, it would not benefit the common stockholders who would be diluted even further by such a mechanism.