CLIENT ALERT

VC 'Down Round' Financings, Part Two

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For existing venture capital investors, a “down round” financing may be necessary to salvage the value of their investment. Down round investors have at their disposal a variety of potential investment terms (including changes to the existing investors’ rights) to protect their downside and enhance their upside, and, given the context, they are often successful at obtaining them. If, however, the investment terms offered by the down round investors are too draconian, the existing investors should consider proposing alternatives that adequately de-risk the down round investment, but do not unnecessarily sap value from the prior rounds.

In our previous article, we discussed that when faced with a “down round” financing the existing investors must be vigilant to ensure that their interests are adequately protected – with a focus on policing their anti-dilution protections. In this article, we examine a few of the terms that down-round investors may require as a condition to the new financing – and the impact those terms have on the investors in prior rounds.

Full Ratchet Anti-Dilution Protection for Down Round

Most VC investors will have “weighted average” anti-dilution protection to reduce the impact of a future down round. However, the down round investors may require “full-ratchet” anti-dilution protection – which effectively re-sets their conversion price to the lower price per share sold in any future down round (without taking into account the number of shares to be issued as compared to the number of shares outstanding). If the down round investors’ full-ratchet anti-dilution protection is triggered by a future down round, this could result in significantly more dilution to the prior round investors that only have weighted average anti-dilution protection. Of course in this context – a down round followed by an even lower priced down round – the company may well have such fundamental problems that the earlier investors’ ability to recoup their investment is at risk. So, trying to block the down round investors from receiving full-ratchet anti-dilution protection may not be worth the effort.

Waiver or Adjustment of Anti-Dilution Protection for Prior Rounds

VC investors typically have price-based anti-dilution protection that is triggered by subsequent issuances at a lower price per share. Down round investors often condition their investment on the waiver of such anti-dilution protection in connection with the down round. Down round investors may also require that the prior round investors agree to reduce the trigger price for their anti-dilution protection to the down round price per share. This prevents dilution of the down round investors by a subsequent round priced above the down round but below one or more prior rounds. Prior round investors, of course, would prefer to only waive their anti-dilution protection for the current down round, rather than permanently re-set their anti-dilution trigger price. Whether they can obtain this more limited erosion of their anti-dilution rights will depend on how critically the company needs the down round financing.

Prior round investors should consider whether, instead of agreeing to waive their negotiated anti-dilution protection for the current down round, to force the founders and other common stockholders to bear the dilution that results from the anti-

dilution protections of the prior round investors. Specifically, if the anti-dilution adjustments are effected for the prior round investors and the down round price per share is calculated based on the post-adjustment fully-diluted capitalization of the company, then the down round investors should not object since their interests will be protected.

Reduction of Liquidation Preferences of Prior Rounds

Down round investors may also condition their investment on a reduction of the existing investors' liquidation preferences. For example, they may require that the liquidation preference of each prior round be reduced to a specific percentage of its current amount. This reduces the overall preference stack and provides the down round investors additional headroom to absorb further value erosion of the company. Of course, this reduces the downside protection for the prior round investors. This concession may be more palatable to existing investors with a liquidation preference that is a multiple of their price per share (e.g., reduction of a 2x liquidation preference to a 1x liquidation preference). However, existing investors should ensure that any such reduction of their liquidation preference does not impact their conversion price (i.e., each preferred share should still convert into one common share).

Prior round investors, however, may prefer that instead of reducing their liquidation preferences, they offer the down round investors a liquidation preference that is a multiple of the down round price per share. This would force the existing common holders to bear much of the risk of the liquidation preference multiple.

Senior Liquidation Preference for Down Round

Down round investors may also require a senior position in the liquidation waterfall (or, in some cases, the conversion of existing preferred shares into common shares). This substantially de-risks the downside for the down round investors – since in a liquidation or sale, they will be paid their full liquidation preference before any proceeds may be paid on any prior round shares. Alternatively, down round investors could achieve seniority over the existing preferred by investing in convertible notes (generally convertible into the next round at a discount) – this also avoids having to agree on a company valuation during uncertain times.

Participating Preferred for Down Round

If the company lacks alternative financing sources, it is not unusual for down round investors to ask for participating preferred stock – upon a liquidation event, this entitles them to the return of their initial investment (or more, if they also require more than a 1x liquidation preference), plus a share (on a pro rata basis with the common stock) of any proceeds that remain after the liquidation preferences of all preferred stock have been paid. In some cases, these participation rights are subject to a cap on the overall return. Participating preferred stock increases expected returns, since the holders are not required to choose between receiving their liquidation preference and getting paid on an as-converted basis.

Existing investors may prefer to give the down round investors a senior liquidation preference rather than a liquidation preference multiple or participating preferred – if they remain sufficiently bullish on the company's value. That is, they may wish to give the down round investors more downside protection and concede as little upside value as possible.

Other Down Round Rights

If the company has not yet produced a marketable product (e.g., software, a device or a drug), down round investors may only agree to invest in installments – with the funding of later installments conditioned on the achievement of certain milestones. Down round investors may also require one or more of the following rights: cumulative dividends; extensive approval rights; redemption rights (generally exercisable after 5 years); rights of first refusal and co-sale rights over transfers by existing preferred investors; and control of the company's board.

Requisite Consents of Prior Rounds

Changes to the anti-dilution protections, liquidation preferences or other rights of prior rounds will require the consent of the existing investors. This may require the consent of the holders of a majority (or a higher percentage) of all existing preferred (voting together as a single class) and/or each existing series of preferred (voting as a separate class), depending on the voting provisions in the current charter and investment documents. If separate series votes are required, the risk of the investors in a series not consenting, and thereby holding up the transaction, increases.

As a general proposition, it may be somewhat easier to obtain the requisite consents if the preferential terms of the down round financing are largely contained within the rights attaching to the new down round preferred, rather than requiring amendment to the terms of the existing preferred (e.g., down round preferred with a liquidation preference multiple, rather than a reduction of existing preferred liquidation preferences). Where obtaining the down round financing is critical to survival of the company, it is important to structure the financing terms to minimize the risk of hold-up by the investors in a prior round.

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