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# CLIENT ALERT

## VC 'Down Round' Financings, Part One

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Venture capital investors provide funding to early-stage growth companies through a series of equity financing rounds, typically by purchasing newly issued convertible preferred stock. For each round, the investors and the company agree on the current value of the company and that value is used to establish the fully-diluted per share value of the common equity. That per share value is used to set the price per share of newly issued convertible preferred and the initial conversion price (i.e., the initial conversion rate is 1:1).

If the company's fortunes continue to improve, you might expect each successive financing round to be at a price per share that is higher than the price per share of prior rounds. And that is how it has played out for many VC-backed growth companies in recent years.

Now, however, with COVID-19 exerting pressure on the global economy, down rounds (i.e., rounds priced at a lower valuation than the prior round) likely will become more prevalent. A down round triggers anti-dilution protections, which automatically adjust the conversion price of each higher priced earlier round of convertible preferred (unless waived by the requisite percentage of preferred holders, which may be required by the down round investors).

Although such conversion price adjustment is self-executing, investors should not sit on their hands. The company will calculate the adjusted conversion prices, and both down round investors and the company's existing investors risk excess dilution of their interests if they do not verify the accuracy of those calculations. Down rounds can also raise conflict issues and subject the company to an increased risk of litigation, so both down round investors and the company's existing investors should ensure that the board and any controlling stockholders properly discharge their fiduciary duties. Although the core risks faced by down round investors, existing investors and the company's board are related, successfully navigating a down round requires investors to understand the risks from three different perspectives.

**From the Down Round Investor's Perspective:** To avoid mispricing the down round shares, it is critical for down round investors to ensure that the adjustment to the conversion price of each higher priced earlier round is accurately calculated (unless the down round investors are able to require waiver of the anti-dilution protections as a condition to their investment). To verify the calculations, down round investors must not only confirm the price per share and the current conversion price of each prior round, but also the type of anti-dilution protection that is in place. Adjustments based on "full ratchet" (as opposed to "weighted average") anti-dilution protections will have a more dramatic impact on the company's fully-diluted capitalization. Down round investors should also ensure that the down round price per share is calculated based on the company's post-adjustment fully-diluted capitalization (which complicates the calculation of both the down round price per share and the conversion price adjustments). And when reviewing the preferred stock voting thresholds in the down round investment documents, down round investors should take into account the impact of such adjustments, as the preferred voting right thresholds are generally determined on an as-converted basis.

**From the Existing Investor's Perspective:** For an existing investor that participated in earlier higher priced rounds to ensure that it gets the full benefit of its negotiated anti-dilution protection, it must confirm that the company has accurately calculated the adjusted conversion price for each series of convertible preferred held by the existing investor. In addition, to avoid excess dilution, each existing investor must also confirm the accuracy of the adjusted conversion price calculations for all earlier higher priced rounds that it did not participate in, as well as the company's calculation of the down round financing price per share. Existing investors should also consider whether they are required to "write down" the value of their existing interests in the company, due to the decreased company valuation reflected in the down round.

**From the Board's Perspective:** A down round creates an increased risk of litigation by existing investors who will likely be disappointed by the dilution of their interests, so the board should take extra care with the approval process. Where a majority of the board is disinterested, approval by the disinterested directors generally should suffice to preserve the "business judgment rule" standard of review in the event of litigation. But if a majority of the directors are interested (e.g., they were appointed by existing investors that will participate in the down round, or they will participate in or otherwise benefit from the down round directly), or if a controlling stockholder will participate in the down round, then the more rigid "entire fairness" standard of review is likely to apply. In that case, one or more of the following procedural safeguards should be considered:

- form a committee of disinterested directors (which must have the authority to negotiate and approve the deal terms and hire its own advisors);
- obtain a fairness opinion;
- condition the down round on approval by a majority of the disinterested stockholders;
- offer all existing stockholders the right to participate in the down round (even if they do not have contractual preemptive rights); or
- document the deliberation of the down round terms and efforts to find more favorable financing.

In sum, down round financings can put unwary investors at risk. Vigilance by both down round investors and existing investors is needed to ensure that their interests are fairly protected, and that the board and any controlling stockholders properly discharge their fiduciary duties.

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