Are You Down Round Ready?

In light of the recent market downturn, many companies may be required to raise money at a lower price per share than in a prior equity financing (a "down round"). This document highlights some key issues related to down round financing transactions.

Key Drivers:

- Inside vs. outside investors
- Severe decrease to valuation such that legacy preference and ownership are a burden
  - New money desire for multiples at lower valuations compared to legacy valuations
  - Consider employees buried under legacy preference
- Regardless of preferences, no single investor wants burden of all the risk while the reward is shared with other non-participating investors

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Carrots

Mechanics to help address legacy preference burdens.

Sticks

Mechanics to balance the risk with the reward.

Down Round

New round at lower valuation than prior rounds. Existing investors potentially receive antidilution adjustments.

Legal Considerations

Fiduciary Duties: All Board members and officers owe "Duty of Care" + "Duty of Loyalty."

Delaware Law: Typically affords Boards benefit of "business judgment rule" unless "insider" transaction.

"Insider" + "Interested Party" Transactions: Not afforded benefit of business judgment rule and instead there is burden placed on Board to defend fairness of transaction.

"Pull Through" Pay-to-Play

All preferred converted to common and then participating investors exchange common shares for new preferred stock having substantially the same rights as the converted preferred (i.e., "pulling through" legacy shares to the newly created preferred stock).

Reset

Financing designed to severely reduce ownership of existing stockholders.

Employee Considerations

- New option pool refresh.
- Option repricing of legacy awards.
- Management Carve Out Plan: Typical to set aside a portion of sale proceeds (10–15% of proceeds) as a "carve out" for employees that stick around to get the deal done.

Classic Pay-to-Play

Charter amended prior to new financing with "pay-to-play."

Existing investors that don't purchase "pro rata" of new financing converted to common and lose rights—preferences and Board seats being most impactful.

"Pro rata" most typically defined as percentage of preferred ownership.

Cheat Sheet on Process

- Disinterested lead investor
- Disinterested approval by Board
- Empowered disinterested committee of Board
- Disinterested stockholder approval
- Process of "rights offering"
- Rights offering to all eligible stockholders (typically just preferred stockholders)
- Documented search for new financing or sale (does not require a banker, but that helps)

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