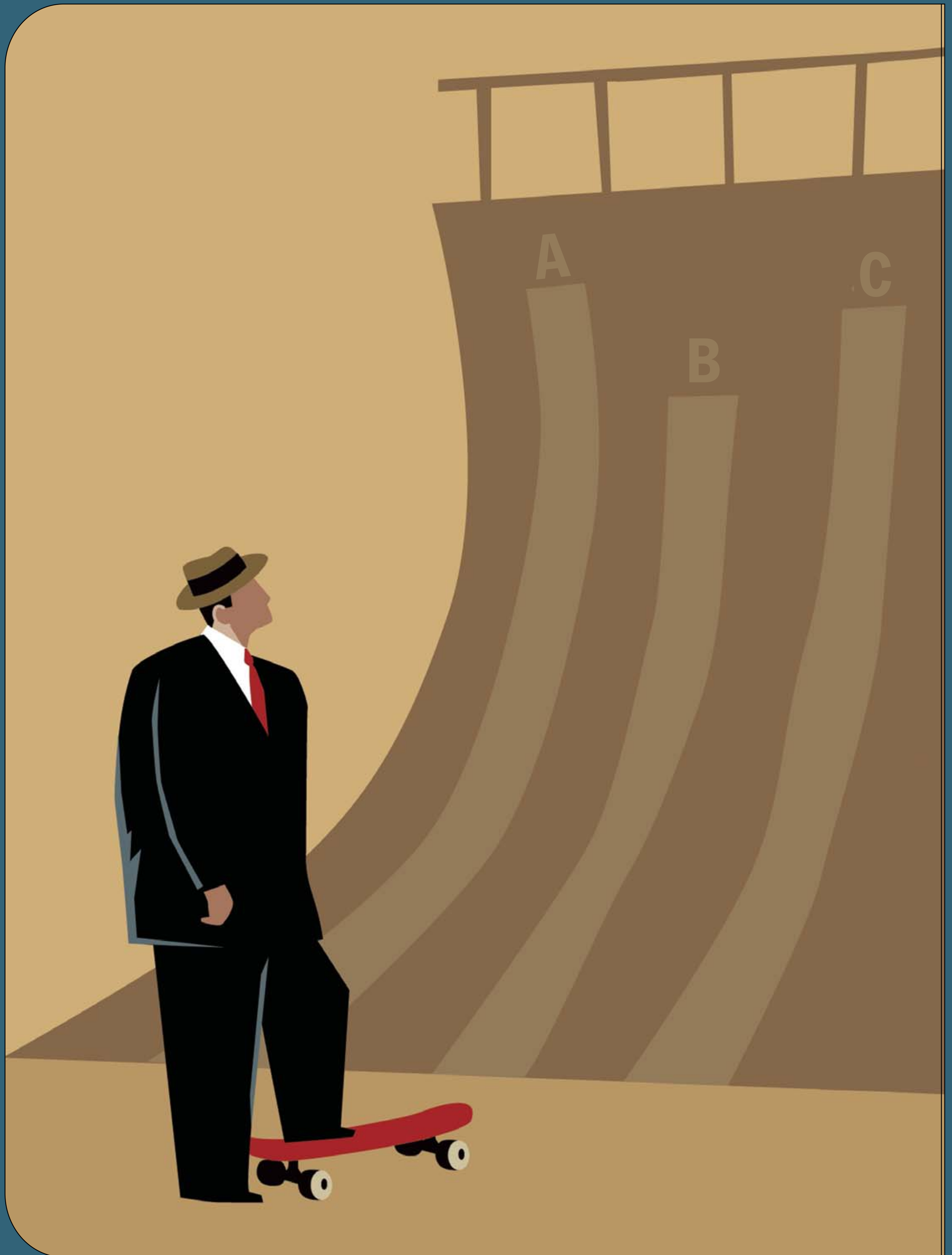
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Navigating Down Round Financings:

A Guide for VCs

BY

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IN TODAY'S TROUBLED ECONOMY, DOWN round financings have almost become the norm, as many portfolio companies ("PCs") are forced to raise money by selling new securities at lower prices than earlier financing rounds. Down rounds often significantly dilute the ownership interests of investors who bought the PC's securities in earlier, higher-priced rounds, and thus the PC's board of directors and the down round investors face increased risk of litigation by earlier round investors whose interests are being diluted.

This article identifies litigation risks to venture capital/private equity investors ("VCs") participating in a down round financing and methods for minimizing these risks. This article also discusses advantageous techniques and subtle traps in negotiating and documenting a down round, including complex antidilution clauses, majority vote provisions and minority veto powers. Such risks, techniques and traps are covered from the perspective of both (1) a VC that participated in the earlier, higher-priced round and also participates in the subsequent down round and (2) a VC whose initial PC investment is in the down round.

I. Delaware Corporate Law Issues[1]

A. Interested Directors

The PC's board often includes representatives from one or more VCs that participated in an earlier, higher-priced round and also participate in the PC's new down round financing, and thus those representatives constitute "interested" directors. Where a majority of the PC's board is composed of

[1] Although the following discussion assumes that the PC is incorporated in Delaware so that Delaware corporate law applies, the laws of most other states are similar to Delaware law on these issues.

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interested directors, the board's approval of such financing is not protected by the business judgment rule.[2] Instead, the financing is subject to the stricter "entire fairness" standard of review, under which directors, if challenged in court, must generally prove both (1) fair dealing (i.e., that the transaction process was fair) and (2) fair price (i.e., that the financial terms of the transaction were fair).

B. Procedural and Substantive Safeguards

Where the PC's board contains interested directors (and particularly if a majority of the board is comprised of interested directors), the PC's board should take one or more of the following steps to build a record of its decision and decision-making process to support a finding of entire fairness in the event of litigation:

- *Form Independent Committee*. If any PC board member has a conflict of interest (e.g., such director is a representative of a VC purchasing part of the down round financing), such interested director should not control the board approval process. In addition, where a majority of the PC's board has a conflict of interest, the board should consider forming an independent committee composed of independent and disinterested directors to evaluate, negotiate and approve the down round financing's terms. Proper use of such a committee should shift to any challenging stockholder(s) the burden of proving that the down round financing was not entirely fair. Such committee must have actual authority to make decisions regarding the financing and negotiate the terms of such financing and must be free from undue influence by interested parties (including controlling stockholders).
- *Obtain Disinterested Stockholder Approval*. If the PC's board is composed entirely of representatives of VCs investing in the down round, it may not be possible to form an independent committee. Instead, the board should consider seeking approval from a majority of the PC's disinterested stockholders, in which event the board's decision should be subject to the business judgment rule,[3] so long as stockholders have received all material information necessary to make an informed decision about whether to approve such transaction (including disclosure of material conflicts of interests).
- *Shop the Deal*. To support the board's determination that the PC down round price is fair, the board should consider soliciting outside investors to determine whether outside financing is available on the same or better terms. Sometimes the PC's board has insufficient time to seek other financing alternatives and existing investors are forced to provide financing to the PC on short notice to avoid a liquidity crisis. In such cases, the existing investors should consider providing short-term bridge financing to allow the PC time to search for better long-term alternatives. If the PC is unable to refinance the bridge within a specified time frame, the bridge investment could automatically convert into the down round financing.
- *Obtain Fairness Opinion*. To further support the value determination, the board should consider retaining an investment banker or other financial advisor to render an independent valuation of the PC and advise on, and deliver an opinion with respect to, the fairness to existing stockholders of the down round financing terms.
- *Offer Existing Stockholders the Opportunity to Participate*. Whether or not contractual or statutory preemptive rights exist, if existing investors are being substantially diluted, the board should consider offering the right to participate in the down round financing to all existing stockholders so that

[2] The business judgment rule is a judicially created presumption that in making a business decision, the director acted on an informed basis, in good faith and in the honest belief that such action served the PC's best interests. Under the business judgment rule, courts give considerable deference to, and do not independently review the merits of, the board's business decision.

[3] However, in a case involving breach of a controlling stockholder's fiduciary duties (discussed in Section C below), disinterested stockholder approval merely shifts to the challenging stockholder the burden of proof with respect to the entire fairness standard.

they can (if they wish) maintain their ownership interests in the PC. If time does not permit the offer to occur prior to the necessary funding date, the PC's board could instead provide existing stockholders the opportunity to purchase their pro rata share for a specified period after completion of the down round financing.

In order to sell securities in compliance with federal and state securities laws without a time-consuming and expensive registration process, the PC will likely rely on the exemption from federal registration afforded by either § 4(2) of the Securities Act of 1933 or the private placement safe harbor of Regulation D promulgated thereunder, as well as comparable exemptions from state registration.

Under Reg D, a PC may raise up to $1 million from an unlimited number of investors. If the PC is raising more than $1 million, Reg D allows only "accredited investors," plus up to 35 nonaccredited investors, to participate in the offering and, if the PC is raising more than $5 million, also requires each nonaccredited investor to be sophisticated (or to appoint a sophisticated purchaser representative).

If the down round exceeds $1 million and the PC has more than 35 nonaccredited stockholders who want to participate in the round, the PC cannot rely on Reg D for an exemption from registration, in which case the PC would have three choices:

(1) Incur the expense and delay of federal registration,

(2) Rely on § 4(2)'s ambiguous private placement exemption if the facts support such an approach, or

(3) Exclude some of the nonaccredited stockholders so that there are no more than 35 nonaccredited participants in the down round.

◎ *Document Exercise of Fiduciary Duties*. The board should fully document all methods used to satisfy its fiduciary duties.

C. Fiduciary Duties of Controlling Stockholder(s)

In general, a stockholder may act in its own self-interest when acting solely in its capacity as a stockholder. However, in some circumstances, a "controlling" VC stockholder (i.e., one that owns a majority of the PC's stock or otherwise exercises actual control over the PC's business affairs) may have a fiduciary duty to minority stockholders.

When a controlling VC stockholder plays a role in establishing the down round financing terms, such VC has a duty not to use its control over the PC or the process to exploit the minority stockholders. A transaction between the PC and the controlling stockholder — where the controlling stockholder derives a benefit to the detriment of the minority stockholders — is generally reviewed in court under the entire fairness test.

Hence, where the controlling VC stockholder buys all or part of the down round, the procedural and substantive safeguards discussed in Section B above (in the context of board duties) should be employed by such controlling VC in order to shift the burden of proof to any stockholder challenging the VC's conduct (as a controlling stockholder) with respect to such financing.

D. Amending Existing Equity Terms

In connection with a down round financing, the PC often needs to amend the existing preferred stock terms. For example, an amendment may be necessary to (1) carve out the down round series from the application of antidilution protection provisions in the PC's charter, (2) grant rights to designate directors, rights of first offer or first refusal and tag-along rights, and/or (3) extend registration rights to the down round series.

Under Delaware law, any amendment to the PC's charter that would adversely affect the powers, preferences or special rights of a class or series of stock requires the approval of a majority of such class or series. The PC's charter or other governing documents may provide

for a greater percentage vote for the approval of any amendment to the applicable stock terms.

A stockholders agreement or registration rights agreement may also contain provisions attempting to protect minority investors from being stripped of their rights. Although the exact language varies, such contracts often require approval of affected securityholders if the amendment adversely affects the rights of such holders relative to other securityholders. These provisions vary significantly and must be reviewed carefully to confirm that no minority stockholder has a veto right over an amendment.

Sometimes the PC's board or controlling stockholders seek to amend the terms of an existing preferred series (or other contractual rights) in such a way as to encourage the PC's stockholders to participate in the down round. For example, the holders of a majority of the existing preferred series might waive antidilution protection while the PC offers the existing preferred stockholders an opportunity to exchange their existing preferred series for a new identical preferred series (which captures the benefit of the antidilution provisions), contingent upon such exchanging stockholder investing its pro rata share of the new down round series. While the concept of "exit consents" (i.e., approving an amendment to securities surrendered in the transaction) is common in amending bond indentures, it does not appear that Delaware courts have yet blessed this practice in the context of amending equity terms.

E. Eliminating Existing Equity

If the PC's board determines that the existing PC equity value is zero or de minimis, VCs participating in the down round may wish to "eliminate" the existing equity so that the PC's stockholders going forward include only those investors participating in the down round financing. Otherwise, the board and down round investors may be subject to continuing fiduciary duties to stockholders with de minimis ownership. Without filing for Chapter 11 bankruptcy, there are a variety of methods a PC can use to expunge existing equity, each of which presents its own legal issues. Some of these methods include:

- *Merger into Newco*. The PC can merge into a new entity ("Newco") and pay nominal cash consideration to existing stockholders in the merger, so that down round investors own 100% of Newco and existing stockholders are "squeezed out." Under current Delaware law, practitioners generally believe that existing "squeezed out" stockholders must be given at least nominal consideration in the merger, though the Delaware bar is currently considering proposing statutory amendments that would expressly permit cancellation of shares in a merger without payment of consideration.

  Under Delaware law, the merger may be effected with majority board and stockholder approval unless the PC's charter or other corporate documents require a supermajority vote. Minority stockholders who do not participate in the merger may be entitled to seek appraisal rights.
- *Reverse Stock Split*. The PC can amend its charter (if necessary) to prohibit the issuance of fractional shares and then adopt a reverse stock split so that all of the existing equity is cashed out for a nominal amount. Under Delaware law, the charter amendment may be effected with majority board and stockholder approval (absent express supermajority voting requirements).

In each of these cases, the PC's board must exercise its fiduciary duties and should consider the procedural and substantive safeguards discussed in Section B above.

F. Indemnification

New VCs should scrutinize the indemnification provisions in the PC's charter to ensure that they provide indemnification for their board representatives to the

fullest extent permitted by law, although Delaware corporate law prohibits indemnification of directors for breach of the duty of loyalty (i.e., self-dealing). Also, VCs investing in a down round should require broad indemnification provisions in the transaction agreements to protect such VCs against claims from existing stockholders relating to the financing.

II. Dilution

A. Antidilution Formulas

VC investments are often made in the form of convertible preferred stock entitled to a senior liquidation preference (to protect the VC if the value of the stock does not appreciate) and entitled to convert to common stock at a mutually agreed conversion price (to reward the VC if the investment does appreciate).

Preferred stock terms generally include antidilution formulas designed to protect investors from economic dilution as a result of future issuances of common stock (or options exercisable for or securities convertible into common stock) at a price below either (1) the fair value ("FV") of the common stock at the time of the subsequent investment or (2) the conversion price of such preferred stock. That is, if a subsequent investment is made in the PC at a price lower than either the then FV of the common stock or the preferred stock's conversion price, then the conversion price will decrease based upon a stated formula and the number of shares of common stock issuable upon conversion will increase.

For a successful PC, each new round of preferred stock financing is generally priced at a conversion price higher than the previous round (reflecting the PC's increasing common stock FV). In such case, a new financing round generally would not trigger antidilution provisions in the existing preferred stock (i.e., the price for the new round is at least equal to the common stock's then FV and exceeds prior rounds' conversion prices).

By contrast, in a down round financing, the investors purchase a new series of preferred stock at a price lower than prior financing rounds' conversion prices, triggering the antidilution provisions of existing preferred stock. In order to assure that antidilution provisions for existing preferred stock do not adversely affect the new investors, the new investors should require either that existing investors (1) waive the antidilution adjustments in connection with the down round financing and/or (2) calculate the amount of the new investors' investment after giving effect to the antidilution adjustments that will be triggered by the down round financing.

B. Adjust Conversion Price of Prior Rounds

However, simply waiving or taking into account antidilution adjustments at closing does not fully protect the new VCs. If the PC closes a future financing round at a price above the conversion price of the down round series, but below the conversion price of the preferred stock series existing prior to the down round series, then such future financing round will trigger only the antidilution provisions for the pre-down round preferred stock, to the detriment of the down round investors.

For example, assume PC has completed the following financing rounds: (1) in year 1, $500,000 common stock round at purchase price of $1 per share, (2) in year 2, $20 million series A preferred stock round with conversion price of $4 per share, and (3) in year 3 (the down round), $10 million series B preferred stock round with conversion price of $1 per share. Assuming that the series A waives its antidilution protection rights in connection with the issuance of the series B, the PC's capitalization immediately after closing the down round would be as shown in Table 1.

TABLE 1	NO. SHARES PURCHASED	PRICE PER SHARE	INVESTMENT AMOUNT	CONVERSION PRICE	FULLY DILUTED SHARE OWNERSHIP	FULLY DILUTED % OWNERSHIP
COMMON	500,000	$1.00	$500,000	N/A	500,000	3.22%
SERIES A	5,000,000	$4.00	$20,000,000	$4.00	5,000,000	32.26%
SERIES B	10,000,000	$1.00	$10,000,000	$1.00	10,000,000	64.52%
TOTALS			$30,500,000		15,500,000	100.00%

If in year 4, the PC issues $30 million of series C preferred stock with conversion price of $1.50 per share, then the antidilution provisions of the series A are triggered while the antidilution provisions of the series B are not. As a result of such antidilution adjustment, the conversion price of the series A would decrease from $4.00 to $2.59,[4] entitling the series A holders to an additional 2,722,008 shares of common stock upon conversion. Table 2 below illustrates the PC's capitalization after giving effect to the series C issuance and application of the series A antidilution provisions.

TABLE 2	NO. SHARES PURCHASED	PRICE PER SHARE	INVESTMENT AMOUNT	CONVERSION PRICE	FULLY DILUTED SHARE OWNERSHIP	FULLY DILUTED % OWNERSHIP
COMMON	500,000	$1.00	$500,000	N/A	500,000	1.31%
SERIES A	5,000,000	$4.00	$20,000,000	$2.59	7,722,008	20.20%
SERIES B	10,000,000	$1.00	$10,000,000	$1.00	10,000,000	26.16%
SERIES C	20,000,000	$1.50	$30,000,000	$1.50	20,000,000	52.33%
TOTALS			$60,500,000		38,222,008	100.00%

As shown in Table 2, the series B bears a significantly higher percentage of the dilution caused by issuance of the series C round, as the series B ownership percentage decreases by approximately 59%, while the series A ownership percentage decreases only by approximately 37%.

One way for the series B investors to remedy this problem is to require, at the time of series B issuance, that the series A antidilution formula be amended so that in the future it will be triggered off the same conversion price as the series B formula. Using the same example, the series A conversion price would still be $4, but its antidilution protection rights would be triggered only if the PC issued future common stock (or options exercisable for or securities convertible into common stock) at a price below $1 per share (the series B conversion price).

Assuming the same facts as above, except that the series A antidilution formula is amended to be triggered only for future issuances below $1, the PC's capitalization would be as shown in Table 3.

TABLE 3	NO. SHARES PURCHASED	PRICE PER SHARE	INVESTMENT AMOUNT	CONVERSION PRICE	FULLY DILUTED SHARE OWNERSHIP	FULLY DILUTED % OWNERSHIP
COMMON	500,000	$1.00	$500,000	N/A	500,000	1.41%
SERIES A	5,000,000	$4.00	$20,000,000	$4.00	5,000,000	14.08%
SERIES B	10,000,000	$1.00	$10,000,000	$1.00	10,000,000	28.17%
SERIES C	20,000,000	$1.50	$30,000,000	$1.50	20,000,000	56.34%
TOTALS			$60,500,000		35,500,000	100.00%

As shown in Table 3, this amendment to the series A antidilution formula causes the dilution to be borne equally by both series A and series B, with each of their ownership percentages decreasing by approximately 56%.

C. Conversion of Accrued but Unpaid Dividends

If the preferred stock terms of all financing rounds provide that accrued but unpaid dividends may convert into common stock, the fully diluted common stock ownership percentage of the down round series relative to existing preferred stock series may shift over time so that the down round series would own a greater percentage of the fully diluted common stock than it did as of the date of issuance.

For example, assume PC has completed two rounds of VC financing: (1) in year 1, $25 million series A round with conversion price of $5 per share and 9% simple dividend rate and (2) in year 3, $25 million series B down round with conversion price of $1 per share and 9% simple dividend rate. The issuance of the series B causes the series A conversion price to be reduced to $1.76.[5] The PC's fully diluted ownership immediately after the series B down round closing (ignoring for simplicity the PC's outstanding common stock) would be as shown in Table 4.

[4] For purposes of calculating antidilution adjustments in this article, we are using the following weighted average antidilution formula: adjusted conversion price = ((conversion price x common stock deemed outstanding prior to dilutive issuance) + consideration received in dilutive issuance)÷(common stock deemed outstanding prior to dilutive issuance + common stock deemed issued in dilutive issuance). Applying this formula to the current example, the conversion price is decreased to $2.59: (($4.00 x 15,500,000) + $30,000,000)÷(15,500,000 + 20,000,000) = $2.59.

[5] By applying the formula described in footnote 4 to the current example, the conversion price is decreased to $1.76: (($5.00 x 5,900,000) + $25,000,000)÷(5,900,000 + 25,000,000) = $1.76.

TABLE 4	NO. SHARES PURCHASED	PRICE PER SHARE	DIVIDEND RATE	INVESTMENT AMOUNT	ACCRUED DIVIDENDS	CONVERSION PRICE	FULLY DILUTED SHARE OWNERSHIP	FULLY DILUTED % OWNERSHIP
SERIES A	5M	$5.00	9%	$25M	$4,500,000	$1.76	16,761,364	40.14%
SERIES B	25M	$1.00	9%	$25M	N/A	$1.00	25,000,000	59.86%
TOTALS				$50M			41,761,364	100.00%

Three years after the series B down round closing, the relative ownership of the PC would shift as illustrated in Table 5. Because the series B's accrued dividends are converted into common stock at a lower conversion price ($1.00 per share) than the series A's accrued dividends ($1.76 per share), the relative ownership of the series B increases by approximately 1%, while the relative ownership of the series A decreases by approximately 1%.

TABLE 5	NO. SHARES PURCHASED	PRICE PER SHARE	DIVIDEND RATE	INVESTMENT AMOUNT	ACCRUED DIVIDENDS	CONVERSION PRICE	FULLY DILUTED SHARE OWNERSHIP	FULLY DILUTED % OWNERSHIP
SERIES A	5M	$5.00	9%	$25M	$11,250,000	$1.76	20,596,591	39.35%
SERIES B	25M	$1.00	9%	$25M	$6,750,000	$1.00	31,750,000	60.65%
TOTALS				$50M			52,346,591	100.00%

Existing investors should consider whether this type of shift would be significant enough over time to warrant amending the dividend provisions of the existing series of preferred stock (e.g., to increase the effective dividend rate) in connection with the down round.

III. Governance and Other Issues

When PC's existing investors acquire a majority of the down round, a new VC (i.e., a VC not previously an investor in the PC) participating in the new round is subject to the risk that such existing investors will have an incentive to act in a manner that would benefit their overall investment in the PC, possibly to the detriment of the new series. Because the interests of the new VCs and the existing investors may not be aligned, the new VCs should negotiate for veto rights and other protections against actions that could adversely affect the down round.

A. Conversion Provisions

For example, preferred stock terms commonly allow holders of a majority of the series to elect to convert *all* of the outstanding preferred stock of such series into common stock. It is also common for subsequent financing rounds to have liquidation rights senior to prior financing rounds. If on a liquidation or sale of the company, the PC's equity FV is below the liquidation value of all outstanding preferred stock, existing investors could elect to convert the down round series into common stock and thereby subordinate such series to their other PC investments.

To illustrate, assume (1) in year 1, VCs X and Y invest in a series A preferred stock with aggregate liquidation value of $20 million on a 50-50 basis and (2) in year 2, VCs X, Y and Z invest in a series B preferred stock with aggregate liquidation value of $15 million one-third each. If the PC were to liquidate in year 3 when its equity FV is $10 million, each of X, Y and Z would receive approximately $3.3 million for its series B (which has a $15 million liquidation preference), and series A would not receive any liquidation proceeds. If, however, X and Y have (and exercise) the right (as holders of a series B majority) to force all series B to convert to common stock, each of X and Y would receive $5 million for its series A (rather than $3.3 million for its series B) and the common stock issued to X, Y and Z upon conversion of the series B would not receive any liquidation proceeds.

Although controlling stockholders may be subject to certain fiduciary obligations (as discussed in Section IC above), new VCs should negotiate for approval rights over forced conversion of their preferred stock series to common stock to avoid this result.

B. Amendments and Waivers

Similarly, new VCs participating in a down round controlled by existing investors should require approval rights over amendments and waivers to the down round preferred stock terms. Otherwise, such existing investors could amend the down round terms in a manner that benefits their existing preferred stock (e.g., amendments or waivers to seniority, dividend rate and

payment terms, conversion rate, preemptive rights, restrictive covenants, etc.) and harms the down round investors.

C. Sale of the Company/Merger/Restructuring

New VCs should also require that the transaction agreements and the charter specifically provide for allocation of proceeds from a sale of the company, merger or other restructuring in accordance with the liquidation preferences set forth in the charter and prohibit avoidance of the down round preferred stock terms (by way of merger or otherwise).

D. Tag-Along Rights

VCs often enter into a stockholders agreement permitting VCs to "tag along" or participate in sales of preferred stock by other VCs. In a successful PC (where the equity value exceeds the aggregate preferred stock liquidation value), a preferred stockholder may have a right to participate pro rata in a sale of other series of preferred stock based on fully diluted common stock ownership, as the sale price would be based on the value of the underlying common stock being transferred.

Where, however, the PC's equity value is below the aggregate preferred stock liquidation value, holders of down round senior preferred stock would not want to permit holders of junior preferred stock to participate in their sale of senior preferred stock pro rata based on common stock ownership.

Instead, new VCs should require that tag-along rights be pro rata based on the amount each preferred holder would receive on a PC liquidation at FV, so as to prohibit junior, out-of-the-money preferred stock from participating in sales of senior preferred stock.

E. Redemption Rights

Preferred stock terms sometimes include provisions permitting the holders of a majority of such stock to require the PC to redeem such stock at face value (plus accrued and unpaid dividends) or other fixed price.

Where, in the future, the down round preferred stock's FV exceeds such stock's fixed redemption price, new VCs generally would not opt for redemption (absent liquidity concerns). However, if prior round investors hold a majority of the down round, they could mandate redemption of the down round preferred stock in order to increase the value of their other PC investments. To protect against such a forced redemption, new VCs should request approval rights over preferred stockholder-mandated redemption of the down round preferred stock.

IV. Conclusion

Down round financings have become increasingly common for troubled PCs in the current economic environment. Because of their dilutive effect on existing PC stock, a down round financing involves a higher risk of litigation from other PC investors. Thus, a PC's board approving, and VCs participating in, a down round should consider all available substantive and procedural safeguards to minimize this risk.

In addition, down round documents can be drafted to include subtle traps and advantageous techniques, such as complex antidilution clauses, majority vote provisions and minority veto powers. VCs investing as a minority investor for the first time in PC's down round should carefully review the financing documentation and negotiate for provisions that protect their investment from actions by existing investors. ◎