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LEGAL EAGLE

VENTURE CAPITAL IN FOCUS: DOWN-ROUND FINANCING

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For many companies that obtained funding before the burst of the Internet bubble, the concern now is obtaining funding necessary to continue operating the business. However, because of the inflated valuations that many companies received in the past, and current market conditions, many companies are receiving lower valuations than in earlier rounds of financing. Although not catastrophic by itself, if investors obtained down-round anti-dilution protection (particularly full-ratchet) in earlier rounds of financing, the lower valuations could be extremely dilutive to management and other shareholders of the company (since most venture capitalists usually demand convertible preferred stock, for purposes of this article, it is assumed that management and founders hold common stock and that the investors hold convertible preferred stock).

Down-round anti-dilution protection is incorporated into the terms of preferred stock to provide investors with additional stock if the company issues new shares at a price below the price paid by the preferred shareholders (typically the conversion price). This protection generally come in two flavors, weighted average and full-ratchet and is designed to protect the investors against decreases in the company's value. In both cases, the protection is obtained by having the conversion price adjust downward upon an issuance at less than the current conversion price, such that the investors will receive extra shares of common stock upon the conversion of the preferred stock for no additional consideration. Weighted average protection, which is the more customary type, results in an adjustment to the conversion price based on the average issuance price as determined by formula. Full-ratchet, a more recent variation and potentially far more dilutive than weighted-average, adjusts the conversion price to the lowest price per share at which the company sold shares in the down-round, irrespective of the number of shares issued or deemed issued.

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Tables 1 and 2 illustrate the difference between weighted-average and full-ratchet: Assume that a company has 1,000,000 shares of stock outstanding (750,000 common and 250,000 preferred) and that the preferred currently converts into common on a one-to-one basis based on a conversion price of $1.00. If the company sells 100,000 shares of common at $.25 per share, the dilutive effect is as shown in the tables.

The difference between weighted-average and full-ratchet can be staggering. Therefore, it is important to understand the key issues associated with completing a down-round, as well as negotiating down-round protection in an earlier round (the number of votes of the preferred shareholders and the value of the liquidation rights of most series of convertible preferred stock will also increase if down-round protection is triggered). The reality is that many times business needs will trump the desire to avoid the down-round protection, and as a result, the following illustrative list of items should be considered:

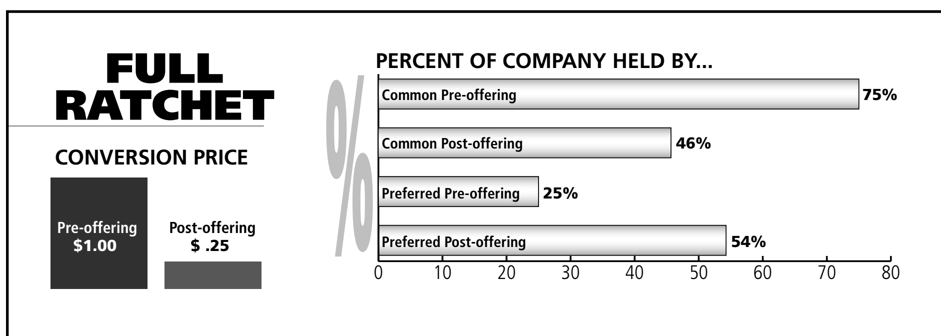

Table 1

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1. Negotiate. Try to limit the scope and effect of down-round protection. If the investors insist upon full-ratchet, negotiate to have it replaced by weighted-average after a stated period of time (e.g. six months or one year later). Also negotiate for as many possible issuances that will be treated as exceptions to the triggering of the anti-dilution protection (e.g. option grants, strategic investments, issuances to senior management, de minimis issuances). These exceptions are one of the more important issues to consider.

2. Realistic Projections and Valuations. By having realistic projections and valuations when negotiating earlier rounds of financing, a company should be better able to predict when it will need to obtain additional financing and can better evaluate the likelihood that a down-round will occur. In addition, if investors are comfortable with the valuation of the company, they may be more willing to accept weighted-average, while giving the company more latitude with respect to future exempt issuances of stock.

3. Board Concerns. When the board of directors approves a down-round financing, care should be taken in valuing the company. Directors have a duty to ensure that the company obtains fair value for shares of its stock. Existing shareholders who do not have down-round protection are generally unhappy when shares are issued to new investors at a price per share that is less than the price they paid for their shares or when their investment is severely diluted, and may question or attack the board's decision.

4. Key Advisors. The importance of having experienced legal, accounting and business advisors when negotiating a financing cannot be overstated. The time to include the advisors in the process is prior to negotiating the term sheet. The complexities associated with today's financings, and particularly the array of rights that investors are demanding, are generally beyond the scope of experience of many business people who do not spend their days negotiating the terms and conditions of these transactions. It is too easy to fall prey to the lure of the money and to concede valuable rights in the process.

5. Bridge Financing. Before agreeing to a down-round, consider whether any sources of debt financing (other than convertible debt) are available. While not necessarily a long term solution for troubled companies, debt financing may be sufficient for a company to weather the storm and avoid triggering down-round protection.

6. Pay or Play. While not an issuer negotiated item, if there are multiple investors in an earlier round of financing, the investors may require that as a condition of obtaining the benefit of the down-round protection in the future, each investor contribute its pro rata share of future financings.

7. Employee Concerns. Employees will not react favorably to investors obtaining full-ratchet because of the potential enormous dilutive effect it may have on the percentage ownership of the company the employees will receive upon exercise of stock options. Employees have abandoned companies over this issue.

8. Know your investors. Do your investors bring value to the company other than their investment (e.g. contacts, management, resources)? Sometimes, an investor who wants to invest less may actually bring more value to the table. The extra value, including who they know, may ease the concern about agreeing to give up more investor friendly down-round protection.

9. Investor Resources. Do your prospective investors have adequate resources to make additional investments in your company if other investors are slow to invest or if market conditions change? In the current market environment, many investors will fund portfolio companies before making new investments in other companies. In addition, investors who have already invested in the company may be more willing to waive their down-round protection if they are making an additional investment in the company.

The reality of financing in today's market is that investors will insist on down-round anti-dilution protection and, in the current market, quite frequently full-ratchet protection. However, before finalizing the terms of down-round protection, companies should understand the scope and significance of this protection to the company and how it could affect its ability to raise future capital.

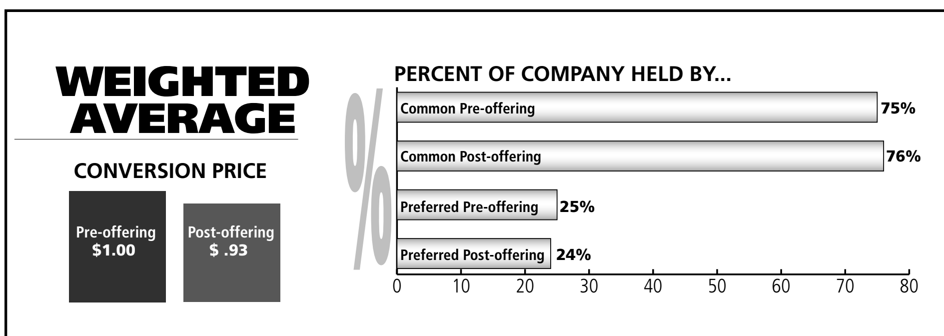

Table 2