Articles + Publications | March 16, 2023

Failing Forward: How to Raise a Successful Down-Round in 2023

WRITTEN BY

Thomas P. Dwyer | Daniel R. Sieck | Ethan Zook

What's a founder to do? Banks are collapsing; interest rates continue to creep upward; the IPO window remains limited; but growth-stage companies need capital and can only cut costs so much. With continued economic tightness expected in the first half of 2023, many startups may need to wrestle with a situation considered rare only a short while ago: raising money at a lower valuation than earlier rounds — the dreaded "down-round."

No one likes down-rounds, but it's important to note that down-rounds often occur as a result of macro-economic trends that impact valuations at the time of the capital raise — and not necessarily a sign that the company raising the round is fundamentally flawed. With careful planning, strong companies with unfortunate timing for their capital needs can raise a down-round, continue to grow, and then raise future rounds at higher valuations once the macro-economic climate improves. If anything, companies that survive an economic downturn often emerge as leaders of the next business cycle.

When contemplating raising a down-round, a startup's board must consider several factors. The board will need to be hypersensitive to these considerations because they could affect both the company's relationships with its key investors and the company's ability to raise money in the future.

Has the board determined there is no reasonable alternative to raising a down-round?

It goes somewhat without saying, but before proceeding with a down-round, a board should explore all viable options for raising capital other than through a down-round. For example, are there opportunities for joint ventures or strategic partnerships that could stave off the need to raise a down-round for the time being? If so, have they been explored fully? Are there debt options the board can pursue, such as mezzanine loans, venture debt, convertible notes, or SAFEs? Has the company explored courting new investors at an increased or flat valuation to the last round of fundraising? If so, what was their feedback? If not, can the company do so?

Even within a traditional preferred stock financing round there are other transactional levers to pull before raising capital at a lower valuation. For example, companies can offer new investors an increased liquidation preference, warrants, or a super pro rata right to get them greater upside. A financing round could be broken out into tranches with milestones and subsequent valuation step ups that provide for a bridge between the current valuation and the board's expectations. This is an area where creative counsel can greatly assist you.

Don't be afraid to call for help. In the past, some founders have been hesitant to hire a financial advisor to assist with the foregoing questions (often fearing that it signals weakness to the market), but when faced with a potential down-round, the company should strongly consider bringing in a financial advisor to help it navigate the market.

What would be the actual impact of a down-round on the company's existing stockholders?

A fundamental consideration before going too far along the down-round path is understanding exactly how the down-round would impact the company's current stockholders. Existing preferred stock investors in the company typically have special rights to encourage their investment, including rights that would give them down-round protections.

Anti-dilution provisions are the most common form of down-round protection. There are various flavors of anti-dilution protection, but by far the most typical formulation over the last decade has been the "weighted-average" approach found in National Venture Capital Association form documents. If an investor holds such a protection, when the company raises a down-round, the company will need to adjust the conversion price for the existing preferred stock based on a formula that weighs the relative impact of the number of shares issued and the price at which they were issued vis a vis the size and price of the prior rounds. The board should run a financial model to assess how the down-round will actually affect its company's capitalization before it seriously entertains the idea of a down-round.

Can the board persuade investors with down-round protections to waive them?

Investors with down-round protections can waive them in the event of a down-round. From a conceptual point of view, anti-dilution is not price protection; it is percentage ownership protection. That ownership percentage can be protected through means other than anti-dilution adjustments. In fact, it may be more efficient to all company stakeholders to give existing investors greater upside through new sweeteners, rather than forcing anti-dilution protection that impacts the entire capitalization table. In addition, a board can try persuading existing investors to waive protections for the good of the company and to help protect their existing investments, but realistically a board should be prepared to give something in return for any requested waiver. Investors with approval rights over the transaction will certainly weigh these concerns and consider their rights as possible leverage in the down-round transaction.

Governance best practices and approvals.

Despite its efforts, there may be times when a board has no choice but to proceed with a down-round. The board should ensure the documents allowing for and/or authorizing the down-round receive the necessary approvals and provide the necessary disclosures to cleanse the transaction of any actual or perceived conflicts. The importance of this process should not be overlooked, as investors who will have their pro rata percentage lowered as a result of the down-round may need to be courted into approving the transaction. It is best practice to seek legal counsel advice and document this process.

Additionally, directors should consider documenting their discussion of industry conditions giving rise to the need to raise a down-round. For example, documenting deteriorating business and fundraising conditions — including knowledge that competitors have had trouble raising money at previous valuations have been hit with lower valuations or have had cash flow issues — could dissuade any Monday morning quarterbacking suggesting a down-round was unnecessary. This market check activity will help establish valuation and terms and will also protect the board from potential claims of failing to act in good faith or in an informed manner.

If possible, a new outside investor could lead the down-round and set the valuation and terms. If only insider investors are involved, objectivity and conflicts could be suspected more readily.

Best practice would suggest getting the disinterested directors to approve the transaction. Sometimes, many or all of the directors have conflicts, so this is easier said than done. Additionally, the company's existing governing documents likely will require at least some level of stockholder approval to effectuate a down-round, and even if not required, it may be a good idea, especially if disinterested board approval was not obtained (or stronger support for the transaction is warranted). The backdoor stockholder approval mechanism is a rights offering, whereby the company allows the stockholders to participate in the down-round. This dampens the risk of later complaints of "why didn't I get a chance at that sweetheart deal?" Of course, if the stockholders hold preemptive rights, the board will need to send out a preemptive rights notice to those stockholders (or have such rights waived) and should pay careful attention to any timing requirements set forth in the governing documents.

Similar process, but different dynamics and terms.

At bottom, the general mechanics of raising a down-round are similar to fundraising at the same or a higher valuation than when a startup's most recent round was raised. But the dynamics of raising a down-round, and the environment in which the process takes place, make the process more critical. When exploring and ultimately pursuing a down-round, a board of directors will want to factor in several corporate governance, investor relations, and public relations considerations to avoid exposure both in a court of law and the court of public opinion. Further, due to a less favorable fundraising environment, a company may see more strict terms being requested, such as higher liquidation preferences, participating preferred stock, price protection terms (some of which could be less favorable than usual), pay-to-play provisions, redemption provisions, more and more strict protective provisions, staggered or staged financings, and senior co-sale or tag along rights. Each of these terms comes with its own set of considerations that should not be overlooked. All this suggests that we will likely see more down-rounds, so it is time to dust off the legal and business playbooks from years ago when such financing situations occurred with more frequency.

RELATED INDUSTRIES + PRACTICES

- Corporate
- Emerging Companies + Venture Capital

