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What's a Board to Do? Navigating a Down Round Financing

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In the high-stakes world of startups, securing capital can often feel like navigating a labyrinth. But what happens when the path leads to a down round? As economic pressures mount, many entrepreneurs face this challenging scenario, where raising funds means accepting a lower valuation than a prior round. This article delves into the board of directors' obligations as it guides a venture-backed company through the strategic maneuvers and critical decisions often found in a down round, and offers insights on how to leverage this situation to fortify your startup's future.

A "down round" is a term commonly used in private capital financing rounds in which the company's pre-money valuation (or effective pre-money valuation) is lower than the post-money valuation from its prior financing round. The lower valuation in the down round could result in more dilution for the existing equity holders than anticipated, potentially leading key stakeholders to oppose the financing altogether. As a result, down round financings often use features designed to secure participation from existing equity holders and their board appointees, whether through the form of additional incentives or potential penalties for not participating. Such features may include pay-to-play or pull-up mechanisms, compulsory conversions, warrant coverage, or super-priority liquidation preferences, all of which can present turbulent waters for a board of directors to navigate. [For more information on these different features, please see our article on the features of a down round].

Conflicts of Interest

The special circumstances necessitating a down round require careful handling, as the risk of conflicts of interest between the board of directors and equity holders necessitates that any such down round financing be carefully considered, and the board of directors should take appropriate steps and consider all relevant factors in evaluating the fairness of the transaction. Most startups with existing venture capital investors have a board of directors comprised primarily of management and representatives of the company's venture capital investors. The investors leading a down round financing often view themselves as backstopping the company at a time when others won't, and expect to be compensated accordingly. On the other hand, management may focus on maintaining their jobs as a primary driver and their equity stake as a secondary driver. Other key stakeholders often include new investors, who may be looking for an opportunistic investment, and non-participating existing equity holders, who will be diluted and who may or may not be engaged and supportive of the transaction. The board of directors considering such a transaction should pay careful attention to its fiduciary duties as it works to bring this diverse set of stakeholders together.

Guidelines for the Board

While not bulletproof, there are certain measures the board of a company can take to mitigate risk and demonstrate that a down round is reasonable, fair, and appropriate in its terms. It is important to make an effort to satisfy as many of these recommendations as possible, as it will show the fairness and appropriateness of the down round financing. Doing so may also help shift the burden of proof during litigation from the company and the board to the plaintiffs challenging the transaction. It could also shift the level of scrutiny that a court may use in reviewing the lawsuit.

Recommended steps include, but are not limited to:

1. **Informed Decision Making**
   a. **Seek out alternatives**: The board should consider and seek out alternative options, including bridge loans, simple agreements for future equity, convertible note offerings, mergers, asset sales, or other transactions that may be less offensive to non-participating equity holders.
   b. **Research**: The board should review current market terms for similar transactions in the same or similar industries if possible, and use these as a guideline in establishing financing terms for the down round.
2. **Process**
   a. **Fair value**: The board should establish a fair price for the down round. While not required, getting a 409A valuation from an independent and reputable third-party valuation firm is effective in supporting the company's position that the pricing of the down round was appropriate.
   b. **Independent committee**: If possible, the board should establish a committee of independent and financially disinterested board members to evaluate and negotiate the terms of a down round and approve the transaction.
   c. **Conflicts of interest**: Any board actions involving interested directors should have the interested directors recuse themselves, and any written resolutions should clearly acknowledge which directors are interested. Transactions involving interested directors can receive extra scrutiny on review and have their own set of approval provisions within the Delaware General Corporation Law and other state laws; it is imperative to follow those provisions.
3. **Documentation**
   a. **Written record**: The board should keep detailed minutes of meetings, keep resolutions in writing throughout the down round financing, and such documents should reflect the board's rationale and analysis, including any outside advice from financial advisors, valuation firms, or legal counsel.
   b. **Disclosure**: The board should fully disclose the status of the company to the equity holders, including the company's financial situation and outlook. The board should also disclose clearly the terms of the down round offering, with an emphasis on the benefits, risks, and future outlook.
4. **Equity Holder Considerations**
   a. **Right to participate**: If permitted under the company's governing documents, the board should consider giving all existing equity holders the opportunity to participate, whether or not such equity holders have contractual preemptive rights. These rights offerings help to cleanse the down round transaction.
   b. **Consent of equity holders**: The board should seek the written approval of the equity holders for the down round, both those participating and those not participating. Approval by the majority of equity holders, especially a majority of non-participating equity holders, significantly helps demonstrate the fairness of a down round transaction. It also helps to show that the equity holders were fully informed of the status of the company, and can also help in shifting the burden of proof during litigation from the board to the plaintiff equity holders challenging the transaction. Please note, in certain down round structures, the vote of certain classes of equity holders will be required to effectuate the transaction.
5. **Compliance**
   a. **Legal counsel**: The board should ensure experienced legal counsel is available to advise and review the down round.
   b. **Fairness opinion**: While not always financially feasible, the board could consider retaining a financial advisor to provide a fairness opinion to support the transaction, the valuation, and even the procedural steps taken.
   c. **Regulatory requirements**: The board should ensure compliance with all applicable laws and regulations,

including securities laws and corporate governance standards, and meet all internal company requirements.

Conclusion

In the often-unforgiving landscape of fundraising, a down round can be a strategic lifeline, enabling a venture-backed company to navigate turbulent financial waters when more favorable alternatives are elusive. However, the path of a down round is fraught with complexities and potential pitfalls. The board of directors must execute its fiduciary duties with unwavering diligence, ensuring informed and prudent decision-making. Engaging experienced legal counsel and financial advisors is not just advisable — it is imperative. This not only helps steer the process but also fortifies the board's commitment to acting in the best interest of the company and its equity holders. Through careful navigation and guidance, a down round can transition from a last resort to a strategic maneuver in the company's survival and future growth.

This article is intended as a guide only and is not a substitute for specific legal or tax advice. Please reach out to the authors or another member of the Troutman Pepper Locke team for any specific questions. We will continue to monitor the topics addressed in this paper and provide future client updates when useful.

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