

What's in a Down Round? Key Features of a Down Round

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Startup financing is a dynamic process, and down rounds have emerged as a critical mechanism for companies navigating challenging economic climates. These down rounds are characterized by a reduction in company valuation and often require complex financial strategies to secure necessary capital. One of the keys to a successful down round is balancing the interests of multiple parties, each with potentially conflicting goals and needs. This article focuses on common features of down rounds and examines common terms that define these financings. By understanding the nuances of down rounds, company leadership can better prepare for the potential impacts on structures and investor relations, ensure informed decision-making, and balance the needs of their existing and prospective investors.

Pay-to-Play or Pull-Up Transactions

Pay-to-play terms are a hallmark of down rounds, and involve scenarios wherein the existing investors, pursuant to the terms of the existing governance documents, are contractually obligated to participate in the new offering or they are penalized, generally by having their preferred shares (or a portion thereof) converted into common shares or a lower class or series of preferred shares. Pull-up transactions, on the other hand, involve scenarios where existing investors are not subject to binding provisions under the existing governance documents that require continued participation in new financing. A pull-up transaction typically involves two steps, wherein existing investors first have their preferred shares converted into common shares, and then are given the opportunity to participate in the offering in order to reconvert their equity into the new preferred shares.

Both transactions have a powerful impact on the existing investors of the company, as existing investors are motivated to invest or they lose the benefits of their preferred status. This also has the potential to attract prospective investors, as the preference stack is largely reset, and new investors would be guaranteed to receive the highest level of preferential terms compared to existing investors. Pay-to-play provisions are also regularly used in financings which include milestone or multiple-tranche closings. When investors have committed to invest further funding when the company achieves certain milestones, pay-to-play provisions will function as a deterrent for investors who may fail to satisfy their commitment.

The downside of pay-to-play provisions is that they will almost inevitably cause friction with existing investors, and therefore these types of provisions need to be reviewed carefully. To encourage participation and mitigate

damaging relationships with existing investors, companies should endeavor to be transparent and clearly communicate the financial position of the company, the necessity of the down round, and the board's belief that it is the best (or, at times, only) path forward for the company.

Cramdowns

If the pull-up transaction is the carrot, compulsory conversion is the stick. Compulsory conversion of equity, also known as a cramdown, involves the mandatory conversion of preferred shares of existing investors who fail to participate in the down round into a lower class of preferred or common shares at a 1-to-1 or worse ratio, dissipating the liquidation preferences and rights of existing investors.

One of the primary advantages of compulsory conversion during a down round is the simplification of the company's capital structure. By converting convertible securities such as notes or SAFEs into equity, the company can eliminate complex financial instruments that may complicate future fundraising efforts or acquisitions. By eliminating certain groups of preferred stock, the company's capital structure can be consolidated, and help align the interests of existing investors with those of new investors, as all parties would hold common equity, reducing potential conflicts between different classes of equity holders. The conversion can also provide clarity to potential investors regarding the company's ownership and valuation, potentially making the company more attractive for future investment.

Cramdowns do have drawbacks, however — for existing investors holding convertible securities, mandatory conversion can lead to significant dilution of their ownership stake, especially if the conversion terms are unfavorable due to the lower valuation. This dilution can be particularly concerning for investors who initially invested at a higher valuation and expected a more favorable conversion rate. Furthermore, compulsory conversion can lead to dissatisfaction among existing investors, who may feel that their interests are being compromised for the interests of new investors. This dissatisfaction can strain relationships and potentially lead to legal disputes if investors believe the conversion terms were unfair or not adequately disclosed.

Warrants

Warrants give prospective or existing investors the right, but not the requirement, to purchase shares at a predetermined exercise price before a certain expiration date. This allows the company to potentially issue the round at the same or higher price than a prior round, but then incentivize investors with a discounted right to purchase more equity.

In practice, warrants can be a very flexible tool, allowing the company to provide additional incentive for prospective lead investors or existing investors to participate. The fact that warrants are issued at a fixed price provides a clear metric against which the warrant holder can measure the growth of the company, and encourages them to exercise the warrant when the company's value has increased. Additionally, as the exercise of the warrant will generally be later down the road, it will help provide an additional influx of cash for the company when it is exercised.

For existing equity holders, however, warrants can lead to dilution of their ownership stake if and when the warrants are exercised. This dilution can be particularly concerning if the warrants are issued at a low exercise

price. The issuance of warrants can also complicate the company's capital structure, potentially making it more challenging to attract future investors or execute strategic transactions.

Liquidation Preference

A liquidation preference is the payout order in the event of a liquidation or sale of the company. Generally, in the event of a liquidation or sale, higher tiers of preferred equity are first in line to get their investment back, followed by lower tiers of preferred equity, followed by common equity holders. This concept is sometimes referred to as "last-in, first out." The amount of the liquidation is commonly 1X, meaning the amount of the equity holders' original investment, but the liquidation preference can also be for multiples of the equity holders' original investment. During a down round, prospective investors may require that the new offering provide them with a liquidation multiple greater than 1X, such as 1.5X or 2X, in order to receive more than their original investment if the liquidation or sale is below a certain value.

By ensuring that new investors receive their initial investment back before other equity holders in the event of liquidation, liquidation preferences can mitigate the risks associated with investing at a lower valuation. This protection makes investing in a company during a down round more attractive by providing a safety net to help preserve investor capital.

However, such liquidation preferences for new investors disadvantage the existing investors. When new investors receive preferential treatment in liquidation scenarios, it can lead to reduced returns for earlier investors. This can be particularly concerning if the liquidation preference is structured as a multiple of the investment, as it can significantly impact the distribution of proceeds in the future.

Conclusion

Down rounds are not always the only (or preferred) choice in a challenging fundraising environment, but they can be a useful means to keep a startup running when more appealing alternatives are not available.

From a legal perspective, companies must ensure that the use of any of the features described here in their down round complies with securities laws and contractual obligations. Transparency and clear communication with the company's investors are crucial to avoid potential disputes or misunderstandings regarding the terms and implications of the down round. Experienced counsel should assist in structuring the down round to minimize conflicts and ensure that all parties are treated fairly.

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