Down Rounds 101

Private life sciences companies looking to raise funds in the current environment might face the prospect of a "down-round" – a financing round at a lower pre-money valuation than the post-money valuation in prior round(s). "Down-rounds" raise various risks and considerations for both companies and investors.

"Down-rounds" affect both ownership percentage and value of shares, and typically trigger antidilution protections, which would increase the conversion price/ratio such that existing investors would receive more Common Stock for each share of Preferred Stock, based on the formula in the company's Certificate of Incorporation.[1] Companies should carefully calculate and evaluate the effects of "down-rounds" on their capitalization and related thresholds for various requisite approvals. Following "down-round" financing, the conversion prices should be reset to reflect any adjustments.

Companies can encourage existing investors to participate (and, potentially, avoid "down-round") by offering senior preference (ahead of prior liquidation preferences), adding a multiple liquidation preference (e.g. 2x instead of 1x), and/or introducing mechanics that would further dilute non-participating investors or even convert Preferred Stock of such investors to Common Stock, such as pay-to-play, cram down (by stock splits or conversion ratio modifications) or pull up (by converting the outstanding preferred stock of participating investors to the new preferred stock).

Careful consideration should be given to fiduciary duties of controlling stockholders and of directors, in particular those representing existing investors who participate in a "down-round," since "Interested party" transactions are not afforded the benefit of the business judgment rule, and may face liability for such financings under the "entire fairness" standard. Due process matters, and adopting practices (to the extent possible) can mitigate potential risks. Customary and advisable practices include a board committee of disinterested directors, consent of a super-majority of the stockholders, offering all stockholders the right to participate in the financing through a rights offering, soliciting outside investors and obtaining a third-party valuation or fairness opinion.[2]

---

[1] Customary protections include: (i) full ratchet, which resets the conversion price to the price of new securities and is unfavorable to founders and, consequently, is rare; (ii) narrow based weighted average, which takes into account the share price and number of the new securities, the original issue price of existing shares and the number of outstanding shares, and counts fewer shares as outstanding; and (iii) broad based weighted average, which is the same as narrow based weighted average, but counts more shares as outstanding and is therefore less favorable to investors and results a smaller increase in conversion rates.

[2] For an overview of good practices see client alert

https://www.goodwinlaw.com/publications/2020/04/04_28-dilutive-down-round-financings-in-the-us.