Hedging COVID-19 Pandemic Risks in Early-Stage Financings

In recent posts, we reviewed **"down-rounds"** and **hedging COVID-19 pandemic risks in M&A**. This post complements them and focuses on early-stage life sciences companies and their potential investors.

While the customary development timelines for life sciences companies may seem less prone to risks associated with COVID-19, the pandemic still resulted in delays and required adjustment to development plans and budgets, and, consequently, made evaluation of investments challenging.

There are several potential structures that companies can use to get investors "off the fence" and commit funds without lowering their valuation. Companies can offer warrant coverage, to allow investors to purchase shares at the lower price contingent upon additional financing (or failure to obtain it).[1] Alternatively, investors may prefer to spread or stagger their investments, such that capital commitments would be tied to achievement of milestones, which is already common in many life sciences financings, but can be further spread or staggered to address COVID-19 specific concerns. These solutions provide companies with sufficient funds for short-term development runway, and prospective future funds, while allowing investors to validate their evaluations and mitigate risk of overpaying. A similar solution is financing through convertible notes or simple agreements for future equity (SAFEs), with a conversion price or exchange price that is based on future financings and/or contingent upon achievement of milestones. The above alternatives are easier to implement than potential, yet unorthodox means, such as post-Closing price adjustment (which raises anti-dilution concerns).

In addition to mitigation through transaction structures, investors can also seek enhanced discretion with respect to a company's development plan and budget, access rights and other covenants and rights, or a combination thereof, such that investors could get comfortable without undermining the company's ability to progress.

Striking the right balance is not always an easy task, in particular during a time of unprecedented uncertainty, but, as long as investors and companies are aligned on the core strategy and goals, there are multiple ways to find it, including those reviewed in this post.

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[1] Lower price can be accomplished by either offering the right to purchase additional shares of the same class at a lower price for shares in the then-current round or by offering the same price or a discount on the price per share for shares in a future financing with a higher price per share.

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]

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[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**.