THE RIPPLE EFFECTS OF THE PANDEMIC: WHAT YOU NEED TO KNOW ABOUT DOWN-ROUNDS

It is fair to say that the effects of the COVID-19 pandemic have been profound. It has adversely impacted businesses of all sizes around the world, though sometimes disproportionately in the case of certain industries and smaller and mid-sized privately-held companies. In general, the pandemic has resulted in reduced revenues, supply chain and logistical problems and a host of other negative consequences. For companies that had previously attracted venture capital or other forms of private equity financing to grow their businesses, the potential for so-called "down-rounds" can be added to that list.

Background

The term "down-round" is commonly used to describe the sale of a company's stock, LLC interests or other equity securities at a price per share that is lower than the price at which the company had previously sold shares to earlier investors. Companies seeking additional equity financing try to avoid down-rounds for a number of legitimate reasons. These include the impact on employee morale, the adverse effect upon key employees who hold stock options and the founders of the company who are often the largest holders of common stock of a privately-held company.

Anti-Dilution Protection

While some of the implications of a down-round are somewhat difficult to measure, one that is not is inherent in the fact that most private equity financings include anti-dilution protection for the investors. Investors in private equity financings typically receive some form of convertible preferred stock. At the time the investors cash out on a sale or merger of the company, this structure gives the investors the right to either sell their preferred shares at the closing of the transaction or convert their preferred shares to common shares and sell those to the buyer. The decision is based on which approach will result in a higher return to the original investors under the terms of the original financing documents.

There are two basic approaches to anti-dilution protection; usually referred to as "Full Ratchet" and "Weighted Average" protection provisions. Fortunately, from the company's perspective, Full Ratchet anti-dilution provisions have become far less common. Full Ratchet anti-dilution basically gives the existing investor the economic benefit of treating his or her entire original investment as if it were made at the new lower price. The impact on the existing common shareholders can be profound and is often viewed by them as inequitable.

Conversely, use of a Weighted Average approach gives the original investors anti-dilution protection but the adjustment is less draconian that the Full Ratchet approach. The size of the adjustment typically is governed by a formula in the original financing documents and is impacted by both the price of the shares sold in the down-round and the size of the down-round financing.[1]

Because of the reduced revenues caused in part by the Covid-19 pandemic, many privately-held companies have found themselves in a position where they need additional funds to provide working capital, fund capital equipment, etc. Unless those funds can be found via existing government programs or private debt financing, some of these companies inevitably will be faced with the prospect of private equity financing at a reduced valuation.

If we can provide further information about this issue or other business matters, please contact PLDO Partner William F. Miller at 508-420-7159 or email wmiller@pldolaw.com.

[1] *A commonly used weighted average formula can be found in the sample Series A Financing Documents on the National Venture Capital Association website [nvca.org] (Section 4.4.4 of the Amended and Restated Certificate of Incorporation)*

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