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DOWN ROUNDS, RECAPS AND PAY TO PLAY PROVISIONS: EMBRACING VENTURE CAPITAL FINANCING STRATEGIES FOR EMERGING COMPANIES IN A CHALLENGING FUNDRAISING CLIMATE

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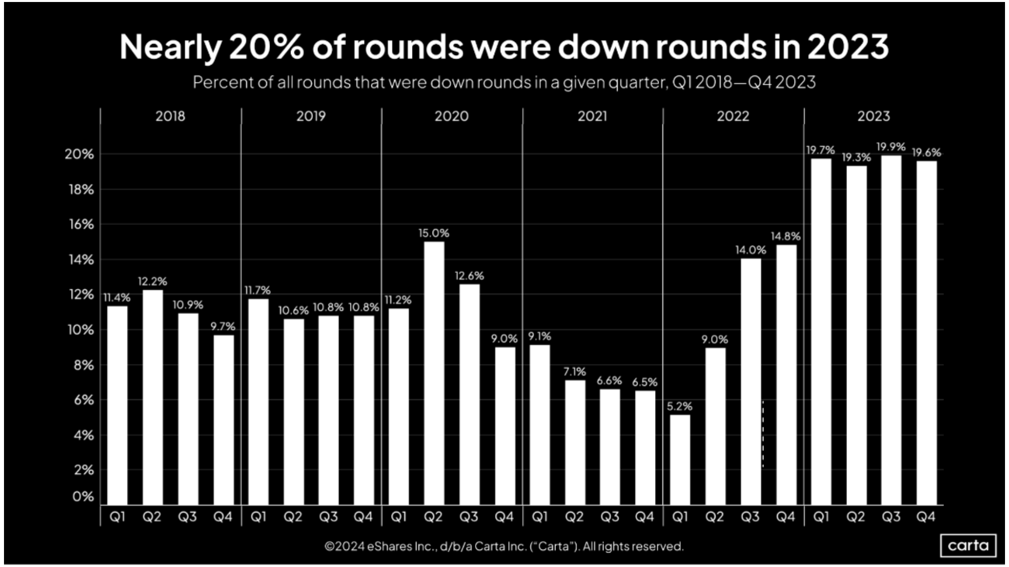
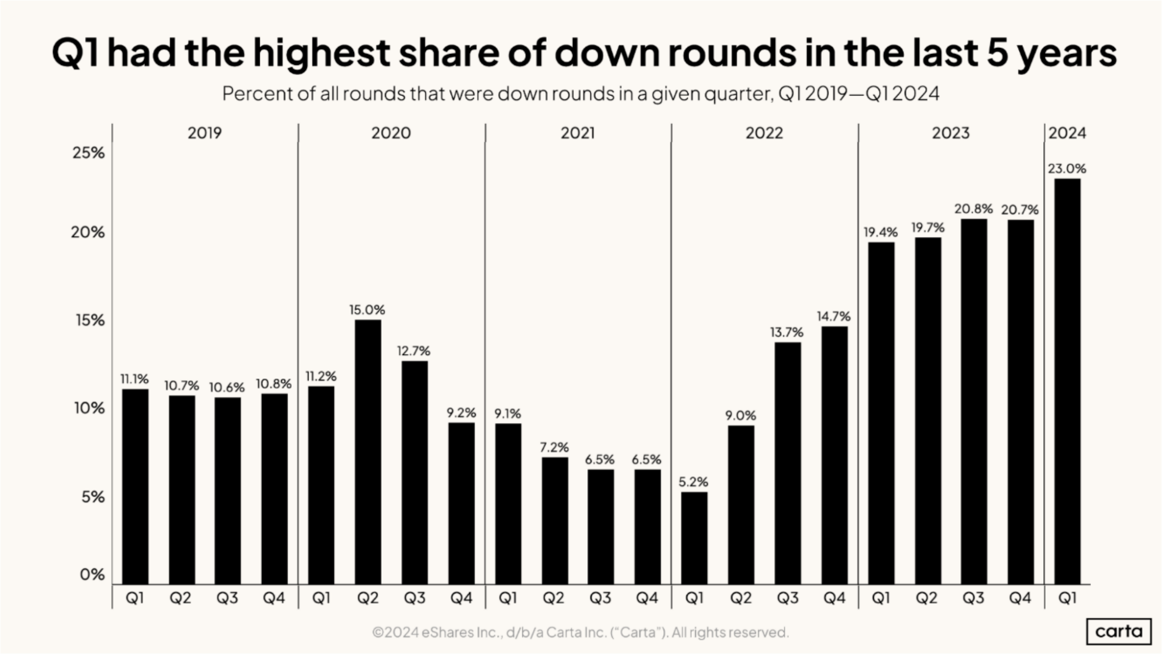
Market Overview 2023

- According to Carta, total startup shutdowns reached 770 in 2023, a substantial increase from 467 in 2022.
- Seed deal count was down 27% in 2023 with only 462 seed investments closing in Q4.
- 2023 saw the four highest quarterly down-round rates since 2018



Market Overview Q1 2024



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Source: https://carta.com/blog/state-of-private-markets-q1-2024/

Causes of Down Rounds, Recaps and Pay to Play Financings

- Decline in number and value of venture capital backed M&A exits
- Lack of success of IPOs for venture backed companies
- Decline in venture capital fundraising of new fund capital to deploy, combined with lack of return on prior capital deployed
- General market uncertainty and volatility
- Macro-environment (interest rates, global instability)
- But venture backed companies still need the cash!

What is a Down Round Financing?

- A “Down Round” financing refers to a new capital raise based on a company valuation that is lower (often materially lower) than a company’s valuation in one or more prior rounds.
- A “Cram down” or “Washout” financing is a down round financing where the terms are severely dilutive to existing investors
    - In severe cases, non-participating stockholders may end up with little to no ownership in the company, although in some cases investors willing to participate may receive ancillary deal terms and preferred stock rights / preferences
- Anti-dilution adjustments can exacerbate the dilution of the round unless waived
    - Broad based weighted average protection is most common
    - Can be waived in whole or in part, but not always waived, and calculations can get tricky if multiple classes or series at different price points have protection and if other variables to round price need to be factored into the dilution formula calculations

Important Down Round Economic Considerations

- Insider led or outside investor led round?
- Priced round or use convertible note or SAFEs structure as bridge to next milestone?
- Valuation / dilution:
  - Up, flat or down? Who sets valuation?
  - Impact of existing dilution protection – waive and/or reset?
  - New dilution protection
- Other key economic terms:
  - Will new money have a senior or multiple of 1x liquidation preference or a participation feature?
  - Terms of any new dividends or adjustments to existing dividends, especially if cumulative dividends?
  - Any warrant coverage?
  - Size of option pool refresh / impact of any management bonus or carveout plan on waterfall

Other Key Negotiated Down Round Terms

- Voting percentages
- Protective provisions / blocking rights / waiver and amendment standards
- Board composition
- Threshold vote required to force mandatory conversion of Preferred Stock (key provision for implementing recaps)
- Timing for redemption, IPO and other trigger dates
- Weaving of existing investor rights with new investor rights
- Drag-along terms and thresholds

What is a Recap?

- A "Recap" is essentially a restart and redo in some fashion of a company's existing capitalization, most often done in connection with a down round financing.
- Usually necessitated by some combination of the following factors:
  - Valuation meaningfully lower than one or more prior rounds
  - Existing preferred stock preference stack is not aligned with current valuation / potential exit expectations of potential new investors and/or key existing investors
  - Potential mis-alignment of existing investors as to whether to continue to invest in the company, which may be exacerbated by when and at what price they invested and their own fund and fund portfolio dynamics
  - If existing investors willing to continue to fund they want to be rewarded for their risk
  - New money and/or existing investors may only be willing to invest if valuation and/or preference stack reset
  - Management team and employee equity is "out of the money" due to the size of the preference stack and the round dilution
  - Desire to simplify the waterfall and capitalization structure, properly incentivize investor participation and provide ongoing incentives to motivate management and employees

Recap Key Economic Considerations

- Will there be a valuation flattening or reset, a liquidation preference flattening or reset, or both, and if so to what degree?
  - Recaps can be accomplished by converting existing shares of one or more series of Preferred Stock into Common Stock or into one or more series of new Preferred Stock with reduced terms, by modifying the liquidation preference, conversion price of one or more series of existing Preferred Stock, or by any combination of these methods.
  - Preferences can be totally flattened, or retain their priorities but with valuation flattened, or prior valuations and percentages could be respected but with the total aggregate preference flattened or reduced, or existing shares can be reclassified based on prior amounts paid, prior preference priority or prior valuation distinctions.
  - There is no one size fits all approach and may be tailored based on the existing capitalization dynamics and who owns and trying to find a rational way to get to a post-closing capitalization table that works for the key constituencies.
- Will there be a Pay to Play or some other structured mechanic designed to incentivize participation in the down round financing?

Pay to Plays, Pull Throughs, Pull Ups and Variations

- A "Pay to Play" classic mechanic is implemented through charter provisions either that exist already in a charter or are implemented in an amended and restated charter for the financing. These mechanics provide that to the extent an existing investor does not invest at least a minimum amount of, or a pro rata of an aggregate amount of, the financing round, some or all of its shares of Preferred Stock will be converted into either Common Stock or a series of Preferred Stock that does not contain the same terms as the holder's existing Preferred Stock (could contain reduced preference or other reduced rights).
  - Most commonly this provision is tied to mandate participation based on some sort of "pro rata" percentage of preferred ownership.
  - Avoiding the conversion can be all or nothing based on hitting the minimum funding amount or can be formulaic relative to the minimum funding amount so that, for example, if only participate at half of pro rata than half of shares converted
- A "Pull Through" mechanic is a variation on the "Pay to Play" mechanic where all of the Preferred Stock or a type of Preferred Stock is first converted into Common Stock under the charter terms, then an existing investor who participates in the new financing at the desired level is able to by contract pull its shares back up into one or more series of new Preferred Stock, which most often have the same rights as the Preferred Stock previously converted into the Common Stock.
- A "Pull Up" mechanic is a variation on the "Pull Through" mechanic and is often just referred to as a different type of "Pull Through" where instead of just receiving back its existing previously converted Preferred Stock, the existing investor who participates in the new financing at the desired level is able to instead receive one or more new series of Preferred Stock that has enhanced terms (such as a senior preference, or the same terms as the new money, or some other agreed upon set of terms designed to incentivize participation) and/or may also received additional warrant coverage.

Special Considerations for Closing a Down Round / Recap

- Enhanced approvals may be required
  - Delaware law (such as series votes), charter provisions, and investment document or side letter covenants or amendment provisions may require enhanced level of approval / consent based on how deal structured
  - Will need some level of approval if waiving anti-dilution protection (and often may need waiver from each affected series under charter) or converting into common
  - Lender approval may be required
  - To eliminate certain director, observer or series specific or investor specific rights may require enhanced investor approval
- Consider deal protection mechanisms to mitigate risk of fiduciary duty breach or other minority stockholder claims (which may be made later with the benefit of hindsight when the company is doing well or is about to be sold)
- Consider appropriate management and employee incentives

Fiduciary Duties

- Duty of Care
  - Requires that directors exercise care in the performance of their corporate responsibilities
- Duty of Disclosure
  - Requires that directors, when seeking stockholder action, disclose to stockholders all material facts that are relevant to the action sought
- Duty of Loyalty
  - Requires directors to act in good faith that a particular action is in the best interest of the company and all of its stockholders (not just any one particular stockholder)
- Business Judgment Rule vs Entire Fairness
  - Courts will generally defer to a Board's decision made in the exercise of its informed, good faith business judgment
  - But if an "interested party" transaction, the burden shifts to the Board to defend that the deal was "entirely fair" and not just the result of the exercise of its business judgment

Balancing Risk Mitigation and Fiduciary Duties with Practical Financing Realities

- A good process is critical
  - Coordinate with counsel early to implement the best process possible
  - To the extent possible seek out potential investors, explore all alternatives (including a potential sale) and conduct a thorough market check, negotiate terms, deliberate and keep good minutes and records of deliberation and market check, and avoid communications that give ammunition to potential claimants
- Other risk mitigation strategies may be available
  - Attract a disinterested lead investor if possible to lead and price the round and negotiate terms
  - Consider a committee of independent, disinterested directors - which may cleanse the deal and shift the burden (but often not possible because of composition of the Board)
  - Consider having the deal cleansed by a majority vote of disinterested stockholders (but careful analysis of who is disinterested required and timing considerations may prevent this vote pre-deal)
  - Conduct a rights offering to all eligible stockholders (often limited either to all preferred stockholders or all stockholders who are “accredited investors”) to provide them with opportunity to participate in the financing / recap

Compensation Tools to Motivate and Incentivize the Team

- Increase unallocated option / equity incentive pool and approve refresh / top up grants to management, key employees and other employees
- Conduct option repricing / exchanges based on new post-financing 409a valuation derived strike price (be mindful of potential tender offer rules)
- Implement management bonus and retention plans / pools tied to exit value / investor return
  - Sometimes referred to as “management carve-outs”

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Biography

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Andrew Ray represents public and private companies, financial sponsors, investors, including venture capital and private equity firms, entrepreneurs and management teams in cross-border mergers and acquisitions (M&A), financings, and growth equity transactions. He has transactional experience in a broad range of industries, including technology, financial services, government contracts, life sciences, real estate, energy and the not-for-profit sector. Various industry publications and credentialing organizations recognize Andy as a leader in both M&A and in technology, media, and communications law, among other fields. Andy is the current leader of the interdisciplinary corporate practice in Washington, DC, and he is the former leader of the financial technology (fintech) initiative.

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Corey S. Mueller advises clients in corporate and securities matters. His practice centers on venture capital financing, private equity transactions, mergers and acquisitions, and securities, with an emphasis on investment in emerging companies. Prior to joining Morgan Lewis, Corey interned at the SEC's Enforcement Division in San Francisco and at a boutique bankruptcy law firm in Walnut Creek, California. In law school, he volunteered with the Investor Justice Clinic, assisting clients who could not otherwise afford legal representation in FINRA arbitration.

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As leader of the firmwide emerging companies and venture capital practice, Jeffrey P. Bodle counsels emerging businesses and other innovative high-growth companies at every stage of their business lifecycle—including in mergers and acquisitions (M&A), angel and venture capital financings, IPOs, securities offerings and compliance, corporate partnering, joint ventures, formation advice, and other strategic and outside general counsel matters. Jeff also represents seed, venture capital, private equity, institutional, and strategic investors in financing, M&A, and portfolio company transactions. Jeff focuses primarily in the technology, healthcare, life sciences, venture capital, and private equity fields.

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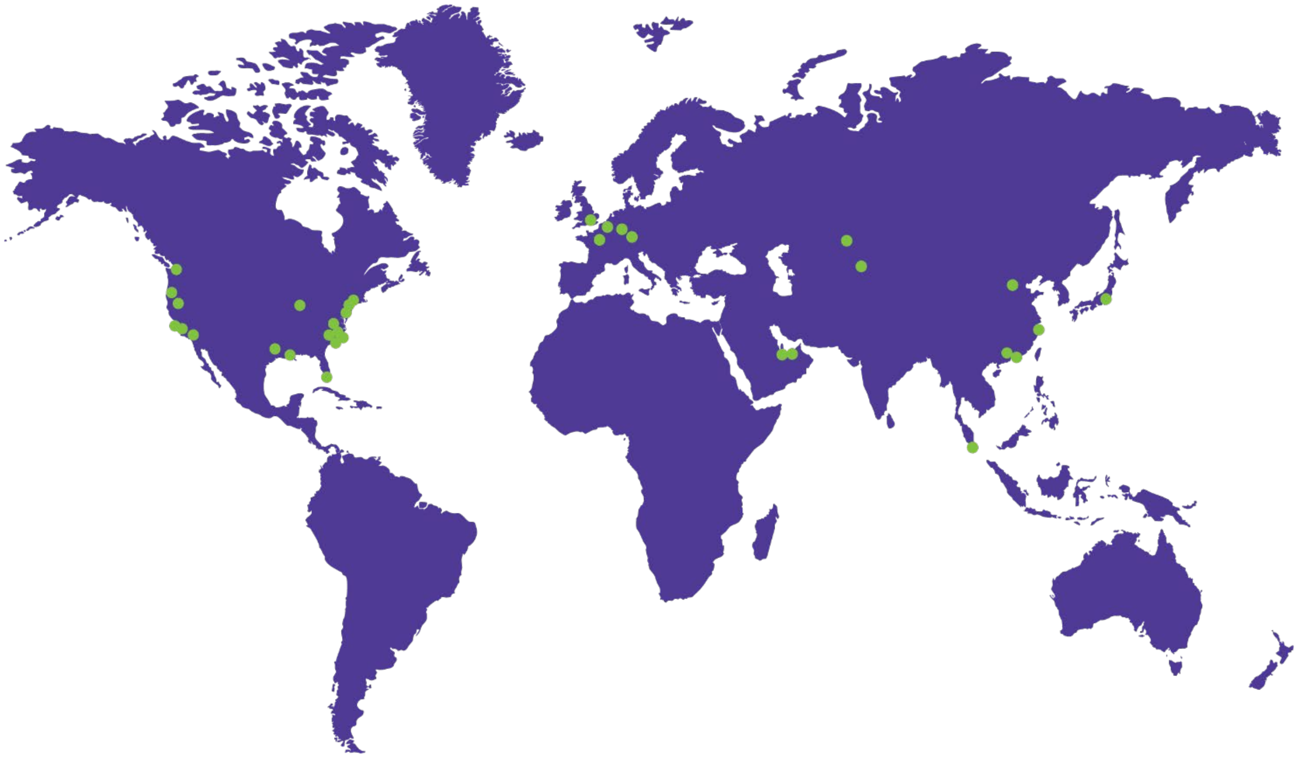

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