



VENTURE FINANCINGS IN A MARKET DOWNTURN

Speakers:

Andrew Harper, Partner

Geoffrey W. Levin, Partner

Martin Wellington, Partner

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Discussion Topics

- A. Market Overview
- B. Down-Market Deal Terms and Structures
- C. Key Legal Concepts & Fiduciary Duties
- D. Takeaways and Questions

Market Overview

Market Overview

- **Market Downturn**
 - Q2 2022 is the first quarter that shows a significant cut in funding since the beginning of 2020
- **Decrease in Number of VC Financings**
 - Number of deals down 24.5% from Q1 to Q2
- **Decrease in Deal Value**
 - Deals are getting smaller - deal value fell 27% from Q1 to Q2
 - Mega-rounds (\$100M+) accounted for \$50.5B in funding, a 31% fall from Q1
- **Valuations Begin to Decrease.**
 - *Seed Stage* – no significant decrease
 - *Early Stage* - median pre-money valuations decreased 16% from Q1 2022
 - *Late Stage* - median pre-money valuations decreased 13% from Q1 2022
- **Changes in Deal Terms and Structures are Here**
 - We are already seeing down-rounds, pay-to-plays and other investor favorable financings of different types.
 - We anticipate more investor-friendly deal terms, decreased valuations and less deal flow generally to continue due to the economic downturn and the ongoing uncertainty of duration and impact of the current macro challenges.

Down-Market Deal Terms and Structures

“Enhanced” Investor Favorable Terms

- **Equity Financings**

- Enhanced Liquidation Preference – senior, multiples above 1x, participation
- Full ratchet anti-dilution protection. Sometimes subject to sunset, but often not.
- Milestone/tranched closings
- Redemption rights
- Cumulative dividends

- **Convertible Notes**

- Higher interest rate and discounts, sometimes escalating over time
- Higher change of control premium, sometimes escalating over time
- Secured or senior debt

- **General**

- Stricter protective provisions or voting rights
- Greater levels of board participation/control
- Super pro rata rights and full options to invest more

Down Round

- **What is a down round?**

- Equity financing at a valuation lower than one or more prior equity financings / shares issued at lower price per share than prior rounds

- **Antidilution Adjustments**

- Usually broad-based weighted average in good times
- Often waived, but not always

- **Important Considerations**

- A simple down-round follows the structure mechanics set out in the existing charter and therefore requires less structuring and negotiation, so may be easier to execute.
- Consider whether to adjust anti-dilution thresholds from prior rounds down to match the new round threshold
- Often insider led with heightened fiduciary and litigation risk due to conflicts
- Think about alternative structures to avoid a down round:
 - Flat round at prior round price with warrants to give effective discount
 - Convertible notes or SAFEs

Recapitalization

- **What is a recap?**
 - A restructuring of the capital stock structure of a company and a related venture financing (often at a lower valuation).
- **Common Objectives**
 - Simplify capitalization structure of the company
 - Reduce liquidation preference to better align with current value of the company
 - Threat of losing rights and preferences to incentivize additional investment
- **Common methods**
 - **Pay to Play** – recaps are often done in tandem with a P2P
 - **Forced conversion** – convert all preferred stock into common stock (sometimes at a ratio greater than 1:1) or into a single junior class of preferred stock and conduct a financing post-conversion (often at a lower valuation to prior round).
 - **Forced conversion with a rights offering** – following the conversion to common, all recently converted preferred holders (or all accredited stockholders) are offered the right to participate in the financing on a pro rata basis.
 - **Rights offering with a “pull-up”** – the converted preferred holders that participate in the rights offering at a certain level (often pro rata) are allowed to “pull up”/convert their recently converted common stock into a new series of preferred stock that sit junior to the new financing shares.
 - **Valuation Reset** – re-designate all existing Preferred Stock into a new series of Preferred Stock based on dollars invested to preserve liquidation preference but without regard to valuation differentials.

Pay to Play Financings

- **What is a Pay to Play?**

- Deal structure designed to incentive investors to participate in a financing by penalizing those who do not participate and/or providing some additional benefit to those who do participate

- **Typical Structures and Mechanics**

- Use mandatory conversion provisions in charter to convert all Preferred Stock into Common Stock; then permit participants in the financing to exchange some or all of their Common Stock for a new series of Preferred Stock
- Amend charter to include a pay-to-play provision to address a future financing and to force convert (at 1:1 or at a dilutive penalty conversion rate) shares of Preferred Stock into Common Stock for investors who do not participate in their pro rata share (or other agreed amount) of a new financing
- Amend charter to include a pay-to-play provision to allow holders who participate in a new financing to “pull-through” their shares of Preferred Stock into a more senior series of Preferred Stock

- **Considerations**

- Participation level required to get the benefits in a P2P deal often set at “pro rata”, but parties often have different understandings of what pro rata means. E.g., percentage of fully diluted shares, preferred shares only, something else?
- Be wary of overengineering an outcome. Investors often create complex models with many assumptions to get the outcome they desire, but more complexity can lead to unanticipated or unexpected outcomes.

Key Legal Concepts & Fiduciary Duties

Approvals and Governance Matters

- **Down-market deals** often trigger additional approval rights from different classes or series of capital stock and stakeholder that can complicate the approval process.
- **Stockholder/Investor Approvals**
 - Delaware Law – 242 additional class/series approvals by series by series preferred and common stock
 - Contractual – amendments to financing documents, side letters and founders' agreements.
- **Lender Approvals**
 - If the company has a credit facility, down-market financings are more likely to require lender approvals
- **Anti-Dilution Rights and Waivers**
 - Often require vote of each series
- **Board Restructuring**
 - Legacy or non-participating investors that the company and/or new investors want off the board often have often have the right to keep their board seats

Fiduciary Duties Overview

- **What are fiduciary duties?**
 - Directors and officers owe fiduciary duties to the corporation and its stockholders that warrant special consideration in down-market financings.
- **Duty of Care**
 - A director must be active and cannot be passive and fail to act in fulfilling role
 - A director must be fully informed (and seek out necessary information to make a decision if not given)
- **Duty of Loyalty**
 - Duty to act in the best interests of the corporation and its stockholders as a whole and not in the director's (or the controlling stockholders' or preferred stockholders') interests where those diverge from what is best for stockholders as a whole. Also, requires focus on generally maximizing the value of the corporation for the benefit of its stockholders.
- **Director Liability Standard**
 - Directors who act in good faith and in a manner consistent with their fiduciary duties are entitled to the protection of the “business judgement rule” – no personal liability exposure and customary protection through corporate indemnification and D&O insurance. However, directors who act in bad faith or who otherwise breach their fiduciary duties can be subject to personal liability for breaches of these duties and may lose the protection of corporate indemnification and D&O insurance.

Fiduciary Duties – Conflicts and Standard of Review

- **Conflicts of Interest** - Directors have a conflict of interest if participating in a financing as an investor or getting some direct benefit from the transaction. These conflicts present duty of loyalty issues.
 - Investor Directors. Need to be mindful of their fiduciary duties, particularly if they or their funds are participating in (or worse leading) a financing.
 - Management Director Conflicts. CEO director and other directors may have conflicts of interests if they are receiving “top-up” grants or other consideration in connection with a down-market financing to compensate them for the impact of dilution.
 - “Relationship” Conflicts. A director can be conflicted due to a close personal or economic relationship to a party participating in a transaction even if that director (or its designating investor) is not participating (e.g., prior employment relationship; close business relationship, etc.).
- **Business Judgment v. Entire Fairness**
 - Entire Fairness Standard. Applies Heightened level of scrutiny and risk. Examines fairness of both process and price/deal terms; shifts burden of proof from complaining stockholders to the company.
- **Reducing Risks When Entire Fairness Standard Applies**. To counter or reduce risks associated with entire fairness analysis, consider/use appropriate and available mitigation tools (addressed below).

Ways to Mitigate Risk

- **Independent Board Committee** – form a committee of the Board comprised of “disinterested” directors to conduct the financing search and the evaluation, negotiation and initial approval processes
- **“Majority of Minority” Stockholder Vote** – if possible (but, often, this can be difficult) obtain approval of a majority of the stockholders who are not participating in the financing round
- **Market Check (w/ or w/o engaging financial advisor)** – Conduct a robust market check for alternative sources of financing
- **Valuation Backup** – Analyze and document the basis for accepting the valuation and other economic terms of a financing round, giving due consideration to prior valuations and results of market check
- **Negotiate Terms** – Avoid merely accepting financing terms being proposed
- **Minutes** – Conduct meetings of the board to establish a strong record of deliberation and analysis, and carefully address conflicts and recusals in the record
- **Rights Offering** – Offer all stockholders to participate in the financing (if they are accredited investors)
- **Disclosure** – provide appropriate levels of disclosure to stockholders in connection with approval and rights offering processes
- **Good Process and Records** – Use as many of the tools above as possible, deliberate and negotiate as much as possible, and keep good minutes and records of all these efforts.

Takeaways and Questions

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