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Valuation Challenges for Fintechs Highlight Legal Considerations in 'Down Rounds'

Partners

Jon A. Hlafter / New York

Sven G. Mickisch / New York

Associate

Tim J. Gaffney / New York

In recent years, fintech has been an attractive sector for growth capital, as evidenced by robust investment and M&A valuations in the sector. While interest remained high in 2019, deal volumes began to level off early in the year, followed by a second-half decline. Investor enthusiasm also has moderated within the tech space more generally, and the valuations of some tech "unicorns" have fallen. Companies and their investors are now considering the possibility that new equity might need to be raised at valuations below the company valuations used in prior financing rounds, potentially resulting in the dilution of early round investors — a so-called "down round." Companies and investors, new and old, should consider a number of issues in light of a possible or approaching down round.

Existing Holders and Dilution

Early stage fintech companies generally have two types of underlying equity interests: common and preferred stock. Management and employees generally hold common stock (either directly or in the form of options or restricted stock units), which has economic and voting rights but rarely other protections for their holders. Outside investors generally hold preferred stock, which typically entitles the holder to a preferred liquidation preference right, along with various prenegotiated rights and protections not afforded to holders of common stock (some of which are discussed below). Preferred stock is often convertible at a rate, based on a predetermined formula, into common stock, giving holders of preferred stock the opportunity to participate in future growth of the company along with holders of common stock.

Preferred shareholders may also benefit from other governance and/or consent rights that might restrict a company's ability to raise new equity funding, including if a company does not have sufficient authorized stock to issue preferred stock or to reserve additional common stock for issuance upon conversion of newly issued preferred stock. While discussion of these rights is outside the scope of this article, it is important for boards and investors to understand them and how they impact the relative bargaining power of different stakeholders in connection with a possible new financing round.

Anti-Dilution Protections

Anti-dilution protections have the effect of increasing the conversion rate for shares, thus entitling the holder to obtain a greater percentage of the company for the same underlying conversion price. (These protections are, of course, waivable, and companies and their existing investors may see new investors demand such waivers where a company has a critical need for immediate new capital.) Often, preferred shares have an anti-dilution right that automatically adjusts their exchange ratio upon a subsequent equity financing at a valuation below the level at which the preferred shares were issued. Unless waived, anti-dilution rights of preferred holders further compound the dilution of common holders, who generally have no similar right, in a down round. This anti-dilution adjustment usually occurs on either a "full-ratchet" or "weighted average" basis, with the latter being more typical and the former being more advantageous for implicated holders of preferred shares.

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Four Times Square
New York, NY 10036
212.735.3000

Full-ratchet. The conversion rate of the preferred shares is adjusted such that they become convertible into an amount of common stock equal to the price per share in the prior investment divided by the price per share in the down round.

Weighted-average. The conversion rate of the preferred shares is adjusted based on the weighted average of the current and prior financing and related per-share prices and down-round conversion rate. The larger the investment size and the lower the associated per-share price in the down round, the larger the adjustment. This adjustment of the preferred conversion ratio also takes into account the existing common shares (including options and warrants).

In both examples above, holders of common stock do not receive a protective adjustment and are more heavily diluted than they would be if no anti-dilution adjustment protections existed.

Employee Alternatives

Because the equity interests held by management and company employees often do not enjoy the same anti-dilution and other protections as preferred shareholders, equity interests held by management and company employees may be greatly diminished in value, or underwater in the case of options, following a down round. To align these individuals' incentives with investors, promote retention and improve morale, the boards of companies undergoing a new investment round should consider adjustments to options and other incentives. Typical adjustments and incentives include (i) granting additional equity awards that reflect post-down-round valuation, (ii) exchanging or repricing underwater options for new at-the-money options and (iii) creating or increasing an employee cash bonus pool.

Other Considerations

A direct investment in exchange for equity in a company must be approved by the company's board. The transaction and the associated board approval may be challenged by shareholders on various grounds, the most common of which is that the company's directors did not fulfill their fiduciary duties when they approved the transaction. Due to the large dilutive effect on shares in a down round, shareholders are more likely to challenge a down round and prior rounds that included anti-dilution protections. While most board decisions regarding equity raises will be subject to the business judgment rule, down rounds involving existing members of management, directors or investors may be challengeable under less deferential entire fairness review. Therefore, companies and their advisers must consider potential conflicts of interest before negotiating the terms of a down round with new investors and, if necessary, should implement procedural safeguards (including those that have been applied in Delaware as the "*MFW* standard") in order to ensure that board decisions will continue to be reviewed under the business judgment rule notwithstanding potential conflicts of interest.

A company also may consider retaining a financial advisor to perform a valuation analysis and provide an opinion to the board about the fairness of the consideration received in the down round. State laws generally allow directors to rely in good faith on information, opinions, reports and statements presented by an outside financial or legal adviser on matters that the directors reasonably believe are within such person's professional or expert competence, so long as the adviser has been selected with reasonable care.

The board should thoroughly document all steps taken in connection with the transaction. Evidence of meetings, considerations and the process can help establish that the board fulfilled its fiduciary duties and will also be an important source material for disclosure to shareholders if any portion of the down-round transaction is subject to stockholder approval.

Conclusion

Because the need for additional capital and a resulting down round may be urgent, companies and investors should become well-versed in common issues that arise in such circumstances. It is essential to understand the rights parties have under existing agreements, so that potential financing options can be quickly and clearly outlined and implemented when needed.