

Down-Round Financings of Private Companies: Considerations for Outstanding Equity Compensation Awards

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The recent market turmoil has forced VC firms and other private company investors to examine closely the real possibility of seeking financing at a lower valuation – what is often referred to as a “down round.” While down-round financings impact all private company stakeholders, one demographic that can become particularly disaffected are employees – often, the one group of stakeholders that start-ups cannot afford to alienate because they are critical to the continuing operation and growth of the business. When employees see the devaluation of their equity holdings in their employer, demoralization can set in, and it is often not long before they will become distracted at best and unretainable at worst.

This is particularly true if employees hold stock options, which are typically viewed to be valuable only to the extent that the per share value of the company is higher than the exercise price of the options that they hold. Given that virtually all options are struck with an exercise price at least equal to the per share fair market value of the company at the time of grant, as soon as a down round occurs, employees’ previously granted options will be underwater and will remain underwater until the company obtains a new valuation that is higher than the valuation at the time of grant. While underwater options may not provide the intended benefits to employees, there may also be disadvantages to them from the company’s perspective.

For a company considering a down-round financing, there are four primary strategies for dealing with underwater options, including restructuring the options via a repricing or in an exchange for new equity compensation awards.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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