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Challenges of "Down Round" Financings in Asia

One of the by-products of the ongoing global financial crisis is a re-emergence of a phenomenon that has not been widely seen since the bursting of the dot-com bubble nearly nine years ago – the "down round" financing.

It is not uncommon for private equity- or venture capital-backed portfolio companies to raise multiple rounds of financing to fund the growth of their businesses. These subsequent financings usually reflect portfolio company valuations that have risen since the last round. However, this is not always the case, and a "down round" financing occurs when a portfolio company raises a new round of financing at a valuation lower than in the preceding round. Compared to financings where the portfolio company's valuation has increased, down round financings are often more difficult to execute and can present business and legal risks. In addition, the legal and regulatory regimes in a number of Asian jurisdictions pose special problems for down round financings.

One key difference between the period immediately following the bursting of the dot-com bubble, when down round financings were last prevalent, and today's environment is the large number of private equity and venture capital investments that have been made in recent years in Asian portfolio companies, most notably in China and India. In this issue of our Asia M&A / Private Equity Newsletter, we examine the legal and business risks that often arise in the context of down round financings, and look at certain unique challenges that may arise when attempting to execute a down round financing in an Indian or Chinese portfolio company.

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General Issues Encountered in Down Rounds

Director and Shareholder Liability for Breaches of Fiduciary Duty. Down rounds can expose directors and, in some jurisdictions, shareholders, to claims that they have breached their fiduciary duty to shareholders of the portfolio company in approving a down round. The nature of these claims and the likelihood of their success depend largely on where the portfolio company is incorporated, since that jurisdiction is usually the source for the law governing the fiduciary duties owed to portfolio company shareholders. While the nature and scope of these fiduciary duties can vary significantly, certain common themes extend across many jurisdictions. In particular, legal liability often exists in situations where one or more directors represent existing investors that are instigating – and setting the price and terms for – the down round. This so-called "inside" down round is a situation with potential conflicts of interest, and participating investors and their board appointees may elect to take special precautions to protect themselves from allegations of self-dealing or other breaches of duty. Measures that are sometimes taken to try to address this risk include:

- requiring the round to be approved by disinterested directors, or by a majority of non-participating shareholders,
- requiring the price and terms to be based on an independent valuation (usually impractical in terms of time and expense, given the exigencies of most down rounds) or some neutral benchmark (such as an average of recent valuation multiples for comparable companies in the same industry),
- if possible, basing the price and terms on an arm's-length negotiation with a significant new outside investor participating in the round, and

- granting preemptive rights, using a rights offering or employing some other mechanism to offer all shareholders the opportunity to participate in the down round on an equal basis.

In addition, "inside" directors and shareholders generally should fully disclose to all shareholders, in advance of any board or shareholder vote on the down round, the nature and extent of any conflicts of interest they may have with regard to the new financing, and recuse themselves from voting on the down round.

Complications Caused by Price-Based Anti-Dilution Adjustments. Private equity and venture capital investors often insist on receiving price-based anti-dilution protections at the time they initially invest in a portfolio company. These protections usually require the portfolio company to issue new shares at a nominal or zero value, or adjust the conversion rate in convertible securities, to effectively "ratchet" the investor's entry price downward in the event the portfolio company issues new shares at a lower valuation subsequent to the investor's initial investment. These protections generally take one of two forms:

- a "full ratchet" adjustment, where any new equity issuance (no matter how large or small) at a lower price triggers a full downward adjustment of the protected investor's entire stake to the new, lower price, or

- a "weighted average" adjustment, which bases the extent of the downward adjustment not only on the price at which the new equity is issued but also on the relative size of the new issuance compared to the protected investor's existing stake (resulting in a partial, rather than full, downward price adjustment when the size of the new equity issuance is smaller than the protected investor's existing stake). These mechanisms can greatly complicate the ability of a portfolio company to execute a down round, because they serve to shift some or all of the negative impact of a down round onto the shareholders who do not have such protections in place (typically the founders and employees, and in some cases later-stage investors as well). As a practical matter, the successful completion of a down round often depends on the waiver by protected investors of some or all of their anti-dilution adjustments. Since there is no guarantee that these waivers can be obtained, however, portfolio companies that anticipate this risk can seek to mitigate it by insisting on weighted average rather than full ratchet anti-dilution adjustments, and perhaps insisting on a "pay to play" provision that requires the protected investor to participate in the new round in order to receive the benefit of its anti-dilution adjustments.

Retaining Incentives for Management and Key Employees. A key business problem encountered in down rounds is avoiding excessive dilution of the equity stakes held by the management team and other key employees, which can remove incentives that might be crucial to the portfolio company's success. Heavy dilution of management and employee stakes may be unavoidable at the outset of the down round due to the simple mathematics of the round, given the amount of new equity required and the depressed valuation at which the round must take place. This problem is exacerbated by the fact that management and employees typically lack access to the capital needed for them to participate in the down round, even if they are nominally offered the ability to participate, and can be further compounded by the impact of the anti-dilution adjustments discussed above. In order to address this problem, it is often necessary to substantially restructure the equity-based compensation and incentive plans of management and key employees in conjunction with a down round, substituting the equity lost to dilution with a promise of performance-based grants of new equity based on the achievement of future milestones (such as revenue, net income or cash flow targets or a realized IPO multiple within a specified timeframe).

In addition, regulations governing foreign ownership can impede the execution of a down round. For portfolio companies in industries subject to limits on foreign ownership, a down round that depends primarily on the injection of capital from overseas investors may result in dilution of the company's domestic shareholders to an impermissible extent. Conversely, certain countries provide important tax and other benefits to foreign-invested companies (such as China's "foreign invested enterprises" (FIEs)), in some cases contingent on the company maintaining a minimum foreign ownership of its equity (25% in the case of an FIE). The loss of these benefits may be a significant impediment to down rounds that depend primarily on the injection of domestic capital, if the new investment dilutes the company's foreign ownership below the relevant threshold.

Special Issues in Down Rounds for Chinese & Indian Portfolio Companies

China. Investors contemplating down rounds in Chinese portfolio companies can face unique issues arising out of the nature of the capital structure of the available forms of legal entities in China. The most common private corporate entity in China, the limited liability company, uses a system of registered capital rather than dividing its equity into shares. Under the Chinese registered capital system, the value of each investor's equity contribution (whether in the form of cash or property) is recorded at the time of contribution, and each investor's percentage share of the equity in the entity (and therefore its share of profits, dividends, and so forth) is determined by the value of its equity contribution divided by the aggregate value of all other existing equity contributions made by it and other equity investors in the company, in each case as recorded at the time of contribution. While there are procedures for reducing the registered capital of a limited liability company with government approval, generally speaking the system does not take into account increases or decreases in the equity value of the company between rounds of financing (for example, that may occur because of dimmed prospects or as a result of operating losses). Consequently, even if all of the company's new and existing equity investors agree to a down round financing, there is no effective method for allowing investors in the new round to receive a greater proportionate share of the equity compared to investors in previous rounds – their new equity contribution will yield a percentage interest in the company that is determined in a formulaic manner based on what is essentially the book value of the new equity contribution compared to the aggregate original book value of all of the equity contributions made in previous rounds.

Traditionally, investors have avoided this problem by investing in entities other than limited liability companies. Historically, the most desirable and commonly used alternative entity was a newly-formed offshore holding company incorporated in a jurisdiction such as the Cayman Islands that holds the portfolio company's business through a wholly-owned Chinese subsidiary. Changes in Chinese regulations in the past few years have, however, severely limited Chinese entrepreneurs' ability to form new offshore holding companies. Another alternative vehicle is a domestic Chinese joint stock company, but these are generally available only for relatively late stage investments. In terms of available domestic legal entities, early to middle stage investors are generally faced with the choice of investing in a limited liability company or a more rarely used form of entity known as a "cooperative joint venture" (CJV) which does not use the registered capital system but presents other complications that can make it unattractive as a platform for venture capital and private equity investments.

India. There are special issues in structuring down rounds in India. The key consideration is how India's "floor price" rules can affect the desired economics of the down round. These rules apply in a variety of situations, including equity subscriptions from listed and unlisted companies and purchases from Indian residents. For unlisted Indian companies, the floor price is determined on the basis of guidelines issued by the former "Comptroller of Capital Issues" and is commonly known as the "CCI Price." This price is determined on the basis of historical net asset value and "profit earning capacity". For listed companies, the floor price is found in the Securities and Exchange Board of India's Takeover Code and is commonly known as the "SEBI Price." The SEBI price is defined as the higher of (i) the average of the weekly high and low closing prices during the six months preceding the date of the public announcement of the relevant share issuance and (ii) the average of the daily high and low closing prices during the two weeks preceding the date of the public announcement. Both the CCI Price and the SEBI Price are backward-looking, computed on the basis of historical information. In a down round, the proposed value of a new share issuance by the portfolio company will typically be based on forward looking expectations as to future cash flow and profitability, but the backward-looking nature of the floor price calculations can operate to prevent new equity from being issued at a price below the applicable floor price. A related point is that an existing investor's anti-dilution protection cannot "ratchet down" the investor to a per share price that is lower than the floor price that is applicable to its existing investment, or involve the issuance of shares at a zero value, nominal or other reduced value that is below the applicable floor price.

Down rounds also typically result in changes in the voting percentages of various existing shareholders, which can have important legal consequences under India's corporate law. For example, any investor whose percentage equity holding in a listed Indian company exceeds 15% is required to make an "open offer" to all shareholders to acquire at least 20% of the shares it does not already own. This "open offer" must be made at the higher of the SEBI Price and the highest price paid by the investor during the 26-week period preceding the date of the public announcement of the acquisition of shares that took it above the 15% threshold. Likewise, certain minority rights arise as a function of voting percentages. For instance, the passage of a special resolution by shareholders of an Indian company requires a 75% supermajority vote (and can therefore be blocked by a shareholder holding more than 25% of the company's equity). Similarly, holders of 10% or more of an Indian company's equity can make statutory "oppression of the minority" claims. The rights and obligations that arise from shifting voting percentages can significantly impact a company's ability to successfully execute a down round. New or existing investors may, for example, decline to participate because of reluctance to cross the 15% threshold and trigger an "open offer" obligation. Likewise, existing shareholders may be reluctant to give necessary consents or waivers if the down round will result in a new or existing shareholder obtaining a voting percentage that gives it the ability to block special resolutions or make statutory "oppression of the minority" claims or if the dilutive impact of the down round would result in existing shareholders losing the benefit of these protections.

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