Low Tide in Southeast Asia Venture Capital and Start-up Ecosphere – Observations on Fraud, Down Rounds and Pay-to-Play Structure Trends

Background

At the height of the start-up funding boom in 2021, venture capital firms were injecting capital into promising start-ups with valuations that only seemed to move in one direction – up and to the right. Fast forward three years, against the backdrop of a gloomy macroeconomic slowdown that came about subsequently, the period of fast and loose money was replaced with tempered expectations and a cautious outlook and the focus on "growth at all cost" shifted to one centred on "clear and viable paths to profitability".

Unsurprisingly, with venture capital money becoming more selective, we have also noticed an unravelling of the issues and problems that may not have been previously apparent. "*Only when the tide goes out do you discover who's been swimming naked*" – Warren Buffett's words have been particularly pertinent in the current funding drought.

In this article, we set out our observations on three major trends:

(a) The prevalence of down-rounds and the resulting implications on anti-dilution rights;

(b) The increasing popularity of pay-to-play provisions utilised by investors and start-ups and the pitfalls to be aware of; and

(c) The increasing number of start-ups facing fraud and other governance concerns and the potential remedies.

Overview of Key Changes

What is a down round and what is its interaction with anti-dilution rights?

A down round is a financing round where a start-up issues shares at a price per share that is lower than the price per share issued during an earlier financing round. It is generally used as a means of last resort when the start-up is in need of additional funds to meet its immediate cash flow needs but is unable to obtain more favourable financing from other sources.

Accordingly, a larger dilutive effect on the share ownership percentages of the existing shareholders of the start-up is created as a result of a down round as compared to an up or flat round. This would in most cases trigger anti-dilution rights attached to the preferred shares held by existing investors in the start-up. Such anti-dilution provisions mitigate (to differing extents) the dilutive impact of a down round by typically lowering the conversion price (and therefore increasing the conversion ratio) at which existing preferred shares would convert to ordinary shares. Practically, this would mean that the largest impact of the down round is felt by ordinary shareholders who would typically be the founders and employees of the start-up.

There are a few ways anti-dilution mechanisms may be implemented. A full-ratchet, anti-dilution mechanism reduces the conversion price applicable to existing preferred shares to the price per share issued in the current funding round. This is less common and gives the fullest protection to relevant

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preferred shareholders given that it only takes into account the triggering share issuance price without considering the number of shares issued in the down round, therefore resulting in the greatest amount of dilution to the ordinary shareholders. On the other hand, the use of the broad-based, weighted average anti-dilution mechanism is more commonly observed where the applicable conversion price is adjusted based on the weighted average price at which the start-up issued its securities (therefore taking into account both the price as well as the number of shares issued in the down round). Such a mechanism results in a smaller anti-dilutive adjustment for the preferred shareholders. A broad-based weighted average anti-dilution mechanism is the default option in the Shareholders' Agreement in the Venture Capital Investment Model Agreements 2.0 suite of documents (**VIMA 2.0 Shareholders' Agreement**).

What is a pay-to-play structure?

A pay-to-play provision is essentially a financing mechanism that seeks to incentivise existing investors to participate in a new financing round where a failure to do so would usually result in such investors having some or all of their preferred shares converted to ordinary shares. This mechanism may or may not be immediately triggered in the down round at hand but is typically introduced in such a situation. This is because against the backdrop of a start-up facing a compression in its valuation, existing investors would naturally be reluctant to inject more capital unless they see value in a further investment in the start-up.

The inclusion of a pay-to-play provision would be helpful in attracting new investors who, notwithstanding the then financial performance of the start-up, are likely to view favourably a situation where existing preferred shareholders are crammed down and investors who are committed and aligned with the long-term interests of the start-up remain as preferred shareholders on the cap table. It also always serves as a signal of confidence to potential new investors when existing investors participate in a funding round – failure to do so would lead to questions on the part of the new investors as to what exactly it is that they are not seeing.

Typically, a pay-to-play is structured in the form of imposing a requirement that existing investors satisfy their *pro rata* share of new financing or be required to invest a specified minimum amount in the start-up. Alternatively, a "pull-through" / "push-up" mechanism is put in place where instead of having a mandatory conversion of the preferred shares to ordinary shares, existing investors who participate in a new financing round are rewarded by allowing their preferred shares to be "exchanged" for a new class of preferred shares on more favourable terms, including a higher liquidation preference. A deeper dive into the mechanics of how liquidation preference works and how it is used in the VIMA 2.0 Shareholders' Agreement can be found here.

As a result of a pay-to-play provision, a non-participating investor would stand to lose its rights, preferences and privileges attached to the preferred shares it holds, including its liquidation preference and anti-dilution rights.

While there are many nuances to the conversion and deal-specific concerns would apply, the incorporation of the compulsory conversion mechanism of a pay-to-play provision can be done through a few methods. One way is that if the pay-to-play is intended to apply only to the present financing round, existing holders of preferred shares may be requested to sign up to a side letter to agree to have their conversion rights exercised in the event that they fail to invest the requisite amount of new funds in the start-up. On the other hand, if the start-up would like to have such an option to turn to in the future if it faces a similar bleak financing situation, the pay-to-play provision may be built into the terms of the existing preferred shares.

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Given its situation-specific use cases, such a pay-to-play provision has not been built into the form of the VIMA 2.0 Shareholders' Agreement.

What are the challenges start-ups face in a down round or pay-to-play financing?

The immediate challenge that start-ups face when trying to implement a pay-to-play provision in a down round is obtaining the relevant approvals and consents from existing investors. Having new shares issued in a down round would trigger the anti-dilution rights attached to the existing preferred shares (as discussed above).

Further, the implementation of a pay-to-play provision would not only likely face pushback from existing investors, depending on the manner in which it is incorporated, it may be deemed a variation of the rights of the preferred shares and therefore require approvals or waivers from the relevant classes of preferred shares. On this note, it bears highlighting that disgruntled shareholders that form at least 5% of the total number of issued shares of an affected class have the right under the Singapore Companies Act 1967 to apply to the court to have the variation cancelled. Such an application must be made within one month after the date that the relevant class consent was given and accordingly, start-ups should take into account this time period before there is certainty that the variation will not be challenged.

Other approvals and consents that should be borne in mind include those in relation to the amendment of a start-up's constitution and/or shareholders' agreement, and if applicable, the reserved matters that may be triggered in such a scenario. Generally, any amendments to a start-up's constitution or any variation of the rights attached to any shares in the capital of a start-up are reserved matters, as is the case in the VIMA 2.0 Shareholders' Agreement.

A related challenge that a start-up often faces in a down round is its potential impact on its management team and employees. For one, the employee share options previously issued on the back of an overheated valuation of the start-up may likely be out of the money (i.e., the strike price of the option is higher than the fair market value of the underlying shares). Accordingly, the start-up would also need to think about re-incentivising its management team and employees. This discussion would need to be factored into the negotiated capitalisation table (given that the incentives are likely to be in the form of repriced or newly issued share options), with an equally challenging conversation around the management targets to be met before the options are issued out and the corresponding dilution, and whether this is factored into the pre-money valuation for that down round.

What are some other start-up struggles and related issues?

In recent times, we have noticed governance issues involving founders or management team members of start-ups being uncovered where in certain instances, existing investors are forced to step in to steady the ship. A quick purview of the news and websites covering the Southeast Asia funding scene would throw up exposés aplenty in the past few years. There are undoubtedly more cases which have been bubbling under the surface and which would come to light in due course.

Where the founders of a start-up are involved, given the sizeable shareholding stake and governance rights that founders would usually hold and be granted, implementing improvements or changes to the governance and management structure of the start-up tends to run into roadblocks and resistance from the founders themselves, even if they had not previously negotiated founder reserved matters (which are generally uncommon and which would add an additional layer of complexity to manage).

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While dealing with such situations would require both judgment calls and a bespoke approach, one tool which we have found useful to put into place in advance is an event of default provision in the start-up's shareholders' agreement where upon the occurrence of a founder committing an event of default, that founder's rights under the shareholders' agreement would be suspended or fall away. Such rights would include the founder's right to appoint director(s) to the board of the start-up, and during the period of suspension it can be provided in the shareholders' agreement that the remaining directors or the directors appointed by the investors exercise the right to appoint replacement director(s) to fill the vacancy.

Potential grounds that are generally considered events of default include, with respect to the founder, conviction for a crime of moral turpitude or a breach of a material obligation under the start-up's shareholders' agreement such as provisions relating to reserved matters, restrictive covenants and information and inspection rights. While this would previously have been seen as an investor-friendly provision in the heat of the 2021 market, in light of recent developments, such a provision would be both useful and justifiable to have from both a start-up and an investor perspective, and this could even be something for consideration in the next iteration of the VIMA suite of documents.

For completeness, the usual bad leaver provision that would allow for the compulsory transfer of a departing founder's shares in a start-up at a discount is something that would similarly come in handy, though the concern would be what the pricing in such provisions is pegged to. Readers would note that the VIMA 2.0 Shareholders' Agreement provides for a sample bad leaver provision that parties can work off.

Conclusion

It is imperative that start-ups and investors are alive to the issues that emerge in a down round. While there are other financing alternatives, including bridge financing by way of the issuance of convertible notes, it may be that start-ups have to resort to a down round financing to tide them through difficult periods.

As start-up cycles go, parties should have these difficult conversations upfront to avoid subsequently having to work with uncooperative existing investors without such mechanisms and options at their disposal.

Going back to the initial analogy with which we started – it is always wise to ensure that the essential bits are covered when faced with a shift in the tides.

This article first appeared here on Singapore Law Watch and was edited for this publication.

If you would like information and/or assistance on the above or any other area of law, you may wish to contact the Partner at WongPartnership whom you normally work with or the following Partner:

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