

**Title:** Protection against down-rounds, a European perspective  
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## 1. Anti-dilution protection

Determining the valuation of a company is a complex issue. Especially in early stage investments, the valuation is to a large extent the product of negotiations and is very likely to be proven wrong in a next investment round. Ideally, as a company develops, it increases its value, and thus its share price. In a so-called 'down round', however, the share price has decreased to less than the price paid by the investors in the previous round. To be protected against such economic (or price-based) dilution investors will require anti-dilution protection.

The price-based anti-dilution clause provides for a protection mechanism that will be triggered whenever the company issues additional equity securities (shares or instruments convertible into shares) at a price which is lower than the price paid for the shares by the investors. As the anti-dilution protection is an agreed right attached to the preferred shares, it functions as an advantage of the preferred shareholders (investors) over the common shareholders, who will 'pay the price' for the dilution.

There are two basic types of anti-dilution protection: (i) full ratchet anti-dilution protection and (ii) weighted average anti-dilution protection. The types of protection differ in the level of compensation available for the investors.

### a. Full ratchet protection

The full ratchet anti-dilution protection is the most investor-friendly type of protection. Under the full ratchet protection, the investors will be brought in the position as if they had invested at the new, lower issue price. It fully preserves the value of their initial investment in a down round. If in a term sheet a full ratchet anti-dilution protection is included, adjustment will apply if the investee company issues new shares at a price less than the applicable conversion price.

The principle of the full ratchet protection can be illustrated by the following example.

#### Example

*A company has raised a Series B round at € 2 per share and raises a subsequent Series C round at € 1 per share. Under the full ratchet protection, the holders of Series B shares will be put in the position as if they had purchased the Series B shares invested at € 1 per, instead of € 2 per share, and therefore will be entitled to twice the shares they held before the Series C round.*

The full ratchet protection focuses on the new price per share and compensates the investors for the full difference in share price, regardless of the real impact of the dilutive event. Consequently, in the example above, the compensation for the holders of Series B shares will be the same regardless of whether the company issues only 1 new Series C share or 1 million new Series C shares. This can cause significant dilution of the shareholders who are not

protected against price-based dilution (typically the common shareholders). The effects of a (full ratchet) anti-dilution protection may be experienced by those shareholders as a severe punishment and may have negative effects on their morale. Companies which are in a position to negotiate better terms will try to have the investors settle for a less onerous form of anti-dilution protection, such as the weighted average anti-dilution protection.

### **b. Weighted average protection**

Contrary to the full ratchet protection, the weighted average anti-dilution protection takes into account the proportional relevance of the subscription price paid in the down round and the subscription price paid in the previous round. Similar to the full ratchet mechanism, it determines a new share price ('weighted average price') on the basis of which the investors will be compensated. However, it will not just bring the old price down to the new price, but will determine the average of both prices, after they are weighted. For the new price the weighting factor is the number of shares issued in the dilutive financing round. For the old price, the factor is either (i) the total number of shares outstanding prior to the dilutive financing round, on an as-converted and fully diluted basis ('broad based weighted average') or (ii) the number of preferred shares outstanding prior to the dilutive financing round, on a fully diluted basis ('narrow based weighted average').

It is important to note that the narrow based weighted average basically stands for all weighted average calculations using less than the shares mentioned under (i) ('broad based weighted average') as a weighting factor for the old price. Thus, in practice the number of shares mentioned under (ii) can vary from all pre-money outstanding shares (on a non-converted and non-diluted basis), to only the preferred shares issued in the previous round. The narrower the base, the larger the effect of the new price, and the more favourable the clause is to the protected investors.

To calculate the weighted average price, parties include a mathematical formula in their shareholders' agreement. Though each formula may look alike, the definition of  $Q_1$  may strongly vary. As mentioned above, the broad based as well as the narrow based weighted average protection depends on the definition of this symbol.

Weighted Average Formula:

$$\text{Weighted Average Price} = \frac{P_1Q_1 + P_2Q_2}{Q_1 + Q_2}$$

$P_1$  = the subscription price previous round<sup>1</sup>;

$P_2$  = the subscription price new round;

$Q_1$  = broad based: the total number of shares outstanding prior to the dilutive financing round, on an as-converted and fully diluted basis;  
narrow based: the number of preferred shares outstanding prior to the dilutive financing round, on a fully diluted basis;

$Q_2$  = the number of shares issued in the new round.

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<sup>1</sup>  $P_1$  can also be defined as the "old conversion price" if the anti-dilution mechanism foresees in adjusting the conversion ratio (please refer to the paragraph 'Anti-dilution mechanisms'). In such event "Weighted Average Price" should be read as "New Conversion Price".

A term sheet typically only indicates that a weighted average protection applies, sometimes it also mentions the terms ‘broad based’ or ‘narrow based’. Considering the different levels of anti-dilution protection provided by each particular weighted average formula, the formula and its contents should be topic of discussion preferably already during the term sheet negotiations.

### c. Combinations and other features

Though not seen very often, the following modifications can be made to the full ratchet and the weighted average anti-dilution protections to address specific needs or concerns of the investors or to find a solution to a deadlock situation:

For instance, parties can agree to calculate the compensation based on the average of the full ratchet and weighted average price. The formula is fairly simple:

$$X = \frac{FR + WA}{2}$$

X = the actual number of additional (ant-dilution) shares to be issued to the investors;

FR = (full ratchet) number of additional shares to be issued under the full ratchet calculation;

WA = (weighted average) number of additional shares to be issued under the weighted average calculation.

Another possibility is that the full ratchet anti-dilution right is limited in time, i.e. after a certain period the full ratchet anti-dilution protection switches to a weighted average formula or is forfeited altogether. For example:

*“In the event that the Company issues equity securities prior to [date] at a purchase price less than the applicable conversion price of the Series [B] Shares, then the conversion price of the Series [B] Shares will subject to a full ratchet / weighted average adjustment.”*

A share price floor can be included, whereby the full ratchet protection switches to a weighted average anti-dilution protection if the price per share in the down round falls below a specific price. For example:

*“In the event that the Company issues equity securities at a purchase price (“Purchase Price”) less than the applicable conversion price of the Series [B] Shares, then the conversion price of the Series [B] Shares will subject to: i) a full ratchet adjustment, if the Purchase Price is greater than € [\_\_\_] per share; and ii) a weighted average adjustment if the Purchase Price is less than € [\_\_\_] per share.”*

Instead of using only the down round as reference for the anti-dilution compensation, parties may include all future rounds in the calculation of the dilution. The full ratchet or weighted average protection is then based on a new price calculated as the weighted average price of all future rounds. Involving all future rounds will limit the dilution when one down round is followed by up rounds. For example:

*“In the event that the Company issues equity securities in one or more issuances and if the weighted average of the purchase prices of such issuance or issuances (the “Weighted Average Price”) is less than the applicable conversion price of the Series [B] Shares, then the conversion price of the Series [B] Shares will be adjusted to the Weighted Average Price.”*

The founders may negotiate a pay-to-play provision requiring the investors to invest their pro rata share in subsequent down rounds in order to keep their anti-dilution protection.

#### **d. Anti-dilution mechanisms**

The anti-dilution protection, whenever triggered, results in the right of the protected investors to receive additional shares. This right can be exercised either by adjusting the conversion ratio of the preferred shares into common shares, or by (directly) issuing additional shares to the investors. One of the advantages of the first mechanism (adjusting the conversion ration) is that the investors do not have to pay for their additional shares. They will however have to make sure that they can vote in the shareholders meeting as-if they had converted their preferred shares into commons shares. In many European jurisdictions voting rights are attached to the nominal value of the shares, often making voting on an as-if converted basis difficult. Under the second mechanism (direct issue of shares), the investors will have to make a payment, which can be considerable when many shares are issued, but are immediately entitled – based on their shareholding – to the voting rights attached to their additional shares. Investors in the US will without exception use the first mechanism. If it is not clear whether voting on an as-if converted basis is legally possible, the following addition to the anti-dilution provision based on conversion adjustment can be a solution:

*“Instead of adjusting the conversion price of the Series [B] Shares as set out in the previous paragraph, the holders of Series [B] Shares may elect that the Company shall procure (to the extent that it is lawfully able to do so) the issue to the holders of Series [B] Shares, by way of capitalisation of the Company’s share premium account or otherwise in accordance with all applicable laws (and in a manner approved by the holders of the Series [B] Shares) in respect of any Series [B] Shares held by them, of such number of additional Series [B] Shares creating a similar anti-dilution protection as set out in the previous paragraph.”*

#### **e. Carve-outs and adjustments**

Not every issuance of shares under the original purchase price should trigger the anti-dilution protection. The most obvious exception is the issue of common shares upon conversion of the preferred shares. Another typical exception set out in term sheets is the issue of shares or options at a discount to employees under an employee stock option plan (ESOP).

Other, less obvious carve-outs should be judged by the investors on a case-by-case basis. Examples are common shares issued or issuable in connection with:

- i. a merger or acquisition of the Company;
- ii. any borrowings from a commercial lending institution;
- iii. a public offering before or in connection with which all outstanding preferred shares will be converted to common shares or upon exercise

of warrants or rights granted to underwriters in connection with such a public offering.

**f. Calculation problems**

Calculating the new conversion price or the number of shares to be issued pursuant to the anti-dilution protection seems very simple. In practice however, calculating the anti-dilution compensation can be quite complex. This is mainly caused by the fact that the anti-dilution protection is based on the share price in the new (down) round. Such new share price in its turn is determined on a fully diluted basis, including all shares to be issued to the existing preferred shareholders pursuant to the anti-dilution protection.

**g. Dilution of ownership**

A distinction must be made between the concept of economic or price-based dilution as explained above and the dilution of ownership.

Dilution of ownership of the existing shareholders' percentage of the company's share capital occurs for example if the company issues additional shares to new shareholders. In such case the pie has been divided into more - and thus smaller - pieces. Dilution of ownership can be prevented by purchasing a proportional number of shares of any future issue of shares. A right to purchase such proportional number of shares is called a pre-emptive right. Dilution of ownership can also occur if the company increases the number of shares outstanding by issuing stock dividends. Protection against dilution pursuant to such action is provided for in the conversion clauses.