

Term Sheet – Anti-Dilution

Traditionally, the anti-dilution provision is used to protect investors in the event a company issues equity at a lower valuation than in previous financing rounds. There are two varieties: weighted average anti-dilution and ratchet based anti-dilution. Standard language is as follows:

Anti-dilution Provisions:

The conversion price of the Series A Preferred will be subject to a [full ratchet / broad-based / narrow-based weighted average] adjustment to reduce dilution in the event that the Company issues additional equity securities (other than shares (i) reserved as employee shares described under the Company's option pool)

- *(ii) shares issued for consideration other than cash pursuant to a merger, consolidation, acquisition, or similar business combination approved by the Board;*
- *(iii) shares issued pursuant to any equipment loan or leasing arrangement, real property leasing arrangement or debt financing from a bank or similar financial institution approved by the Board;*
- *(iv) shares with respect to which the holders of a majority of the outstanding Series A Preferred waive their anti-dilution rights at a purchase price less than the applicable conversion price. In the event of an issuance of stock involving tranches or other multiple closings, the anti-dilution adjustment shall be calculated as if all stock was issued at the first closing.*

The conversion price will also be subject to proportional adjustment for stock splits, stock dividends, combinations, recapitalizations and the like.

Full ratchet means that if the company issues shares at a price lower than the Series A, then the Series A price is effectively reduced to the price of the new issuance. One can get creative and do “partial ratchets” (such as “half ratchets” or “two-thirds ratchets”) which are a less harsh, but rarely seen.

In a “full ratchet world” if the company sold one share of its stock to someone for a price lower than the Series A, all of the Series A stock would be repriced to the issuance price.

In a “**weighted average world**,” the number of shares issued at the reduced price are considered in the repricing of the Series A. Mathematically it works like this (note that despite the fact one is buying preferred stock, the calculations are always done in as-if-converted to common stock basis):

$$\text{NCP} = \text{OCP} * ((\text{CSO} + \text{CSP}) / (\text{CSO} + \text{CSAP}))$$

Where:

- NCP = new conversion price
- OCP = old conversion price
- CSO = common stock outstanding
- CSP = common stock purchasable with consideration received by company (i.e. “what the buyer should have bought if it hadn’t been a ‘down round’ issuance”)
- CSAP = common stock actually purchased in subsequent issuance (i.e., “what the buyer actually bought”)

Consequently, “anti-dilution provisions” generate a “conversion price adjustment” and the phrases are often used interchangeably.

You might note the term “broad-based” in describing weighted average anti-dilution. What makes the provision a broad-based versus narrow-based is the definition of “common stock outstanding” (CSO).

- A broad-based weighted average provision includes both the company’s common stock outstanding (including all common stock issuable upon conversion of its preferred stock) as well as the number of shares of common stock which could be obtained by converting all other options, rights, and securities (including employee options).
- A narrow-based provision will not include these other convertible securities and limit the calculation to only currently outstanding securities. The number of shares and how you count them matter – make sure you are agreeing on the same definition (you’ll often find different lawyers arguing over what to include or not include in the definitions – again – this is another common legal fee inflation technique).

In our example language, we’ve included a section which is generally referred to as “**anti-dilution carve outs**” (the section *(other than shares (i) ... (iv))*). These are the standard exceptions for share granted at lower prices for which anti-dilution does not kick in. Obviously – from a company (and entrepreneur) perspective – more exceptions are better – and most investors will accept these carve-outs without much argument.

One particular item to note is the last carve out: *(iv) shares with respect to which the holders of a majority of the outstanding Series A Preferred waive their anti-dilution rights*. This is a carve out that started appearing recently which we have found to be very helpful in deals where a majority of the Series A investors agree to further fund a company in a follow-on financing, but the price will be lower than the original Series A.

In this example, several minority investors signaled they were not planning to invest in the new round, as they would have preferred to “sit back” and increase their ownership stake via the anti-dilution provision. Having the larger investors (the majority of the class) “step up” and vote to carve the financing out of the anti-dilution terms was a huge bonus for the company common holders and employees who would have suffered the dilution of additional anti-dilution from investors who were not continuing to participate in financing the company. This approach encourages the minority investors to participate in the round in order to protect themselves from dilution.

Occasionally, anti-dilution will be absent in a Series A term sheet. Investors love precedent (e.g. the new investor says “I want what the last guy got, plus more”). In many cases anti-dilution provisions hurt Series A investors more than prior investors if you assume the Series A price is the low watermark for the company. For instance, if the Series A price is \$1.00, the Series B price is \$5.00, and the Series C price is \$3.00, then the Series B is benefited by an anti-dilution provision at the expense of the Series A. However, our experience is that anti-dilution is usually requested despite this as Series B investors will most likely always ask for it and – since they do – the Series A proactively asks for it anyway.

In addition to economic impacts, anti-dilution provisions can have control impacts.

1. First, the existence of an anti-dilution provision incents the company to issue new rounds of stock at higher valuations because of the ramifications of anti-dilution protection to the common stock holders. In some

cases, a company may pass on taking an additional investment at a lower valuation (although practically speaking, this only happens when a company has other alternatives to the financing).

2. Second, a recent phenomenon is to tie anti-dilution calculations to milestones the investors have set for the company resulting in a conversion price adjustment in the case that the company does not meet certain revenue, product development or other business milestones. In this situation, the anti-dilution adjustments occur automatically if the company does not meet in its objectives, unless this is waived by the investor after the fact. This creates a powerful incentive for the company to accomplish its investor-determined goals. We tend to avoid this approach, as blindly hitting pre-determined (at the time of financing) product and sales milestones is not always best for the long-term development of a company, especially if these goals end up creating a diverging set of goals between management and the investors as the business evolves.

Anti-dilution provisions are almost always part of a financing, so understanding the nuances and knowing which aspects to negotiate is an important part of the entrepreneur's toolkit. We advise you not to get hung up in trying to eliminate anti-dilution provisions – rather focus on (a) minimizing their impact and (b) building value in your company after the financing so they don't ever come into play.