101 ANTI-DILUTION CLAUSES

RITA KHORIATY

WHAT ARE THEY?

Clauses usually inserted in shareholders' agreements to the benefit of investors

THEIR PURPOSE?

Protecting an investor from dilution resulting from later issue of stock at a lower price than the investor originally paid

TWO SORTS OF DILUTION

1. Dilution in terms of percentage: reduction in the ownership percentage caused by the issuance of new stock
2. Dilution in terms of value:

   reduction in the value of the participation although the ownership percentage remains unchanged

REMEDIES TO AVOID DILUTION

Remedy to avoid dilution in terms of percentage:

Preferential right

Remedy to avoid dilution in terms of value:

Ratchet clauses and average weighted clauses

CONCRETE EXAMPLES

RITA KHORIATY

STARTING WITH AN ANALOGY

RITA KHORIATY

"A" bought 10 pants at USD10 each for a total price of USD100 and then "B" comes along and buys 10 pants at USD1 each for a total price of USD10

- FULL RATCHET CALCULATION
- WEIGHTED AVERAGE CALCULATION

APPLYING TO CAPITAL INCREASES

RITA KHORIATY

INCORPORATION OF A COMPANY

1. CAPITAL: USD150
2. TOTAL NUMBER OF SHARES: 150
3. NOMINAL VALUE OF THE SHARE: USD1

SHAREHOLDING UPON INCORPORATION

Shareholder	Number of shares	Percentage of shares
A	50	33.33
B	50	33.33
C	50	33.33

FIRST INCREASE OF CAPITAL

FIRST ROUND OF INVESTMENT:

Issuance of 50 additional shares at an issue price of USD5 per share

FIRST CASE:

A, B and C do not exercise their preferential right pro rata to their respective participations, all new shares are subscribed by INVESTOR 1

SHAREHOLDING UPON FIRST ROUND OF INVESTMENT (NO PREFERENTIAL RIGHT)

Shareholder	Number of shares	Percentage of shares
A	50	25 (50/200)
B	50	25 (50/200)
C	50	25 (50/200)
INVESTOR 1	50	25 (50/200)

→ A, B and C are diluted in terms of percentage: their respective ownership percentages have decreased (from 33.33 % to 25 %).

SECOND CASE:

A, B and C exercise their preferential right pro rata to their respective participations

SHAREHOLDING UPON FIRST ROUND OF INVESTMENT (PREFERENTIAL RIGHT)

Shareholder	Number of shares	Percentage of shares
A	66	33.33 (66/200)
B	66	33.33 (66/200)
C	66	33.33 (66/200)

→ A, B and C are not diluted in terms of percentage: their respective ownership percentages are not changed (33.33 %).

SECOND INCREASE OF CAPITAL

SECOND ROUND OF INVESTMENT:

Issuance of 50 additional shares at an issue price lower than the price paid by INVESTOR 1, i.e. at USD3 per share

FIRST CASE:

A, B, C and INVESTOR 1 do not exercise their preferential right pro rata to their respective participations, all new shares are subscribed by INVESTOR 2.

SHAREHOLDING UPON SECOND ROUND OF INVESTMENT (NO PREFERENTIAL RIGHT)

Shareholder	Number of shares	Percentage of shares
A	50	20 (50/250)
B	50	20 (50/250)
C	50	20 (50/250)
INVESTOR 1	50	20 (50/250)
INVESTOR 2	50	20 (50/250)

→ A, B, C and INVESTOR 1 are diluted in terms of percentage: their respective ownership percentages have decreased (from 25 % to 20 %).

→ **INVESTOR 1 is also diluted in terms of value:**

- He had 50 shares which value amounted to USD5 each, i.e. USD250 in total
- Now he has 50 shares which value amounts to USD3 each, i.e. USD150 in total

SECOND CASE:

A, B, C and INVESTOR 1 exercise their preferential right pro rata to their respective participations

SHAREHOLDING UPON SECOND ROUND OF INVESTMENT (PREFERENTIAL RIGHT)

Shareholder	Number of shares	Percentage of shares
A	62.5	25 (62.5/250)
B	62.5	25 (62.5/250)
C	62.5	25 (62.5/250)
INVESTOR 1	62.5	25 (62.5/250)

→ A, B, C and INVESTOR 1 are not diluted in terms of percentage: their respective ownership percentages are not changed (25 %).

HOWEVER, in terms of value, INVESTOR 1 is diluted:

- He had 50 shares which value amounted to USD5 each, i.e. USD250 in total;
- Now he has 62.5 shares which value amounts to USD3 each, i.e. USD187.5 in total.

THEREFORE, WHETHER INVESTOR 1 EXERCISES HIS PREFERENTIAL RIGHT OR NOT HE WILL BE DILUTED IN TERMS OF VALUE.

HOW SHALL INVESTOR 1 BE COMPENSATED OF SUCH LOSS OF VALUE?

FULL RATCHET

- INVESTOR 1 will require that the new issue price (USD3) applies to him retroactively.
- He had paid upon the first capital increase USD250 and received 50 shares.
- Had the issue price been USD3 instead of USD5, he would have received 83 shares.
- He will ask to obtain 33 additional shares at no additional cost.

WEIGHTED AVERAGE

- INVESTOR 1 will require that an average reference issue price be applied to him retroactively.
- Reference price = (200 x 5) + (50 x 3) / 250 = USD4.6.
- He had paid upon the first capital increase USD250 and received 50 shares.
- Had the issue price been USD4.6 instead of USD5, he would have received 54 shares.
- He will ask to obtain 4 additional shares at no additional cost.

ADJUSTMENT MECHANISM

RITA KHORIATY

RETROCESSION

- The founders commit to assign, pro rata between them and at no cost to INVESTOR 1 the necessary number of shares.
- The founders will lose some of their shares.

ALLOCATION OF THE PREMIUM

- The premium will be allocated to the issuance of the necessary number of shares.
- The founders will not loose shares.
- However, the founders will be diluted in terms of percentage.
- The company will not fully benefit from the money injection.

CONCLUSION

RITA KHORIATY

- Full ratchet clauses are more favorable to investors whereas founders should try to negotiate weighted average clauses.

- Anti-dilution clauses should be negotiated with the utmost care in order to avoid their paradoxical effect!