



The Dilution Dilemma An Explanation of Ratchet Protection

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After the due diligence process is concluded and the parties agree there is a good fit (and a collective sigh is let out by all parties), the next step is to negotiate the terms of the deal (a.k.a, the “Term Sheet”). While, within the four corners of the Term Sheet many hotly contested term awaits the company/issuer and investors, this article will briefly discuss one particular (and often cantankerous) term, the investor’s antidilution protection.

Antidilution price protection gives investors in early rounds the benefit of a reduced effective price per share if the company/issuer issues its shares in a later round at a lower price (commonly referred to as a “Down Round”). Antidilution provisions are necessary according to investors because investors taking part in a financing will want protection against subsequent offerings at lower prices, as well as protection against adverse changes in corporate structure—such as a stock split, recapitalization and (depending on the rigidity of the antidilutive option) stock options. While investors view antidilutive devices as a safety-net, companies view the same provisions as being unfair and often a deterrent for subsequent investors. In essence, both parties are correct, and therein lies the conflict.

There are two antidilution provisions: (i) *full-ratchet* and (ii) *weighted-ratchet antidilution*¹.

¹ Actually, while it’s true that there are two main antidilution provisions there are subcategories of Weighted Average Antidilution Price Protection, Narrow Based and Broad Based and each of these two terms has fairly loose definitions. Generally the main difference is in the definition of outstanding shares, with a more broad definition having the result of lessening the price effect of a Down Round on the effective price of an earlier offering. For example, a Narrow Based Weighted Average Antidilution Price Protection Provision might include only Common Stock and convertible Preferred Stock then outstanding, while a Broad Based Weighted Average Antidilution Price Protection Provision would include Common Stock outstanding or issuable upon conversion or exercise of all Preferred Stock, warrants, convertible debt, options and any other contingent right to Common Stock.

- Broad Based Weighted Average - most favorable to company/founders
- Narrow Based Weighted Average - in the middle
- Full Ratchet - most favorable to investors

The above definition courtesy of www.VCExperts.com.

Definition and Mechanism For Full Ratchet

Investors seek antidilution protection because of the reasonable fear that after the investment occurs, the company (issuer) will issue *preferred shares* at a lower price thereby negatively affecting the investor in two ways. The first is of course the shares are issued at a lower price, which lowers the value of the investor's shares. The second is the dilutive effect occurring after the issuance. Dilution affects the investor in two ways; it lowers the valuation of the stock and concurrently lowers the investor's percentage of ownership in the company.

Weighted Average Full Ratchet

For the company/issuer, if given the choice to choose between the weighted average and full ratchet antidilution, the more palatable choice is weighted average antidilution (a Faustian paradox to be sure).² Weighted average antidilution adjustment works like this, upon a sale of stock at a price lower than the conversion price of preferred stock, the conversion price is lowered to a price that is an average of the price at which the company/issuer has sold stock, valuing the common stock outstanding at the pre-adjusted conversion price.³

Full Ratchet

The second antidilutive protection is known as full ratchet antidilution. Full ratchet antidilution views all subsequent stock sales/issuances issued at a lower price than what the investor's purchase price was as if they were the same, resulting in the same adjustment to the conversion ratio regardless of the number of shares issued. The conversion price is ratcheted down to the lowest price at which stock is sold after the issuance of the convertible preferred, even if only one share is sold at that price. Thus, if the next round of financing is for a price that is half of the first round price, the conversion price of the original preferred will be cut in half so that the original preferred investors will receive twice as many common shares upon conversion (for no extra consideration), resulting in significant dilution to the founders and other common stockholders. In this way, the original preferred investors are effectively retroactively given lowest price at which the company/issuer's stock is sold.

Weighted Average dilution can be determined by using the following formula:

$$x = \frac{x^1 y^1 + x^2 y^2}{y^1 + y^2}$$

Where:

- x = applicable conversion price following new issuance.
- x¹ = applicable conversion price prior to new issuance.
- y¹ = number of shares of common stock outstanding prior to new issuance before (or may be shares outstanding on a fully diluted basis—this is often called broad based antidilution).
- y² = price per share of new issue.
- x² = number of additional shares of common stock issued in new issue.

² There are a number of weighted average formulas from a more of a broad-based to narrow-based, the variation being in which common stock equivalents are included in the fully diluted base over which the dilutive effect is spread.

³ An issuance of warrants, stock options, or convertible securities is deemed to be a sale of the underlying stock.

Pro's and Con's for Investor.

During negotiations, an investor will ask for ratchet antidilution as a matter of course. Whether the company/issuer capitulates to the request, however, depends upon a host of different factors including (i) how desperate the company/issuer is for capital, (ii) the inexperience of the management team and its advisors, (iii) the inability of the company/issuer to attract capital, and (iii) (perhaps, the most important factor) the current market environment.

For instance, post bubble more companies were forced to take full ratchet antidilution than pre-bubble. The reason why is fairly obvious, there was so much money chasing the same companies that the negotiating leverage remained with the company/issuer. However, when the bubble burst, the pendulum swung to the investor and companies began giving up more equity and agreeing to more restrictive terms.

For example, in 2002, the number of companies agreeing to full ratchet clauses was 29%⁴ (compared with 69% for weighted average) juxtapose that to today, where the number of companies agreeing to full ratchet clauses (in the New York Metro Area) is 11% (compared to 89% for weighted average).⁵

For an investor, it is obvious why one would argue for an antidilution clause. For a company/issuer, however, what is the argument against an antidilution clause? For starters, a full ratchet antidilution clause will undoubtedly make a future investor think twice before investing in the company/issuer. Further, a full ratchet may create such a dilutive ripple effect that it crushes the common shareholders. The foregoing is an important fact because for the most part (discounting any angel investors, and friend and family investors) most of the common shareholders are the management team. Therefore, assuming that the company/issuer must seek an additional round of capital and a prospective investor agrees to make the investment, the management team may view the potential dilution event as so onerous that they may (and often do) become disincentivized.

As a side note, a valuable counterweight used by many companies in negotiations is a provision known as “pay or play”. Simply put, pay or play is a term of art meaning either the investor plays (*i.e.*, participates in the next round) or pays (*i.e.*, it does not participate in the next round) by being diluted in the current investment round. The pay or play clause has gained considerable traction, especially since deal leverage pendulum has shifted (albeit slightly) from the investor to the company/issuer.

While, it is beyond the scope of this article to talk about all of the various negotiating aspects of antidilution protection, it is important that one consider the fact that antidilution protection is not a panacea for the investor (it could be a major deterrent for later stage investors) nor is it a non-starter issue for the company/issuer (chances are if the company/issuer experiences a down round the company/issuer holding the

⁴ Fenwick & West: Trends in Legal Terms in Venture Financings in the San Francisco Bay Area, (Q2, 2002).

⁵ According to the Reitler Brown Silicon Alley Venture Capital Price Index™.

antidilution trigger will acquiesce and remove the trigger or lessen its affects because it will want to keep the company/issuer alive—of course there are exceptions, etc.). In any event, a discussion regarding antidilution provisions between company/issuer and the investor is understandably tense but necessary; however, if both sides understand the market place and the dynamics involved on both sides before entering into negotiations a reasonable compromise should be attainable.

In conclusion, while market conditions have improved considerably (or at least there is a lot more money that needs to be deployed or else suffer the unforgiving terms of a claw back), antidilution clauses still causes consternation with companies/issuers and investors.

Definition courtesy of www.VCExperts.com.

Broad Based Weighted Average Antidilution. A weighted average ratchet adjusts downward the price per share of the preferred stock of investor A due to the issuance of new preferred shares to new investor B at a price lower than the price investor A originally received. Investor A's preferred stock is repriced to a weighed average of investor A's price and investor B's price. A broad-based ratchet uses all common stock outstanding on a fully diluted basis (including all convertible securities, warrants and options) in the denominator of the formula for determining the new weighed average price.

Narrow-Based Weighted Average Ratchet. A type of antidilution mechanism. A weighted average ratchet adjusts downward the price per share of the preferred stock of investor A due to the issuance of new preferred shares to new investor B at a price lower than the price investor A originally received. Investor A's preferred stock is repriced to a weighed average of investor A's price and investor B's price. A narrow-based ratchet uses only common stock outstanding in the denominator of the formula for determining the new weighed average price.

Full Ratchet Antidilution Price Protection. "Full Ratchet" (sometimes called "Ratchet") Antidilution provisions reduce the effective per share purchase price of the investor's shares purchased in a round to the actual, lower price set in a later offering or event (for example, a subsequent financing round or issuance of shares as consideration for a transaction) thereby raising the number of shares of Common Stock into which the investor's Preferred Stock will convert. Full Ratchet is more favorable for the investors who receive it and can result in significant dilution for founders and other holders of Common Stock in the event of a Down Round.

Weighted Average Antidilution Price Protection. Weighted Average Antidilution provisions reduce the effective purchase price per share of the investor's shares purchased in a round by a weighted percentage reduction determined by reference to the price decrease and the comparative number of cheaper shares issued to the total number of shares outstanding.