ANTI-DILUTION CLAUSES

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INTRODUCTION

Investors willing to invest in a *startup*'s *equity* assume that the company's valuation will go up over time.

But it is not automatic: the risk of so-called ***down rounds*** is always around the corner.

How can investors be protected?

With **anti-dilution clauses** typically present from the *term sheet of* the transaction.

WHAT ARE THE ANTI-DILUTION CLAUSES FOR?

Such clauses aim protecting the investor from the risk of dilution of its investment in the *startup*

WHEN?

In the context of so-called *down rounds*. These are the *start-up*'s capital increases following the investor's entry round, which are offered with a subscription price of new shares based on a lower valuation than the investor's investment in the previous *round*

IN ALL CASES?

Typically, anti-dilutive clauses do not apply in capital increases mandated by law, those implementing *stock option plans*, those issued upon merger in lieu of *cash*

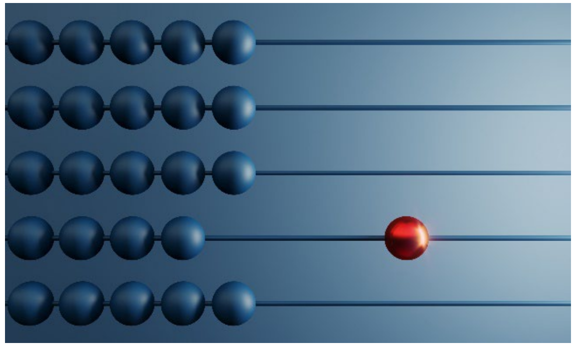
HOW DO ANTI-DILUTION CLAUSES OPERATE?

By way of an allocation of certain amount of shares to the protected investor for free or against payment of a minimal amount to compensate for the dilutive effect suffered.

The prejudice of dilution is transferred in whole or in part to the other shareholders other than the investor protected by the anti-dilution clause.

HOW TO DETERMINE THE NUMBER OF SHARES TO BE ALLOCATED TO THE PROTECTED INVESTOR?

There are two main **calculation mechanisms**



Full ratchet
method

Weighted average
method

THE FULL RATCHET METHOD

Principle:

To the protected shareholder are allocated an additional number of shares such that it obtains that greater shareholding in the capital stock that it would have obtained if the *pre-money* valuation (on the basis of which the capital increase he or she subscribed to was resolved) had corresponded to the valuation at the ***lower*** *pre-money* placed on the basis of the *down round.*

Example:

Subscription price of the units of the protected investor capital increase *round*: 10 euros each.

Subscription price of the *down round* shares: 5 euros each.

The protected investor who purchased 1,000 shares at 10 euros each through the Full Ratchet clause can benefit from an additional 1,000 shares (for free or for token value) by adjusting his purchase price to 5 euros.

THE WEIGHTED AVERAGE METHOD

Principle:

To the protected shareholder are allocated a number of shares such that it obtains that greater shareholding which it would have obtained if the *pre-money* valuation (on the basis of which the capital increase subscribed to was resolved) had corresponded to the weighted average between *(i)* that *pre-money* valuation *and (ii)* the valuation underlying the *down round*.

The *weighted average* system is distinguished into *narrow-based* (where only units already issued and outstanding are taken into account) and *broad-based* (where existing but not yet exercised options and conversions are also taken into account).

Example:

$$New\ Conversion\ Price = \frac{Old\ Conversion\ Price\ x\ (Outstanding\ Shares\ Before\ Financing + \frac{Consideration\ Received}{New\ Price\ Per\ Share})}{Outstanding\ Shares\ Before\ Financing + New\ Shares\ Issued}$$

Where:
Old Conversion Price: the Subscription Price of the investor's entry capital increase
Outstanding Shares Before Financing: the number of existing shares/shares before the new round
Consideration Received: the amount of the down round
New Price per Share: the Price per share/share of the down round
New Shares Issued: the number of shares/units issued with the down round

HOW TO LEGALLY ATTRIBUTE ANTI-DILUTION PROTECTIONS

The **anti-dilution protection**, is generally included in the by-laws of the company. In this case, it can:

- constitute a "**different right**" that connotes a category of shares or quotas pursuant to Article 2348 Civil Code or Article 26, paragraph 2, Decree Law 179/2012, or that is in addition to other different rights included within the "protected" category;
- or, in S.r.l. only, consists in a "**special right**" (*diritto particolare*) of the shareholder under Article 2468, Paragraph 3, Civil Code.

Flash news by **focus team Venture Capital**: crccd_venture@crccdlex.com

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