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# **How to efficiently advise our clients – Pan-European lean investment documents**

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# Anti-dilution clause

- An **anti-dilution provision** is a mechanism that serves to mitigate the dilutive effect of future stock issuances at a lower price (“down round”) on certain stockholders having preferred shares.

It is triggered when there is a new series of shares issued and typically an issue price per share is lower than the price paid for the issuance of the preferred shares.

- A **typical protection** entails on the issuance of additional shares to a particular stockholder to maintain that stockholder's percentage interest in the company.

There are **two types of price-based anti-dilution protection: weighted average and full ratchet.**

- **Weighted average** gives the preferred shares' holder an entitlement to new shares issued in the down round in the amount intended to offset the dilution caused by the down round. Anti-dilution adjustment is applied based on the defined mathematic formula. The formula takes into consideration the preferred shares price, the amount of shares before down round, the amount issued in the down round, as well as the number of shares held by the entitled shareholder. The purpose is to define what shall be the broad-based weighted average price for the entitled holder of the preferred shares and how many shares shall be allotted to the entitled shareholder.
- **Full ratchet** gives the holder of preferred stock rights to convert preferred stock into a number of shares of common stock equal to the amount invested by the preferred stockholder divided by the price per share in the current round. As a result, holders of the preferred shares effectively get a price adjustment to the price paid in the down round.

Example: if an investor purchased 1,000 shares of preferred stock, with full-ratchet anti-dilution protection, for \$10,000 (\$10 per share), and in a future down round the company sells shares for \$5 per share, the investor's preferred stock would be convertible into 2,000 shares of common stock ( $\$10,000 \div \$5$ ), and each share of preferred stock would be convertible into two shares of common stock.

- **Sample clauses** entail weighted average clause. It is more common since the full ratchet provision will always result in a larger conversion rate adjustment than the weighted average provision and, for that reason, is more detrimental to common stockholders than the weighted average formula.
- **Alternative to anti-dilution adjustments** – Anti-dilution result could be obtain in different ways, such as negotiating a similar solution to anti-dilution clause or other investor-friendly terms, for example, a better liquidation preference, accruing dividends, “participating” preferred and warrant coverage.
- **Specific regulation under Polish law** - In a simple joint-stock company, anti-dilution clauses placed in the articles of association allow shares to be privileged with respect to the exercise of voting rights. The holders of so-called "founder's shares" automatically, with each new share issue, obtain as many new votes attributable to the existing "founder's shares" as necessary for that holder to retain the same percentage of votes as they had before that new issue. There is no limit on the votes incorporated in the shares.



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