High profile venture capital transactions – anti-dilution provisions under Dutch law

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High profile start-ups (again) claim a hot rise in 2014. For private startups, reaching a billion-dollar valuation used to signify entry into an exclusive club. The club is becoming less exclusive as venture capitalists funnel large sums of capital in the best startups. We all know Uber, Airbnb, Spotify and Dropbox, to name a few; very large in size, but from a legal perspective still a start-up. These kind of start-ups are in nothing similar to small companies starting from a garage; this also applies for the legal documentation. In high profile venture capital transaction many venture capital specific provisions are to be expected. Anti-dilution provisions are one of them.

Anti-dilution provisions protect investors in a down round: a later issuance at a lower price than the first issue price. They are designed to attract strong first round investors. The possibility of a down round greatly enhances the venture's initial flexibility and hence its investment value but initial investors may wish to protect their interests against dilution.

As professional venture capital investors will more and more require protection against dilution, we take a look at anti-dilution provisions from a Dutch law point of view.

Pre-emptive rights under Dutch law

Article 206a of Book 2 of the Dutch Civil Code provides that, unless the articles of association dictate otherwise, each shareholder has a pre-emptive right upon the issue of new shares pro rata the total amount of its shares held by that shareholder. Sounds good, but holders of preferred shares (a very frequent phenomenon in venture capital companies) in principle have no pre-emptive rights. Also, any minority short of a controlling interest can overturn or manipulate any such statutory anti-dilution protection and no room is provided for pricing arrangements. For venture capital purposes, pre-emptive rights on the basis of Article 206a are simply insufficient.

Contractual anti-dilution provisions

Anti-dilution provisions kick in in a down round by adjusting the share price at issuance. The initial venture capital investors become entitled to more shares by contractually creating the situation that the initial investors are deemed to have invested in the first round at a lower price. Sophisticated venture capital transactions typically show one the following anti-dilution mechanisms:

a) Broad Based Weighted Average anti-dilution
b) Narrow Based Weighted Average anti-dilution
c) Full Ratchet anti-dilution

Weighted Average anti-dilution provisions are the milder form of anti-dilution protection, where the Full Ratchet anti-dilution provisions are the more aggressive form of protection. The *Broad Based* Weighted Average formula takes into account all issued shares, while the *Narrow Based* Weighted Average formula only takes into account the shareholding of the protected investor. Various calculation methods exist.

The outcome of the various anti-dilution provisions can be shown on the following basis:

	Initial Shares	**Round B**
Founders	3,000,000	3,000,000
Investor A	1,000,000 **(A Shares)**	1,000,000
Investor B	0	1,000,000
Total	4,000,000 **(Total Shares)**	**5,000,000**

Investor A initially acquired 1 million shares (**A Shares**) at a price of EUR 1 (**Old Price**) and in a down round Investor 2 acquires 1 million shares (**New Shares**) at a price of EUR 0.50 (**New Price**).

a) Broad Based Weighted Average anti-dilution

With the following Broad Based Weighted Average formula, the effect for Investor A would be that he is entitled to 111,111 new shares:

i. Average Price = (Old Price*Total Shares + New Price*New Shares) / (Total Shares + New Shares)

Average Price = (1*4,000,000 + 0.50*1,000,000) / (4,000,000 + 1,000,000) = EUR 0.90

ii. New Shares = A Shares*Old Price/Average Price – A Shares

New Shares = 1,000,000*1/0.9 – 1,000,000 = 111,111

b) Narrow Based Weighted Average anti-dilution

With a Narrow Based Weighted Average formula, the effect for Investor A would be that he is entitled to 333,333 new shares:

i. Average Price = (Old Price*A Shares + New Price*New Shares) / (A Shares + New Shares)

Average Price = (1*1,000,000 + 0.50*1,000,000) / (1,000,000 + 1,000,000) = EUR 0.75

ii. New Shares = A Shares*Old Price/Average Price – A Shares

New Shares = 1,000,000*1/0.75 – 1,000,000 = 333,333

c) Full Ratchet anti-dilution

Full Ratchet anti-dilution provisions entitle the investor confronted with a down round to a number of shares calculated on the basis of a price equal to the price per share paid by new investors.
With the following Full Ratchet formula, the effect for Investor A would be that he is entitled to 1,000,000 new shares:

i. New Shares = A Shares*Old Price/New Price – A Shares

New Shares = 1,000,000*1/0.50 – 1,000,000 = 1,000,000

Pay to Play

A Pay to Play provision is usually also included with the anti-dilution provisions in the investment agreement. This ensures that initial investors may only exercise their anti-dilution rights under the condition that they participate in future financing rounds.

Dutch law observations

Anti-dilution provisions have a strong Anglo-Saxon background. The contractual mechanisms work under Dutch law, but the Dutch law provisions regarding the issue of shares are to be taken into account. Shares in a Dutch limited liability company cannot be issued ‘at no cost’, or similar wording. Article 191 of Book 2 of the Dutch Civil Code prescribes that at the moment of the issue of shares the nominal value of the shares must be paid up.
An issue of shares ‘at no cost’ pursuant to anti-dilution provisions, however, would be preferred by venture capital investors. One of the possibilities to get closest to the ‘at no cost’ scenario, would be to include an obligation to create and maintain a reserve for dilution scenarios. This reserve ensures that the additional shares can be issued to the protected investor ‘at no cost’ at that time. Another possibility would be to agree that for newly issued shares under the anti-dilution provision only the nominal value is paid up by the protected investor.

Conclusion

Anti-dilution provisions can be an effective tool under Dutch law. This does not necessarily mean that such provisions are attractive for later-round investors in a Dutch law environment. Initial investors must bear in mind that requiring these kind of provisions may have a potential downside from a commercial perspective.

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