Anti-dilution clauses in venture capital deals under Spanish law

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What are anti-dilution clauses all about?

Anti-dilution clauses protect investors in situations where the company in which they have invested decides to issue new share capital at a price per share that is lower than what the initial investors paid for theirs.

The valuations of early-stage companies or companies with new business models can fluctuate significantly, even more so now, in the current economic context. This causes investors to seek protection from down-round financing. As a general rule, the higher the pre-money valuation is, the higher the risk involved; thus making it even more necessary for investors to include this type of mechanism to protect themselves. As an exception to the foregoing, shareholders agreements normally establish that said mechanisms will not be applicable to transactions where stock options plans are being exercised in benefit of the employees.

Preemptive rights under Spanish law

The Spanish Companies Act establishes (under its Article 304) that, in the context of cash contributions, all shareholders have the right to subscribe a number of shares that is proportional to the nominal value of the ones they already hold. Although this right (which is legally recognized) is the most basic anti-dilution mechanism, in many cases it is not sufficient to protect investors being that, on many occasions, investors cannot take part in the new rounds of financing and, therefore, the stakes they hold are particularly diluted. In other cases, even if investors can still participate in the new share capital increases and keep their stake in the share capital, if down-round financing is carried out, the average price paid by the investor will be higher than the current price of the company's shares.

Types of anti-dilution clauses

The types of anti-dilution clauses that are most commonly used in venture capital transactions are explained below, as well as an explanation of how they work in practice.

1. Weighted-average-price clauses

The most common anti-dilution clauses are those known as weighted-average-price clauses. This method involves calculating a new average price for the investor (which is always lower than the price paid by the investor at entry). If we divide the total amount invested by the investor by the new average price per share, this will give us the total number of shares to which said investor will be entitled and, therefore, the additional number of shares that the investor is entitled to receive under such anti-dilution clause.

There are two types of clauses using weighted-average price: (i) *broad-based weighted-average price*; and (ii) *narrow-based weighted-average price*, whose application is explained in the example below:

A company has the following share capital structure:

	Initial Shares	Round B	Round C
Founders	30,000	30,000	30,000
Investor A	45,000	45,000	45,000
Investor B	0	30,467	30,467
Investor C (down-round)	0	0	21,093
Total		**105,467**	**126,561**

Investor B invested 3 million euros and paid **98.47 euros** per share to acquire 30,467 shares. Some time later, a new round of financing (a down-round) takes place wherein a new investor joins the share capital (Investor C) and 21,093 shares are issued at a price **47.41 euros** each, for a total investment of 1 million euros.

Let's see how the different weighted-average-price clauses would work in favour of Investor B.

1.A) *Broad-based weighted-average price*:

The following formula is used in this type of mechanism:

i) Average Price = Total shares * Price B + + Share capital increase/total shares + + additional shares.

Average Price = 105,467*98.47 +
+ 1,000,000/105,467 + 21,093 =
= 89.96 euros

ii) Number of total shares held by Investor B = Investor B's Investment/ /new average share price

Number of total shares of Investor B =
= 3,000,000/89.96 = 33,349 shares

iii) Number of new shares to be issued to Investor B = Total shares – prior shares

Number of new shares to be issued
to Investor B = 33,349 – 30,467 =
= 2,882 shares

This means that under this type of clause Investor B would be entitled to receive 2,882 additional shares. Thus, the company's cap table would be the following after the anti-dilution mechanism is applied:

	BROAD Adjustment	After Adjustment
Founders	0	30,000
Investor A	0	45,000
Investor B	2,882	33,349
Investor C (down-round)	0	21,093
Total	**2,882**	**129,443**

It is clear that this causes a dilution in relation to the rest of the shareholders and Investor C will have taken into account the anti-dilution mechanism when it negotiates its entry.

If this type of clause is used, it is very important to clearly define the number of shares that are to be considered as "Total Shares" when drafting the shareholders agreement. For example, it should be decided whether to include shares that the company may have issued under a stock option plan. Normally, the company will wish to increase this number, whereas the investor will seek to lower it.

1.B) *Narrow-based weighted-average price*:

The main difference between this mechanism and that which is described under Section 1.A above is that its formula does not take into account all the previous shares but only Investor B's protected shares. Said difference normally causes the average price to drop, thus it is a formula that is more beneficial for the investor, being that the latter will receive a greater number shares.

The following formula is used in this type of mechanism:

i) Average Price = B Shares * Price per B Share + Capital increase /B Shares + + additional shares.

Average Price = 30,467*98.47 +
+ 1,000,000/30,467+ 21,093 =
=77.58 euros

ii) Number of total B shares = Investor B's Investment/new average price

Number of total B shares =
= 3,000,000/77.58 = 38,670 shares

iii) Number of new shares to be issued to Investor B = Total shares – Prior shares

Number of new shares to issue to
Investor B = 38,670 - 30,467 =
= 8,203 shares

That is to say, under this method, Investor B would be entitled to receive 8,203 new shares. Thus, the company's cap table would be the following after the anti-dilution mechanism is applied:

	NARROW Adjustment	After Adjustment
Founders	0	30,000
Investor A	0	45,000
Investor B	8,203	38,670
Investor C (down-round)	0	21,093
Total	**8,203**	**134,764**

Thus, under this scenario Investor B will receive more additional shares, being that only Investor B's protected shares are taken into account under this formula.

It should be noted that the final impact of applying such weighted-average price formulas will depend, to a great extent, on the size and price of the share capital increase.

2. Full ratchet

The "full ratchet" formula is much simpler than the weighted-average price formulas. The full ratchet formula protects the investor and it is more aggressive for the company. Under this type of clause, Investor B will be entitled to an average price that is equal to the price of the new round of financing; that is to say, 47.41 euros. In such case, Investor B will be entitled to receive 32,811 new shares.

3. Pay to play

On occasions the mechanisms that are referred to in Sections 1 and 2 above are combined with what is known as a "pay to play" method. That is to say, the investor will only be able to enjoy its anti-dilution right if it continues to participate in the new rounds up to a specified amount.

Subscription of new shares by the investor under Spanish law

When drafting this type of clauses in the relevant shareholders agreements, it is important to include a provision wherein the other shareholders must waive their preemptive rights in favor of the protected investor. Most of the investments made through venture capital transactions in Spain normally involve limited-liability companies ("*sociedades de responsabilidad limitada*") and the Spanish Companies Act requires that the nominal value of the new shares must be fully subscribed and paid up. Therefore, if the new shareholder does not want to undertake the obligation to pay even the nominal value of the new shares, this must be taken into account when drafting the clause. To do so, a relatively common method is used which involves requiring the companies to create a reserve for those situations where the anti-dilution right is exercised in order to avoid paying the nominal value In such cases, the investor will receive the new shares free, by way of a capital increase made against such available reserves. In other cases, investors require the founders or other majority shareholders (who normally entered the share capital at prices that were much lower) to grant them a call option in order to exercise the anti-dilution rights.

Conclusion:

Anti-dilution clauses provide investors with an effective mechanism for minimizing the negative impact that may arise for their investment in cases of down-round financing. The decision regarding which specific clause should be used will depend, to a great extent, on the characteristics of each company and, particularly, on the initial valuation at which the investor has subscribed its shares and the share capital structure of the company in question.