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A Primer on Anti-Dilution in Private Placement Offerings

Private placement offerings are terrific and venerable vehicles to raise company financing outside of the public capital market and without going public. However, because of their very nature they often involve a higher degree of risk than is typically associated with an underwritten and registered offering. That is not always the case, but it is commonly the case. As a result, many investors seek to blunt that risk.

A prime investor strategy in protecting against risk is to insist on some form of protection against a decrease in company value that results in dilution of the investor's stake. If there is a so-called "down round", whereby the issuer sells additional securities at a lesser price per unit or share than what the original investor paid, that will cause the original investor's stake to potentially shrink significantly (this dilution is as above and beyond the dilution that results when an issuer issues additional units or shares resulting in more shares overall, because the new units or shares are being sold at a lower price, thereby shrinking the original investor's stake at a greater rate).

Commonly, in those circumstances, the anti-dilution protection would be triggered, reducing the amount by which the investor stake would shrink. In the world of *preferred securities*, there is often a conversion mechanism that allows the holder of the preferred securities purchased in a private placement to convert those preferred securities into common securities. Anti-dilution protection typically makes that conversion more favorable (i.e., the investor gets more shares of common upon conversion) based on certain circumstances that trigger the protection, as well as a formula that calculates the extent of the protection.

WEIGHTED AVERAGE ANTI-DILUTION PROTECTION: This is the most common form of anti-dilution provision, which tends to come in two flavors, "broad" and "narrow". Broad-based weighted-average anti-dilution protection will factor in any and all issuer securities that can ultimately turn into common stock (including any instrument convertible into, exercisable for or exchangeable for common stock.) Typically, the formula will reduce the applicable conversion price of the investor's preferred stock by an amount calculated against the ratio of that number of shares of common stock that would be issued in the down round using the pre-down round conversion price, compared to the number of common shares that are issued in the "down round" using the lower offering price.

Narrow-based weighted-average anti-dilution protection, by contrast, will only factor in a subset of issuer securities convertible into shares of the issuer's common stock. Typically included in that subset are outstanding preferred securities. The subset will typically not factor in options, warrants and shares that are awarded via a stock incentive pool. Similar to the broad-based weighted-average approach, narrow-based weighted-average anti-dilution protection will also reduce the investor's conversion price in an amount calculated against the ratio of the number of shares of the common shares that would be issued in the "down" round using the pre-down round conversion price, compared to the number of common shares that that are issued in the down round using the lower offering price.

FULL RATCHET ANTI-DILUTION PROTECTION: This mode of anti-dilution protection is the least used and is the most onerous to the issuer. Simply, full-ratchet anti-dilution protection will adjust the conversion price of the investor's outstanding preferred stock to the NEW lower price at which the issuer is selling new shares. Any issuer should approach this form of anti-dilution protection with extreme caution. It is not a coincidence that it is not commonly offered to investors for early stage rounds, as it can frustrate incoming investors who may view it unfavorably.