

Cracking the Anti-Dilution Formula

A quick guide to its nuances and
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June 2020

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About NDA

We are an India Centric Global law firm (**www.nishithdesai.com**) with four offices in India and the only law firm with license to practice Indian law from our Munich, Singapore, Palo Alto and New York offices. We are a firm of specialists and the go-to firm for companies that want to conduct business in India, navigate its complex business regulations and grow. Over 70% of our clients are foreign multinationals and over 84.5% are repeat clients.

Our reputation is well regarded for handling complex high value transactions and cross border litigation; that prestige extends to engaging and mentoring the start-up community that we passionately support and encourage. We also enjoy global recognition for our research with an ability to anticipate and address challenges from a strategic, legal and tax perspective in an integrated way. In fact, the framework and standards for the Asset Management industry within India was pioneered by us in the early 1990s, and we continue to remain respected industry experts.

We are a research based law firm and have just set up a first-of-its kind IOT-driven Blue Sky Thinking & Research Campus named Imaginarium AliGunjan (near Mumbai, India), dedicated to exploring the future of law & society. We are consistently ranked at the top as Asia's most innovative law practice by Financial Times. NDA is renowned for its advanced predictive legal practice and constantly conducts original research into emerging areas of the law such as Blockchain, Artificial Intelligence, Designer Babies, Flying Cars, Autonomous vehicles, IOT, AI & Robotics, Medical Devices, Genetic Engineering amongst others and enjoy high credibility in respect of our independent research and assist number of ministries in their policy and regulatory work.

The safety and security of our client's information and confidentiality is of paramount importance to us. To this end, we are hugely invested in the latest security systems and technology of military grade. We are a socially conscious law firm and do extensive pro-bono and public policy work. We have significant diversity with female employees in the range of about 49% and many in leadership positions.

Accolades

A brief chronicle of our firm's global acclaim for its achievements and prowess through the years –

- **Legal500:** Tier 1 for Tax, Investment Funds, Labour & Employment, TMT and Corporate M&A 2020, 2019, 2018, 2017, 2016, 2015, 2014, 2013, 2012
- **Chambers and Partners Asia Pacific:** Band 1 for Employment, Lifesciences, Tax and TMT 2020, 2019, 2018, 2017, 2016, 2015
- **IFLR1000:** Tier 1 for Private Equity and Project Development: Telecommunications Networks. 2020, 2019, 2018, 2017, 2014
- **AsiaLaw Asia-Pacific Guide 2020:** Tier 1 (Outstanding) for TMT, Labour & Employment, Private Equity, Regulatory and Tax
- **FT Innovative Lawyers Asia Pacific 2019 Awards:** NDA ranked 2nd in the Most Innovative Law Firm category (Asia-Pacific Headquartered)
- **RSG-Financial Times:** India's Most Innovative Law Firm 2019, 2017, 2016, 2015, 2014
- **Benchmark Litigation Asia-Pacific:** Tier 1 for Government & Regulatory and Tax 2019, 2018
- **Who's Who Legal 2019:**
Nishith Desai, Corporate Tax and Private Funds – Thought Leader
Vikram Shroff, HR and Employment Law- Global Thought Leader
Vaibhav Parikh, Data Practices - Thought Leader (India)
Dr. Milind Antani, Pharma & Healthcare – only Indian Lawyer to be recognized for 'Life sciences-Regulatory,' for 5 years consecutively
- **Merger Market 2018:** Fastest growing M&A Law Firm in India
- **Asia Mena Counsel's In-House Community Firms Survey 2018:** The only Indian Firm recognized for Life Sciences
- **IDEX Legal Awards 2015:** Nishith Desai Associates won the "M&A Deal of the year", "Best Dispute Management lawyer", "Best Use of Innovation and Technology in a law firm" and "Best Dispute Management Firm"

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1. Introduction

An investor's decision to invest in a company is driven by the expected potential of the company and the price such investor pays, reflects such expectation. As the story often goes, if a company fails to meet its potential causing its valuation to dip, it will issue its shares at a lower valuation (commonly termed as down round) in the future, and as a corollary, the value of the investment made by such investor would also suffer. A typical feature of most venture capital and early stage investments, anti-dilution protection serves as a measure to soften the impact of such a future down round on existing investors.

Unlike in a situation in which additional investment rounds may increase the valuation of a company, a down round, along with diluting the shareholding percentage, will also reduce the value of the shares held by a shareholder. Events such as share splits, bonus issue, consolidation, reclassification of share capital, issue of options and issue of ordinary shares against convertible instruments are typically exempted from the ambit of anti-dilution events given the effect of such issuances are different, as they affect the interest of all shareholders equally.

2. Types of Anti-Dilution Protection

Broadly, there are two types of anti-dilution protection – full ratchet and weighted average methods.

Rarely used, the full ratchet method is the simplest to understand but stacks the deck unfairly against other shareholders and founders of a company. Under this method, the existing investor’s shares would be repriced at the prevailing price of the down-round thereby protecting such investor from any dilutive issuances. Suppose a seed investor subscribed to 100 convertible instruments of a company at a price of INR 1000 per share. After a year, due to certain unforeseen circumstances, valuation of the company dips and it raises funds from a new investor at a price of INR 500 per share, then in a classic case of dilutive issuance such as this, had the seed investor negotiated a full ratchet anti-dilution protection for itself, the company would have been obliged to compensate him by reducing the value of his shares to INR 500 per share and effectively entitling him to be subscribe to another 100 shares for the price that the investor has already invested.

While this method of anti-dilution protection may be most favoured by investors, founders often suffer the collateral damage who would be diluted disproportionately while the existing investor escapes unscathed.

A more balanced and common approach would be the weighted average method which (unlike full ratchet) also takes into account the number of shares being issued in the down round. This method ‘averages out’ the impact of a down round across parties. This may be illustrated as:

CP2 = CP1 * (A+B) / (A+C), where:

CP2	<i>conversion price in effect immediately after new round</i>
CP1	<i>conversion price in effect immediately prior to new round</i>
A	<i>number of shares of outstanding share capital immediately prior to the issuance</i>
B	<i>number of shares which existing investor would have received if it invested at CP2</i>
C	<i>umber of shares issuable upon conversion</i>

A ‘broad-based weighted average’ method takes in to account all common outstanding shares on a fully diluted basis, thereby including all outstanding warrants, options and convertible shares. Whereas, a narrow-based formula can be tailor made to exclude certain classes of shares over others.

Such adjustments, whether by way of a full ratchet or weighted average method, can be given effect to by various mechanisms including: (a) issuance of additional shares at the prevailing price for free to the existing investor, (b) transfer of additional shares from founder(s) at the lowest permissible price to the existing investor, (c) in case of convertible instruments, by adjusting the conversion price as per the prevailing price, (d) buy-back of shares of existing investor by the company, (e) reducing the sale proceeds of the promoters or other shareholders. The most commonly issued method remains to be an adjustment to the conversion price.

We also see variations such as ‘Pay to Play’ provisions wherein anti-dilution protection is made available to an existing investor only if such investor also participates in such a down round. As an alternative, investors sometimes prefer to instead have the right to block such issuances as opposed to an anti-dilution right. A typical early-stage protection, anti-dilution provisions are usually available to an investor for a limited number of years or across limited investment rounds, after which deal-makers expect investors to absorb dilutive issuances as a business risk.

3. Hurdles and Solutions in Enforcement

Easier negotiated than implemented, there may be certain legal and regulatory challenges in enforcing this protection.

A foreign investor seeking to exercise their anti-dilution right, would have to be mindful of the pricing guidelines as prescribed under the Foreign Exchange Management (Non-debt Instruments) Rules, 2019 (“**ND Rules**”) which dictate that the price at which shares of an unlisted / private Indian company is issued to a non-resident, should not be less than the fair market value of such shares as determined by any internationally accepted pricing methodology duly certified by a Chartered Accountant or a Merchant Banker registered with the Securities and Exchange Board of India (“**SEBI**”) or a practising Cost Accountant.¹ Accordingly, issuance of shares ‘free of cost’ or at any cost below the fair market value to a non-resident under an anti-dilution protection would be a challenge.

The ND Rules further require that the price / conversion formula of any convertible instrument is determined upfront at the time of issuance and in every case, the price at which a conversion takes place to be not lower than the fair market value of the equity shares determined at the time of issuance of the convertible instrument. This could further complicate the scenario where any changes to the conversion formula are contemplated to achieve the anti-dilution protection, as at no point of time the conversion price can fall below the fair value of equity shares at the time of issuance.

Any issuance of shares (other than in case of a rights issuance) for a price which is lower than the fair market value may also come within the ambit of Section 56(2)(x)(c) of the Income Tax Act, 1961 which would deem the difference between the discounted value and the fair market value (determined based on book value of assets less liabilities) as ‘income from other sources’, taxable at a rate as high as 40% in the hands of the acquirer.

There are a few possible calculated steps to take which would assist with ensuring a smooth enforcement of the anti-dilution right in the future. One would be to ensure that the shares which carry anti-dilution protection are issued at a price which are sufficiently higher than the fair market value today, such that any revision to the conversion price post-dilution still swims comfortably above the then fair market value.

Compared to the multitude of challenges in India, most mature economies offer simpler legal and regulatory landscape, at least in the case of unlisted shares. Investors in other jurisdictions are also toying with other variations of price protection measures such as ‘Golden Shares’ which grant investors a smaller equity stake to begin with, but in cases of anti-dilution or liquidity events, guarantee preferential rights to its holders above other shareholders.²

For an often-used provision, draftsmen are often unlikely to want to understand the mathematics behind an anti-dilution formula and how formulae change with changing commercials. Higher information barriers in development or intermediate -stage private stage investment companies are a key determinant in opting for anti-dilution right.³ An investor is more likely to overvalue his investment in such a private company where access to information may be skewed, limited or even misleading, when compared to a widely traded public company which is heavily regulated. Understanding this mathematics and identifying potential blind spots in an early-stage investment today is likely to yield a more nuanced anti-dilution protection which may be easier to enforce tomorrow.

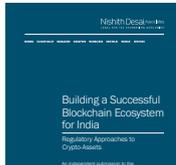
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1. Rule 21(2)(ii) of Foreign Exchange Management (Non-debt Instruments) Rules, 2019

2. Golden Shares and Anti-dilution Provisions – Tom Hockaday and Tony Hickson, Oxford University Innovation, June 2015

3. Understanding Anti-Dilution Provisions – Michael A. Woronoff and Jonathan A. Rosen, Fordham Law Review, Vol. 74, 2005

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Research @ NDA

Research is the DNA of NDA. In early 1980s, our firm emerged from an extensive, and then pioneering, research by Nishith M. Desai on the taxation of cross-border transactions. The research book written by him provided the foundation for our international tax practice. Since then, we have relied upon research to be the cornerstone of our practice development. Today, research is fully ingrained in the firm's culture.

Our dedication to research has been instrumental in creating thought leadership in various areas of law and public policy. Through research, we develop intellectual capital and leverage it actively for both our clients and the development of our associates. We use research to discover new thinking, approaches, skills and reflections on jurisprudence, and ultimately deliver superior value to our clients. Over time, we have embedded a culture and built processes of learning through research that give us a robust edge in providing best quality advices and services to our clients, to our fraternity and to the community at large.

Every member of the firm is required to participate in research activities. The seeds of research are typically sown in hour-long continuing education sessions conducted every day as the first thing in the morning. Free interactions in these sessions help associates identify new legal, regulatory, technological and business trends that require intellectual investigation from the legal and tax perspectives. Then, one or few associates take up an emerging trend or issue under the guidance of seniors and put it through our "Anticipate-Prepare-Deliver" research model.

As the first step, they would conduct a capsule research, which involves a quick analysis of readily available secondary data. Often such basic research provides valuable insights and creates broader understanding of the issue for the involved associates, who in turn would disseminate it to other associates through tacit and explicit knowledge exchange processes. For us, knowledge sharing is as important an attribute as knowledge acquisition.

When the issue requires further investigation, we develop an extensive research paper. Often we collect our own primary data when we feel the issue demands going deep to the root or when we find gaps in secondary data. In some cases, we have even taken up multi-year research projects to investigate every aspect of the topic and build unparalleled mastery. Our TMT practice, IP practice, Pharma & Healthcare/Med-Tech and Medical Device, practice and energy sector practice have emerged from such projects. Research in essence graduates to Knowledge, and finally to *Intellectual Property*.

Over the years, we have produced some outstanding research papers, articles, webinars and talks. Almost on daily basis, we analyze and offer our perspective on latest legal developments through our regular "Hotlines", which go out to our clients and fraternity. These Hotlines provide immediate awareness and quick reference, and have been eagerly received. We also provide expanded commentary on issues through detailed articles for publication in newspapers and periodicals for dissemination to wider audience. Our Lab Reports dissect and analyze a published, distinctive legal transaction using multiple lenses and offer various perspectives, including some even overlooked by the executors of the transaction. We regularly write extensive research articles and disseminate them through our website. Our research has also contributed to public policy discourse, helped state and central governments in drafting statutes, and provided regulators with much needed comparative research for rule making. Our discourses on Taxation of eCommerce, Arbitration, and Direct Tax Code have been widely acknowledged. Although we invest heavily in terms of time and expenses in our research activities, we are happy to provide unlimited access to our research to our clients and the community for greater good.

As we continue to grow through our research-based approach, we now have established an exclusive four-acre, state-of-the-art research center, just a 45-minute ferry ride from Mumbai but in the middle of verdant hills of reclusive Alibaug-Raigadh district. **Imaginarium AliGunjan** is a platform for creative thinking; an apolitical ecosystem that connects multi-disciplinary threads of ideas, innovation and imagination. Designed to inspire 'blue sky' thinking, research, exploration and synthesis, reflections and communication, it aims to bring in wholeness – that leads to answers to the biggest challenges of our time and beyond. It seeks to be a bridge that connects the futuristic advancements of diverse disciplines. It offers a space, both virtually and literally, for integration and synthesis of knowhow and innovation from various streams and serves as a dais to internationally renowned professionals to share their expertise and experience with our associates and select clients.

We would love to hear your suggestions on our research reports. Please feel free to contact us at research@nishithdesai.com

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