What is anti-dilution and why does it matter to me as a company founder?

By Richard Friedman

When additional shares of stock are issued, that additional issuance has a "dilutive" effect on the ownership percentages of all the existing stockholders. Said another way, more people are sharing the pie as the number of stockholders increases, each person's slice of the pie gets smaller. An anti-dilution provision is a mechanism that serves to mitigate the dilutive effect of future stock issuances on certain stockholders. The most common protections are designed to apply in situations in which stock is sold to new investors at a price lower than that paid by earlier investors (for more about such "down rounds," see our article). This article provides an overview of anti-dilution protections.

What are different types of anti-dilution protections?

- **Price-based anti-dilution**: When a company raises money in a down round, that issuance is viewed as diluting the value of the stock held by the earlier investors. For that reason, investors often negotiate anti-dilution protection as part of their investment in order to offset the dilutive effects of future down rounds.

- **Contractual anti-dilution**: Less commonly, some stockholders may negotiate the right to receive, for no additional payment, additional shares of stock as necessary to protect them from dilution of their percentage interest in the company from new share issuances, regardless of the price at which new shares are sold.

How does price-based anti-dilution protection work?

To implement price-based anti-dilution, the company's charter includes a mechanism to automatically adjust the rate at which preferred stock converts to common stock if the company has a down round.

Initially, preferred stock converts to common stock at a 1:1 ratio. This conversion ratio affects, among other things, relative voting rights, how proceeds in a company sale will be allocated among stockholders, and the number of shares that investors will hold after an IPO when the preferred converts to common. When a price-based anti-dilution adjustment is made, the conversion ratio of preferred to common becomes greater than 1:1, resulting in a change to the common stock equivalent number in the company's capitalization table (for more about capitalization tables, see our article).

There are two types of price-based anti-dilution protection:

- **Weighted average**: This form of protection adjusts the conversion ratio by an amount intended to offset the dilution in implied value of the shares caused by the down round. This adjustment involves a formula that compares (a) the number of shares that would have been issued to the new investors if they would have paid the same price as the earlier investors against (b) the number of shares actually issued to the new investors at the lower price. Most commonly, a "broad-based" weighted average formula is used and incorporates the fully-diluted capitalization of the company, thereby lessening the dilution impact on the common stock holders. Sometimes, the formula may include only the outstanding shares of stock (referred to as a "narrow-based" weighted average formula), which is more favorable to the early investors; for more about calculating the fully diluted capitalization, please see our article).

- **Full ratchet**: Full ratchet anti-dilution lowers the effective purchase price of the protected stock to the actual price paid in the down round. A full ratchet provision will always result in a larger conversion rate adjustment than a weighted average provision and, for that reason, is more detrimental to founders and other common stock holders.

For more about these specific formulas, please see this article.

Do all preferred stock financings include price-based anti-dilution protections?

Not always. While most Series A (and later) financings include weighted average anti-dilution protection, Series Seed financings may or may not include that protection. Full ratchet provisions are not commonly seen.

Do all issuances of lower priced stock trigger price-based anti-dilution protection?

Certain issuances are typically excluded from the anti-dilution mechanism. One common exception is the issuance of options to employees and consultants pursuant to a board-approved option plan. Sometimes the charter will include a specified maximum number of excluded option plan shares. This is one more factor to consider in sizing the option pool (for more on considerations in properly setting the option plan reserve, please see our article).

Another common exception covers the issuance of warrants in connection with lines of credit. To the extent that the company issues any shares of stock below the price paid by the preferred stock investors, the charter should be reviewed to assess if the issuance may trigger the anti-dilution provision.

How does contractual anti-dilution work?

A typical protection entails the company agreeing by contract to issue additional shares to a particular stockholder to maintain that stockholder's percentage interest in the company until the company raises a specific amount of financing, regardless of the price at which shares are sold that dilute the proposed stockholder's percentage interest in the company.

If the protection does not automatically terminate when the next round of financing is raised, new venture capital or angel investors may require that the company get the holder of those rights to agree to terminate the rights before the new investors will invest.

Do convertible notes and SAFEs have anti-dilution protection?

Convertible notes and SAFEs do not represent a specific percentage interest in the company until converted. So, in one sense, the investors do not have stock holdings to dilute until their notes or SAFEs are converted into shares, and at that time they will receive the same anti-dilution protections as the new investors in the priced round that converts the notes or SAFEs.

In another sense, however, if the notes or SAFEs have a valuation cap, then that effectively provides the investors with anti-dilution protection with respect to the amount of shares they will be issued upon conversion. With a valuation cap, the issuance of additional shares by the company prior to the conversion will reduce the investors' conversion price, assuring the investors that they will receive a minimum percentage of the company as of immediately prior to the priced round as measured by the valuation cap. For more about valuation (or conversion) caps, please see our article.

In addition, notes or SAFEs may contain "most favored nation" provisions that allow the holders to take advantage of more favorable terms in future note or SAFE financings, such as a lower valuation cap.

What is my takeaway as a founder?

Broad-based weighted average protections are typical in preferred stock financings, and founders should expect to see them proposed and required by many investors. To the extent that the company can avoid down rounds and other issuances of lower-priced shares in non-exempt transactions, these particular provisions should not harm the founders. However, other types of anti-dilution protection which are less common can be more harmful to founders. These should be scrutinized carefully before you agree to them.
