

An Introduction To Antidilution Provisions

(Part 1)

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*Dilution in the value of stock is always a danger.
And the only way to guard against it is through
a carefully drafted antidilution provision.*

DURING THE INVESTMENT BUBBLE of the late '90s when it seemed as if all investments always went up, issuers, investors, bankers, and attorneys did not spend a lot of time worrying about those long sections in the middle of the preferred stock or convertible note terms that govern the soporific topic of antidilution. Clients did not read them because they are too

boring (after all, the lawyers read them), partners at law firms asked associates at law firms to read them (after all, it is good for the associates to work through the issues), and associates skimmed them (after all, they must be correct since they came from the last deal and someone else reviewed them then). All it takes is one down round to send everyone scurrying to read

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them. With the bursting of the bubble came more than one down round.

Another result of the hot equity market of the '90s was the development of the market for so-called PIPE (private investment in public equity) transactions, in which a public company sells securities privately and registers the public resale of those securities by the investor. Many large public companies with active markets for their common equity and many smaller public companies with thin markets have engaged in PIPE transactions. Furthermore, because clear standards for antidilution provisions have evolved in the venture capital community, many attorneys have simply transferred these provisions into the public realm, where they may not be appropriate. Little systematic thought has been given to antidilution provisions in recent years. Some notable articles include Stephen I. Glover, *Solving Dilution Problems*, 51 *Bus Law* 1241 (1996); Stanley A. Kaplan, *Piercing the Corporate Boilerplate: Anti-Dilution Clauses in Convertible Securities*; 33 *U. Chi. L. Rev.* 1 (1965); David L. Ratner, *Dilution and Anti-Dilution: A Reply to Professor Kaplan*, 33 *U. Chi. L. Rev.* 494 (1966).

In general, antidilution provisions protect holders of convertible, exchangeable, or exercisable securities from adverse consequences that may result from certain corporate actions taken by the issuer. Although in all instances antidilution provisions should operate mechanically and many types of events should always be covered, in many cases, the type of antidilution protection that an investor will want should vary depending on the nature of the issuer and the difficulty of properly assessing the correct value for the issuer's underlying common stock. Different types of provisions should be negotiated for privately held companies than for large public companies with well established trading markets. Furthermore, there is a large class of small publicly held companies

with thin trading markets, and special consideration should be given to these companies and what types of antidilution provisions would be appropriate for securities issued by them.

Antidilution provisions are contractual in nature, whether they appear in contractual agreements such as warrants or notes, or embedded in charter provisions in the form of preferred stock terms, and courts tend to interpret them narrowly and enforce them as written. See *Wood v. Coastal States Gas Corporation*, 401 A.2d 932 (Del. 1979). Sometimes, seemingly minor matters can have far-reaching consequences. In *Wood*, the certificate of incorporation of Coastal States Gas Corporation ("Coastal") omitted to include a provision for an antidilution adjustment upon a stock dividend. Despite the fact that the certificate of incorporation included provisions for many other typical situations (or perhaps for that reason) the Supreme Court of Delaware determined that the holders of Coastal's Preferred Stock had no right to an adjustment in the event of a stock dividend.

This article will consider the standard antidilution provisions as they exist in typical venture capital transactions, and the different considerations that arise in the context of public companies with active well established markets and public companies with thin markets. In addition, this article will consider, briefly, antidilution provisions in certain common investments such as options and warrants. Part 1 of this article focuses on the antidilution protection typically used in venture capital transactions. Part 2, which will appear in the August issue, will address the considerations that arise in the context of public securities as well as addresses certain commonly seen instruments such as options and warrants.

THE CONTEXTS • In the context of private venture capital transactions, antidilution provisions cover three types of occurrences:

- Forward and reverse stock splits, stock dividends, and similar events which, while they change the number of shares outstanding, do not change the relative ownership of the stockholders;
- Capital reorganizations, mergers, and similar events which cause changes in the common stock into which a convertible security may be converted or for which a warrant or option may be exercised; and
- Issuances of additional shares of common stock or common stock equivalents at prices below the conversion rate or exercise price of the convertible or exercisable security.

The first two of these occurrences are well understood and require little discussion. In the case of stock splits and similar events the exchange rate must be adjusted mathematically to preserve the deal among the parties. In the case of mergers and other changes to the common stock, the securities, or other consideration, to be received on conversion must be restated to reflect the changes to the common stock.

The Low-Priced Issuance Problem

In the case of low-priced issuances by privately held companies, investors typically bargain for and obtain a sharing of the risk of a decline in valuation with the existing stockholders. A typical venture capital investment takes the form of a purchase of preferred stock that is convertible into common stock of the issuer at the rate of one share of common stock for each share of preferred stock. If the issuer subsequently sells common stock (or its equivalent, i.e., other securities that are convertible into common stock) at a per share price of less than the original issue price per share of the preferred stock, the per share value of the venture capitalist's investment will decline.

An Example

Take a simple example, a venture capitalist acquires one million shares of Series A Preferred Stock of Easy Company for \$1 million. Easy Company has a pre-money valuation of \$1 million and has one million shares of common stock outstanding. After the investment, Easy Company has a valuation of \$2 million (the original \$1 million plus the cash invested by the venture capitalist). Easy Company also has the equivalent of two million shares of common stock outstanding (the original one million plus the one million issuable upon conversion of the preferred stock). In this case, each share is worth one dollar. Assume now that hard times arrive, and Easy Company needs to raise more capital. Easy Company issues one million shares of Series B Preferred Stock for \$900,000 (90 cents per share). Easy Company is now worth \$2,700,000 (90 cents per share) and has the equivalent of three million shares of common stock outstanding. Each share is now worth 90 cents (including the shares for which the Series A investor paid one dollar). The venture capitalist's original \$1 million has been turned into \$900,000.

How An Antidilution Provision Would Work

A typical venture capital antidilution provision would operate to lower the conversion rate of the investor's Series A Preferred Stock to 97 cents from one dollar. That is, it would reduce the conversion rate to reflect the weighted average price at which the shares of Easy Company were issued. For these purposes, it values all stock outstanding before the issuance of the Series A Preferred Stock as issued at the same per share price as the Series A Preferred Stock, in the above example, one dollar per share. As a result, the total money deemed paid to Easy Company for its shares is \$2,900,000 and the total number of shares outstanding is three million yielding a weighted average price per share

of approximately 97 cents. This represents a conversion rate of one share of common stock for every .97 shares of Series A Preferred Stock. The Series A Preferred Stock would therefore convert into 1,030,928 shares of common stock. The following table illustrates the effect of this provision:

Security	Capitalization Before Series B Issuance	Capitalization After Series B Issuance		
	Number of Shares	Adjusted Converted Rate	Number Shares	Notional Value
Common Stock	1,000,000	N/A	1,000,000	\$872,165
Series A Preferred	1,000,000	.97	1,030,928	\$927,835
Series B	—	.90	1,000,000	\$900,000 Preferred (Approximately, since the Series B Investor in this example owes slightly less than one third. The actual number is \$890,800)
Total	—		3,030,928	\$2,700,000

As this table illustrates, a portion of the decline in value of Easy Company has been shifted to the holders of common stock from the Series A investors. In effect, the investor is asking the holders of common stock to bear some of the risk of an inaccurate valuation.

Why Risk-Shifting Is Important

The issuer could take the position that a decline in the value of the business is simply a risk that an investor takes. But this is unrealistic; venture investors and others want to shift some of the risk and cost of dilution to the holders of common stock. Investors use a variety of rationales to support this position. Perhaps the most compelling argument is that an investor is at an informational disadvantage relative to the founding stockholders and that the investor's valuation is based on assumptions about the business provided to it by the founders. If those assumptions turn out to be wrong, the argument goes, a disproportionate share of the loss should fall on the holders of common stock. In addition, investors will argue that the founders

are in control of the day-to-day business activities of an issuer. As such, they have primary responsibility for preserving and, hopefully, growing the value of the company. If management is not successful, it should bear the brunt of the depreciation in value.

The venture capitalist's percentage ownership of Easy Company will also decline, but, strictly speaking, a mere decline in percentage ownership is not necessarily a dilution. Such a change could accompany an accretive event if additional shares are sold at a price above that paid by the venture capitalist. A decline in percentage interest, while it may accompany a dilutive transaction, goes more to issues of voting power and control than to financial value. A simple decline in percentage interest is dealt with in other contractual provisions such as rights of first refusal rather than antidilution provisions.

ANATOMY OF A TYPICAL VENTURE CAPITAL ANTIDILUTION PROVISION •

Venture capital transactions take a variety of forms, but tend to follow certain broad outlines. Several provisions are common to most transactions, and careful attention to them at the outset can help to avoid some of the more common difficulties.

Definition Of Additional Securities

The typical antidilution provision used in venture capital transactions starts with a definition of the types of issuances that may trigger an adjustment to the conversion rate of the instrument in question. From a drafting perspective, this definition begins by including all shares of common stock that may be issued in the future (either directly or indirectly through the issuance of options, warrants, and convertible instruments) and then excludes some specific issuances. As a result, any future issuance of any security will trigger an adjustment, unless it fits

into one of the specifically enumerated exceptions. Subject to the exclusions described below, all shares of common stock which are issued or which might be issued in the future pursuant to options, warrants, and other convertible securities (other than shares of common stock which are expressly excluded) are then defined as “Additional Shares of Common Stock.”

Typical Exceptions

Some of the exceptions are self-evident and should always be included, without need for negotiation. The obvious exceptions include:

- Shares of common stock required to be issued in the future pursuant to options, warrants, and convertible instruments already outstanding on the issue date of the convertible instrument in question; and
- Shares of common stock issued or deemed issued as a dividend or distribution with respect to the relevant convertible security itself.

Exception For Options

Because outstanding securities are known at the time of the transaction, they can, and should, be taken into account in the valuation of the issuer and its securities. An issue may arise, however, with respect to options that have not been granted. Companies often plan for future issuances, and expect investors to take them into account at the time of a financing. A typical provision would set aside a specified number of options which may be issued to employees, consultants, and others without triggering antidilution protection. This exclusion reflects an understanding between the company and the investor concerning future possible transactions.

Exception For Dividends

With respect to dividends on the preferred stock itself, no adjustment is needed because,

whatever dilutive effect such a dividend might have on stockholders generally, such a dividend would be accretive to the preferred stock.

Miscellaneous Exceptions

Other issuances which might be excluded are:

- Securities issued upon the conversion of the preferred stock itself (although this exclusion does not seem necessary since preferred stock is never converted below the applicable conversion rate);
- Securities issued in connection with lease lines, bank lines, and other commercial financings (again these are often subject to a negotiated maximum number); and
- Securities issued in an initial public offering.

No Adjustment For Shares Sold Over Conversion Price

The definition of additional shares of common stock is followed by a provision making it clear that there will be no adjustment for shares sold (directly or indirectly) at a price per share in excess of the conversion price, whether or not such securities would otherwise fit within the definition of shares for which an adjustment could be made. From a financial point of view, issuances at a price per share greater than the conversion price would be accretive rather than dilutive. Furthermore, to the extent that antidilution provisions are intended to mitigate the risk that the investor has placed too high a valuation on the issuer, no adjustment would be needed.

Exception For Approved Issuances

The antidilution provisions sometimes exclude any issuance, whether in connection with a business transaction, financing, or otherwise, so long as the issuance is approved by the holders of a majority of the issued and outstanding

shares of preferred stock. The purpose of this exclusion is to provide an issuer with flexibility to pursue reasonable business activities. This exclusion is particularly important when there are many holders of preferred stock, as may happen if the preferred stock financing includes friends, family and angels. In this case, it is a matter of administrative convenience.

Dividends, Splits, And Other Algebraic Adjustments

Once the universe of possible issuances of additional shares which may trigger the antidilution provisions is established, a typical venture capital antidilution provision will treat each type of issuance in turn. Some of these transactions are purely quantitative changes to the number of outstanding shares and are easily dealt with in an algebraic way. These issuances include:

- Splits (sometimes referred to as subdivisions);
- Reverse splits (sometimes referred to as combinations), and
- Common stock dividends.

Formula For Splits

The value of a convertible preferred stock could be dramatically and adversely affected if these types of changes are not dealt with. Assume Easy Company has one million shares of common stock outstanding and one million shares of Series A Preferred Stock outstanding (with a conversion rate of one-for-one). In this case, investors in Easy Company own one-half of the company's equity. If Easy Company then splits its common stock two-for-one, it will have two million shares of common stock outstanding and (assuming no adjustment is made to the preferred stock) one million shares of preferred stock outstanding. Without an adjustment, investors in Easy Company only own one-third of

the company, but Easy Company is otherwise unchanged. To avoid this result, the conversion rate of the preferred stock must be reduced to a number that, when divided into the number of shares of preferred stock, will yield two million (in this case .5). Thus the conversion rate (i.e. 1) is multiplied by a fraction the numerator of which is the number of shares of common stock outstanding before the split and the denominator of which is the number of shares of common stock outstanding after the split. The formula can be stated as follows:

$$OR \times (CS1 \div CS2) = NR.$$

In this formula, "OR" is the original conversion rate for the preferred stock; "NR" is the new conversion rate for the preferred stock; "CS1" is the common stock outstanding before the split; and "CS2" is the common stock outstanding after the split.

Reverse Splits

The same analysis applies to a reverse split. Suppose that instead of a split, Easy Company has a one for two reverse split. In this case, Easy Company would end up with 500,000 shares of common stock and one million shares of preferred stock. The preferred stock holders would now own two-thirds of the company. To make an appropriate adjustment, the preferred stock conversion rate (i.e. 1) would have to be multiplied by a fraction the numerator of which is the number of shares of common stock outstanding before the reverse split and the denominator of which is the number of shares of common stock outstanding after the reverse split. This new rate is then divided into the number of shares of preferred stock outstanding and this yields 500,000 shares of common stock to be issued upon conversion of the preferred stock.

Common Stock Dividends

Common Stock dividends issued pro rata to

holders of common stock behave exactly as stock splits. Other types of dividends can also be dilutive, but are not subject to the straightforward mathematical adjustments described above.

These formulas are precise and are triggered by changes in capital structure that do not reflect substantive changes in the underlying business, as a financing or an acquisition might. They are much the same as saying "1/2" is the same as "5/10." Nevertheless, these adjustments are not automatic as a matter of law; they are contractual provisions which must appear in the relevant charter or contract. It is hard to imagine a circumstance in which the parties would intend anything other than that their securities be adjusted to reflect these events. Nevertheless, many companies have issued warrants (and possibly other securities) that do not have these provisions. The reasoning has been that all parties want a short, simple, clean warrant, and none of the parties expects a split or a dividend to occur. For this reason, the parties are willing to take the risk of an adverse event. Having said all that, one would like to have courts impute these provisions in each case in which they have not been drafted into the instruments, unless there is clear and convincing evidence of the parties' intent to the contrary.

Adjustments For Structural Changes

Changes to the basic structure of an issuer's business such as a merger with another business, a sale of assets or a reorganization, to name a few, are not susceptible to the same kind of algebraic treatment as stock splits and stock dividends. For example, if Easy Company and Fox Company merge, an entirely new company will be created with the shareholders of each owning a portion of the resulting entity. Presumably, the relative ownership of each group of stockholders will be based on the rela-

tive value of the businesses contributed. Thus, assuming Easy Company is worth half of Fox Company, the shareholders of Easy Company will own 1/3 of the combined entity. This result should obtain without regard to the actual number of shares of each company which may be outstanding before the merger. If Easy Company has two million shares outstanding and Fox Company has one million shares outstanding when Easy Company merges into Fox Company (which is the surviving company), Fox Company will issue 500,000 shares to the shareholders of Easy Company. As a result, Fox Company will have 1,500,000 shares outstanding after the merger, one third (500,000) of which will be owned by the former stockholders of Easy Company. This ratio should be the result of an arm's length negotiation and should reflect the relative values of the two businesses.

Assume that of Easy Company's original two million shares, one million are common stock and one million are preferred stock (convertible on a one-for-one basis). Under these conditions, half of the shares issuable to the shareholders of Easy Company should go to the holders of its preferred stock. Because the exchange ratios of a possible future merger are very rarely, if ever, known at the time of a preferred stock investment, a simple formula cannot be drafted to cover these situations. To make matters more complex, the consideration paid in a merger may not consist entirely of common stock. There may be multiple classes of stock or there may be stock and cash or other assets.

Other Reorganizations And Reclassifications

Similar concerns also arise in reorganizations and reclassifications that do not involve business combinations. For example, Easy Company may reclassify its common stock into voting and non-voting shares. This could be done for many reasons. If Easy Company has two million shares of stock outstanding, of which

one million of common stock and one million are shares of preferred stock (convertible on a one-for-one basis), and Easy Company reclassifies its common stock into 500,000 shares of voting stock and 500,000 shares of non-voting stock on a prorata basis, what should the preferred stock convert into? In this example, the answer seems easy: The preferred should convert half into voting and half into non-voting shares. Nevertheless, as in the case of mergers, reclassifications can be complex and are not likely to be known in advance of an investment.

Transactions Involving Third Parties

Often, transactions that involve third parties (such as mergers, consolidations, and sales of assets) are treated separately from those that only involve the issuer (such as reclassifications, exchanges and substitutions). Nevertheless, the basic approach to each of these types of transactions is the same. In each case, the antidilution terms provide that the outstanding preferred stock will be convertible into the kind and amount of stock and other securities and property that would have been received by the holder of preferred stock if he or she had converted his or her preferred shares immediately before such transaction. This basic statement is then followed by a provision to the effect that further adjustments will be made upon any future changes to the stock and other securities or property issued in the transaction.

Depending on the nature of the changes, these types of transactions can materially affect the risk characteristics of a conversion feature. For example, a preferred stock that converts into common stock converts into a security that has a higher level of upside and downside risk than a preferred stock that converts into a secured note. Assuming these transactions are fair and not entered into with the intent of undermining the value of the preferred stock, the usual and customary approach works well in

almost all circumstances, since it gives the investor the right to acquire exactly what the common stockholders got. Presumably the aggregate risk embedded in the common stock was unbundled and distributed among several securities but, in the aggregate, is still present. The standard approach also has the benefit, over a more complex approach, of being easily understood and easily determinable. This simplicity makes it easier to engage in business combinations and other transactions than it would be if the more complex approach were used. Finally, if no provisions covering these circumstances were included, it would be necessary to negotiate with the preferred stockholder, without a baseline expectation from which to begin. A baseline expectation adds efficiency and continuity and reduces risk and cost in transactions. The traditional approach has the benefit of being a generally fair balance between economics and practicality. For these reasons, it is hard to imagine why parties would intend anything else.

Adjustments For Financially Dilutive Events

The types of events described above (stock splits, mergers, and the like) are not financially dilutive in the sense that they do not change the value associated with the equity of the issuer. Stock splits may allocate the value among a greater or lesser number of shares, but the value of the issuer remains constant. Similarly, a merger may cause the value to be added to that of another issuer, and the issuer's shareholders may own a smaller percentage of the resulting business, but, assuming an arm's-length negotiation, the value is the same. Nevertheless, new equity is not being raised and a new dollar price per share is not being set.

New Valuations

In the private company venture capital context, when additional shares of common stock

are issued in a financing for cash, something different is true—new equity is raised and a new valuation is set. That valuation might be higher or lower than the valuation used at the time the existing preferred stock was sold and its initial conversion rate established. If the new price is higher than the applicable conversion rate, the transaction will be accretive (in a financial sense). For example, assume Easy Company has two million shares outstanding, one million of common stock (worth one dollar per share) and one million of preferred stock convertible on a one for one basis (i.e. at one dollar per share). If Easy Company then issues one million shares of preferred stock convertible at a two shares of preferred stock for one share of common stock basis (i.e. at two dollars per share), the implicit value of East Company will have gone up. The notional value of a share of common stock would be two dollars. As a result, Easy Company, which had a value of \$2 million before the issuance, would have a value of \$5 million after the issuance, and each share of common stock would be worth two dollars. Such a transaction would confirm that the original valuation at which the Series A Preferred was purchased was fair to the investor. Although some sort of theoretical argument could be made for an upward adjustment to the conversion rate, don't try it—no sensible investor will ever agree to it.

Down Rounds

The opposite is true, however, when new money is raised at a valuation below that at which the last financing took place. Such a financing is commonly referred to as a “down round.” For example, assume Easy Company has two million shares outstanding, one million shares of common stock (worth one dollar per share) and one million shares of preferred stock convertible on a one for one basis (i.e. at one dollar per share). If Easy Company then issues

two million shares of a new series of preferred stock convertible on a one share of preferred stock for two shares of common stock basis (i.e. at 50 cents per share), the valuation of Easy Company will have declined. The notional value of a share of common stock would be 50 cents. As a result, Easy Company, which had a valuation of \$2 million (or one dollar per share) before the issuance, would have a value of \$2 million (or 50 cents per share) after the offering. Immediately after this offering, the common stock would have a value of \$500,000 as would the initial series of preferred stock. Absent a contractual agreement to the contrary, the common stock and the preferred stock share equally in the loss of value.

Disproportionate Sharing

Venture capitalists, however, insist upon disproportionate sharing. Disproportionate sharing comes in two basic varieties: weighted average and full ratchet. Weighted average is by far the most prevalent allocation method and is widely considered the most fair.

Weighted Average

As its name implied, the weighted average method involves a calculation of the weighted average price at which shares have been issued and adjusts the conversion price to that number. For example, return to Easy Company. Easy Company issued one million shares of common stock at one dollar per share, one million shares of Series A Preferred stock of one dollar per share, and two million shares of Series B Preferred Stock at 50 cents a share. Easy Company has raised \$3 million and issued four million shares with a weighted average price per share of 75 cents. If the Series A Preferred Stock had a weighted average price adjustment, the conversion price of this series would be reduced from one dollar to 75 cents. At 75 cents the Series A Preferred Stock would be convertible into

1,333,333 shares of common stock (not one million). Presumably, the Series B investor would take this adjustment into account at the time of her investment. After such an investment Easy Company's capitalization would look as follows:

- Common Stock 1,000,000;
- Series A Preferred Stock 1,333,333;
- Series B Preferred Stock 2,000,000.

If Easy Company had a full ratchet provision, the conversion price of the Series A would be adjusted to the lowest price at which additional shares of common stock are issued (50 cents in the example of Easy Company). In such a situation Easy Company's capitalization would work as follows:

- Common Stock 1,000,000;
- Series A Preferred Stock 2,000,000;
- Series B Preferred Stock 2,000,000.

As these tables indicate, a full-ratchet provision can have a draconian effect on the common stock. This effect is exacerbated by the fact that the full ratchet provision does not take into account the number of shares issued at the low price. Thus, if one share of Series B Preferred Stock were issued for 50 cents, Easy Company's capitalization would look as follows:

- Common Stock 1,000,000;
- Series A Preferred Stock 2,000,000;
- Series B Preferred Stock 1.

The principal justification advanced for full-ratchet provisions is that valuation is highly uncertain. Often the investor believes that management has asked for a very highly speculative valuation. As a result, the investors agree to the high valuation but ask for a full ratchet provision to guard against dramatic valuation risk. For this reason, full ratchet provision tends to become more popular in very risky transactions or in periods of economic uncertainty. From management's point of view, it is very impor-

tant to guard against the draconian effects of a full ratchet provision in every way possible, including taking great care to exclude all planned or anticipated possible issuances from the operation of the provision (done by excluding them from the definition of additional shares of common stock) and limiting the provision to a fixed period of time—say one year.

Formula For Weighted Average

For drafting clarity, the weighted average adjustment provision often includes a formula along the following lines:

$$\text{NCP} = \frac{(\text{P1})(\text{Q1}) + (\text{P2})(\text{Q2})}{\text{Q1} + \text{Q2}}$$

In this formula, "NCP" is the new conversion price; "P1" is the conversion price in effect before the new issue; "Q1" is shares outstanding (or deemed outstanding before the new issue); "P2" is the weighted average price of shares issued (or deemed issued) in the new issue; and "Q2" is the number of shares issued (or deemed issued) in the transaction.

Identifying The Outstanding Shares

One issue that seems to arise with great frequency is determining which shares are outstanding or deemed to be outstanding before the new dilutive issue. In particular, should shares that are potentially subject to options that have not been granted from the company's option plan be included or excluded? Keep in mind that the larger the number of shares outstanding before a dilutive issuance the less dilution will be involved. For this reason, the holders of common stock would like to treat as many shares as possible as outstanding and the preferred stockholders want to include as few as possible. Practitioners and investors often refer to "broad based weighted average" provisions; however, there is no accepted definition

of “broad-based” in this context. As a result, the drafting must be very clear on this point.

Additional Provisions

In addition to the substantive provisions discussed above, the antidilution provisions of a typical preferred stock also include several general provisions designed to ensure the proper operation of the substantive provisions.

Ministerial Provisions

Some of these provisions are of a ministerial nature. These provisions require that the issuer send advance notices of record dates for dividends and similar events to the holders of preferred stock. Such notice gives the holders the opportunity to convert and participate directly in the event, rather than through the operation of the antidilution provision. The issuer is also required to send notice as to each adjustment of the conversion price. This notice provision typically requires that the issuer deliver a certificate to each holder of preferred stock describing each adjustment and detailing the facts and calculations on which the adjustment is based.

Another provision requires the issuer to reserve and keep available at all times sufficient authorized and unissued shares of common stock to accommodate the conversion of all of the issued and outstanding preferred stock. There is often a provision expressly prohibiting the issuer from closing its stock transfer books

against the transfer of any shares of preferred stock or common stock issuable upon conversion of the preferred stock. The issuer is also often required to pay any taxes which may be incurred by virtue of its issuance of any shares of common stock upon conversion of the preferred stock. Finally, the issuer is obligated to take all actions necessary to assume that all shares of common stock issued upon conversion of shares of preferred stock will be duly and validly issued, fully paid and non-assessable. With these provisions the mechanics are complete.

Final Provisions

Two final provisions are also often included. One is a covenant that the corporation will not take any action, by amending its charter or otherwise, to violate the effect of the antidilution provisions. The other is a covenant to act in good faith and make appropriate adjustments to the conversion price for events which are not specifically dealt with in the preferred stock designation. This latter provision is an attempt to give courts a basis upon which to reform the contract on the occurrence of some unforeseen dilutive event.

Part 2 of this article, which will appear in the August issue, will address certain frequently encountered instruments such as options and warrants and will examine the considerations that arise in the context of public securities.

PRACTICE CHECKLIST FOR

An Introduction To Antidilution Provisions (Part 1)

There is only one reliable way to deal with the risk that the value of securities may be diluted by developments in a company’s capital structure: through a well thought-out antidilution provision.

- An antidilution provision should start with a definition of the types of issuances that may trigger an adjustment to the conversion rate of the instrument in question. This definition should include all shares of common stock that may be issued in the future (either directly or indirectly through the issuance of options, warrants, and convertible instruments) and then exclude some specific issuances.

- Splits (sometimes referred to as subdivisions), reverse splits (sometimes referred to as combinations), and common stock dividends can be dealt with through the formula $OR \times (CS1 \div CS2) = NR$. (In this formula, "OR" is the original conversion rate for the preferred stock; "NR" is the new conversion rate for the preferred stock; "CS1" is the common stock outstanding before the split; and "CS2" is the common stock outstanding after the split.)
- Changes to the basic structure of an issuer's business such as a merger with another business, a sale of assets or a reorganization, to name a few, are not susceptible to the same kind of algebraic treatment as stock splits and stock dividends. Similar concerns also arise in reorganizations and reclassifications that do not involve business combinations. Similarly, transactions that involve third parties (such as mergers, consolidations, and sales of assets) are treated separately from those that only involve the issuer (such as reclassifications, exchanges and substitutions) require adjustments tailored to the details of the transaction.

THE WEB-WISE LAWYER

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Why, Oh Why Wyoming?

Over the years I have stumbled over several references to perceived advantages of Wyoming incorporation. Unlike Nevada, the Secretary of State of Wyoming does not tout Wyoming's corporate advantages (at <http://soswy.state.wy.us/>). Third-party services, however, such as Wyoming Corporations (at www.corportions_today.com), stress many of the same advantages as Nevada, plus these three:

- State tax not being considered;
- Wyoming draws little attention;
- No Nevada "stigma."

In addition, they trumpet a lower corporate fee structure in Wyoming versus their principal rival Nevada.

Conclusion

Does it make sense to incorporate in a state other than the state where your company has its main operations? It must, since a large ma-

jority of the Fortune 500 companies are incorporated in Delaware, but are not headquartered in that state. But, do all businesses need the "expertise" of Delaware's jury-less Court of Chancery and that state's alleged pro-board of directors application of the "business judgment rule"? That, of course, is an individual, case-by-case analysis—part of the art of lawyering. Another part of the art of lawyering is dealing with clients, some of whom are less than ethical role models. (I wonder how many small business owners see Nevada incorporation as justification for tax-deductible Las Vegas gambling junkets?) Peripheral issues aside, a lawyer might advise against shopping incorporation to Delaware or Nevada when the business is closely held and can be characterized as a "pseudo-corporation," but could advise differently when the business does business across state lines. Whether the decision to incorporate away from home makes sense or not, the Internet certainly makes it easy and inexpensive.