

MEMO TO THE PARTNER

ANTI-DILUTION PROVISIONS

Samuel C. Louderback*

TO:	Partner
FROM:	Associate
RE:	<u>Anti-dilution Provisions for Inclusion in the Articles of Amendment Designating the Series A Preferred Stock of SocialTech, Inc.</u>

I. INTRODUCTION

As requested, I have drafted the anti-dilution provisions to include in the Articles of Amendment establishing the Convertible Preferred Stock, Series A with a par value of \$0.01 per share (the “Series A Preferred Stock”), of SocialTech, Inc. (“SocialTech”), a Tennessee corporation, which will be issued to our client, Peter Pennybags (“Pennybags”), a Tennessee resident.¹

Attached to this memorandum as Rider A is a draft of the requested anti-dilution provisions and a list of relevant defined terms. Other associates at our firm drafted part of the remaining provisions of the Articles of Amendment, while attorneys at Gill & Jones, the law firm representing SocialTech, drafted the remaining portions.² Subject to your approval, the anti-dilution provisions and accompanying defined terms contained in Rider A should be incorporated into the appropriate sections of the Articles of Amendment.

This Memorandum sets forth: (1) the transactional context in which the issuance of the Series A Preferred Stock is expected to occur and the authority for the designation and issuance of the Series A Preferred Stock; (2) the key substantive issues I encountered in drafting

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¹ See generally Ryan D. Franklin, *Memo to the Partner: Proposed Antidilution Provision for Series A Preferred Stock*, 16 TENN. J. BUS. L. 109 (2014).

² See generally Adam G. Smith, *Memo to the Partner: Proposed Anti-dilution Provision*, 8 TENN. J. BUS. L. 433 (2007).

the attached anti-dilution provisions; and (3) an analysis of the specific drafting choices I made to address those issues.

II. TRANSACTIONAL CONTEXT

Pennybags is a co-founder and the current Chief Operating Officer (“COO”) of SocialTech. SocialTech is a technology company incorporated under the laws of the State of Tennessee on January 7, 2014. SocialTech needs cash to continue financing its operation of a social networking site for the American Bar Association (“ABA”). The site is a platform that helps foster communications and relationships among the nearly 400,000 attorney members of the ABA throughout the world.³

SocialTech has made no equity offerings since its formation, when it issued common stock to its two co-founders, Pennybags and Emily Smart (“Smart”). SocialTech recently purchased ten Supermicro SuperServers (the latest server technology on the market) in anticipation of the high traffic it expects when the ABA site rolls out in December. Furthermore, SocialTech believes it has discovered a niche in the social networking space, and if the ABA launch proves successful, it hopes to launch similar sites for other professional organizations (SocialTech is meeting with the American Medical Association next month to discuss a similar social networking site for their organizational members). Thus, SocialTech needs additional financing for expenses associated with the ABA launch and to fund the hiring of more programmers this fall in anticipation of the launch. SocialTech enjoys the benefits of its closely held status and prefers to keep the status quo; therefore, it is not interested in seeking any outside investors at this time.

SocialTech plans to designate a new series of convertible preferred stock—the Series A Preferred Stock—to be issued to Pennybags in exchange for the desired capital. SocialTech currently has one issued and outstanding class of common stock, which is held by the two co-founders of the company. SocialTech’s Articles of Incorporation authorize the issuance of up to 10,000,000 shares of common stock (1,000,000 shares are currently outstanding) SocialTech’s Articles of Incorporation are currently outstanding, and 5,000,000 shares of preferred stock. Currently, Pennybags holds 40% of the outstanding shares of common stock, while Smart holds the remaining 60%. No shares of preferred stock have been issued to date. SocialTech does not have any outstanding long-term indebtedness. Furthermore, SocialTech has not committed to issue any additional shares of common stock or preferred stock and does not have

³ See ABOUT THE AMERICAN BAR ASSOCIATION, http://www.americanbar.org/about_the_aba.html (last visited Jan. 30, 2016) (indicating that the ABA has 400,000 members).

any obligations to issue stock options, warrants, or other call rights for SocialTech stock.

Due to the nature of SocialTech's business and its potential for success, Pennybags' primary concern regarding the Series A Preferred Stock issuance is value. If demand for SocialTech's services continues to grow, it will almost certainly require future equity offerings. With any equity offering, there is the potential to dilute the value of Pennybags' option to convert his preferred stock into common stock.⁴ Accordingly, Pennybags has asked us to draft the anti-dilution provisions necessary to protect him from a potential loss in the value of his preferred stock investment in SocialTech that could result from, for example, the future issuance or sale of additional shares of common stock or securities convertible or exchangeable into common stock at a price below the then applicable conversion price.⁵ Pennybags has already negotiated for additional anti-dilution adjustments and anti-destruction provisions to further protect his interests in the event of other dilutive occurrences such as mergers or stock splits.⁶

Under Tennessee law, the charter may authorize the issuance of one or more classes of shares that are convertible at the option of the shareholder into "securities, or other property . . . [i]n a designated amount or in an amount determined in accordance with a designated formula or by reference to extrinsic data or events."⁷ If the charter provides for it, "the board of directors may determine . . . the preferences, limitations, and relative rights . . . of . . . [a]ny class of shares before the issuance of any shares of that class."⁸

As an alternative to establishing the preferences,
limitations, and relative rights of each class of capital stock
by a shareholder-approved charter amendment, T.C.A. §

⁴ See Michael A. Woronoff & Jonathan A. Rosen, *Understanding Anti-Dilution Provisions in Convertible Securities*, 74 FORDHAM L. REV. 129, 133 (2005) ("[A]ctions taken by an issuer that increase the number (or decrease the value) of shares of [a corporation's] common stock outstanding will also decrease or 'dilute' the value of the conversion right.").

⁵ See Franklin, *supra* note 1, at 111.

⁶ See Woronoff & Rosen, *supra* note 4, at 133 (providing examples of common dilutive occurrences).

⁷ TENN. CODE ANN. § 48-16-101(c) (2012); see also TENN. CODE ANN. § 48-16-102 (2012) (noting that the charter may give the board power to fashion limitations and rights of issued stock); 14A TENNESSEE PRACTICE, LEGAL FORMS BUSINESS ORGANIZATIONS § 4:23 (Nancy Fraas MacLean ed., 2d ed. 2002) [hereinafter 14A TENNESSEE PRACTICE] ("The charter is required to set forth the number of shares of each class of capital stock that the corporation is authorized to issue and, if more than one class is authorized, a distinguishing designation for each class.").

⁸ TENN. CODE ANN. § 48-16-102(a) (2012).

48-16-102 states that, if the charter so provides, the board of directors may determine the preferences, limitations, and relative rights of a class before the issuance of shares of that class, or one or more series within a class before the issuance of any shares of that series. Such capital stock, often referred to as “blank check preferred,” allows the board of directors the flexibility to create from time to time preferred stock without having to obtain prior shareholder approval (which is otherwise generally required for an amendment to the charter).⁹

Article 7 of SocialTech’s charter provides blank check authority to its board of directors for the designation of series of preferred stock in accordance with Tennessee Code Annotated sections 48-16-101 and -102.¹⁰ Thus, SocialTech’s board of directors has the power to establish the Series A Preferred Stock and to issue it to Pennybags.¹¹ Before doing so, however, SocialTech “must deliver to the Secretary of State for filing articles of amendment that set forth, among other information, the text of the amendment determining the terms of the class of shares.”¹² Rider A represents the draft of the relevant anti-dilution provisions to be submitted as part of the Articles of Amendment.

Furthermore, “a corporation, by its directors, may grant rights, options or warrants to subscribe for or to purchase shares of any authorized class, at the times and on the terms that are set forth in . . . the contracts, warrants or instruments that evidence such rights, options or warrants.”¹³ Additionally, the securities or instruments “that evidence the rights, options or warrants” may contain provisions that provide for adjustment of the exercise price.¹⁴ Thus, under its blank check authority, SocialTech’s board of directors can issue the Series A Preferred Stock and may establish the conversion price or rate and any anti-dilution adjustments to that price or rate as it sees fit.

⁹ 14A TENNESSEE PRACTICE, *supra* note 7.

¹⁰ See, e.g., Amsurg Corp., Preliminary Proxy Statement (Form PRE 14A) 27 (Apr. 24, 2001) (“[T]he Board will be permitted to designate each share of blank check Preferred Stock as a member of a class or series and . . . will be empowered to determine . . . the following: . . . the dividend rights of each share of blank check Preferred Stock; . . . the voting rights, . . . the conditions or restrictions, . . . the redemption provisions, . . . and . . . the preference . . . in the event of liquidation . . .”).

¹¹ See TENN. CODE ANN. § 48-16-103(a) (2012) (“A corporation may issue the number of shares of each class or series authorized by the charter.”).

¹² 14A TENNESSEE PRACTICE, *supra* note 7.

¹³ TENN. CODE ANN. § 48-16-205(a) (2012).

¹⁴ TENN. CODE ANN. § 48-16-205(b)(1) (2013).

The offer and sale of the Series A Preferred Stock also must be authorized under the federal securities laws.¹⁵ Section 4(a)(2) of the Securities Act of 1933, as amended (the “Securities Act”), exempts “transactions by an issuer not involving any public offering”¹⁶ from the registration requirement of section 5.¹⁷ Offers and sales of securities by an issuer that satisfy the conditions identified in Rule 506 of Regulation D “shall be deemed to be transactions not involving any public offering within the meaning of section 4(a)(2) of the Act.”¹⁸ Under Rule 506(b), SocialTech is within the section 4(a)(2) exemption because it did not use general solicitation or advertising to market the securities and Pennybags qualifies as an “accredited investor.”¹⁹ Thus, SocialTech is exempt from registering this offering with the Securities and Exchange Commission.

III. KEY SUBSTANTIVE ISSUES

“Anti-dilution provisions are typically designed to protect against events that cause economic dilution, dilution that occurs as a result of a decrease in the value of the investment.”²⁰ The two main types of anti-dilution provisions are labeled based on the approach that they take in preserving the value of the conversion feature to the investor: “full-ratchet” and “weighted-average.”²¹ Each of these approaches has benefits for certain parties and pitfalls for others.²² Determining which of these approaches to employ will therefore have a significant impact on the favorability of the anti-dilution provision to the interests of both SocialTech and Pennybags.

¹⁵ See 15 U.S.C. § 77e(a) (2012).

¹⁶ 15 U.S.C. § 77d(a)(2) (2012).

¹⁷ See *generally* 15 U.S.C. § 77e (2012) (noting unlawful actions in connection with unregistered securities).

¹⁸ 17 C.F.R. § 230.506(a) (2013); see also FAST ANSWERS - RULE 506 OF REGULATION D, <http://www.sec.gov/answers/rule506.htm> (last visited Jan. 30, 2016) (“Rule 506 of Regulation D is considered a ‘safe harbor’ for the private offering exemption of Section 4(a)(2) of the Securities Act.”).

¹⁹ See 17 C.F.R. §§ 230.502(c), -506(b) (2013). Pennybags qualifies as an “accredited investor” as defined in Rule 501 because, as COO, he is an executive officer of SocialTech. See 17 C.F.R. § 230.501(a)(4) (2014).

²⁰ Woronoff & Rosen, *supra* note 4, at 136.

²¹ See *id.* at 145.

²² See *generally id.* at 145-50 (describing the mechanics and effects of both types of economic based anti-dilution provisions).

The two most important terms in the provision are “Common Stock Deemed Outstanding” and “Additional Shares of Common Stock.”²³ These defined terms play a vital role in determining how broadly or narrowly the category of securities the anti-dilution provisions accounts for is demarcated.²⁴ “[A] broad-based approach compares a dilutive issuance to a larger pie than does a narrow-based approach, making the issuance appear less significant.”²⁵ SocialTech and the common shareholders will “seek to maximize the inclusiveness of the definition” of Common Stock Deemed Outstanding “in order to dampen the volatility” of the anti-dilution formula.²⁶ At the same time, however, SocialTech and the other common shareholder will try to minimize the inclusiveness of the Additional Shares of Common Stock “to maintain flexibility to issue securities for certain corporate purposes without triggering any antidilution adjustment at all.”²⁷ While a narrow-based approach is ideal for Pennybags as the Series A Preferred Stock holder, the practice norm is a more broad-based approach.²⁸

Lastly, SocialTech and Pennybags have agreed to the terms of a carve-out for employee benefit plan securities.²⁹ The carve-out will allow SocialTech to issue securities to its employees without triggering the anti-dilution provision.³⁰ The carve-out is set forth within the “Additional Shares of Common Stock” definition in Rider A.

IV. ANALYSIS OF DRAFTING CHOICES

A. *Conversion Price Adjustment Approach*

While “[t]he cash flow rights of typical V[enture] C[apital] preferred stock cause the economic incentives of its holders to diverge from those of the common stockholders,”³¹ as a soon-to-be holder of

²³ See CARLA J. GARRETT ET AL., *LAWYERS GUIDE TO FORMULAS IN DEAL DOCUMENTS AND SEC FILINGS* § 3.03 (Matthew B. Swartz ed., 2015).

²⁴ See *id.*

²⁵ See Dan M. Mahoney, *Down Round Financings: How to cope with lower valuations for your client company*, 11 BUS. L. TODAY 3 (Jan./Feb. 2002, available at <http://www.abanet.org/buslaw/blt/2002-01-02/mahoney.html> [hereinafter Mahoney]).

²⁶ See GARRETT ET AL., *supra* note 23.

²⁷ *Id.*

²⁸ See *id.* (“A relatively all-inclusive (and therefore relatively ‘broad-based’) weighted-average provision is the usual outcome nowadays.”).

²⁹ Mahoney, *supra* note 25.

³⁰ See *id.*

³¹ *In re Trados Inc. Shareholder Litig.*, 73 A.3d 17, 49 (Del. Ch. 2013) (citing William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1832

both the common stock and the Series A Preferred Stock of SocialTech, Pennybags has seemingly competing interests in this transaction. As a holder of shares of SocialTech Series A Preferred Stock, Pennybags wants to protect the value embodied in his conversion price to the greatest extent possible against, among other things, any future dilutive issuances. However, as a common shareholder, after a dilutive issuance that triggers these anti-dilution provisions occurs, Pennybags does not want the value of his common stock diluted any further by an adjustment to a preferred stock conversion price. Because SocialTech plans to issue common stock to other employees, Pennybags can share some of the burden of this decrease in value of his common stock with the other common shareholders (including Smart) in the event of a future dilutive issuance. Thus, it is in the best financial interest of Pennybags to get the most advantageous terms possible in these anti-dilution provisions.

“Under the full-ratchet approach, the conversion price is reduced to the exact price per share paid in the dilutive issuance, in effect allowing the holder of the convertible security to receive stock at that lower price.”³² “[T]he full-ratchet approach completely shifts the costs of any decline in the value of the business to common shareholders.”³³ “[R]atchet antidilution provisions heavily favor the preferred stockholders and are disadvantageous to the issuer and the common holders.”³⁴ Thus, because this is a friendly transaction, where Pennybags is both the investor and a common shareholder, this approach is not conducive to the structure of this transaction.

“Under the weighted-average approach, the conversion price is reduced to the weighted-average price per share of securities issued (or deemed issued) both prior to and in the dilutive issuance.”³⁵ Thus, under the weighted-average approach, “all stock outstanding (or deemed outstanding) prior to the dilutive issuance” is treated as “being issued at the conversion price in effect immediately prior to the dilutive issuance.”³⁶ “Unlike the full-ratchet approach, the weighted-average method provides a more significant adjustment ‘if a larger number of shares of stock is issued at a lower price, and a less significant adjustment if a smaller

(2013) (noting “the preferred’s financial interest is defined by contract rights that conflict intrinsically with the interests of the common”)).

³² Woronoff & Rosen, *supra* note 4, at 145.

³³ *Id.* at 146.

³⁴ GARRETT ET AL., *supra* note 23.

³⁵ Woronoff & Rosen, *supra* note 4, at 147.

³⁶ *Id.*

number of shares is issued at a lower price.”³⁷ Thus, I chose to use the weighted average approach because it is the more common approach³⁸ and it is fairer to the existing common shareholders.

B. *Key Defined Terms*

1. Common Stock Deemed Outstanding

A key point of negotiation of a weighted-average provision is the definition of Common Stock Deemed Outstanding.³⁹ SocialTech and the common shareholders ideally want the most inclusive definition to avoid triggering the anti-dilution formula.⁴⁰ This type of definition would fall under the “broad-based” category. “Narrow-based formulae exclude certain shares from the calculation, taking into account only a subset of outstanding shares.”⁴¹ Because Pennybags will be both a common stock holder as COO and a Series A Preferred Stock holder, Pennybags agreed to a more broadly based definition of Common Stock Deemed Outstanding than we would prefer for a typical investor. Again, however, Pennybags is not the typical investor. Pennybags would benefit from a broad-based definition as a common shareholder, but would benefit from a narrow-based definition as a preferred stock holder. In balancing these interests and because broad-based is the norm in practice, we have agreed to draft the definition broadly.⁴²

2. Additional Shares of Common Stock

The breadth of the definition of Additional Shares of Common Stock also plays a major role in an anti-dilution provision. The Additional Shares of Common Stock definition is not only included in the weighted-average formula, but also triggers the Conversion Price adjustment mechanism.⁴³ The anti-dilution formula is triggered if SocialTech issues or is deemed to issue Additional Shares of Common Stock.

³⁷ *Id.* (citing EDWIN L. MILLER, JR. ET AL., VENTURE CAPITAL FINANCINGS OF TECHNOLOGY COMPANIES, 1 Internet Law and Practice §§ 3-1, -20 (2002)).

³⁸ Woronoff & Rosen, *supra* note 4, 148.

³⁹ See GARRETT ET AL., *supra* note 23.

⁴⁰ See *id.*

⁴¹ Woronoff & Rosen, *supra* note 4, at 149.

⁴² Pennybags has consented to this definition and has provided us with documentation stating that he fully understands its implications to him as a Series A Preferred Stock holder.

⁴³ See Franklin, *supra* note 1, at 117.

Furthermore, the Additional Shares of Common Stock definition includes a carve-out for the stock options (to purchase common stock) that SocialTech's board anticipates granting to its employees at some point in the near future, which is a corporate norm.⁴⁴ Because Pennybags is an employee (who would take part in this type of offering), Pennybags and SocialTech have agreed to the terms of this carve-out. This carve-out authorizes the issuance of up to 500,000 shares of SocialTech common stock without triggering anti-dilution protection.

C. *Minor Drafting Decisions*

- I decided to express the conversion price adjustment calculation as a formula rather than as text. The precedent documents I viewed were mixed regarding this decision.⁴⁵ I determined that the provision is easier to read as a formula than as text. Additionally, if it were written as text, the reader of the document would likely convert the text into a formula in order to do the conversion price adjustment calculation. Thus, expressing the calculation as a formula likely saves the reader time.
- I chose to hyphenate anti-dilution because this is seemingly the preferred spelling in Tennessee (as determined by the majority of documents filed in Tennessee that make reference to anti-dilution provisions, as well as looking at various blog posts on anti-dilution provisions by Tennessee attorneys).
- The defined terms section is in a separate section from the conversion price formula. This appeared to be the norm in the precedent documents I viewed.
- A number of the precedent transaction documents I viewed included the definition of Common Stock Deemed Outstanding in the description of the terms used in the conversion price formula. I moved this definition into the Defined Terms section making the overall provision cleaner and more easily understood. This move

⁴⁴ See GARRETT ET AL., *supra* note 23 (“[S]ome of the carveouts are so essential to normal corporate functioning (e.g., stock option issuances and exercises) that they should always be insisted upon.”).

⁴⁵ See, e.g., Sealy Mattress Co. of Memphis, Prospectus Supplement, 74 (Apr. 9, 2009); L2G Newco, Inc., Charter, 5-9 (Sept. 25, 2001).

also highlights the importance of the definition of Common Stock Deemed Outstanding.

- The Defined Terms section appears prior to the anti-dilution provision in accordance with the majority of the precedent documents I reviewed.⁴⁶

⁴⁶ See, e.g., L2G Newco, Inc., Charter, 5-9 (Sept. 25, 2001).

RIDER A**(d) Adjustments to Conversion Price for Dilutive Issuances.**⁴⁷Section (i). Defined Terms.

For purposes of **Section (d)**, the following definitions shall apply:

(A) “**Additional Shares of Common Stock**” means all shares of Common Stock issued (or deemed to be issued under Section () by the Corporation after the Original Issue Date, other than up to 500,000 shares of Common Stock issued or issuable to directors, officers, or employees of, and consultants to, the Corporation under a stock purchase or option plan or other employee benefit arrangement (collectively, the “Employee Plans”) approved by the majority of the members of the Board of Directors.

(B) “**Common Stock**” means the common stock of the Corporation, par value \$0.01 per share.

(C) “**Common Stock Deemed Outstanding**” means, at any given time, the sum of 1) the number of shares of Common Stock underlying the Series A Preferred stock to be converted; 2) the number of shares of Common Stock actually outstanding; and 3) the number of shares of Common Stock issuable upon the exercise of all outstanding Options or Convertible Securities.

(D) “**Conversion Price**” means the rate at which shares of Series A Preferred Stock may be converted into shares of Common Stock. This rate will initially equal \$1.00, but will be subject to adjustment as provided in **Section (iv)**.

(E) “**Convertible Securities**” means any evidences of indebtedness, shares (other than Preferred Stock issued on or before the applicable Original Issue Date), or other securities directly or indirectly convertible into or exchangeable for Common Stock.

(F) “**Corporation**” means SocialTech, Inc., a Tennessee corporation.

(G) “**Options**” means rights, options, or warrants to subscribe for, purchase, or otherwise acquire Common Stock or Convertible Securities.

⁴⁷ These are provisions and terms that will be included as a part of a larger document which is why they are labeled this way.

(H) “**Original Issue Date**” means the date on which the first share of the Series A Preferred Stock was issued.

(I) “**Preferred Stock**” means the Series A Preferred Stock.

...

Section (iv). Adjustments to Conversion Price.

Conversion Price Adjustments for Certain Dilutive Issuances. If the Corporation issues or sells (or is deemed to issue or sell) Additional Shares of Common Stock at any time after the Original Issue Date, without consideration or for per share consideration in an amount less than the applicable Conversion Price in effect immediately before such issuance or sale, then the applicable Conversion Price shall be reduced, concurrently with the actual or deemed issuance or sale, to a price (calculated to the nearest one-hundredth of a cent) determined in accordance with the following formula:

$$CP\ 1 = CP\ 0 \times \left(\frac{OS\ 0 + Y}{OS\ 0 + X} \right)$$

Where:

1. “CP 0” is the applicable Conversion Price in effect immediately before the issuance of Additional Shares of Common Stock;

2. “CP 1” is the applicable Conversion Price in effect immediately after the issuance of Additional Shares of Common Stock;

3. “OS 0” is the number of shares of Common Stock Outstanding immediately prior to such issue of Additional Shares of Common Stock;

3. “X” is the number of Additional Shares of Common Stock issued or sold in the actual or deemed transaction; and

4. “Y” is the number of Additional Shares of Common Stock issuable for the aggregate consideration received by the Corporation from the actual or deemed issuance or sale at CP 0.