

“Price Protection” in Venture Capital Financings: What Entrepreneurs Should Know



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Venture capital investors are not like the rest of us. When regular folks buy a share of stock and the stock subsequently trades for a lower price, they take their losses. All of them. When a venture capitalist buys a share of stock, and the company subsequently sells shares at a lower price, the venture capitalist doesn't usually feel the full loss. Sometimes, the VC doesn't take any loss at all. Welcome to the world of “**price protection.**”

You'll find price protection in the “Anti-Dilution” section of the term sheet. It is the long, usually complicated and sometimes controversial part of that section that protects a venture capital investor in a prior round from some of the deprecations of a subsequent down round financing (a round priced lower than the current round).

Consider this is example of price protection in action, in it's simplest (and most deadly) form. A VC buys 1 million shares of Series A Preferred Stock for \$1.00 per share, with each A share convertible into one share of Common Stock at the option of the VC or automatically upon a qualifying IPO. The entrepreneur owns the 1 million shares of Common Stock that are outstanding, so in this example the VC and the entrepreneur each own 50% of the company. A year later, the company sells one share of Series B Preferred Stock for \$0.50. With that, each share of A Preferred

held by the VC is now convertible into two shares of Common Stock. The VC now owns, in effect, 2 million shares on an as converted basis, while the entrepreneur still owns 1 million shares, and the B shareholder owns 1 share. Which means our A shareholder now own almost 67% of the company, and our entrepreneur now owns about 33%. The entrepreneur is not happy.

As for the particulars, when the B share was sold for \$0.50 per share, the “conversion price” of the A shares was reduced from \$1.00 per share (the price of the A shares when issued) to \$0.50 per share. Now, the number of shares of common stock that a typical convertible preferred stock converts into is equal to the price per share (in this case \$1.00) divided by the conversion price (in this case \$1.00 before the sale of the B share and \$0.50 after the sale of the B share). The math here is simple: Before the issuance of the B share the conversion rate was 1/1, or one share of common for each share of A preferred, and after the issuance of the B share the conversion rate is 1/.5 or 2 shares of common for each share of A preferred. The operative point here is that upon the sale of the B share for \$0.50, the conversion price of the A shares was reduced to \$0.50.

The above example illustrates the way so-called “ratchet” price protection works. Ratchet price protection is the most generous form of price protection – from the entrepreneur’s perspective, the most onerous. Having been both a venture backed entrepreneur and a venture capital investor myself, I will side with the entrepreneur on this one. The problem with ratchet protection (above and beyond the fundamental question of why venture capital investors should be protected from falling share prices at all) is that the amount of protection isn’t tied to the amount of dilution experienced by the A shareholder. In the example, the sale of just one share of B stock for \$0.50 – out of 2 million shares outstanding before the transaction – reduces the conversion price of the A stock all the way to \$0.50. That single share of dilution in effect takes the VC holding the A shares from one-half ownership of the company to two-thirds ownership. And that’s ... ridiculous.

For a couple of reasons, including its severity, ratchet protection is pretty unusual. It tends to darken the entrepreneur’s door in situations where the deal is otherwise troubled, as for example in (very) down rounds, recaps, and situations where there is a paucity of trust between the investor and the management team (which itself suggests the deal is problematic). If you see it in your term sheet, you might suggest to the investor that it was some sort of typo. If that is not the case, you should push back hard, and perhaps re-think whether you want to work with that particular investor at all, life being, as they say, too short.

While ratchet protection is rare, absent a distressed situation, “weighted average” price protection works its way into the vast majority of venture capital term sheets. As the term “weighted average” suggests, formula protection is designed to soften the punitive nature of ratchet protection by making sure the adjustment to the prior round conversion price reflects just how dilutive the subsequent down round is, not just in terms of price but in terms of number of shares issued at the lower price.

The formula in weighted average price protection is as follows: $CP2 = CP1((A+B/A+C))$ where CP2 is the “new” conversion price of the previously outstanding preferred stock after the closing of the down round; CP1 is the conversion price of the previously outstanding preferred stock prior to the closing of

the new down round; A is the number of shares of stock of all kinds outstanding (on a fully-diluted to common stock basis) prior to the closing of the down round financing; B is the number of shares actually issued in the down round financings; and C is the number of shares that could have been issued in the down round financing if the price of the shares in the down round financing had been equal to CP1.

Ok, now let's go back to our example, and see how formula price protection compares to ratchet protection. Refer to this spreadsheet: [Price Protection](#). Fill in the known variables in the red cells (put in 0 for the "Pool Out" and "Pool Reserve" numbers). At the bottom of the spreadsheet you will see the result if ratchet protection had been in place (the percentage of ownership goes up 16.67% for A and down 16.67% for common; B's ownership is 1/2,000,001 which shows as 0% due to rounding).

Now take a look at the two formula protection calculations above the ratchet numbers (the two are the same in this example: more on that in a minute). Note that there is no change to either the A or common ownership percentage, at least when rounded off, because the new B shares represent such a small (1/2,000,001) part of the total. The "protection" afforded A because of the down round is essentially zero because the actual dilutive impact on A when the company sells just 1 share of B at \$0.50 is essentially zero.

The flip side of the initial example - a down round of vanishingly small proportions relative to the company's prior capital structure - is a down round of immense proportion relative to the company's prior capital structure. In the example, leave everything the same except let's change the amount of the B financing to \$1 billion dollars. Because the B financing is so large, the difference between formula and ratchet protection is itself just a rounding error: in effect, the formula protection yields the same result as the ratchet.

Before we move on to some of the nuances of price protection, play around with the size and price of the B round (and the A round, if you like) in the spreadsheet, and notice how formula protection provides proportionately more or less price protection for the A stockholders depending on both the price of the B round shares and the gross size of the B round shares. Plug in, for example, a B round price of \$0.50 per share with gross proceeds of \$1 million and notice how formula protection provides a healthy chunk of protection, but nowhere near full ratchet protection. Also note that the cost of the protection (the reduction in percentage ownership positions post-B financing relative to what they would have been in the absence of any price protection) is parceled out to the Common and B shareholders, to the benefit of the A shareholders.

Now for some nuances. First, note that there are two varieties of formula price protection, "Narrow" and "Broad." The differences relate to the value of "A" in the formula. Recall that the definition of "A" is fully-diluted shares outstanding before the dilutive financing. Note that the bigger A is the *less* protection will be afforded by the formula. Thus, the common will want A to be as big as possible. In practice that usually means that common will want A to include not only all outstanding option shares (basically, employee incentive options) but also any such shares/options reserved for future issuance as incentives. The Series A shareholders, on the other hand, would not want to count those "reserved for future

issuance” shares/options. The good news, for entrepreneurs, is that they usually win this point. Perhaps that is because the impact of winning the point is usually quite modest.

The next nuance, often more important, is the difference between the theoretical impact of price protection (particularly ratchet protection) and the real world impact. Note from the above analysis that the cost of price protection is born by the common shareholders and the down round preferred shareholders (the Preferred B shareholders in the examples); further note that in a variety of real world scenarios the B takes the biggest hit, and that the hit in the ratchet case can be huge. So huge, in fact, that prospective B shareholders often condition their investment in the down round on the A shareholders waiving some or all of their price protection. And A shareholders, unless they are able and prepared to fund the company themselves, almost always agree to waive at least some of their price protection. This situation highlights one of the realities of venture negotiations after the A round: the terms of the A round deal are not chiseled in stone, but only written on paper. And thus can be the subject of re-negotiation part and parcel with the negotiation of subsequent rounds. As a practical matter, ratchet protection is commonly modified, and often waived, in down rounds, and formula protection is not always immune from such renegotiation.

And so the basics of anti-dilution price protection, a concept that in principal can be hard for entrepreneurs to understand, but in reality one that venture capitalists almost always insist on. But even if you can't avoid it altogether, as an entrepreneur you should understand it, and, in the case of ratchet protection, push back hard. And remember: when push comes to shove, the new B investors are going to be more worried about incenting the management shareholders going forward than protecting the prior A investors from dilution.

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