

Issue 1 / Volume 2

DILUTION AND ANTI-DILUTION CLAUSE: THE BASIC UNDERSTANDINGS

Nguyen Quoc **BAO***

This article is a joint publication between TND Legal¹ and Kien Thuc Phap Ly². Any citation referred to this article should be made in the below form³.

Nguyen Quoc Bao, “Dilution and Anti-dilution clause: The Basic Understandings” (2020) 2 TND Legal & Kien Thuc Phap Ly.

Abstract

Anti-dilution clause can be considered as an inherent clause of any investment agreement. Nonetheless, this is not a familiar concept for private companies in Vietnam. This article shall discuss and analyse the very intrinsic features of dilution and anti-dilution clauses, suggesting how those concepts should be incorporated into an agreement.

Keyword: Dilution, Anti-dilution

A. Introduction

1. Dilution occurs whenever the target company calls upon investment from new investors. Dilution adversely affects the founders (or existing shareholders) in the sense that their interests are jeopardised due to the ownership proportion being subsided. A dilution event may take a variety of forms but all of which end up with either (i) percentage dilution or (ii) economic interest dilution⁴. While a mere percentage dilution would not be a serious concern of the founders, economic interest dilution is the primary target of the anti-dilution clause.

* Nguyen Quoc Bao is currently senior associate of TND Legal and founder of Kien Thuc Phap Ly.
1 TND Legal is a full-service commercial law firm in Ho Chi Minh City Vietnam <www.tndlegal.com>
2 Kien Thuc Phap Ly is a legal knowledge center with free open access <www.kienthucphaply.com>
3 The citation is made under OSCOLLA reference format.
4 Lemlem Fekadu Arega, *Preemptive Rights and Anti-dilution Rules: The Lessons From US to Ethiopia* (CEU 27 Mar 2015) 14.

Issue 1 / Volume 2

2. It is worth noting that dilution is not conceptualised under the laws of Vietnam, at least in a so explicit manner. Therefore, this notion is primarily governed by contractual arrangements. It means that one must be proactive in recognising the dilution event and its impact in the course of concluding a deal.
3. This article is not purported to bring about a comprehensive analysis on how dilution and anti-dilution clauses operate and interact in a deal structure. Rather, it is only dedicated to elaborating the very intrinsic understandings of those prominent issues so as to allow the readers to familiarise themselves with these concepts. Henceforth, this article excludes the public company from its coverage. In light of the foregoing, it commences with the analysis of each particular kind of dilution and then moves forward to the anti-dilution clause ecosystem.

B. Percentage dilution and economic interest dilution – How to draw a line between them?

Percentage dilution

4. A genuine percentage dilution theoretically does not touch upon the financial interests of the existing shareholders. In the most simple form, it should only hinder the decision-making capability of the affected shareholder since it causes their loss of the voting rights (for ordinary shareholders and super-voting preferential shareholders)⁵. As opposed to the foregoing, an economic interest dilution event would target the financial side of the affected shareholder, making them less beneficial than the period before the new investment is made. From the personal observation of the author, most economic interest dilution events are accompanied by the percentage dilution but not the vice versa.
5. Below is the illustration of the *pure percentage dilution*:

⁵ In the context of Vietnamese laws, only shareholder holding ordinary shares or super-voting preferred shares would be affected by the voting rights being minimised due to the fact that other preferred shareholders (i.e. redeemable preferred shares or shares with preferred dividends) are not granted with voting rights. To note that this structure of share classes is default-by-law, each JSC may come up with its own kind of preferential shares so long as they are provided under the their charter/articles of association (2020 Enterprise Law, art. 114.2; art. 116 – 118); One may argue that the shrinkage of voting right caused by percentage dilution would create an indirect adverse impact on the economic interest of the affected shareholders since they are unable to drive the company toward the beneficial pathway (at least to the extent that they so believe). Nonetheless, this is not a readable outcome.

Issue 1 / Volume 2

Illustration 1: A JSC is initially established with the charter capital amounting to VND100,000,000 (equivalent to the total outstanding shares of 10,000). A then calls for the additional investment of VND12,000,000 from B by way of issuing 1000 new shares and allocating the same to B.

	Total outstanding shares of A (shares)	Ownership proportion of B (%)	Ownership proportion of the existing shareholders of A (%)
Pre-investment (made by B)	10,000	0%	100%
Post investment (made by B)	11,000	9.1%	90.9%

The above simple illustration has presented how genuine percentage dilution works. In which, the share proportion of the existing shareholders of A (which include the founders and also, the investors of the previous rounds without an anti-dilution shield) decreases from 100% down to 90.9%.

6. There are three notable features that should be brought into our attention with respect to the *genuine percentage dilution* (Illustration 1 above in Section 5):
- (a) As indicated in Section 4, percentage dilution mainly affects the voting right, be it *substantial* or *minimal*, of the existing shareholders. To clarify, the voting authority can be classified into either (i) majority vote (50% upward required) or super-majority vote (65% or 75% upward required) or (ii) the veto right (negative right). Turning back to the Illustration 1 above, having 9.1% of ownership proportion at hand, B may not be able to overshadow matters adopted by majority vote (or even super-majority vote). However, it is a different story where B is granted with *veto right*, which practically renders the minority shareholder the right to disapprove vital decisions of the company (a.k.a. reserved matters)⁶.

⁶ To note that the term “reserved matter” is neither specified by the 2014 Enterprise Law nor the 2020 Enterprise Law. These prominent set of legislations only refer to a few instances where super-majority vote is required by default. The drafters and builders of specific investment contract (or shareholders’ agreement or share subscription agreement, as the case may be) routinely adopts additional instances at will.

Issue 1 / Volume 2

- (b) *Percentage dilution* shall not theoretically turn into economic dilution so long as the share subscription price given to the new investor is no less than (i) the par value of share (nominal price of share)⁷ or (ii) the fair market price of share for the time being⁸. In Illustration 1, it can be obviously seen that the share subscription price (VND12,000) is higher than the par value (VND10,000) thereof and on the assumption that the market price for the similarly-situated share is also VND12,000, the financial benefits of the existing shareholders of A remain intact subsequent to the investment.
- (c) Technically speaking, the anti-dilution clause (which will be elaborated later in this article) is not designed to simply prevent the percentage dilution unless such dilution also results in the downfall of economic interests⁹. Having said that, percentage dilution and its adverse consequences created upon the existing shareholder can be somewhat limited or prevented by employing the *veto right*, *pre-emption right* or *right of first refusal*¹⁰.

Economic interest dilution

7. In most practical cases, economic interest dilution is witnessed in (i) the cheap issuance of new shares (accounting for a majority of cases); (ii) structural changes of ordinary shares; and (iii) distribution of cash¹¹. This article shall only maintain its concentration on embracing the notion of “cheap issuance of new shares”.
8. As briefly indicated in Section 6.b above, it is generally agreed that “cheap” may fall under either one of the two circumstances as below¹².
- (a) “Cheap” compared to the initial value of investment

⁷ This still is a arguable concept as the fluctuation of market price can pull the actual value of share below the par value. Par value should never be construed as the minimum threshold of the share price.

⁸ Micheal A. Woronoff và Jonathan A. Rosen, “Understanding Anti-Dilution Provisions in Convertible Securities” (2005) 74 Fordham L Rev 129, 134.

⁹ Woronoff và Rosen (n 8) 135.

¹⁰ See more: David A. Broadwin, *An Introduction to Anti-dilution Provisions (Part 1)* (The Practical Lawyer, June 2014) 30; These provisions can also be deemed as a type of anti-dilution clause (See Section 12 below).

¹¹ Liang Tao, “The Enforceability of Anti-Dilution Provisions in Private Placement in China” (2013) 6 Tsinghua China L Rev 45, 48.

¹² Woronoff và Rosen (n 8) 136; See more: Arega (n 4) 15.

Issue 1 / Volume 2

From the perspective of the Vietnamese legal framework, initial value of investment represents either (i) the total par value if the affected shareholder is the founding one engaging the company at the time of establishment or (ii) the total amount paid in exchange for the shares if the affected shareholder acquires the shares via subsequent share subscription transactions, secondary market (share sale and purchase transaction), stock dividends, ESOP or otherwise.

Illustration 2.1: “Cheap” compared to the initial value of investment being the par value (as indicated in (i) above)

Taking the Illustration 1 specified in Section 5 with the only difference is about the subscription price of new shares offered to B by A being VND9,000,000. Accordingly, B subscribed for 1000 newly issued shares for the actual price of only VND9,000 per share, which is lower than the par value of the share as registered.

Illustration 2.2: “Cheap” compared to the initial value of investment being the total amount paid for acquiring relevant shares (as indicated in (ii) above)

Taking the Illustration 1 specified in Section 5, if any existing shareholder of A possessed its current shares by way of acquiring from other former shareholder at the purchase price of VND13,000 per share. The issuance of new shares at the price of VND12,000 per share contemplated by A would lead to the downfall in the economic interest of the relevant existing shareholder. To specify, for the same quantity of shares the new investor would need to pay less than what was paid by the relevant existing shareholder.

- (b) “Cheap” compared to the market price of share (current value) at the time of issuance

Market value or (also referred to as) current value represents the actual value of “an investment immediately prior to the occurrence of dilutive event”¹³.

Illustration 2.3: In consideration of the parameters specified in Illustration 1 of Section 5, if the market price is VND15,000 per share but A allocates shares to B at the price of only VND12,000. It essentially means that, on the one hand, A only absorbs the total investment of VND120,000,000 by issuing 1,000 new shares while it should have collected the total amount VND150,000,000 if it sticks with the

¹³ Woronoff và Rosen (n 8) 136.

Issue 1 / Volume 2

market price of share. On the other hand, B may only possess only a smaller portion of shares should the market price be applied to its share subscription. Irrespective of which, the existing shareholders of A suffer the financial adverse impact on its end.

It is worth noting that “an event may be dilutive to the initial investment, the current value, or both”¹⁴.

C. Anti-dilution Clause – How should the Western’s approach be sketched into Vietnamese market?

9. Emanating from the Western practice, anti-dilution clause is not a strange regime and also diversified in both form and substance. The capital market in the Global North has been developed for a long time and therefore, a wide range of capital instruments has been employed routinely. Put it simply, while the employment of multiple classes of shares under which their holder is conferred upon different rights and obligations can barely be seen in common private enterprises in Vietnam¹⁵, it is a common practice for the Western companies to regularly use convertible securities. Henceforth, it is not logical to wholly adopt the anti-dilution regime of the Global North into the Global South.
10. No one can argue that the *full-ratchet approach* and *weighted-average approach*¹⁶ are cornerstone provisions of Western’s anti-dilution regime. However, these prominent methodologies cannot be simply used in the Vietnamese market effectively. To clarify, the target of these two anti-dilution methods is the new conversion price applicable to the affected shareholder upon the occurrence of a dilutive event. Absent the “event of conversion”¹⁷, it is merely meaningless to adopt these provisions. Therefore, for those enterprises employing only common shares and dilutive event directly affects the holder of those shares, these methods are impractical.
11. Given such, the author opines that it is more sensible to place the anti-dilution clause into the following three categories (similarly to the commercial practice in China)¹⁸:

¹⁴ *ibid.*

¹⁵ In the most general sense, many SMEs in Vietnam have only common shares within their shareholding structure.

¹⁶ See more: <<https://www.investopedia.com/terms/a/anti-dilutionprovision.asp>>; See also: Woronoff và Rosen (n 8) 145-147.

¹⁷ In Vietnamese market, it is commonly the conversion from the preferred shares or convertible bonds into common shares.

¹⁸ Tao (n 11) 60.

- (a) The percentage maintenance provision;
- (b) The down-round prohibition provision; and
- (c) The down-round adjustment provision.

	Percentage maintenance provision	Down-round prohibition provision	Down-round adjustment provision
Purpose	Anti percentage dilution	Anti percentage dilution and economic interest dilution	Anti economic interest dilution
Nature	Flexible	Non-flexible (since this is a prohibiting clause)	Flexible
Level of complexity	Medium	Low	High
Anticipated success of negotiation	High	Very low	Medium (depending on how compensation for dilution event is qualified)

Percentage maintenance provision

12. In the context of Vietnamese laws, only percentage maintenance provision (via preemptive right/right of first refusal¹⁹) is explicitly recognised²⁰. The down-round prohibition provision and down-round adjustment provision are often found in the contractual arrangement but not the right-by-default set out by the laws. One way to another, no sophisticated anti-dilution formulas are governed by the laws of Vietnam as in other several countries²¹.

Down-round prohibition provision

¹⁹ Arega (n 4) 19.

²⁰ Under the 2020 Enterprise Law, the common shareholder is entitled to subscribe newly-issued shares in proportionate to its shareholding (2020 Enterprise Law, art. 115.1(b)).

²¹ See more: Allens Arthur Robinson, *Vietnam Legal Update* (AAR, April 2008) 10.

Issue 1 / Volume 2

13. In terms of *down-round prohibition* provision, it essentially refers to the event of cheap issuance of shares as specified in Section 8 above. Given such, one must have its starting point to impose the prohibition. There can be three scenarios to structure this anti-dilution clause:
- (a) Scenario 1: To prohibit the cheap issuance of shares in the subsequent rounds whereby “cheap” refers to the subscription price of new shares compared to the *initial investment* as indicated in Section 8(a) above – This scenario is favourable to the affected shareholder if the market value of shares drop below the initial investment;
 - (b) Scenario 2: To prohibit the cheap issuance of shares in the subsequent rounds whereby “cheap” refers to the subscription price of new shares compared to the then-*market value* of that shares as indicated in Section 8(b) above – This scenario is favourable to the affected shareholder if the market value of shares is above the initial investment;
 - (c) Scenario 3: To prohibit the cheap issuance of shares in both abovementioned cases – This scenario is favourable to the affected shareholder regardless of the circumstances.

These instances are described in the respective illustrations as below.

Illustration 3: X is the existing shareholder of A who subscribed for 1000 shares at the price of VND10,000 per share in 2015. In 2020, A offered another 1000 shares to Y for its subscription at the price of VND15,000 per share. During the investment, a report was delivered by a reputable valuation company, indicating that the market price for the relevant share is VND18,000 per share.

In the above illustration, X does not suffer the dilution to its initial investment but it suffers the dilution to the current value of share. If X is equipped with the anti-dilution provided in Scenario 1, X can do nothing but watching the downfall of its economic interest; If X is equipped with anti-dilution provided in Scenario 2, X can trigger its protection and prevent A from issuing such new shares to Y at such a price; If X is equipped with the scheme provided in Scenario 3, it is obviously that X is fully protected regardless of circumstances.

14. Having said that, it is very difficult for the investor to successfully negotiate on the adoption of Scenario 3 as it is too broad and considered as a one-sided clause. The entrepreneurs constantly argue that market price should be the only factor to reference to since initial

Issue 1 / Volume 2

investment can either go down or go up (subject to the poor or good business performance of the company). Taking this illustration below as an example.

Illustration 4: X is the existing shareholder of A who subscribed for 1000 shares at the price of VND10,000 per share in 2015. In 2020, A offered another 1000 shares to Y for its subscription at the price of VND9,000 per share. During the investment, a report was delivered by a reputable valuation company, indicating that the market price for the relevant share is actually VND9,000 per share.

If X is protected under Scenario 1, X may trigger its right thereunder and prevent the company from issuing such share at such a price.

However, from the entrepreneurs' perspective, the investor should suffer from the loss in value of their investment due to the poor performance of the company. Put differently, it is unreasonable for the company and other shareholders to be prevented from calling additional funds since the initial investment of the affected shareholder has been decreased as the result of the market dynamic. Therefore, Scenario 2 should be the most balance way to structure the down-round prohibition provision. That said, it is difficult to agree upon such a provision unless the negotiating power of the investor is so substantial that this clause was made as a "contract of adhesion". This is simply because no entrepreneurs fond of the fact that its ability to call up new investment is significantly restricted.

Down-round adjustment provision

15. Down-round adjustment provision allows the affected investor to receive a compensation to redress the damages it incurred in relation to the down-round financings²². The key question of this scheme is who should be the one paying the compensation (company itself or the founders)?

Company to make compensation

16. If made by the company, the compensation can either be made by way of (i) allotment of bonus stocks; (ii) right to subscribe additional shares offered solely for the affected shareholder at a nominal or preferred (discounted) price or (iii) cash distribution. However, it is argued that these methodologies of compensation may be challenged by several factors as below clarified (from Section 17 to Section 19).

²² Tao (n 11) 61.

Issue 1 / Volume 2

17. In terms of (i) and (ii), there raises concerns that these anti-dilution provisions would contradict to the pre-emption right conferred upon other existing shareholder under the 2020 Enterprise Law, under which it provides that when new shares are issued, all existing shareholders let alone the affected one should firstly be offered for subscription on a pro-rata basis. In addition to the foregoing, many legal practioners opine that such anti-dilution provisions may also violate the rule that shares must not be sold below the market price (hereinafter referred to as “down-shares”) as specified in the 2020 Enterprise Law²³. This pose a serious concern as a vast majority of new shares issuance arising from the anti-dilution clause embrace the “preferred price” being lower than the market price applicable to the protected shareholder.
18. That being said, the author opines that these hinderances can be eventually overcome by sophisticated contractual provisions. For (i), a waiver to the pre-emption rights of all existing shareholders upon the occurrence of the dilutive event, incorporated into the shareholder agreement, is sufficient to restrict the outreach of the pre-emption right. For (ii), it is worth noting that 2020 Enterprise Law provides for certain exceptions to the rule of “not lower than market price”. One of which, only added in the 2020 Enterprise Law, is other circumstances specifically provided by the resolution of the GMS²⁴. This essentially means that more rooms are now available for the issuance of down-shares. A simple clause, indicating that the shareholders shall procure their upvote for the down-shares in a GMS upon the occurrence of dilutive event, being incorporated into a shareholder agreement would likely be somewhat sufficient to “indirectly” enforce the relevant anti-dilution shield.
19. The main concern would in fact be the question of which fund should the company use to settle the compensation. If the company is in a good financial health, there might be no issues with respect to either the allotment of bonus stocks (if the stock inventory is still available) or cash payment made by the company to the affected shareholder. However, absent capital surplus this would be a much bigger concern.

Founders to make compensation

²³ 2020 Enterprise Law, art. 128.

²⁴ Interestingly, the 2005 Enterprise Law and the 2014 Enterprise Law only refers to extraordinary exceptions provided under the charter of company while leaving the otherwise adopted GMS resolution out of its scope.

Issue 1 / Volume 2

20. Under this approach, the founding shareholder must “grant shares or cash to investor if down-round financings occur”²⁵. Both the transfer of shares and cash payment, if made by the founder, would be much easier. Indeed, there is merely no restriction imposed on the transfer of shares between the founding shareholder(s) and the affected ones. Those transactions are simply considered as civil transactions and therefore, primarily subject to the contractual agreements of the parties.

REFERENCES

Allens Arthur Robinson, *Vietnam Legal Update* (AAR, April 2008)

Arega L, *Preemptive Rights and Anti-dilution Rules: The Lessons From US to Ethiopia* (CEU 27 Mar 2015)

David A. Broadwin, *An Introduction to Anti-dilution Provisions (Part 1)* (The Practical Lawyer, June 2014)

Micheal A. Woronoff và Jonathan A Rosen, “Understanding Anti-Dilution Provisions in Convertible Securities” (2005) 74 Fordham L Rev 129

Tao L, “The Enforceability of Anti-Dilution Provisions in Private Placement in China” (2013) 6 Tsinghua China L Rev 45

²⁵ Tao (n 11) 62.