Original Article

Implementation of Anti-dilution Agreement in Venture Capital Contracts According to Iran's Legal System

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Abstract

Venture capital investment is one of the most important and most effective means of financing new businesses. In this type of investment, during the short-term or medium-term relationship with startup companies while financing and providing management support for these types of businesses, investors finished this relationship in different ways and exit the startup companies at the time they find their benefits obtained. One of the most important issues for investors is to prevent dilution of capital and maintain percentage of ownership in the startup companies. The most important tool for investors in this regard is to prevent percentage and economic dilution through contractual agreements. In this essay, while clarifying the concept of venture capital, dilution, the situations that lead to the dilution, and the types of anti- dilution agreements, we conclude that the application of this agreement is permissible in accordance with the legal rules in force in Iran.

Keywords: Venture Capital, Dilution, Anti-dilution agreement, Conversion rate adjustment.

Introduction

Venture capitalists, in order to finance startup businesses, provide financial and managerial support to grow and enhance the value of such businesses and exit the entrepreneur at the right time in a manner that provides anticipated returns for investors. To obtain their goals in investment, they have considerable rights and privileges under the contracts they make. These contracts can be consisted of variety of financial, control, and exit arrangements, each of which will affect different aspects of the parties' relationships. Given the major impact that startups and small businesses have on moving the wheels of the world's economies, especially developing countries, it is appropriate to study the different dimensions of their relationship with investors and determine whether the well-known contractual terms which are used in venture capital industry around the world could be used in line with Iran's legal system.

Given the risks faced by venture capitalists, it is always possible that a start-up may decide to raise capital or make any changes to its capital structure. These decisions, on a case-by-case basis, can lead to a decrease in the investors' ownership percentage or a decrease in the value of their investments.

Investors, on the one hand, to maintain their ownership which can indirectly affect their control over startups, and on the other, to maintain their financial interests and the value of their investments rely on contractual arrangements. The most important contractual agreement specifically used for this purpose is anti-dilution right.

It should be noted that this agreement with respect to types of dilution, way of arranging and process of implementation can have both financial and control effects in combination and may help maintain ownership despite the value of the investment. In this essay, what is at the heart of the debate is the economic dilution and its prevention.

In the present article, in the first part, while exploring the concept of venture capital and dilution we going to enlighten the anti- dilution agreement, in the second part we have considered the types of this agreement.

Venture capital and dilution

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In this part we are going to clarify the concept of venture capital in dilution in two separate subdivisions.

- ### Venture capital investment

Every startup business will face major executive and financial problems at the start of its journey and will need financing and management assistance to grow and succeed. It is extremely difficult for this kind of businesses to access to traditional and well-known financial resources such as banking facilities due to obstacles such as uncertainty, Asymmetric Information, the nature of assets and market conditions. These barriers indicate a high level of investment risk in these businesses and diminish the motivation of traditional investors, so business owners should look for new ways to meet their financial needs [1]. This is where the concept of venture capital investment comes into play. With these descriptions, venture capital is one of the financing ways that particularly active in startups.

Given the above, venture capital is the financial and management support of privately-owned startups for a specified period of time aiming to maximize the return on investment as they exit [2].

One of the most prominent features of this type of investment is its ability to cope with a variety of risks, such as Asymmetric Information, agency risk, innovation risk, and business risk [3]. Despite facing the above risks, these types of investors have considerable flexibility in designing contracts to maximize the return [4]. They generally use complex contracts and design intricate arrangements to control the risks involved in the investment process. Contracts should be designed in such a way as to reduce the problems posed by the risks to the parties [5]. In fact, each of the agreements in a venture capital contract is designed to deal with certain types of risks [6]. Among the risks which venture capitalists are faced to we can refer to Asymmetric Information [3] and agency risks [7]. They try to reduce the impact of these risks in the form of contractual arrangements. Among those used to this end is the agreement to prevent stocks from being diluted.

Asymmetric information in the valuation of startup businesses at the time of investment increases the likelihood of dilution situations, and on the other hand, principal and agent conflict of interest at the time of occurrence of dilutive events is inevitable to somewhat. In view of the above, the existence of a means to mitigate the conflict of interest is essential, and one of the most important of these is the agreement to prevent dilution of stocks [8].

Other issues that should be considered in this type of investment are the type of stock used by investors. The type of stock used in venture capital is an important issue that has received extensive research worldwide. Over time, companies' willingness to use a variety of financing strategies has changed. Issues such as agency problems, investor institution structure, market conditions, taxation and incentives have been influential in this regard. In the venture capital literature generally, convertible preferred stock is recognized as an appropriate type of stock for investors [9-18]. One of the most important advantages of using convertible preferred stock is the right to avoid dilution by adjusting the conversion rate, which is discussed below

- ### Dilution

Investigating the anti-dilution agreement requires examining the concept of dilution and identifying the types of dilutive events that we will deal with subsequently.

The word dilution in the investment literature implies a decline, and in the case of securities and equities, it is divided into two types: dilution of percentage and economic dilution.

- ✓ #### Percentage dilution:

This refers to situations that will reduce the investor ownership percentage. This occurs when common stocks or any other convertible shares are issued. This type of dilution does not have a direct impact on the economic value of the investment made [19]. The issue of new equity shares at a fair price will not diminish the value of the investor's stocks, but it should be borne in mind that this type of dilution has a negative non-financial impact on the investment. For example, it may be mentioned the exercise of particular powers reserved for holders of a certain percentage of the capital stock of the company. With this type of dilution, the possibility of exercising those powers will be eliminated and thereby the power of investor control will be reduced. In diluting the percentage of ownership, the investor uses contractual arrangements such as Pre-emptive Right to maintain his ownership and control [20].

- ### Economic dilution

This indicates situations where a decrease in the value of existing stocks causes the economic value of the investment to decline. Economic dilution by emphasizing the starting point of calculating the economic devaluation, is divided into two types: Dilution from initial investment and Dilution from current value. In the first type, the basis of calculation is the value of the investment at the time of occurrence, and in the second type, the basis of calculation is the value of the investment prior to dilutive events. What is at stake in the anti-dilution agreements, which is common in venture capital literature, is the issue of economic dilution [21], and this writing is based on this type of dilution.

Many situations, such as stock dividend, stock split, reverse stock split, distributions of cash and property, issuance of additional common stock, issuance of common stock purchase rights or securities convertible into common stock and the like under different circumstances can lead to a decrease in the value and dilution of the capital of the company and consequently the dilution of the investor's stock [20].

At a glance, the types of situations that lead to a dilution can be divided into three types of structural changes in common stock, cheap issuance of common stock and distribution of cash or property.

Distributing items such as property, cash, and the like to common stock holders will typically lead to a depreciation of stocks [20, 22]. This has no effect on ownership percentage and leads to economic dilution as there is a reverse relationship between the distribution of profits, properties and corporate assets and stock price fluctuations [23]. Cash dividends have a negative impact on the company's assets and working capital, and the company will be required to raise capital through the issue of shares and attract new investors. In this case, the price of new shares will generally decrease in proportion to the dividend paid [24].

In this type of dilution to protect the value of the investment, different solutions such as conversion rate adjustment [22], assign distribution interests to holders of convertible shares equal to the time when their shares were assumed converted [22], provide any distribution to the notice of the holders of convertible preferred stocks and provide them with the opportunity to convert the stocks and to enable them to enjoy the benefits of distribution [25, 26], and finally the complete ban on any kind of distribution [8] is used.

Prevalent agreement in venture capital investment contracts is the complete ban on any distribution. Companies that are subject to venture capital investments because of the lack of the amount of flowing cash and being unprofitable in the early years of investing, generally prohibit any payments resulting from the distribution of property or cash and thereby prevent possible economic dilution [27]. The aforementioned arrangement is generally not in the form of anti-dilution, but will be discussed in a term such as Dividend Right. Therefore, this agreement is not directly the subject of this article and will not be discussed in greater detail. In the following sections we are going to concentrate on some of the dilutive events and anti-dilution agreements that are common in venture capital contracts.

Types of dilutive events and prevalent anti-dilution agreements in venture capital industry

After getting acquainted with the concept of venture capital and dilution, we will continue to look at a variety of stock dilution situations and preventive agreements that are common in the venture capital industry and examine the application of these agreements in the Iranian legal system.

In venture capital contracts, what is discussed below anti-dilution agreement, is the conversion rate adjustment process, given the dilution situation in two parts of the issue of common stocks at lower prices and the structural change of common stock or convertible shares. Therefore, in the following two separate sections, we will explain how to adjust the conversion rates and apply these agreements to the Iran's' legal system. Given the nature and legal system governing commercial companies provided for law of Iran, the subject of venture capital investment will mainly be in the form of private joint stock companies, so what is presented in this section is restricted to the laws governing private joint stock companies.

- ### Release shares at a lower price

In this case, the issuance of new common stock is set at a price lower than the share price at the time of initial investment (initial price) or at the time of dilution (market price). According to the above explanation, the conversion rate of the stock will be adjusted in two ways: market price and initial price.

The market price method is designed to protect convertible shareholders from being diluted economically at the time when the diluent position occurs [19]. This approach is based on the view that if new common stock are issued at prices lower than market prices, even if this price is higher than the initial price (stock price at the time of investment), the holders of convertible preferred stocks will suffer losses. The application of this method is where the initial price is determined by the parties fully aware of the market price at the time of investment and the relationship is likely to have the lowest level of asymmetric information. As explained above, this approach does not protect the venture capital investors from the risk of asymmetric information [8]. In practice, for startups that have a small market share, it is difficult for them to determine the market price and the set price may not reflect the potential value of their stocks [28]. So in this essay we will discuss initial pricing methods.

✓ Initial pricing

This method applies when new common stocks are issued at a price lower than the price which was determined on the day of the investment [21]. This approach is widely used in startups and is particularly important in venture capital contracts [20]. The above method is divided into two types of fully ratchet and weighted average [29].

➢ Fully Ratchet

If a venture company releases new stocks at a price lower than the initial price, the former will fall to the value of the newly issued stocks; in other word, each time the company releases a new round of stocks at a price lower than the stocks issued at the time of investment, The conversion rate changes as if all previous period stocks were re-priced to fully offset the devaluation of the first investor [30]. At first glance, this approach is appealing to investors as it fully protects them from any downturn until exit, but on the other hand, it will be unfair to entrepreneurs because of the risk of falling prices completely Imposed on them. One of the main factors predicting such an arrangement is asymmetric information at the time of investing as it leads to inappropriate pricing by the investor and in the long run forces the investee company to issue stocks at a lower price. Investees emphasize that this is not simply a result of asymmetric information and may be due to future market developments or weak management [8] and if business expectations for the above reasons are not met, the partners will be forced to adopt a dilutive finance. However, if the previous capital is injected in a fully ratchet manner, there will be no incentive for new investors to participate and this will be a major problem for the first investor and the founders.

➢ Weighted Average

The most common way to enforce an anti-dilution agreement is weighted average. This method also reduces the rate of conversion of preferred stocks into common stocks. Unlike the fully protected method, in this new method the adjustment rate is affected by the number of shares issued at lower prices, that is, the higher the number of shares issued at lower prices, the greater the rate of adjustment at conversion price the lower the number of shares issued at a lower price, the lower the rate of adjustment at the conversion price.

This type of anti-dilution agreement is divided into two types: Narrow- based and Broad- based, which differ in the meaning of the term "outstanding common stocks". At the Broad-based, outstanding common stocks also includes common stocks resulting from the conversion of preferred stocks and other rights, options and shares, while the Narrow- based only includes common stocks in the present. The broader the concept of outstanding common stock, lessening the effect of anti-dilution agreement for investors [31].

Article 166 of the legal bill on the amendment of a part of commercial code of Iran enacted in 1969 authorizes the option to purchase shares for former shareholders. It is a legal mechanism for preventing dilution. However, exercising this right will not meet the expectations of investors because: (a) This right is relative to the former ownership and cannot be increased; (b) exercising this right requires the buy of new stocks subject to options while in anti-dilution term, investor do not seek to buy new stocks, but seek to preserve the value of the initial capital and the percentage of ownership at no new cost; and c) this right further seeks to prevent percentage dilution and will not be useful in cases of economic dilution. In view of the foregoing, the provisions of the legal bill on the amendment of a part of commercial code of Iran can't provide the purposes of investors and there is no choice but to use contractual agreements. Therefore, it should be analyzed that if it is possible to apply worldwide venture capital arrangements in accordance with Iran's legal system.

Note 2, Article 24 of pre mentioned code in the definition of preferred stocks, states that "Some shares of the Company may be given privileges in accordance with the provisions of this Act. Such stocks are called preferred stocks." According to this definition, the possibility of using preferred stocks in Iran's law is envisaged generally, although there are no references to the types of that and associated privileges [32].

According to the above definition, any such benefits may be granted unless it is contrary to the positive laws [33] or the Sharia law [34, 35]. And among the privileges reserved for holders of preferred stocks is the right to convert to common stocks [36] at a fixed or determinable price and rate.

Articles 43 to 49 of the legal bill on the amendment of a part of commercial code of Iran discuss the issue of conversion of bearer shares in to registered shares and vice versa, with the approval of the extraordinary General Assembly or mentioned Articles of association. But there is no definite possibility of converting preferred stock into common and vice versa.

According to the above explanations, the legal system governing the preferred shares is completely vague and any consideration for such shares is the result of agreements between the stockholders of the company. Given the contractual nature of these concessions, if the basic conditions of the transaction were true and not explicitly contravened by the law, consideration of the right to convert preferred stocks for holders of such stocks is effective and has no impediment. The same applies to the determination of the conversion rate within the framework of the pre-defined terms of the parties, so that the stockholders can, in accordance with the terms stated in the form of a contract or condition, conclude about determining the conversion rate at the time of the event that causes the stock to dilute economically.

Although the anti-dilution agreement comes as a condition of the investment contract, the condition itself is a complete contract and it contains an independent obligation, and, given the specific nature of the subject and the agreement of the parties, is listed among other contract conditions [37]. Subject to the principle of voluntarism and liberty of contract and to the principle of validity of transactions, subject to non-infringement of rule of laws [37], public order and public morality [37], there is no prohibition on the use of these agreements unless the basic conditions of the transaction are met and there are no conditions that are invalid or invalidating.

On the other hand, the right to modify the conversion rate may be one of the contractual adjustment of the contract [37] provided in the context of an investment contract (adjustment condition [37]). Predicting the adjustment requirement in contracts is generally based on avoiding disrupting the economic equilibrium of the transaction, and this is particularly evident in long or medium run contracts as the economic conditions at the time of conclusion of the contract can be affected by several factors. Investors are looking for a way to protect their interests so that the trading economy does not undergo much change until the end of the contract, so they expect adjusting terms under the contracts. What is important in this regard is to determine the basis of adjustment in order to avoid ignorance of the contractual considerations. Specified duration of venture capital contracts, diluting situations and the way of adjusting conversion rate, removes the ignorance of the parties to the present agreement and the whole contract and eliminates qa-rar [37]. This agreement is generally valid and does not constitute invalid or invalidating conditions. As a result, there is no prohibition on using the agreement to prevent the dilution of stocks in venture capital industry in accordance with the Iran's legal system.

To achieve the above goals, investors and entrepreneurs may benefit from the more commonly accepted agreements in the Iran's contracting system, which are also face to a greater acceptance in courts. For example, the founders' gratuitous conveyance of their property or shares to the investor may indicate the amount of loss resulting from the dilutive events. But many of these deals in dilutive events do not fit the financial position of startups or the spirit of venture capital investments. In this case, assuming dilutive positions and applying the above agreement, all financial burden resulting from the dilution will be transferred to the founders, and on the other hand, the existing contractual balance will be eliminated by reducing the percentage ownership of the founders. Although this agreement has greater legal transparency in accordance with the Iran's legal system, in fact it is not compatible with the economic situation of entrepreneurs because the founders do not actually have sufficient assets to compensate the losses. In designing investment contracts, it must always be borne in mind that startups at this stage in their lives, have no real asset but their own creative idea, and on the other hand, investors generally invest less than 50% of the startups valuation, in contrast, a variety of conditions for control and oversight are included in the contract [38]. This strategy will give investors the right to control and, in turn, give the founders a sufficient amount of ownership of the company, which on the one hand will motivate them to increase the value of their stocks, and on the other hand, control the risks involved in investing, particularly the agency risk and information asymmetry [39]. In view of the above, any condition that disrupts this equilibrium does not only guarantee the interests of either party in the long run, but also causes the parties to be ineligible or misused.

If parties use gratuitous contracts and the entrepreneurs transfer their shares to the investor after dilutive events taking place and reducing their ownership, the conflict between the original interests and the agent will become more pronounced and will not only diminish the founders' motivation to continue working to enhance the value of the company but also It can stimulate them to abuse the asymmetry of information and to secure personal gain.

- Structural changes in common stocks

Significant structural changes in common stocks include stock split, reverse stock split and stock dividend. Some of these dilutive events are within the legal framework provided for in the legal bill on the amendment of a part of commercial code of Iran, although in some cases lack of transparency may lead to ambiguity in practice.

Stock split is that each stock is separated into multiple parts. In other words, the decline in the par value of each share is called the split of stocks by increasing the number of shares without any change in the capital stock. For example, a share of 1000 Rials is broken down into 10 pieces of 100 Rials [40]. The main motivation for splitting stocks is to reduce the value of equity appropriately to facilitate the attraction of small investors [41]. The term 'stock split' is mentioned in Article 32 of the Act, but no specific legal regime is provided for, and this may raise doubts about the rights of shareholders and the exercise of these rights [42].

This can lead to a dilution of ownership and economics. For example, if the common stocks split and this right is not given to the preferred stocks (with the right to convert one to one), besides to the fact that the ownership of the preferred stock holders in the company will decrease after the stock split, generally the increase in the number of shares may lead to a decrease in the value [20]. Therefore, it is necessary to anticipate anti-dilution agreement in this case.

Like stock split, stock dividend lead to issuance of new stocks, increasing the number of shares and thus reducing its value. Subject to Article 240, the right of determining dividend method has delegated to the general assembly, and if not assigned by that, it is left to the board of directors, and in Article 158 discusses the issue of new shares and the payment of their nominal amount from matured claims [42] (dividends) is referred to. Due to the need of startup companies to have cash flows and the lack of liquidity in these companies, stock dividends can be considered. Therefore, under the above conditions, dilution of stocks is inevitable and it is necessary for investors to prevent it by using anti- dilution agreements.

Reverse stock split is against the stock split. The main reasons for stock consolidation can be things like stock price increases (if the stock price is below of the normal value it will have a negative impact on investor sentiment) or legal requirements regarding minimum stock prices for public offering (in some markets Finances have been set for the stock price minimums [43]). Given the increase in stock prices as a result of stock consolidation, if the stock conversion rate is not adjusted as a result of stock conversion, the amount of investor ownership will be very high and the common stock holders will not agree to stock consolidation unless the conversion ratio decreases. This is the only deal to prevent the dilution of stocks at which the conversion price rises [44].

There is no wording in the law which governing commercial companies in Iran, in this respect. Only in one case has the decrease in the number of stocks been mentioned in the context of the forced reduction of the company's capital in Articles 141 and 189, which differs from what we consider because of the term reverse stock split in this assay does not lead to a decrease or increase in capital.

The first and easiest way to come to mind is to forbid such things, but forbidding them in general is inconsistent with the economic realities of startups, as they may for many reasons, such as market development, economic crises, competing with similar companies and so on requires the reform of their capital structure. Making these changes, although initially leading to the dilution of the venture capitalist investment, in the long run not only prevent the decline of capital but also contribute to the growth of the company provide their interests as well. Therefore, we must look for a way to keep investors' position and value of their capital while that do not conflict with the needs of startups for growth and development.

Despite the numerous restrictions on startups in control agreements, such as subjecting certain matters to the consent of a specific majority of the board of directors, in particular the consent of the investors chosen member, the need to use the anti-dilution agreement remains in force because regarding to the startups situations going to have some of these dilutive events after investing is inevitable.

In these cases, holders of convertible preferred stock generally use the conversion rate adjustment [25]. In this way, convertible preferred stock holders retain their ownership percentage before and after the change and minimize the impact of this on depreciation [20]. For example, if the stock is split in a ratio of one to two, the conversion price is also halved, so the number of shares that will be issued as a result of the conversion will double [20].

According to the explanations given in the preceding section, there is no prohibition on the use of this type of agreement in accordance with the governing legal system, although in practice the tendency is to use common agreements in Iranian legal literature. So, depending on the situation we are facing on, different conditions can be foreseen. For example, if the common stocks were to be split or consolidated, the preferred stocks would also be split or consolidated to reduce their dilutive effect.

With respect to the issue of stock dividend, it may also be possible to act in favor of the holders of preferred stocks similar to common stocks holders, but if the preferred stock profit is fixed at all, it would be impossible to apply this arrangement and should use a way like conversion rate adjustment. The difference between the conversion rate adjustment and the terms and conditions that are commonly cited in Iran's law is that in venture capital contracts, an independent agreement is provided under the right to convert stocks that outline all the modes of conversion and the situations that will lead to conversion. This is not usually the case for anti-dilution. This term will only adjust the conversion rate and consequently the predetermined conversion ratio to ensure that the investor's interest is exercised at the time of exercising the right to convert [30]. Converting preferred stocks into common stocks will result in a restructuring of the capital and ownership of the company and will disrupt the contract financial and control equilibrium, thereby making it difficult to deal with the risk of asymmetric information and conflict of interest arising out of the agency. So perhaps the current agreements in the Iranian legal literature seem to have a similar effect to the conversion rate adjustment, but they are not really in full compliance with it. In light of the foregoing, we believe that the agreement to prevent the dilution of stocks which is prevalent in venture capital industry is the best way to meet the purpose of this agreement.

Conclusion

The primary rule in commercial companies is the priority of the majority, and this rule often ignores minority rights. When minority stockholders have sufficient bargaining power, they try to obtain the necessary concessions through their negotiations. Venture capitalists primarily fall into this group and foresee themselves privileges in the shareholder agreement. This bargaining power and the conflicting interests of the parties to the contract lead to long-term negotiations and ultimately a modification of demands in order to secure the parties. Thus, in contracts between venture capitalists and start-ups, investors, in order to achieving the expected goal, avoiding opportunistic behaviors, reducing the risks faced, and ultimately gaining the expected benefits from investing try to obtain the necessary rights which may leads on maintaining the percentage of property and the value of the investment. The most effective of these arrangements is to prevent stocks from diluting, which will preserve the investment value through different ways of adjusting the conversion rate. There were some cases in the legal system of private joint stock in Iran that prevented the dilution of ownership but there was nothing to prevent economic dilution, so the only way left is to use contractual agreements. In the opinion of the author, the usual conditions for securing the interests of the investor in Iranian law are not very consistent with the concept of venture capital, and the best condition to meet the interests of the contracting parties is the common agreement in the venture capital industry. According to the studies, the agreement to prevent the dilution of stocks in its most common form has not been in conflict with the basic rules governing the contracts law and its use is unhindered.

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