

## GUEST ARTICLE

OPTIONS TO CONSIDER FOR  
FOUNDER ANTIDILUTION  
PROTECTION

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“As a possible favorable differentiating factor, it may be worthwhile for venture firms to offer some anti-dilution protection to founders.”

It has become increasingly clear over the last 10 years that the principal risk for entrepreneurs in accepting a venture capital investment is post-Series A dilution of their equity position.

Other risks in taking money from outside investors have been clear for much longer. These risks include valuation risk—whether the entrepreneur has surrendered too much equity in the company in exchange for the amount of the investment—and the risk of not taking enough money to accomplish promised near-term goals. In addition, a founder has always had the risk of losing equity through vesting/forfeiture provisions.

But given the wash-outs associated with the burst of the Internet bubble, the subsequent tightening of investment standards and the frequency of “down-round” financings (the VC equivalent of the *droit de seigneur*), many experienced entrepreneurs have avoided VC financings and have turned to larger angel rounds or investments from strategic partners or hedge funds. Some think that these deals are simply the less desirable ones, but increasingly that is not the case.

As a possible favorable differentiating factor, it may be worthwhile for venture firms to offer some anti-dilution protection to founders.

#### Bonus for staying

One approach that has been used is to adopt a program for founders and senior executives that is similar in concept to the

“stay bonus” contracts adopted by astute boards of directors when a possible acquisition of the company is on the horizon. Those contracts essentially say that if the individual remains an employee of the company at the time of the sale or for a specified period of time after the sale, the employee gets a fixed bonus or a bonus equal to a percentage of the acquisition consideration.

The parallel approach for a founder would be (subject to a number of complications discussed below) that the founder and the company would enter into a contract that specifies that the company must pay to the founder, simultaneous with an acquisition, an amount equal to a specified non-dilutable percentage of the gross amount payable to the company’s stockholders in the acquisition *minus* the amount otherwise payable to the founder with respect to his or her equity. This percentage would vest according to the same schedule as the founder’s sweat equity, and the vested percentage (including full acceleration) would be payable on the acquisition.

In other words, the founder would get the full percentage if employed by the company at the time of the acquisition, or, if the founder quits before an acquisition, the founder would only get the vested percentage. An IPO could be treated similarly, with the founder receiving an amount of stock (or options) so that the founder would have his or her specified percentage of the pre-IPO fully diluted equity.

This program has one significant advantage over other forms of dilution protec-

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tion, such as a warrant guaranteeing a specified percentage of the common equity at the time of a liquidity event. The founder under this program effectively would be a creditor of the company who would not be subject to the prior (and dilutive) claims of existing and future issuances of preferred stock.

One significant disadvantage of this type of program, compared to owning stock, is that the proceeds to the founder would be taxable as compensation income, rather than as a capital gain or tax deferred. This tax treatment would effectively result in lower after-tax proceeds than the percentage-equivalent equity position, although, at least in a cash acquisition, there would be no issues regarding the founder's ability to pay the tax.

On the other hand, if the acquisition were for equity of the acquirer, there is a possible planning issue in that the founder must be able to sell the equity in order to pay the tax on the receipt of the acquisition proceeds if it is not a tax-free reorganization. In a private/private acquisition, the founder's interest in the program would simply carry over to the surviving company, and the bonus would be reduced based on the share of the surviving company's equity initially held by the shareholders of the founder's company.

### Important questions

The program creates a number of drafting and planning considerations that must be addressed, some of which are discussed above, including:

- Should the participant's payout be based partly on how long the participant works for the company before the acquisition occurs, that is, subject to vesting?
- Should vesting be accelerated in whole or in part if the participant is terminated without cause or quits for good reason? More senior executives are attempting to get some preferential treatment under these circumstances based on fairness arguments.
- Should vesting be accelerated, in whole or in part, on the acquisition? Should vesting be subject to a double trigger where the founder continues to vest after the acquisition but fully vests if he or she is terminated without cause or quits for good reason? In this event, there would have to be a retroactive true-up of the bonus. This is awkward since the acquirer would be liable for a contingent payment that could be substantial. On

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the other hand, stay bonus programs present the same problem but likely with much less onerous economics.

- Should the vested portion of the participant's interest be forfeited completely in the event that the participant quits employment without good reason?
- What happens if the acquisition is a sideways merger, that is, a merger with another private company? The typical provision in a stock option plan is that the option holder—on exercise of the carried-over option after the acquisition—gets what he or she would have received if the option had been exercised prior to the acquisition. If two private companies merge, then the value of the combined business theoretically increases. Giving the founder the same percentage protection as was in effect before the acquisition would be a windfall. The analogy to the typical stock option plan would be to give the founder continuing anti-dilution protection, but to multiply the founder's guaranteed percentage by the percentage of the combined company that the shareholders of the founder's original company own immediately after the acquisition.
- Should an IPO be treated as a liquidity event similar to an acquisition? One would think so because having the contract survive the IPO would create unusual disclo-

sure and market issues for the IPO and the subsequently traded public company. Paying a taxable bonus on an IPO, rather than on a cash or tax-free acquisition, would create liquidity problems for the founder that are not easily remediable. The bankers would not want to see the founder sell shares in the market before lock-up expiration in order to pay the tax, the market may not be sufficiently liquid regardless, and lastly a company loan might be prohibited under Sarbanes-Oxley depending on the founder's officer status at the time of the IPO.

- Should any proceeds from the participant's sale of equity be a credit against the payout? This question also arises with respect to a prior sale or transfer. A reduction would appear to be sensible because the rationale for this sort of program is protection against “overly dilutive” future dilution, not a simple increase in the founder's equity position.

### More questions

Other related questions are whether the reduction itself should itself be reduced by what the founder paid for his or her stock? Presumably yes. Also, how are pre-acquisition dividends, ordinary and extraordinary, treated? Should they reduce the amount payable to the founder?

What if, for example, the company does a pre-acquisition spinoff or recapitalization? A warrant would normally contain a provision that the warrant holder on exercise would receive what the warrant holder would have received if he or she had exercised the warrant prior to the extraordinary event. That would be difficult to implement here. Perhaps the founder could receive his or her guaranteed percentage in the spun off company but without further anti-dilution protection.

For a sample agreement that attempts to implement this approach and deals with most of the foregoing issues, please email the author at [emiller@sandw.com](mailto:emiller@sandw.com).

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