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ANTI-DILUTION PROVISIONS IN AMERICAN AND ITALIAN VENTURE CAPITAL INVESTMENTS: A COMPARATIVE APPROACH

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Introduzione

Il presente progetto di ricerca propone una riflessione giuridica sulle clausole anti-diluitive impiegate nelle pratiche di investimento Venture Capital ("VC") in imprese startup, con particolare attenzione alle implicazioni secondo il diritto societario italiano. Il presente elaborato prende le mosse dalla constatazione che ai fini di poter trattare il fenomeno anti-diluitivo quale rimedio sia prima necessario comprendere la vasta casistica in cui la diluzione del socio investitore può avere luogo. In altre parole, per comprendere l'operatività di queste clausole e il loro contesto di implementazione, è stato opportuno passare al setaccio le varie ipotesi che le clausole anti-diluitive sono chiamate ad arginare.

Il primo capitolo tratta il fenomeno della diluizione in senso stretto e volge lo sguardo ai meccanismi contrattuali sviluppati dalla prassi anglosassone e in particolare americana per farvi fronte. Il primo capitolo si apre dunque con la descrizione di due tipi di clausole, la c.d. *full ratchet clause* e la c.d. *weighted average clause*. In secondo luogo, si passa alla trattazione della soluzione del diritto societario italiano al problema diluitivo, con la disciplina dei diritti di sottoscrizione/opzione (*preemptive rights*). In terzo luogo, si va a trattare la questione dell'importazione delle clausole anti-diluitive nel contesto italiano e di come conciliarne il funzionamento con la disciplina del diritto di sottoscrizione del socio di Srl. In particolare, si va ad affrontare il tema delle deroghe al principio di proporzionalità. Infine, il capitolo approfondisce gli strumenti attualmente utilizzabili per l'investimento in startup italiane a cui le clausole anti-diluitive possono inerire, come quote e strumenti di debito convertibili.

Il secondo capitolo, invece, tratta il fenomeno anti-diluitivo in senso largo, prendendo le mosse dal contesto americano e andando in particolare a delucidare le innovazioni contrattuali succedutesi nella prassi di investimento c.d. *early stage* e che ad esso è collegato. In particolare, se il primo capitolo terminava con la rassegna degli strumenti di investimento nel contesto startup italiano, il secondo capitolo, in chiave comparatistica, dirigerà l'attenzione del lettore sul versante americano. Diretta espressione di ciò sarà la sezione dedicata alla teoria sul c.d. diritto di exit dell'investitore a cui sono da ricollegarsi tutta una serie di previsioni contrattuali e opportunamente passate in rassegna nella nostra trattazione, che saranno definite come meccanismi anti-diluitivi in senso largo. Questo capitolo, infatti, si prefigge lo scopo di trattare dell'anti-diluizione come effetto complesso, ovvero come risultato del contestuale operare di una serie di clausole a ciò preordinate. Saranno trattati come meccanismi anti-diluitivi in senso largo, ad esempio, diritti di veto e c.d. *liquidation preferences*. Infine, il capitolo tratterà del problema degli effetti anti-diluitivi in relazione ad un rapporto di investimento complesso e cioè con una pluralità di parti i cui interessi entrano in conflitto, problema noto come *trilateral bargaining*.

Il terzo e ultimo capitolo si cura di trattare nello specifico i problemi sollevati dall'implementazione delle clausole anti-diluitive *strictu sensu* nel contesto italiano, analizzando gli ostacoli formali e sostanziali riscontrati in dottrina e in giurisprudenza. Si inquadra il problema prendendo le mosse dalle riforme di diritto societario intervenute tra il 2012 e il 2017 che hanno introdotto una speciale disciplina per le società startup e per le piccole e medie imprese (c.d. PMI). Si considera come tali interventi legislativi non siano culminati in una riforma organica del tipo Srl nel suo complesso e, dunque, come si renda necessario il ricorso all'ermeneutica adeguatrice di certe norme della disciplina generale. Ciò comporta offrire un'interpretazione che renda la disciplina del Codice Civile più conforme ai bisogni dell'archetipo socio-economico della Srl *VC*-

backed, in ragione dell'esigenza concreta delle imprese startup di procurarsi sostentamento finanziario a cui le clausole anti-diluitive sono funzionali.

Il terzo capitolo, dunque, considera prima l'ammissibilità in astratto e poi l'utilizzo in concreto dei meccanismi anti-diluitivi *strictu sensu*, partendo dal riconoscimento che i suddetti strumenti contrattuali hanno ricevuto da parte del Consiglio Notarile di Milano nella Massima n.186 del 3 dicembre del 2019. In particolare, si osserva come nella suddetta Massima le previsioni anti-diluitive vengano definite quali clausole statutarie che prevedono l'obbligo, in caso di futuri aumenti di capitale a pagamento, di assegnare gratuitamente un certo numero di azioni o quote di nuova emissione ai beneficiari della categoria protetta. Ciò, supponendo che i futuri aumenti di capitale siano deliberati a un prezzo inferiore a quello che nelle clausole stesse è stabilito per evitare la diluizione della categoria protetta. Nello specifico, il Consiglio Notarile di Milano ha così ammesso la possibilità di assegnare quote in misura non proporzionale ai conferimenti, descrivendo le suddette clausole, nella motivazione che accompagna la Massima, come espressione del bisogno di protezione dell'investimento sociale. Si osserva come questa necessità, ad esempio, possa sorgere qualora un investitore sottoscriva una partecipazione di minoranza e in un secondo tempo venga deliberato un aumento di capitale basato su un prezzo di emissione inferiore rispetto al valore della società. In questa evenienza, infatti, due opposti interessi andrebbero a scontrarsi: quello dei soci di maggioranza di determinare liberamente gli aumenti di capitale e quello del socio di minoranza di proteggere il proprio investimento in società—configurandosi, dunque, la funzione delle clausole anti-diluitive proprio nella mitigazione di questi interessi di segno opposto.

Il capitolo poi analizza più da vicino quelli che sono stati identificati come gli aspetti problematici della disciplina del tipo Srl e impeditivi dell'efficacia dei meccanismi anti-diluitivi

di importazione americana. In particolare, viene offerta una trattazione critica del principio di rilevanza centrale del socio, soprattutto alla luce delle considerazioni fatte a inizio capitolo. In seguito, si approfondisce il tema di una possibile incompatibilità di queste clausole con il divieto di patto leonino. Nello specifico, si riporta la vicenda alla base del giudizio Cass. N. 17498/2018 che ha ulteriormente ridimensionato il divieto alla luce del *favor* che il legislatore riserva per le tecniche atipiche di finanziamento dell'impresa e si riportano le contrastanti osservazioni dottrinali in merito.

Infine, l'ultima parte del capitolo esamina il terreno contenzioso rappresentato dall'exit societario. Si fa notare come il diritto di recesso normativamente accordato al socio Srl possa rappresentare un ostacolo all'efficace implementazione delle clausole anti-diluitive quando il suo esercizio offre l'occasione per comportamenti opportunistici e, non da ultimo, per una possibile emorragia di risorse societarie. Infatti, il diritto di recesso dei soci Srl ex comma 3, articolo 2473 del Codice Civile, attribuisce al socio recedente il diritto di ottenere il rimborso della propria quota, secondo il valore che la quota detiene in quel momento. In aggiunta a ciò, il presunto carattere inderogabile del diritto di recesso si estenderebbe fino a comprendere anche il criterio legale di apprezzamento del valore della quota, con la conseguenza che le clausole che predeterminano l'ammontare dovuto al socio recedente sono invalide se questo è inferiore all'effettivo valore della partecipazione. A questo proposito, la soluzione offerta da un'autorevole dottrina e seguita da chi scrive è quella di ammettere una regolazione *ex ante* del recesso grazie a una interpretazione teleologica del rimando che il comma 1 dell'articolo 2481-*bis* fa all'articolo 2473 del Codice Civile. Questo perché, eccetto i casi in cui il diritto di recesso sia *espressamente* qualificato come inderogabile, il suo carattere imperativo viene fatto derivare dal principio di rilevanza centrale del

socio, oggetto di critica nel presente elaborato nella sua configurazione dove possa diventare di ostacolo agli interessi del socio stesso.

CHAPTER I

Anti-dilution *Strictu Sensu*

1. Dilution and Anti-Dilution *Strictu Sensu*

Dilution is the phenomenon that concerns a decrease in value of the shareholders or quotaholders' investment in a company. Although dilution may be connatural to the investment and, more generally, to the business risk, the interest in the preservation of the value of one's own investment is also legitimate and deserving of protection. The Anglo-Saxon praxis has responded to this need developing *ad hoc* contractual mechanisms that accompany a venture capitalist type of investment, possibly, because of the riskier nature of the early-stage financing of enterprises that don't generate any revenue (in other words, startups). The American praxis in particular, where this type of investments is widespread – emblematic of that is the Silicon Valley industry – has developed a plethora of contractual provisions to surround the use of debt, equity, or mixed investment instruments, the majority of which, in our opinion, protects the investor from a dilution of her investment *latu sensu* and that, for this reason, will be the object of analysis in the following chapter. For what is relevant here, the purpose of the present chapter is to compare anti-dilution provisions *strictu sensu* with the European solution to the issue of dilution.

Strictu sensu, dilution may be regarded as the physiological consequence of not partaking in capital increases in proportion to one's pre-existing stake in the company. We can distinguish between nominal and substantial dilution; the former consists in a curtailment of the company stake (i.e. expressed in percentage of the share or quota capital) held by shareholders or quotaholders who do not partake in capital increases in proportion to their company stake. The

latter occurs when a capital increase is carried out at a lower price than the shares or quotas' market value, with the result of an overall drop in value for pre-existing stakes.[1]

In the Anglo-Saxon practice, anti-dilution provisions are contractual instruments that work in tandem with the convertible preferred stock or convertible financial instruments subscribed to by investors. In particular, anti-dilution clauses are responsible for a non-proportional allocation of the losses in administrative weight (caused by a nominal dilution) and/or of the losses in the financial value of the shares (caused by a substantial dilution).[2] Indeed, through anti-dilution provisions, in case the beneficiary (usually the VC investor) doesn't wish to take part in rounds of capital increase, she is protected against loss in value, for the loss, or better, the dilution is borne solely by the shareholders (usually the founders) not benefitting from these clauses.[3] In simpler words, as a result of these provisions, the VC investor is not diluted even though she does not contribute to the capital increase. Consequently, the weight of the investor's dilution is placed on other subjects, with the result that the dilution overall obtained does not follow a principle of proportionality.

Anti-dilution provisions are mechanisms that represent for VC funds an incentive to invest in startups, given that, thanks to them, the investors get to maintain their administrative and financial position in the company, either with no additional financial outlay, or with a lower one than what otherwise entailed by the principle of proportionality.[4] Scholar Awwad highlights also how the use of this kind of provisions helps to resolve some of the complex agency problems that characterize the investor-founder relation by representing one solution to the problem of information

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[1] AGSTNER, P., CAPIZZI, A., and GIUDICI, P. (2020). Business Angels, Venture Capital e la Nuova S.r.l.. In *Orizzonti del Diritto Commerciale, N. 2,* pp. 353–452.
[2] Agstner et al., 2020, p. 419.
[3] *Ibid.*
[4] AWWAD, A. A. (2021). Il Problema delle Clausole "Anti-Diluitive". *Le Nuove Leggi Civili Commentate, N. 1,* p. 177.

asymmetry.[5] Indeed, apropos of this, she observes how the information asymmetry may likely lead to a difference in opinion regarding the value estimation of the company stakes, given that each party has a value expectation based off of the information at their disposal and, in this sense, anti-dilution provisions allow the parties to bridge this gap.[6]

In the Italian landscape specifically, this reading is supported by the content of Recommendation n. 186, from December 3rd, 2019, by the Notarial Council of Milan, dedicated to the reception, admissibility, and legitimacy of this kind of clauses. Indeed, although we'll examine the content of this Recommendation more in depth further on, for what is relevant here, this Maxim situates anti-dilution provisions within the dialectics of majority and minority stakeholders. In particular, these contractual provisions are viewed as serving the function of protecting the interest minority shareholders/quotaholders have in maintaining their stake or, at the very least, in containing a possible dilution of their investment, yet granting, at the same time, the majority shareholders/quotaholders the freedom to determine capital increases at a lower price.[7]

The anti-dilution provision that grants the maximum protection from dilution to its beneficiary is the "full ratchet" clause. Thanks to this provision, indeed, its beneficiary obtains exactly the number of shares that is necessary to maintain unaltered both the value of her investment and her shareholding position, for free.[8] The full-ratchet provision is thus able to ensure both a substantial equivalence and a nominal one (with the relevant administrative and financial consequences) to the stake held by the beneficiary prior to the operation of capital increase, and this at the expenses of the other shareholders who, symmetrically, suffer a reduction in value of their own investment

[5] Awwad, 2021, p. 177.
[6] Awwad, 2021, pp. 177-178.
[7] Awwad, 2021, p. 180.
[8] Agstner et al., 2020, p. 419.

and a shrinkage of their shareholding position.[9] In the US, according to the relevant case-law, the only remedy that would be left to the shareholder undergoing a non-proportional dilution following the application of a full-ratchet clause would be to invoke the breach of fiduciary duties, however, if and only if such provision were to cause the shareholder to suffer an unfair damage – nevertheless, invoking a breach of fiduciary duties under these circumstances tends to be interpreted restrictively by US case-law.[10]

Another kind of anti-dilution provision is the "weighted average clause," whereby the beneficiary obtains a new number of shares on the basis of the weighted average price between the actual amount of capital raised through the last round of capital increase and the foregoing capital, and this based off of a discounted conversion price that can be calculated through different formulas according to the type of weighted average clause.[11] Differently from the full ratchet clause, the protection against dilution accorded here is not as comprehensive, since the mechanism still requires some financial outlay from the beneficiaries. Albeit less protective, weighted average anti-dilution provisions seem to be the most widespread in practice[12]—more likely than not, that is because they appear more balanced in consideration of the different interests at play than the full ratchet clauses. Moreover, weighted average anti-dilution clauses can be broad-based, meaning that what is included in the weighted average is the capital raised through all kinds of shares and convertible instruments.[13] Weighted average clauses can also be narrow-based, meaning that the weighted average is calculated on the basis of one category of shares – and as such they tend to ensure greater protection, less dilution.[14]

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[9] Agstner et al., 2020, pp. 419-420.
[10] For reference see Agstner et al., 2020, pp. 420-421.
[11] Agstner et al., 2020, p. 421. Awwad, 2021, p. 176.
[12] Awwad, 2021, p. 177, footnote 6.
[13] Agstner et al., 2020, p. 421.
[14] *Ibid.*

2. European Solution to Dilution: Pre-Emptive Rights

In case of capital increase, the clash between the principle of proportionality in a strict sense and the need for freedom of contract may emerge with particular strength when the anti-dilution provisions widespread in the American praxis (full ratchet and weighted average clauses) are contained either in the operating agreement or in shareholders' agreements. Through anti-dilution clauses, indeed, the parties resolve to autonomously regulate their own dilution, whereas European legal systems tend to face the issue of dilution by having a default recognition of pre-emptive rights for the shareholders of limited liability companies. The European system thus is known in the literature as "opt out system," because the default recognition of pre-emptive rights entails that it is the parties' choice, in the exercising of their private autonomy, to *opt out* and regulate their interests otherwise when confronted with dilution. The American system, to the contrary, not presenting such default recognition of pre-emptive rights, is considered, instead, an "opt in system" (this entailing that it is the parties' prerogative to *opt in* and regulate their mutual interests through the recognition of pre-emptive rights).

In particular, preemptive rights allow the shareholder to maintain unaltered her shareholding position if and only if she wishes to participate in capital increases and provide further contributions. In Italy, the carrying out of a capital increase operations is articulated in the following moments: 1) the decision to proceed with a capital increase formalized in a deliberation, 2) the offering for the quotaholders to subscribe to the capital increase round, 3) the actual subscription to the capital increase. In *Srl* companies, the deliberation of capital increase can be provided either at the end of a quotaholders' meeting, or by the management board appropriately delegated by the quotaholders. Article 2481-*bis* of the Civil Code provides the discipline for capital

increase by means of new contributions (capital increase against payments), which differs from the discipline of capital increase by means of allocating reserves (except for the legal reserve) and available funds to capital (so-called free capital increase). The latter, indeed, does not represent an instance of real capital increase, rather, it is an operation that modifies the legal regime of the relevant accounting values that will go to increase the portion of company equity unavailable for distributions.

With capital increase by means of new contributions, those willing to participate must provide at least 25% of the contributions for the part of capital increase they're subscribing to, if not the higher percentage or the integral value established for it. As an alternative, according to paragraph 4 of article 2464 of the Civil Code, such obligation may be fulfilled by providing an insurance policy or a bank guarantee. Other than in cash, contributions can also be made in kind through the provision of goods and/or credits, or they can even be contributions of work and services, in which case the contributor will have to provide an insurance policy or bank guarantee for the entire value assigned to the contribution.[15]

The peculiarity of pre-emptive rights when it comes to *Srl* companies has been ascribed to a difference in terminology in comparison with what provided in the discipline for the *Spa* company type, such that it had scholars speculating over the difference between a "subscription right" (*diritto di sottoscrizione*) as opposed to an "option right" (*diritto d'opzione*).[16] The former is contained in article 2481-*bis* relating to the *Srl* type while the latter is provided for *Spa* shareholders in light of the company's own interest in maintaining a homogenous shareholding composition rather than, as it was then conceived to be the case for *Srl* quotaholders, being

[15] For a comprehensive account of capital increase operations in *Srl* companies cfr. GIANNELLI, G. (2020). Le Operazioni sul Capitale. In IBBA, C., and MARASÀ, G. (eds.). *Le Società a Responsabilità Limitata: Vol. 2.* Milano: Giuffrè Francis Lefebvre

[16] Giannelli, 2020, p. 1579.

provided in the subjective interest of quotaholders themselves.[17] Evidently, in this vein, the option right was thought to have an objective connotation, in line with the objective nature of shares as capital instruments, while it was postulated that subscription rights would have a subjective nature.[18]

Either way, in both cases, pre-emptive rights entail a right to be offered the subscription to capital increase in proportion to one's stake in the company. A difference initially suggested, other than the one in subjective or objective nature, between one and the other, was that option rights would be considered freely transferable (in light of their objective nature) and, because of that, they were also thought to have an economic value per se (a premium). On the other hand, since the *Srl* was, for a very long time, conceived as having an inherently closed ownership structure, subscription rights, unless it was otherwise provided in the operating agreement or instrument of incorporation, were believed to be non-transferable.[19] The transferability of pre-emptive rights in the *Spa* model, that logically presupposes their renounceability, means that shareholders not partaking in capital increases could always profit off of transferring their option rights.[20] In this way, the shareholders facing a nominal dilution can still protect themselves against the negative outcomes of economic dilution through the bargaining of a good price for their option rights.

Conversely, we might ask ourselves what mechanism is in place to protect the quotaholders in case their subscription rights are excluded. The answer, according to some scholars and importantly for our discussion even further on, is to be found in the quotaholders' right of withdrawal from the company, with the related right to be reimbursed for the value of their quota.[21]

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[17] Giannelli, 2020, p. 1579.
[18] Giannelli, 2020, p. 1580.
[19] Giannelli, 2020, p. 1579.
[20] *Ibid.*
[21] Giannelli, 2020, p. 1589.

The right of withdrawal belongs to the quotaholders that do not consent to the exclusion of their subscription rights; exclusion that has to be formalized and expressed for every operation of capital increase, even if contextually to the deliberation establishing the capital increase per se. According to Giannelli, this means that the right of withdrawal belongs not only to the dissenting quotaholders, but also to the abstained, the absent, and to those who have obtained the annulment of their vote.[22]

The right of withdrawal functions, in a way, as a cautionary mechanism for whenever the quotaholders' pre-emptive rights are being excluded, given that the withdrawing quotaholders have the right to be reimbursed for the value of their quota according to what its market value is, which, as in the words of Giannelli (2020), may cause a "hemorrhage of company resources."[23] He writes that the alternative that may present itself would be between seeking the necessary resources to pay off the withdrawing quotaholders, or risk that, with third parties entering the company, there might be an important "spillage of assets."[24] In this instance, if there were no buyers of the withdrawing quotaholders' stake, or in case the company didn't have sufficient resources to pay them back, this issue might even lead to a dissolution of the company altogether or to a capital reduction for a bigger amount than what had originated the quotaholders' withdrawal in the first place.

Thus the considerations just made foreshadow one of the core issues that are being discussed in the present work, namely, the way the quotaholders' right of withdrawal, in the formulation in which it has been intended so far, has the potential to jeopardize not only the growth but the very existence of a company in *Srl* form. This theme shall be dealt with more in depth

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[22] *Ibid.*
[23] *Ibid.*
[24] *Ibid.*

further on, however for what interests our discussion here, the first paragraph of article 2481-*bis* recalls the discipline contained in article 2473, which delegates the definition of the terms and conditions for the exercising of the right of withdrawal to the provisions contained in the operating agreement. Nevertheless, some authors have also highlighted that by revoking the deliberation that legitimizes the exercising of the right of withdrawal, this is then deprived of its efficacy and the same should happen if the situation *quo ante* is reinstated because an indivisible capital increase that was deliberated is not then subscribed to in full.[25]

Another relevant topic is whether quotaholders have a right to withdraw from the company should a regime of limited transferability or non-transferability of their pre-emptive rights be established. Indeed, the right of withdrawal is expressively mentioned in two instances: 1) for the exclusion of the quotaholders' subscription rights, pursuant to article 2481-*bis*, and 2) for limitations on the transferability of quotas, pursuant to paragraph 2 of article 2469. On the other hand, nothing is explicitly mentioned in case limitations are established not on the transferability of the quotas per se, but on subscription rights.

According to Giannelli, article 2481-*bis* and article 2469 actually follow two different rationales: where the right of withdrawal recognized in article 2481-*bis* serves the function of allowing quotaholders to seize the asset value of their stake, which would otherwise be diluted after the attribution to third parties of the right to subscribe to capital increase – especially considered there is no mandatory premium price that they'd need to pay in such instance – the right of withdrawal contained in article 2469 is justified in light of the quotaholders' inability to transfer their stake; inability to otherwise profit off of the value of their investment in the company.[26]

[25] For reference see Giannelli, 2020, p. 1589, footnote 96.
[26] Giannelli, 2020, pp. 1589-1590.

In line with the rationale of protecting quotaholders from being prevented from monetizing the value of their investment, Giannelli writes that the right of withdrawal should then be awarded if the transferability of subscription rights were to be excluded (for that would be another way for quotaholders to partially capitalize on the value of their stake in the company).[27] Instead, he argues, the situation is different if subscription rights are not completely excluded but simply limited, in which case the right of withdrawal is not automatically accorded, given that the possibility of disinvesting is still available to quotaholders by means of possibly selling their stake.[28]

Apropos of the right of withdrawal, Giannelli writes:

> In *Srl*s, the safeguard mechanism nevertheless allows the quotaholder to preserve the asset value of her stake not by maintaining her status as a quotaholder or through the company's equity increase (which could even be missing, considered there is no mandatory premium), but by encouraging withdrawal, which, due to the absence of a market for the quotas (that also, it must be said incidentally, poses quite a few problems), becomes the only feasible course and yet at an appreciable cost for the company.[29]

Ergo, if preemptive rights are one solution to the problem of dilution, specularly, the right of withdrawal that comes with the reimbursement of the value of the stake remedies situations in which preemptive rights are excluded or limited. However, if on the one hand the right of withdrawal so conceived can function as a protective mechanism, on the other hand, it may pose factual challenges to the implementation of anti-dilution provisions borrowed from the Anglo-Saxon praxis, as it'll become clear further on.

[27] Giannelli, 2020, p. 1590.
[28] *Ibid.*
[29] Giannelli, 2020, p. 1591.

3. The Contractual Exclusion of Pre-Emptive Rights for the Functioning of Anti-Dilution Clauses

As scholar Awwad rightfully highlights, anti-dilution provisions represent a different mechanism employed to face the issue of dilution than pre-emptive rights.[30] The latter, indeed, constitute the typically European mechanism for the protection of pre-existing shareholders/quotaholders. Notwithstanding the protective function of preemptive rights, they also serve as a means of control of the shareholding/quotaholding composition.[31]However, pre-emptive rights are not as appealing to VC investors as anti-dilution provisions are, for they require them to provide additional contributions so as to not be diluted, whereas anti-dilution provisions protect the value of their investment regardless.

In order to reconcile the use of anti-dilution provisions borrowed from the Anglo-Saxon contractual and investment practice with the default recognition of pre-emptive rights granted in opt-out systems, including the Italian one, as far as we're concerned, the answer is to be found in the exercising of freedom of contract and private autonomy. Particularly, just how it's possible for the parties to opt out of the recognition of pre-emptive rights—or, conversely, opt in where such default recognition is lacking—entrepreneurs and investors may directly regulate their interests by negotiating the terms and conditions of the anti-dilution provisions accompanying the subscription of, for instance, convertible preferred quotas, participative financial instruments, or a combination of these and other equity or debt instruments.

These clauses, in fact, do not constitute a mechanism that is isolated from the overall structure of staged financing, organized around the incremental providing of funding at the meeting of

[30] Awwad, 2021, p. 182.
[31] Awwad, 2021, p. 187.

predetermined financial or non-financial performance goals. The structure of staged financing entails that capital increase rounds in which VC investors do not take part presuppose a failure, ascribable to the founders' poor management, to meet the milestones set at the basis of the investment plan. On this occasion, the VC fund is protected against the dilution of the investment provided till then thanks to the anti-dilution provisions that had been negotiated and subsequently incorporated either in the company's operating agreement (i.e. through its modification) or quotaholders' agreement. In the Italian context, the insertion in either document engenders different consequences in terms of legal force. Indeed, if anti-dilution clauses are contained in the operating agreement (*statuto*) then they have an enforceability *erga omnes*; whereas, if they're contained in the quotaholders' agreement (*patti parasociali*), the provisions are merely binding on the parties.

As scholar Awwad also underlines, in many opt-out systems, the Italian one included, pre-emptive rights have progressively become less rigid, particularly in light of special or different interests that justify their relinquishment, albeit this remark mostly concerns public companies.[32] In fact, when it comes to public companies, some authors have talked about an "attenuated" or simply "residual" interest of the shareholders in the preservation of their administrative weight within the company, being the protection of the investment eventually entrusted to a direct recourse to the stock market.[33] What's more, the Italian bankruptcy law establishes that if a company is experiencing financial difficulties, shareholders/quotaholders' pre-emptive rights may be entirely sacrificed.

[32] Awwad, 2021, p. 183.
[33] For reference see Awwad, 2021, p. 183, footnote 25.

Thus, for the purpose of working out some of the challenges brought about by importing anti-dilution provisions in a context like the Italian one, it is crucial not to think of the contraposition between opt-out and opt-in systems in a radically neat and stagnant way—as Awwad writes:

> Considerations of this kind may lead one to ask whether anti-dilution clauses may pose a compatibility issue with the discipline of pre-emptive rights in opt-out systems and, in any case, whether or not they may, fully or partially, "replace," promote the substitution of, or overlap with pre-emptive rights within opt-out systems as well.[34]

As seen, subscription rights presuppose the principle of proportionality in the form of contributions to be provided in case of capital increase in exchange for the right to maintain one's weight within the company and not see one's stake diluted. They are configured as rights that the existing quotaholders have in being preferred, in proportion to their individual stake, for the subscription of capital increase so as to not lose the value of their investment. For this reason, anti-dilution provisions are not completely antithetical to subscription rights in essence. Rather, the matter isn't determining which one shall prevail in the dialectics between one mechanism and the other, respectively pre-emptive rights and anti-dilution provisions, but, that of landing on a whole new conceptual sublimation. Apropos of this, it seems to me that anti-dilution provisions confer a peculiar kind of subscription right to their beneficiary, one that is of a contractual nature (rather than of normative derivation), and one that is neither based on the principle of proportionality nor on the obligation to provide further contributions in case of capital increase.

Indeed, unless one were to subscribe to the argument that by taking away the principle of proportionality and the obligation to provide contributions the subscription right would be denaturalized in its essence, I'd say that anti-dilution provisions confer upon their beneficiary a subscription right that is intended to be non-proportional; one where the beneficiary has a certain

[34] Awwad, 2021, p. 184.

number of quotas freely assigned to her against a financial outlay that she would have provided prior to the capital increase (in case of full ratchet clause); or, one where the beneficiary has quotas assigned to her at a discounted price than what the principle of proportionality would entail (weighted average clause).

This interpretation of mine, however, is not unproblematic. In truth, the legal epistemology requires that a special constituent possesses all the elements of the general one, plus one or more "specializing" facets. Evidently, as it has been just characterized, the peculiar subscription right that follows anti-dilution provisions, without the principle of proportionality and the contribution obligation, cannot technically be considered a "special" subscription right. Additionally, this would be of a contractual nature, whereas pre-emptive rights are indiscriminately granted to all quotaholders by the general discipline contained in the Civil Code.

The question that remains to answer is whether this epistemological issue may then be resolved by configuring this "peculiar" subscription right either among the "particular rights" concerning distributions or the management of the company pursuant to paragraph 3, article 2468, of the Civil Code (going indirectly, and perhaps, with a bit of a stretch, to touch on the aspect of distributions)[35] or among the rights attributed to special categories of quotas, as provide for by the special discipline concerning startups and small-medium enterprises ("SMEs"). In other words, the rights configured by means of anti-dilution provisions may be admitted as having either a subjective or an objective nature.

[35] For a comprehensive analysis of particular rights of quotaholders cfr. DONATIVI, V. (2020). I Diritti Particolari dei Soci. In IBBA, C., and MARASÀ, G. (eds.). *Le Società a Responsabilità Limitata: Vol. 1*. Milano: Giuffrè Francis Lefebvre. For instance, Donativi inscribes "increased" subscription rights (*diritto d'opzione maggiorato*) within the particular rights accorded by paragraph 3 of article 2468, given the "great morphological potential" that this provision holds (p. 865).

As for the procedure for eventually modifying them, the silence of the *Srl* discipline regarding the procedure for modifying the rights attributed to categories of quotas has led many scholars to affirm the analogical application, from the *Spa* discipline, of article 2376 of the Civil Code, which provides for special meetings, not suitable, however, for the modification of particular individual rights pursuant to article 2468 of the Civil Code.[36] Therefore, depending on their configuration, the analogical application of the norm that prescribes special meetings with the majority rule seems more appropriate for the modification of rights attributed to categories of quotas pursuant to paragraph 2 of article 26 of *d.l.* 179/2012.[37] To add to that, Recommendation n. 40/2014 by the Notarial Council of Florence (before Recommendation n. 186 by the Notarial Council of Milan having to do with the legitimacy of anti-dilution clauses in the Italian system specifically intervened[38]) had established that subscription rights attributed to the holders of categories of quotas in startups adopting the *Srl* legal form, following paragraph 2 of article 26 of *d.l. 179/2012*,

[36] Agstner et al., 2020, p. 428.

[37] Paragraph 2 of article 26 of *d.l.* 179/2012 – in whose framework the VC-backed *Srl* sub-type is inscribed – allows a startup to issue categories of quotas, albeit within the limits established by law. This has had some scholars argue for a typological assimilation between the *Spa* and the startup or SME adopting the *Srl* legal form, such that the limitations mentioned by article 26, *d.l.* 179/2012, should be derived analogically from the legal discipline of the *Spa* (see Agstner et al., 2020, p. 427). Following this line of reasoning, all the quotas that belong to the same category shall attribute the same rights, and in case of quotas with multiple voting rights, then each shall not attribute more than three votes; additionally, the quotas with excluded or limited voting rights shall not exceed half of what the legal capital amounts to (Agstner et al., 2020, pp. 427-428). Nonetheless, Agstner et al. highlight how solutions that simply import or transpose imperative norms from another type are unconvincing (p. 428). They argue that the silence of the discipline is not enough for favoring an interpretation directed at restricting private autonomy, but rather it constitutes sufficient grounds for reducing the perimeter of the limitations referred to by paragraph 2 of article 26 to the absolute minimum. This, in their reading, would coincide with the prohibition concerning leonine pacts, yet still within the limits in which such prohibition stands, and with pre-emptive rights in case of capital reduction due to losses (a circumstance where pre-emptive rights are expressively qualified as non-derogable by article 2482-*quarter* of the Civil Code) (Agstner et al., 2020, pp. 428-429).

[38] Recommendation n. 186/2019 by the Notarial Council of Milan explicitly stated that the right to be assigned a certain number of newly issued shares or quotas for free so as to not be diluted (thus derogating from the principle of proportionality) can be qualified either as a "different right" connoting a category of shares or quotas pursuant to article 2348 of the Civil Code or paragraph 2 of article 26 of *d.l. 179/2012*, or as a "particular right" pursuant to paragraph 3 of article 2468 of the Civil Code. In the same direction, the Notarial Council of Milan also recalled its previous Recommendations—n. 73 and n. 126—provided with regard to other kinds of administrative and economic rights.

should be governed by the same principles grounded in the *Spa* discipline. On the contrary, if these provisions are particular rights granted to quotaholders individually, pursuant to article 2468, then their modification necessitates of the unanimity rule or, at least, of the consent of those who'd be affected by the change.

4. Derogation from the Principle of Proportionality

The possibility of assigning quotas in a non-proportional way to the contributions made is essential to the functioning of anti-dilution provisions and is also key to the attainment of the "rewarding" effects for the first investors of the startup.[39] To add to that, *contra* what expressed in the motivation attached to Recommendation n. 186 by the Notarial Council of Milan, we ought to believe the assignment when anti-dilution clauses are triggered wouldn't constitute an instance of extreme disproportionality, given that the contributions originally made by the VC fund would go partly towards the legal capital, partly to cover the difference between the amount of the original investment and the nominal value that is assigned to the convertible quotas.

On the other hand, the (non-proportional) assignment of quotas that occurs as an effect of anti-dilution provisions is not technically an instance of free capital increase, for, albeit the beneficiaries of such clauses subscribe to the newly issued quotas without having to provide contributions, the value represented by their new quotas is contributed to by the other quotaholders. For this reason, article 2481-*ter* of the Civil Code, prescribing an attribution of quotas necessarily proportional in case of free capital increase, wouldn't be applicable under this circumstance.

[39] Agstner et al., 2020, p. 412.

The only limit that the non-proportionality encounters, according to Recommendation n. 186/2019 by the Notarial Council of Milan, is that of the effectiveness of the legal capital in terms of a correspondence between the total amount of the contributions provided and that of the legal capital. This, pursuant to paragraph 4 of article 2346 and to paragraph 2 of article 2468 of the Civil Code, requires that the total amount of the contributions made by subscribers other than those from the protected category still needs to be at least equivalent, in each case of non-proportional attribution of shares or quotas, to the total amount of capital increase effectively subscribed to. However, scholars Agstner et al. underline that this requirement doesn’t pose particular issues when the legal capital corresponds to the legal minimum; in such instance, indeed, the nominal value of the quotas assigned to the beneficiary of the anti-dilution provision would be easily covered using part of the amount contributed to by the non-beneficiary quotaholders.[40]

For *Spa*s, the discipline of the Civil Code prescribes a mandatory safeguard mechanism in case of capital increase reserved to third parties. Indeed, if shareholders’ option rights encounter limitations either in the operating agreement or in the shareholders’ agreement so as to allow the entering of third parties into the company, the shareholders are protected against economic dilution (but not nominal dilution) by the rule that establishes a mandatory share premium to pay in case of capital increase. This means that if the shareholders do not get to maintain their respective weight within the *Spa*, it is also true that the value of their investment in the company is salvaged by the mandatory premium share that the new shareholder would have to pay to the company in order to enter its shareholding composition.[41]

For *Srl* companies, on the other hand, neither the general discipline contained in the Civil Code, nor the special one that came out of the 2012-2017 reforms mandate a premium to pay for

[40] Agstner et al., 2020, p.423.
[41] Awwad, 2021, p. 185.

third parties entering the quotaholding composition when subscription rights are being excluded. Instead, the regulation of the exclusion is entrusted to private autonomy. Nevertheless, if, on the one hand, a premium is demanded for a capital increase, on the other, this does not comport the analogical application of article 2441 from the *Spa* discipline, which ties the premium price to the company net asset value. This means that if there is a premium price that is established for an operation of capital increase, its amount is left for the private autonomy to determine.

In addition, given the lack of mandatory premium for *Srl*s, the watering down of the quotaholders' stake that may follow as a result of that is also left for the private autonomy to deal with. In fact, if third parties subscribe to the capital increase without having to pay a price somewhat proportional to the net asset value of the company, then the function of the premium price as a mechanism geared towards the protection of quotaholders against the watering down of their quotas is certainly dimmed.[42] Indeed, by means of subscribing solely to the increase of nominal value, third parties acquire *de facto* a right to all the net assets that are not allocated towards it.[43]

That being said, the deliberation of capital increase must contain the terms and conditions for the exercising of subscription rights, including the relevant deadline for the quotaholders and taking into consideration the more general deadline set for the capital increase. Generally speaking, an operation of capital increase is approved in the extraordinary meeting of the quotaholders whereby they may contextually express their decision to subscribe to it, and therefore exercise their subscription rights. Alternatively, on that occasion, the quotaholders may also relinquish the exercising of their subscription rights, i.e. so as to allow other parties to subscribe to the capital

[42] Giannelli, 2020, p. 1586.
[43] *Ibid.*

increase in their place.[44] Finally, their rights of first refusal regarding the unsubscribed portions of capital increase (*diritti di prelazione*) are subject to a provision in this sense contained in the deliberation that approves the capital increase.[45] Otherwise, neither the quotaholders nor third parties have a right to subscribe to the unsubscribed portions and, as a consequence, paragraph 3 of article 2481-*bis* applies. In particular, this paragraph prescribes that if the capital increase is not subscribed to in full by the due date contained in the relative deliberation, then the legal capital will be increased only for the amount that is equal to the subscriptions that will have been made and if the deliberation of capital increase so allows.

In terms of limitations on subscription rights, it is noteworthy that, in the past, the *Srl* discipline permitted their exclusion only in case of contributions in kind.[46] Instead, the exclusion of subscription rights, according to the new discipline, not only is accepted without reservation, but it also doesn't need to be specifically motivated in light of a particular interest (i.e. the company's, or the quotaholders'), provided that it is contained in the instrument of incorporation or operating agreement (even after being modified following a majority decision).[47] It follows that quotaholders' subscription rights are freely transferable, given the regime of free transferability of the quotas themselves.

As mentioned, according to article 2481-*bis*, the operating agreement can provide for the total or partial exclusion of subscription rights, in which case the quotaholders have the right to withdraw from the company, except for in case of capital reduction below the legal minimum. However, Giannelli highlights how the norm raises some concerns given that the generic provision

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[44] See CAMPOBASSO, G. F. (2015). *Diritto Commerciale: 2: Vol. 2: Diritto delle Società.* 9th Ed. Milanofiori Assago: UTET Giuridica. Also, Giannelli, 2020.
[45] Giannelli, 2020, p. 1583.
[46] Giannelli, 2020, p.1580.
[47] Giannelli, 2020, p. 1582.

regarding the exclusion of subscription rights contained in the operating agreement must be integrated by a specific one each time there is a deliberation of capital increase.[48] The scholar argues, indeed, that such specification is necessary so as to allow the quotaholders who have not partaken in the decision (the dissenting quotaholders) to exercise their right of withdrawal.[49] Instead, a prior provision in the operating agreement to exclude the quotaholders' subscription rights is not required if the decision concerning the exclusion is taken unanimously.[50]

An interesting question is whether or not, once the operating agreement provides for the exclusion of subscription rights, the managers delegated to proceed with the capital increase pursuant to article 2481 of the Civil Code have the authority to opt for the exclusion in each specific case. For Giannelli, the answer is negative and cannot be overcome even by an extensive interpretation of the first paragraph of article 2481, whereby the operating agreement is supposed to provide for the terms and conditions of capital increase operations.[51] Indeed, the exclusion or limitation of subscription rights represents a relevant modification of the rights that belong to quotaholders and, for this reason, pursuant to number 5, paragraph 2, article 2479 of the Civil Code, it is a non-derogable prerogative that belongs to them exclusively. Additionally, what would confirm the non-delegable nature of excluding quotaholders' subscription rights is the first paragraph of article 2481-*bis*, granting a right of withdrawal, pursuant to article 2473, to all the dissenting quotaholders (presupposing the quotaholders' participation in the decision making).[52]

From this, Giannelli highlights two corollaries: first, that the operating agreement of an *Srl* company may authorize future limitations as well as the exclusion of subscription rights, however,

[48] Giannelli, 2020, p. 1583.
[49] *Ibid.*
[50] *Ibid.*
[51] Giannelli, 2020, pp. 1584-1585.
[52] Giannelli, 2020, p. 1585.

a generic deliberation cannot suppress the quotaholders' pre-emptive rights indefinitely, given that such a compression would need to be eventually ratified for every deliberation of capital increase.[53] The second corollary highlighted by the scholar is that, in fact, the prior authorization to exclude subscription rights is relatively irrelevant, since the deliberation of capital increase and the one that modifies the operating agreement by introducing the exclusion of subscription rights may be taken contextually.[54]

5. Convertible Quotas and Convertible Debt Instruments for Italian Startups

In the Italian context, startups in *Srl* legal form, pursuant to article 26 of *d.l. 179/2012*, are allowed to create special categories of quotas, including the issuing of convertible quotas.[55] For instance, VC investors may subscribe to a category of quotas that grants them special rights and that may also be converted into an ordinary stake upon mechanisms of voluntary or automatic conversion that has them benefitting from a rather advantageous conversion price cap.

A startup that adopts the *Srl* legal form may also issue convertible instruments[56], yet within the limits contained in article 2483 of the Civil Code for convertible *debt instruments* (unless the

[53] *Ibid.*
[54] *Ibid.*
[55] While this possibility for Italian startups is fairly recent, according to the empirical data gathered by Kaplan and Strömberg in a study dated from April 200, in a sample of 213 VC investments in 119 US startups, the absolute vast majority (95,8%) of the instruments used throughout the financing rounds was represented by convertible preference shares.
[56] The theme of convertible financial instruments – either in the form of seed debt or seed equity, or so-called *convertendi* instruments like SAFE contracts – is extremely important in the context of business angels and venture capital financing operations (Agstner et al., 2020, p. 403). In particular, business angels typically utilize seed debt or SAFE contracts in the early stage of startup financing, whereas VC investors usually prefer employing convertible equity instruments (Agstner et al., 2020, p. 403). The reason this theme is relevant is because it directly touches on the possibility of executing a conversion below par.

special discipline of crowdfunding can be applied), but without limitations for convertible *participative* financial instruments, and therefore without any problem for the issuance of convertible quotas and for SAFE contracts.[57]

The discipline of debt securities contained in article 2483 of the Italian Civil Code is one of the fundamental tenets of the financial organization of the *Srl* type, especially as it came out of the 2003 reform.[58] However, the use of debt instruments has not been largely successful and that is due to the several limitations that their issuance is subjected to, such as 1) the expressive provision in the operating agreement, 2) the confinement of the primary market to professional investors subject to prudential supervision pursuant to special norms, 3) a minimum cut of 50.000 euros for each debt instrument, 4) the warranty of the first subscriber towards subsequent buyers, except for other professional investors or quotaholders of the issuer, 5) the possibility of modifying the conditions of the loan limited to expressive provisions in this sense in the operating agreement and upon consent of the majority of the holders of such instruments, calculated *per capita*.[59] This quite "restrictive" discipline, indeed, had its rationale in what, at the time (before the 2012-2017 reforms), was considered the defining typological characteristic of the *Srl*, that is, the prohibition of recourse to the general public for funding.[60] Indeed, for a long time, the scholarship even denied the possibility for an *Srl* to issue convertible debt instruments, thinking that in so doing it would have eluded the normative prohibition.[61]

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[57] See Agstner et al., 2020, p. 411. The profiles of inquiry that Agstner et al. identify revolve around: 1) the use of convertible debt securities or convertible financial instruments for startups that take on the *Srl* legal form; 2) the applicability of the provisions contained in article 2483 of the Italian Civil Code in such cases; 3) the possibility of establishing conversion rates below par; 4) the necessity of eventually analogically applying from the *Spa* type the discipline of safeguards for the holders of such instruments in the course of the conversion period (p. 404).
[58] Agstner et al., 2020, pp. 404-405.
[59] *Ibid.*
[60] Agstner et al., 2020, p. 406.
[61] For reference *Ibid.*

Nevertheless, after the introduction of the new socio-economic archetypes, following the reforms of 2012-2017, the possibility of issuing convertible debt instruments for the *Srl* can no longer be denied.[62] That said, the provisions contained in article 2483 of the Civil Code are still susceptible to being applied to convertible debt instruments, for this article was not expressively derogated by the 2012-2017 reforms.[63] What this entails is that convertible debt instruments could be subscribed to at first only by professional investors (i.e. institutional investors like banks or financial intermediaries), thus to the exclusion of private individuals like business angels, and could be transferred to them only secondarily.[64] This dynamic appears even more unfathomable considered that, as per article 2483, the first professional investors that are to acquire convertible debt securities would then become, substantially, guarantors towards the second buyers for the solvency of the startup.[65]

Fortunately enough, this considerable issue could be overcome exploiting one of the main novelties brought about by the 2012-2017 reforms, whereby a startup is allowed to use crowdfunding platforms to place convertible debt securities on the market.[66] Indeed, the implementing rules established by CONSOB (Regulation N. 18592/2013) have broadened the pool of subjects allowed to subscribe to this kind of instruments by including the category of "support investors." These are specifically defined as the investors who use crowdfunding platforms (and yet this is hardly ever the case with business angels).

Nevertheless, according to Agstner et al., the implementation rules contained in CONSOB Regulation N. 18592/2013 go to support, from a systematic point of view, the argument that the

[62] Agstner et al., 2020, pp. 406-407.
[63] Agstner et al., 2020, p. 407.
[64] *Ibid.*
[65] *Ibid.*
[66] Agstner et al., 2020, pp. 407-408.

limitations contained in article 2483 of the Civil Code ought not to apply to startups issuing instruments that attribute some form of participatory rights, a category which convertible instruments may very well belong to.[67]

As with respect to SAFE contracts, the same authors believe that they ought not to be categorized as debt securities, susceptible, therefore, of the application of the discipline contained in article 2483 of the Civil Code.[68] That is because the contribution that is made following the subscription of a SAFE contract is not aimed at gaining a return on the investment with a certain markup (in a fixed or variable amount), but rather at obtaining the pre-emptive right to participate in future rounds of capital increase at a predetermined advantageous price.[69] SAFE contracts thus attribute participatory rights, for they provide for the right to participate in future capital increases and in possible distributions of the residual capital following a liquidation event, however deferred with respect to creditors of the company.[70]

Normally, the conversion rate applied in case of VC financing practices entails a strong discount, and that is equally the case with seed debt, seed equity, and SAFE contracts. Thanks to this mechanism, the holder of such instruments is able to obtain quotas that are likely to have a much greater value than the contributions originally made.[71] This practice inserts itself in the context of the mechanisms proper to staged financing, whereby the investors that intervene in the earlier phase subordinate their subsequent involvement upon the obtainment – through conversion

[67] See Agstner et al., 2020, pp. 409-410. However, paragraph seven of article 26, *d.l.* 179/2012, in mirroring paragraph 6 of article 2346 of the Civil Code from the discipline of the *Spa*, establishes the principle that holders of such instruments ought not to exercise voting rights in the quotaholders' general meeting, but does not replicate the norm from the *Spa* discipline that recognizes the possibility for holders of these instruments to have voting rights limited to specific topics.
[68] Agstner et al., 2020, p. 411.
[69] *Ibid.*
[70] *Ibid.*
[71] *Ibid.*

– of a considerable return on their investment for the risk taken on in the initial stage of the business enterprise.

CHAPTER II

Anti-dilution *Latu Sensu*

1. Anti-dilution as a Complex Effect and The American Corporate Context

When it comes to the contribution that the Delaware company law has made towards the success of the Silicon Valley system, legal scholars trace its positive influence back to a special sensitivity to private autonomy, in reference to which they talk about an "enabling" and "non-paternalistic" system that stands in direct contrast to those (especially within civil law countries) where the law dictates mostly mandatory provisions for corporate affairs.[72] As Agstner et al. noted, the flexibility of American corporate law in general, and of the Delaware company law in particular, has been responsible for facilitating the financing of startups through "contractually innovative instruments."[73] The present chapter is an analysis of what we shall define as anti-dilution mechanisms *latu sensu* as they've been developed by American VC practice, with a view to considering anti-dilution as a complex result that can be achieved through the contextual working of many different provisions. It is a complex result since for any given security employed in the VC financing context, the different uses of contract provisions can achieve a "functionally similar payoff for the investor,"[74] ultimately an overall protection against the dilution of her investment.

[72] Agstner et al., 2020, pp. 387-388.
[73] Agstner et al., 2020, p. 388.
[74] BURCHARDT, J. et al. (2016). Venture Capital Contracting in Theory and Practice: Implications for Entrepreneurship Research. *ET&P*, (25–48), p. 33.

2. Contract Innovation

Over two decades ago those who invested in so-called "early-stage technology companies," also known as startups, would purchase shares of common stock alongside the founder [75]. Contract innovation[76] is the process by which contracts evolve and change; for instance, one of the major changes that Coyle and Green identify in VC contractual practices was the use of convertible notes, previously utilized in the context of so-called bridge-financing, that is, "in situations where a company needed a loan from its current investors to keep it afloat until a new infusion of capital could be raised," and the use of simplified versions of convertible stock documents.[77] The scholars additionally argue that using equity instead of debt is in and of itself a form of contractual innovation that has gone "largely unappreciated in the contractual innovation literature."[78]

To begin our discussion in an orderly manner, it must be said that common stocks have several drawbacks for VC investors due to their lack of comprehensive protectiveness, i.e. "if and when liquidation occurs, the common stockholder will be subordinated to all other classes of securities and other creditors in liquidation, and share ratably with the founders of the company."[79] For this reason, sophisticated investors have long begun to utilize alternative investment structures "that

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[75] COYLE, J. F., and GREEN, J. M. (2014). Contractual Innovation in Venture Capital. *Hastings Law Journal, Vol. 66,* pp. 133–183. Coyle and Green's article is a study of venture finance contractual innovations to fill in the gaps in the literature due to the little attention that the American legal scholarship has historically paid to the phenomenon at hand (pp. 134-135). However, they recognize an inversion of such tendency, first, in the work of Stephen J. Choi et al. who have proposed a general theory of contractual innovation, and then in the work of Kevin E. Davis who has "analogized the process of contractual change to the process of technological change" (see Coyle and Green, 2014, p. 136, footnotes 1 and 2).
[76] Interestingly, it is underlined how often times what hinders innovation is the presence of default rules that make it more costly for parties to vary the terms by express agreement (in this direction Coyle and Green refer to the work done by Charles J. Goetz and Robert E. Scott, Lisa Bernstein, Kathryn E. Spier, and Omri Ben-Shahar and John A. E. Pottow) (p. 138).
[77] Coyle and Green, 2014, p. 136.
[78] Coyle and Green, 2014, p. 137.
[79] Coyle and Green, 2014, p. 147.

offered more in the way of contractual protections," i.e. convertible notes and, even more so, convertible preferred stock.[80] Indeed, the founders would eventually need to raise more substantial rounds of capital to grow the business (expand its scale), but wouldn't have a sufficient cash flow so as to secure bank loans on convenient terms (if at all). At this stage, institutional figures like VC funds would come into play and structure their financing over several rounds so as to hold leverage even after the initial investment is made.

The VC fund would invest an amount that would typically give the company sufficient capital to operate for 12 to 18 months before it would need additional investment and the goal for the company would be to achieve certain milestones during the investment period.[81] The first round in which a VC fund invests in a company is commonly known as "Series A round," whereby the investors purchase Series A Convertible Preferred Stock of the company.[82] As Coyle and Green remark, this convertible preferred stock and the investment contracts associated with the Series A round of financing contain "a standard panoply of rights designed to protect the VC investors' interests," given they'd be purchasing a minority stake in the company (usually around twenty to thirty-five percent).[83] Apropos of the array of privileges these investors would be entitled to:

> The holders of Series A Preferred Stock would, for example, typically be entitled to a preferred dividend and a liquidation preference, which would give them priority over the common stockholders in respect of any distributions of cash until the company had returned the investors' initial investment plus any accrued but unpaid dividends. The preferred stock would be convertible to common stock on a 1:1 basis.[84]

[80] Coyle and Green, 2014, pp. 148-149.
[81] Coyle and Green, 2014, p. 151.
[82] Coyle and Green, 2014, p. 150.
[83] *Ibid.*
[84] *Ibid.*

In addition to that, “the lead VC fund and other larger investors would also typically receive contractual preemptive rights to subscribe for additional shares in any future financing round, if they wished to maintain their ownership percentages of the company,” and, in terms of veto rights:

> The consent of Series A stockholders would be required for the company to undertake certain actions, such as authorizing or issuing additional stock, incurring indebtedness, agreeing to undergo a change in control or other liquidation of the company, paying dividends, or redeeming outstanding shares of stock.[85]

As far as corporate governance is concerned, the VC investor would also demand for one of its partners a seat on the board of directors.

For successful companies the process of raising capital continues over a number of years at increasingly higher valuations by selling shares of new series of preferred stock (“Series B, Series C, Series D, and so on”) usually while their existing investors participate in the subsequent rounds to maintain their pro-rata stake in the company.[86]

A convertible note, on the other hand, is a debt instrument that could be converted into equity and that was originally used in the context of so-called “bridge finance,” that is, serving as a bridge between one round of venture financing and the next.[87] The convertible note would bear interest, have a formal maturity date, give the holder priority over equity holders, and put the holder “on an equal footing with other unsecured debt holders and trade creditors in liquidation,” with the additional upshot of having the prerogative to be converted into either common or preferred stock—“thereby giving the holder a chance to participate in the upside if a company ultimately achieves a successful exit.”[88] Instead, when convertible debt starts being used at the first round of

[85] Coyle and Green, 2014, pp. 150-151.
[86] Coyle and Green, 2014, p. 151.
[87] *Ibid.*
[88] Coyle and Green, 2014, pp. 151-152.

financing for a new venture, it takes on the name of "seed debt" (or "seed notes").[89] Standard terms for these debts instruments are, as said earlier, that they would bear interest and that the principal and interest would become due and payable upon demand at maturity, that is, if the notes are not converted to equity prior to that.[90] As mentioned, one of the upshots of such instruments is the possibility of configuring them in such a way that if the company were to raise a new round of equity from outside investors, then the noteholders would be able to convert their notes into shares of the new series of preferred stock. Another of the standard terms attached to their subscription is the provision of a warrant coverage. Additionally, in case of so-called "exit events," i.e. change in control or IPO, special provisions "would often provide for the noteholders to receive two or three times the principal amount of their notes, plus interest, upon consummation of an exit."[91]

What is important to highlight is also that these notes would not require any period payments for the enterprises were expected to use all of the cash raised via these debt instruments on ongoing operations rather than on servicing interest payments.[92] Referring to the work done by Charles R.P. Pouncy, Coyle and Green remark that the notes could be thought of also as "deferred equity instruments," for the noteholders' expectations "were not to have the principal repaid with interest, but to receive equity at some future date."[93] One other important upshot of these instruments is that, as debt, the notes would have priority in liquidation over the preferred and common stock, thus offering a remarkable downside protection[94].

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[89] Coyle and Green, 2014, p. 152.
[90] *Ibid.*
[91] Coyle and Green, 2014, p. 153.
[92] Coyle and Green, 2014, p. 154.
[93] For reference see Coyle and Green, 2014, p. 153.
[94] Coyle and Green, 2014, p. 154. See GORDON SMITH, D. (2005). The Exit Structure of Venture Capital. *UCLA Law* Review, pp. 315–356. In quoting Bratton's work, Gordon Smith addresses the topic of "downside protection" as corresponding to having the power to 1) replace the company's managers, 2) force premature sale or liquidation of the enterprise, 3) protect the investment contract from opportunistic amendments (p. 332).

When seed notes started to be used more and more in the earliest financing stages, certain features that were typical of bridge notes were modified, for instance, the warrant coverage was substituted with the provision of a discounted price for the next financing with equity.[95] The features of seed notes "struck a balance between giving early-stage investors more protection than common stock investments provided and keeping the terms simple enough to save time and transaction costs."[96] As evidence of that, if the company attracted additional investors, the noteholders had the prerogative to convert their notes into preferred stock, for instance, usually Series A Convertible Preferred Stock, "with the same rights, preferences, and privileges accorded to holders of that stock" and without having to spend time negotiating them with the founder (for the later investors would be the ones doing the negotiation at their own time and expense).[97]

With regard to advantages from the founder's perspective in the use of these debt instruments, the notes would allow her to defer negotiations over the valuation of the company until the next financing. With regard to possible disadvantages, on the other hand, there would be the fact that if the note matured before a conversion event, the company would be obligated to repay the principal and accrued interest in full, unless the noteholder agreed to grant an extension (but the noteholder may then have the leverage to renegotiate the economic terms of her investment to her favor).[98] As to possible disadvantages from the noteholders' perspective, Coyle and Green remark that in contrast to stockholder, noteholders are not owed fiduciary duties by the principals of the company.[99]

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[95] Coyle and Green, 2014, p. 161.
[96] Coyle and Green, 2014, p. 162.
[97] Coyle and Green, 2014, pp. 161-162.
[98] Coyle and Green, 2014, p. 162-163.
[99] Coyle and Green, 2014, p. 163.

Nevertheless, perhaps the greatest single most important feature of the convertible notes is the provision of a conversion price-cap, in other words, the discount that noteholders would benefit from when converting the notes into equity instruments. As an example, a price cap provision would state that "the principal of the notes would convert into Series A convertible preferred stock at the next equity round of financing at a discount (typically twenty percent) to the Series A price," meaning that "if the new investors were paying $1.00 per share for Series A stock, […] the seed noteholders would convert their notes at a price of $0.80 per share."[100] What's more, the conversion price cap written into the contract may get even more sophisticated by means of imposing a ceiling on the price at which a seed note would convert into the equity security at the next financing. For instance, if we assumed that the conversion price cap is set at $10 million, this would mean that if the company carried out its next financing round below $10 million, the noteholders would still convert at a discounted price whatever price paid by the new investors, but if the company were to raise a round at a valuation higher than $10 million, the noteholders would be able to convert the notes as if the price was reflective of a $10 million valuation instead, thus resulting in an even greater discount and realizing a significant return.[101]

However, Coyle and Green note that:

> As the view that convertible notes were a deferred equity investment gained traction, the debt-like features of these notes came to be viewed as annoyances in some quarters. In Silicon Valley, the overwhelming majority of the notes had a maturity date of one year owing to restrictions imposed by the California Finance Lender's Law. In cases in which the issuing company had not yet raised additional capital on the maturity date, therefore, the companies were obliged to either repay the note in full or to go back to their investors to negotiate an extension.[102]

[100] Coyle and Green, 2014, p. 164.
[101] Coyle and Green, 2014, pp. 164-165.
[102] Coyle and Green, 2014, pp. 165-166.

As a consequence, a further step in the contractual innovation idiosyncratic to VC financing was the development of even more agile instruments which sought to retain some of the existing features of convertible notes, including discount and conversion cap provisions, while also "eliminating the terms that marked them as debt instruments."[103] This effort resulted in the devising of so-called "convertible security" and in "simple agreement for future equity" (known in the literature as SAFE contract).[104]

The convertible security was created by Yoichiro Taku who devised it to be, in essence, a convertible note lacking a maturity date and an interest rate provision.[105] Because of that, the security would not be formally a debt, yet at the same time it would not be a traditional equity instrument either, for the holder is not entitled to dividends and has no voting rights.[106] Apropos, Coyle and Green remark: "the instrument is best conceptualized as a novel type of warrant for which an investor pays full value today for an unspecified security at some late date."[107] Nevertheless, this kind of contractual instrument didn't gain much traction initially, for it was seen as being more advantageous for founders rather than investors, for having eliminated the debt-like features that would confer upon investors a form of leverage. On the other hand, the SAFE contract created by Carolynn Levy resembles in many aspects a convertible security.[108] Commonalities, in fact, are that both instruments draw heavily from convertible notes, but strip away their debt-like features and stipulate a conversion to equity "upon the occurrence of a particular future event."[109] That being said, for its creator, the goal with a SAFE contract was to produce an investment

[103] Coyle and Green, 2014, p. 166.
[104] *Ibid.*
[105] Coyle and Green, 2014, pp. 166-167.
[106] Coyle and Green, 2014, p. 167.
[107] *Ibid.*
[108] Coyle and Green, 2014, p. 168-169.
[109] Coyle and Green, 2014, p. 169.

instrument that would be "layperson-friendly" and provide a "simple and inexpensive means of investment" into an early-stage company.[110]

Then, as seed notes gained popularity, simplified versions of preferred stock were devised to be just as competitive and took on the name of "seed stock"[111]. The contracts here would have a less exhaustive list of protective provisions, including a less exhaustive list of representations and warranties, a lack of provisions relating to dividend preferences or co-sale rights, as well as, often times, an omission of provisions related to a price-based anti-dilution protection. On the other hand, investors would typically be granted a board seat and receive a right of first offer on future financing. They would be typically entitled to a non-participating preferred liquidation preference and obtain, frequently, certain blocking rights, such as the ability to prevent the company from being sold without their consent.[112] The result is that, albeit seed stock instruments are comprehensive of less rights than traditional Series A ones, the rights therein granted are, however, "more robust than those typically included in a seed note."[113]

3. Exit Theory

"Before venture capitalists invest, they plan for exit. That is, they plan to withdraw their investment, adjusted for any return, from the entrepreneur's company."[114] Indeed, the VC fund virtually plans its disinvestment whether the enterprise is successful (i.e. the more milestones the

[110] Coyle and Green, 2014, p. 170.
[111] Other names include "Series Seed," "Simple Series A," "Series A-1," and "Series AA" (Coyle and Green, 2014, p. 153; p. 171).
[112] Coyle and Green, 2014, p. 172.
[113] *Ibid.*
[114] Gordon Smith, 2005, p. 316.

company meets, the more control is given back to the founders) as well as non-successful, for "the ability to control exit is crucial to the venture capitalist's business model of short-term funding of nascent business opportunities."[115] What this means is that planning the exit is connatural to the structure of VC staged financing, that is, to invest incrementally and, should the enterprise not go so well, to disinvest timely so as to quickly re-employ the resources into other more promising enterprises.

Gordon Smith identifies three ways by means of which investors achieve the ability to exit, namely, 1) by controlling the board of directors of the company they invest in, 2) by obtaining specific contractual rights of exit, 3) by terminating the providing of funding—or with a combination of these three methods.[116] However, typically VC investors do not have control over the board of directors at the beginning of the investment and which is crucial because the board is endowed with the power to initiate most of the important exit decisions, i.e. mergers, IPOs, and liquidations.[117] In fact, while the approval of stockholders is required for mergers, charter amendments, dissolutions, and sales of all or most of the substantial assets, they typically do not have the power per se to initiate exit events, unless such power is expressively given to them in the constitutional documents of the corporation or in a separate contract.[118] Apropos, it may be said that under corporate law, the board of directors has a "large reservoir" of authority. Thus, it may be said that the contractual provisions that VC funds use with their investment are designed to ensure "optimal allocation of decisionmaking authority while preserving the venture capitalist's exit options."[119] The central issue pertaining to an optimal allocation of decision-making authority,

[115] *Ibid.*
[116] Gordon Smith, 2005, p. 317.
[117] Gordon Smith, 2005, p. 318.
[118] Gordon Smith, 2005, pp. 318-319; pp. 338-339.
[119] Gordon Smith, 2005, p. 318.

however, revolves around the fact that if one party has all the control over the exit decisions, that party "will be able to reap private benefits at the expense of the other."[120]

That being said, in the early stages of the investment relationship, the venture capitalists are concerned primarily with protecting themselves from forced exit.[121] Thus during the initial period, because they do not typically control the board of directors, they're protected against the founders' possible opportunistic behavior thanks to negative covenants and liquidation rights. Additionally, because these investors use the structure of staged financing, they have limited exposure to harm in the initial period, since, should the management of the startup go south, they'll have provided only partial funding. On the other hand, at a later stage, the VC investors may likely either demand majority board control in exchange for additional financing, or acquire the majority of votes by means of subsequent rounds of financing subscribed to. Instead, the threat of disinvesting from the enterprise (if it still needs funding) deters the potential founder's holdup and offers her an incentive to quickly maximize the potential of the company.

According to Aghion and Bolton's theory of incomplete contracting, because of the myriad of potential outcomes of the investment, the parties cannot create a complete contract that specifies all future actions in advance, rather, investors and founder agree to allocate control over future actions among themselves.[122] In light of that, the authors describe a contingent control mechanism that would allocate decisionmaking authority according to certain incentives and consider this solution preferable to unilateral control in the hands of either party. Gordon Smith remarks that incremental increases in voting power via staged financing are "the key to an elegant contingent

[120] *Ibid.*
[121] Gordon Smith writes: "In the early stages of the investment [...] venture capitalists are less concerned about initiating exit than they are about preventing exit from being forced on them" (pp. 319-320).
[122] For reference see Gordon Smith, 2005, p. 321, footnote 22.

control mechanism embedded in most venture capital relationships."[123] In Gordon Smith's words: "control is thus contingent […] in the sense that it shifts from common stockholders to preferred stockholders over successive stages of financing, and this can occur either because the venture capitalists bargain for additional seats on the board or because the venture capitalists acquire a majority voting stake in the company."[124] On the other hand, shared control may exist when the VC fund owns a majority of the voting stock but doesn't have a majority of the board directors and neither does the founder; rather, the parties agree to have representatives of each side on the board alongside a number of either independent or mutually agreed upon directors.[125]

Expression of the right of exit for VC investors are all the contractual mechanisms to this end negotiated prior to investing in the company. Before proceeding with the disinvestment per se, in case the startup is performing poorly, there are contractual mechanisms in place to protect the value of the VC investment, among which are anti-dilution provisions *strictu sensu*. Instruments like these are indeed essential to VC investment practice. But even before anti-dilution clauses *strictu sensu* find execution, there is a whole array of provisions that work contextually to ensure that anti-dilution as an overall complex effect is achieved. For instance, veto and control rights expressed in so-called negative covenants will prevent the founder from undertaking actions that may comport the dilution *latu sensu* and in substantive terms of the venture capitalists' investment into the company. Or, again, liquidation preference provisions will deter the founder to engage in opportunistic behavior and consume the financing to the extraction of private benefits.

In fact, because the financing of a startup is a delicate process with agency costs that are likely to become more exacerbated, the financing relation between venture capitalists and the

[123] Gordon Smith, 2005, p. 324.
[124] Gordon Smith, 2005, p. 327.
[125] The shared control structure is envisioned by Bratton and described as being similar to the contingent control structure brought to the fore by Aghion and Bolton (For reference see Gordon Smith, 2005, p. 331; p. 333).

startup is structured in a way so as to "avoid the issue of an inadequate commitment, on the part of the founder, towards the needs [of the company] and the promises [made]."[126] As a result, the financing is very "procedural" and structured around stages – that is, the financing is spread over so-called financial or non-financial "milestones," according to which, at the meeting of certain performance goals, the investor will provide further equity or debt capital.

The diverging interests between VC investors and founders include a difference in respective goals, i.e. the founder likely derives substantial nonmonetary benefits from her role in the company and thus aims at a "flexible future expansion" and a long-term control of the company, while the VC funds' involvement is designed to be short-term. In light of that, "VCs want the option to take control of the company in case of poor performance, and full control of their own exit in case the venture develops positively."[127] Thus, the contractual provisions at the base of the investment must "encompass a range of eventualities unique to venture financing, especially regarding the venture's various lifecycle stages and its expected degree of development over time."[128] For this reason, "efficient contract design can help to align the incentives of VCs and the entrepreneur, thereby limiting opportunistic behavior on the part of the latter and, as a consequence, value destruction of the VC's investment."[129]

In fact, VC investments into prospective and promising enterprises give rise to "pronounced principal-agent conflicts," due to "substantial information asymmetries."[130] When facing the problem of so-called moral hazard, this is looked at in the referred literature, i.e. in the work of Kaplan and Strömberg, as:

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[126] Agstner et al., 2020, p. 380.
[127] Burchardt et al., 2016, p. 35.
[128] *Ibid.*
[129] *Ibid.*
[130] Burchardt et al., 2016, p. 25.

> 1) the entrepreneur's unwillingness to expend value-maximizing effort after VC funds are committed, or 2) the potential of extracting informational rents from knowing more about her own quality/ability than the VC, or 3) having the leverage of threatening to leave when human capital is particularly valuable to the firm, or 4) being in control of the venture project with no prospect of intervention in the event of disagreement with the VC investors.[131]

Thus theoretical remedies to the so-identified issues posed by potential moral hazard include, for instance, using mechanisms such as performance-sensitive compensation, investor liquidation rights, control rights, and vesting rights.

The seminal empirical study conducted by Kaplan and Strömberg compares the propositions of investment theories with real world entities. They find, for example, that the allocation of cash flow, control, and liquidation rights relies on them being 1) interrelated, and 2) shifts gradually with performance, while in many theoretical models they are not interrelated and are presented in all-or-nothing scenarios.[132] In these scholars' words, their work follows in the steps of and expands previous work done by Sahlman, Gompers, and Black and Gilson. For the purpose of what concerns us, these authors importantly compare famous control theories pioneered by Grossman and Hart as well the traditional principal-agency approach proposed by Holmstrom with empirical data pertaining to VC concrete investment practices. One interesting highlight is the convergence between Black and Gilson's argument regarding automatic conversion provisions and their findings that "automatic conversion provisions provide important non-monetary

[131] See KAPLAN, S. N., and STRÖMBERG, P. (2000). Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts. *NBER Working Paper N. 7660*. Also cfr. Burchardt et al., 2016, p.26.

[132] Kaplan and Strömberg, 2000, p. 7.

incentives to entrepreneurs because they transfer control from the VC to the entrepreneur if the entrepreneur performs well."[133]

On the other hand, the main focus of exit theory in the scholarly literature concerns the tradeoff between liquidity and control, whereby investors who have "easy exit options" would have fewer incentives to invest in monitoring, which is functional to improve ongoing performance; while the resulting temporary "lock-in" of the investor that may take place is precisely meant to encourage investment in such monitoring activities[134] (specularly, lock-in during the early stages of the financing relationship is followed by increasing exit rights with the passage of time). In fact:

> Absent some pressure to provide for investor exit, an entrepreneur may be perfectly happy to maintain the status quo (continuing operation with no mergers, public offering, or other exit events for the venture capitalist), either because the entrepreneur enjoys the private benefits associated with the status quo or because the entrepreneur recognizes some houldup value in deferring exit,[135]

whereas VCs usually have more interest in a sale/exit since they must return the cash flows from the disinvestment to their own investors within a given period of time.[136]

Thus, when venture capitalists lack board control, they seek "more targeted protection" through the terms of the venture capital investment. For instance, they may devise redemption and liquidation rights which entitle them to receive the original issue price of, for example, preferred stock, either as redemption price or as liquidation preference. Additionally, should there be an IPO which gives them a chance to disinvest, they may demand for registration rights either as

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[133] Kaplan and Strömberg, 2000, p. 8.

[134] In fact, as Burchardt et al. remark with regards to negative corollaries of the VC's staging, there is a possibility that the fund may discontinue the investment too early after the receipt of negative performative updates and thus abandon what may look like non-promising enterprises (p. 36). See also Gordon Smith, 2005, pp. 337-338; p. 344.

[135] Gordon Smith, 2005, p. 345.

[136] See the work of Gompers and Lerner, 1998. For reference see Burchardt et al., 2016, p.27.

"piggyback rights" or as "demand rights;" that is, depending on whether the registration rights provisions respectively give them the right to have their shares included in an IPO or to request an IPO or private placement of their shares.[137]

4. Anti-dilution Provisions *Latu Sensu*

Besides the workings of anti-dilution provisions *strictu sensu*[138], there are other contractual mechanisms that work in tandem to make sure that an overall effect of anti-dilution is achieved and these mechanisms which the present sub-section offers a description of shall be intended as anti-dilution provisions *latu sensu*; that is because anti-dilution is a complex effect that may be obtained through the contextual working of different contractual rights.

For instance, the function of negative covenants is to offer protection to the investor against those actions that would have the venture capitalist consider an exit, in fact:

> Redemptions of common stock, payment of common stock dividends, the issuance of additional preferred stock, and the creation of a new class of preferred stock on parity with or superior to the existing preferred stock would all have the effect of decreasing the value of the venture capitalist's investment, and may be part of a "squeeze out" strategy.[139]

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[137] See the work of Aghion, Bolton, and Tirole. For reference see Gordon Smith, 2005, p. 344; p. 349.

[138] Apropos of which, Kaplan and Strömber write: "Venture capital financings also frequently include antidilution protection which protects the venture capitalist against future financing rounds at a lower valuation than the valuation of the current protected round. In the extreme case, known as full ratchet antidilution protection, the protected security obtains a claim to enough additional common shares to effectively reduce the price of the protected issue to that of the new issue. In a convertible issue, this is accomplished by decreasing the conversion price on the protected issue to the same conversion price or common stock price of the new issue. The other common type of antidilution protection is the weighted average ratchet. Under a weighted average ratchet, the reduction in the conversion price (or common stock price) of the protected issue is a function of the number of shares issued and the conversion price of the new issue" (p. 22). With regards to these two types of anti-dilution provisions – the full ratchet and the weighted average clauses – their study has found that the vast majority (almost 76%) of the financings sees the use of the latter rather than the full ratchet mechanism (p. 22).

[139] Gordon Smith, 2005, p. 346.

VC investors thus frequently use control-related covenants alongside their investment instrument of choice so that they're able to use decision and veto rights "to influence the strategic direction of the venture," i.e. by having the ability to enforce or block management and board decisions.[140] Veto rights in favor of the investor may comprehend: veto rights to forbid assets sales, to change the shareholders' agreement, to prevent the company from selling shares, to impede changes in the capital structure, to forbid the dissolution of the company or the acquisition or sale of subsidiaries, to prevent changes in the existing business plan, and even to prevent changes in the number of employees.[141] Control rights may consist in clauses that enable the VC firm to exchange the current management, which usually includes the founders—this is known as the "management replacement clause." Instead, voting rights consist in "prespecified rights in percent assigned independently of the share of equity to the different parties involved in the company,"[142] while board rights and board seats consist in, respectively, prespecified rights in percentage and prespecified number of seats assigned to different parties in the company board.

VC investors may also use the covenants precisely to make the allocation of control rights contingent on some measure of the enterprise's financial or non-financial performance, for, as said, they usually want the option of taking control of the company when the performance is poor and of having full control of their own exit.[143] For this reason, it may be fair to speak of an allocation of "disproportionate" control rights in favor of the VC investors. The interesting aspect in the case of making control contingent on certain measures is that, in this way, the covenants do not set rules for a static distribution of control (although it certainly remains an option), but they provide for a

[140] Burchardt et al., 2016, p. 37.
[141] Burchardt et al., 2016, p. 28.
[142] *Ibid.*
[143] Burchardt et al., 2016, pp. 35-37.

dynamic allocation of control rights. The reason why these provisions are important is because not all the potential conflicts of interests between founders and investors can be resolved *ex ante* (this is the so-called theory of incomplete contracting elaborated by Aghion and Bolton).

Citing the relevant literature on the matter, Burchardt et al. write: "control rights define a 'pecking order' of governance regimes, which can move the venture from full entrepreneur control to contingent control to full VC control depending on the VC's perceived need of protecting its financial interests."[144] Thus control rights are distributed so as to mitigate the possible moral hazards that are envisioned (as Burchardt et al. write, "information asymmetries imply that a wealth-constrained entrepreneur maximizing his private benefit function may engage in opportunistic behavior, which is not aligned with the interest of a return-oriented financial investor with time-limited commitment"). For this reason, the use of control covenants increases with agency costs as well as with all the potential conflicts of interest.[145]

As brought to light by Gompers, some agency problems are related, for instance, to higher levels of asset intangibility and greater research and development intensity.[146] As a result, the allocation of control and decision rights—particularly, exit provisions—is used to mitigate potential holdup problems related to the investor's termination of the investment.

With the dynamic distribution of control rights, if the enterprise meets the performance expectations that are set, then the founder remains in control and, as per the incentive established in the covenants for this purpose, receives performance-contingent compensation. A form of balance thus may be reached with the VC relinquishing rights to interfere with operational decisions over time and in return obtaining exit rights throughout the investment period (in this

[144] Burchardt et al., 2016, p. 37.
[145] Burchardt et al., 2016, pp. 37-38.
[146] For reference see Burchardt et al., 2016, p. 41.

case, the financing contract would have a time-dependent evolution of decision and control rights).[147]

Burchardt et al., referring to empirical studies, remark how evidence has shown that, even so-configured, exit rights can however still be renegotiated in the course of the financing relationship "when corporate law gives common shareholders more advantage" (and when VCs lack board control, which is often times the case at the beginning of the investment period).[148] For this reason, they conclude how "more theoretical and empirical work on how bargaining power and legal conditions influence contract design (security choice and control rights) with respect to exits" needs to be done.[149] Finally, they concur on how future empirical work ought to deliver "evidence on the presence of contractual difference due to legal, fiscal, and institutional factors" outside of the United States.[150]

The plethora of exit rights that may be attributed to the VC investors can be made to include also the right of the VC firm to sell parts of the allotted shares in an IPO, drag along and tag along rights, rights of first refusal (the right to purchase shares held by other shareholders before these shares may be sold to third parties), as well as preemptive and redemption rights. Interestingly, preemptive rights are configured by Burchardt et al. as pertaining to the array of exit rights that may be assigned to an investor. Redemption rights consist in the "right of the VC firm to sell back shares to the entrepreneur at a prespecified price and after a prespecified period of time."[151]

Redemption rights may have three different declinations: 1) in terms of mandatory redemption provisions 2) in terms of put options (also known as optional investor redemption), 3)

[147] Burchardt et al., 2016, p. 40.
[148] *Ibid.*
[149] Burchardt et al., 2016, p. 42.
[150] *Ibid.*
[151] Burchardt et al., 2016, p. 28.

in terms of call options (also known as optional company redemption).[152] Mandatory redemption provisions put the company under the obligation to repurchase the investor's shares at a specified time, although usually subject to waiver by the venture capitalist, with the twofold purpose of allowing the investor to recoup her original investment ("from a company that seems unlikely to succeed") and to provide her with leverage over the founder "based on the credible threat of withdrawal."[153] However this possibility looming over the fate of the company may dissuade other investors from investing – given that the capital may be used up in the redemption – for this reason, the more flexible put provisions may be used instead. These allow the investor to force the repurchase of shares at will and although they have the same purpose as mandatory redemption rights they do prove to be more flexible. However, if they're not clearly limited in time, meaning, exercisable within or after x amount of years, they may end up being harsher on the founder than mandatory redemption provisions. Usually, given the initial lock-in of the investor, these provisions would contain an average term of x amount of years before put options would be exercisable. Instead, call options allow the company to purchase the investor's shares at the company's discretion.

Additionally, included in the array of exit rights attributable to the investors there may be lockup provisions, either in the form of initial lockup, according to which initial shareholders wouldn't be allowed to sell their shares at exit without the consent of the investors, or in the form of "post-IPO lockup," that is, a prespecified period of time after an IPO in which the investment may not be sold, or both initial and post-IPO lockup provisions.[154]

[152] Gordon Smith, 2005, p. 348.
[153] Gordon Smith, 2005, p. 348; p. 349.
[154] Burchardt et al., 2016, p. 28.

Upon consummation of an IPO all shares of preferred stock are converted to common stock and this conversion removes all of the special rights and privileges associated with the preferred stock. Apropos, Gordon Smith notes how conversion rights play a key role in exit decision and how, generally speaking, VC investments contain two kinds of conversion provisions: "1) optional conversion which allows the venture capitalist to convert at will; and 2) automatic conversion which requires the venture capitalist to convert upon the occurrence of specified events, most importantly an IPO."[155] The first type of provisions allows conversion from the moment the preferred shares are issued, unless accompanied by some suspensive condition, and at the investor's discretion. Importantly for our discussion, automatic conversion provisions, which are triggered by an IPO of the company's shares, contain "complex procedures for adjusting the conversion rates to prevent dilution of the venture capitalists' investments."[156] What's more, different outcomes relating to different exit strategies may take the form of contractual provisions that allocate cash flow rights differently for IPOs and trade sale, for instance, due to the presence of an automatic conversion clause that would apply in the occurrence of an IPO and not come into effect in case of a trade sale.[157]

Finally, with respect to the provision of a liquidation preference, this functions as a deterrent against the founder's opportunistic behavior aimed at forcing an exit out of the investors, for the liquidation preference would entitle the venture capitalist to receive a fixed amount (that must be paid prior to any payments being made to non-beneficiaries of these provisions) and that usually corresponds to the original investment, and to participate in any distributions that occur after payment of the liquidation preference.[158] An important note that Gordon Smith makes with

[155] Gordon Smith, 2005, p. 354.
[156] *Ibid.*
[157] Burchardt et al., 2016, p. 39.
[158] Gordon Smith, 2005, pp. 347-348.

regard to liquidation is that in venture capital financing this includes not only the sale of assets pursuant to a failure of the company, but also any sale of the controlling stake; "in other words, 'liquidation' covers the spectrum, from utter failure to grand success."[159] "The participation provision deters the controlling entrepreneur from upside exits, that is, exits that may seem favorable to the entrepreneur but not the venture capitalist," including favoring mergers over public offerings.[160] However, many VC deals leave off the participation rights associated with liquidation preferences because considered a too unbalanced tradeoff to the sole advantage of investors.[161]

5. Trilateral Bargaining

Up until this point the issue of dilution has been dealt with only taking into account the interests of investors and founders considered in a bilateral relationship. However, the funding cycle of a startup is, in reality, made up of various stages that see a variety of figures partaking in the financing of the enterprise. Typically, in the very first stage, the funding comes from the founder herself as well as from a group of people close to her (the so-called *FFF* group, an acronym which stands for "friends, family, and fools").[162] Normally, these first "believers" acquire ordinary shares, which attribute them the same rights and risks as the founder. Then the second cluster of investors – while the company is still in its early stage of development – are well off subjects who in the American corporate culture have earned the appellative of "business angels," and who invest

[159] Gordon Smith, 2005, p. 347.
[160] Gordon Smith, 2005, p. 348.
[161] Gordon Smith, 2005, p. 347.
[162] Agstner et al., 2020, p. 382.

either individually or in groups (the scholarly literature talks about "angel groups" or "superangels"). These investors provide not only funding, but also offer their expertise and know-how in the form of consulting activity.[163] The angels' investment is more sophisticated than the very first investors or "believers" (the founder and the FFF group), yet not as structured as that of Venture Capital funds. As a matter of fact, in the past, angels used to purchase ordinary shares, but as of recently, they employ more protective instruments: i.e. seed equity and seed debt – with a conversion rate below par.[164] However, worthy of mention is also their recent resorting to even more innovative instruments, such as the "Simple Agreement for Future Equity," also known as SAFE contract, whereby their contribution is qualified neither as seed equity nor as seed debt, but is provided in exchange for the investors' right to automatically become shareholders in case of future capital increase and at the same conditions set for the new investors' entering the company on that occasion (yet while also benefitting from an *ad hoc* conversion price gap).[165] SAFE instruments are described by Coyle and Green as "deferred equity investments;" in the "Post Money SAFE version," the investor has also the right to eventually partake in distributions alongside shareholders.

Additionally, with SAFE contracts, the conversion of the investment into the assignment of a stake in the company is automatic and it may never happen (with the result that the relevant funds are lost) if the company doesn't proceed with further rounds of capital increase after the execution of these contracts.[166] In the Italian legal framework, Agstner et al. qualify them as atypical contracts very similar to option contracts.[167] In simpler words, through a SAFE contract

[163] Agstner et al., 2020, p. 383.
[164] *Ibid.*
[165] Agstner et al., 2020, pp. 383-384.
[166] See Agstner et al., 2020, p. 384, footnote 122.
[167] Agstner et al., 2020, p. 384.

the investor would be making a contribution that gives her the right to become a shareholder if and when the company proceeds to a capital increase – a contribution that would otherwise be lost (similarly to the price paid for an option contract).

The company's further expansion usually witnesses the arrival of institutional investors, such as Private Equity or Venture Capital funds, employing, *strictu sensu* and *latu sensu*, the anti-dilution mechanisms we've seen so far within the investment structure of staged financing[168]. For instance, a typical staged financing operation that follows the reward for performance principle will entail that the proprietary interests as well as the administrative rights will be assigned in such a way as to allow the founder to recoup her investment when the project is completed, or in case there is a sale of the shares, or transfer of the holding or the business i.e. following an IPO. On the contrary, the investor will be able to gain full control of the company if the business performance doesn't prove successful, which occurs, for instance, at the stage when the startup is considered a "living dead."

A startup is in the living dead stage when it doesn't generate losses or profits and, therefore, from the investor's viewpoint, it is a venture from which it is more convenient to disinvest in order to quickly redirect the resources into more promising enterprises (the startup is usually part of a portfolio of companies for which certain performance expectations are set at the time of the investment).[169] That is a corollary of the general purpose of the investment practice characterizing venture capitalists; that is, to invest timely (and incrementally) into risky enterprises to obtain disproportionate returns.

[168] In the US, typically, a single financing round executed by Venture Capital funds ranges from 2 to 10 million USD, while the average duration of the investment as a whole is five years (Agstner et al., 2020, pp. 584-585). See also empirical data from Kaplan and Strömberg, 2000.
[169] See Agstner et al., 2020, pp. 380-381, footnote 109.

Yet, in the delicate operation represented by structuring the financing of a startup, as already foreshadowed, there may be other situations of conflict to take into account – that is, other than the primary founder-investor conflict. For instance, the interests of pre-existing investors may very well collide with contractual practices that are put in place by VC investors to obtain their disproportionate returns. This type of problem is also known as "trilateral bargaining."[170]

Moreover, this issue may present itself in a phase prior to a living dead situation, when the VC investor doesn't intend to partake in further rounds of capital increase but is protected against dilution by anti-dilution provisions *strictu sensu*, in which case the conflict of interests that need to be coordinated is trilateral and is that of pre-existing diluted shareholders, undiluted investors, and new investors entering the shareholding structure (i.e. other institutional investors, business angels, etc.).

Certainly, the latter is a theoretical situation, given that new investors may be discouraged from investing in a company that is underperforming or approaching a living dead situation (also given the unwillingness of some of the pre-existing shareholders to further participate in capital increase rounds, despite having the means to do so). However, if some investors are protected by anti-dilution mechanisms, they might simply not have an interest in providing further capital, for they are warranted against dilution and, at the same time, under no contractual obligation to do so given the underperformance of the company with regard to the milestones at the base of the investment plan – for which, no breach of fiduciary duties could be ascribed in this sense on the investors' part.

Yet, as alluded to, because Venture Capital funds tend to invest incrementally – at the meeting of certain milestones – new investors can come into play for every financing round,

[170] Agstner et al., 2020, p. 381.

creating a complex financial structure, and giving rise to multiple potential conflicts of interest. It is in this context of conflict that the issue of dilution is inscribed – dilution that can have two main forms: the first, "proper dilution," is the watering down of the shares held by an existing shareholder, and then there's the dilution that takes the form of asset stripping.[171]

This issue and the more general agency costs that derive from situations of conflict among shareholders are faced in practice through an array of different contractual instruments either in the shareholders' agreement or in the company's operating agreement. The contractual provisions, including but not limited to anti-dilution clauses *strictu sensu*, usually serve to ensure, on the one hand, that the investor keeps her promise to provide funding when the milestones are met and, on the other, they're used to protect the value of the investment while granting the beneficiary the right to exit should the performance expectations not be met.

Typically, Venture Capital funds subscribe convertible preference shares which grant special kinds of rights and safeguards compared to ordinary shares, for instance, they give the owners a preferential right to distributions, or "upside protection," as well as a preferential right to the distribution of the liquidation residue, or "downside protection."[172] At the same time, convertible preference shares give the subscribers the right to convert them into ordinary shares, which is usually done when wanting to take advantage of the increase in value of ordinary shares, while also benefitting from the conversion price cap established for them.

When it comes to the protective mechanisms that are usually employed in investment agreements (i.e. in the share purchase agreement, the preferred share purchase agreement, the investors' rights agreement, the voting agreement, etc.), as already outlined in depth *supra*, we may find clauses for the allocation of undistributed accumulated profits towards the final

[171] Agstner et al., 2020, p. 381.
[172] Agstner et al., 2020, p. 385.

liquidation preference, which strengthens a deterrent effect from opportunistic behaviors on the part of managers/founders as well as the anti-dilution effect *latu sensu* that results from this kind of provisions; conversion options for shares of a different category which execute anti-dilution provisions *strictu sensu*; pre-emptive rights when there is no default recognition of them; redemption rights, and even tag along and drag along provisions. Another common practice is to have liquidation privileges exceed the original price paid for the acquisition of the privileged shares, thus giving their holders economic rights almost comparable to seed debt, yet with the advantage of taking part in the control of company affairs, i.e. through the provision of veto rights for extraordinary corporate transactions.[173] The contextual operating of all of these provisions thus ensures the overall achievement of a protection of the VC fund's investment against dilution, *latu sensu,* whether as a result of agency costs, conflicting interests among a plurality of parties, and/or underperformance of the company; especially when the VC investor is not a majority shareholder or doesn't have *de facto* control of the enterprise.

[173] See Agstner et al., 2020, p. 486; pp. 386-387.

CHAPTER III

The Peculiarity of the Italian Context for the Implementation of Anti-dilution Provisions: Obstacles and Remedial Interpretation.

1. Preliminary Considerations. Reception of VC Praxis in Italy and 2012-2017 Company Law Reforms

Prior to the company law reforms that occurred between 2012 and 2017, the legal type of the Italian limited liability company, *Srl*, didn't have much financial flexibility to offer, which is key to any kind of investment practice. The rationale behind the five-years span of reforms was however nested in the broader intention of reviving the Italian economy altogether, under the assumption that this would be possible only through a modernization of company law that would in this way stimulate domestic as well as foreign investments. The line of reasoning followed by the lawmaker departed from the empirical data that also emerged in the context of the Small Business Act[174], namely, that small-medium enterprises represent, numerically, the vast majority of undertakings – and that is certainly true, even historically speaking, within the Italian landscape.

[174] A Communication dated from 2008 by the European Commission, titled *A Small Business Act for Europe*, stemming from the reformative fervor of those years, highlighted the important role of small-medium enterprises (SMEs) in society, "key players for the wellbeing of local and regional communities," and, symmetrically, stressed the necessity to make the European Union "a world-class environment for SMEs" (European Commission, 2008, p. 2). According to the criteria established in the second attachment to Recommendation 2003/361/EC of the European Commission, now contained in article two, paragraph one, letter f), of Regulation EU 2017/1129, small-medium enterprises are undertakings that have less than 250 employees, an annual turnover that is below 50 million euros, or assets in the balance sheet below 43 million euros.

In a comparative vein, the Commission underlined the need for the EU "to take further significant measures to release the full potential of SMEs," given the lower productivity rate and slower growth rate than their counterparts in the US (European Commission, 2008, p. 3). In particular, significant data would have shown how circa 21% of small-medium undertakings indicated access to finance to be a major problem, with an even higher percentage for micro-enterprises (European Commission, 2008, p. 3). As a result, the ambitious policy agenda laid out in the Communication "A Small Business Act for Europe" aimed at realizing "a genuine political partnership between the EU and Member States that respects the principles of subsidiarity and proportionality," with a set of 10 principles "to guide the conception and implementation of policies both at EU and Member State level" (European Commission, 2008, p. 4).

In particular, with the Recommendation dated 10 July 2012, the European Council urged Italy to improve SME's access to financial instruments, and, particularly, access to capital, with a view to the funding of innovative and growing enterprises. In line with the European Recommendation, the ministerial report that accompanied the promulgation of *d.l.* 179/2012, the so-called Italian Startup Act, made explicit reference to the need for facilitating the constitution, development, and funding of enterprises that are technologically innovative. In concrete, this meant relaxing the already existent norms by taking as a point of reference the English and American corporate systems. In fact, in the context of the so-called charter competition among European Member States[175], the existent model of the Italian *Srl* had shown all of its inherent limitations.[176]

However, it is important to clarify that a startup is neither a legal type per se nor a sub-type of the limited liability company, but it does take on this legal form in the vast majority of cases, as

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Relevant, for the purpose of this work, is, however, principle number VI, which establishes the fundamental need to facilitate access to finance for small-medium enterprises. Specifically, the principle recites: "The EU and Member States should facilitate SMEs' access to finance, in particular to risk capital, micro-credit and mezzanine finance […]" (European Commission, 2008, p. 11). In connection with that, the European Commission stated the intention to "evaluate options for introducing a private placement regime destined to facilitate cross-border investment" so as to strengthen European Venture Capital markets, considering that "risk aversion often makes investors and banks shy away from financing firms in their start-up and early expansion stages" (European Commission, 2008, pp. 12; 11).

[175] DE LUCA, N. (2021). *European Company Law.* 2nd Ed. Cambridge: Cambridge University Press. As de Luca highlights, "as in the US, [in Europe] too, the freedom of establishment stimulates a competition amongst Member States to create the best economic and legal conditions for companies or individuals to operate" (p. 96). An interesting development in the European corporate context is represented by the introduction, in 2017, of a Slovene simplified corporation model, one endowed with great financial and administrative flexibility. In this instance, the aim of the legislative policy was specifically that of facilitating the incorporation and development of innovative undertakings that would be financed by Venture Capital funds (Agstner et al., 2020, p. 372, footnote 73). Besides this precedent, however, it is true that "at present, no Member State has asserted itself as the 'European Delaware'," as "none seems to have a clear competitive advantage over the others" (de Luca, 2021, p. 96).

Traditionally, a major position in the corporate context was held by the UK, whose attractiveness for small-medium undertakings lies in the special attention that is normally paid to shareholders and, at the same time, in the extremely low start-up costs, which include the absence of minimum legal capital requirements (de Luca, 2021, pp. 96-97). However, following a process of legislative imitation, the prominent position held by the UK declined over time as other European Member States passed laws permitting the formation of so-called "One-Euro limited companies" (de Luca, 2021, p. 97). This process of legislative imitation rocketed, particularly, following the Small Business Act, with the implementation of laws permitting the constitution of One-Euro limited companies, for instance, in Germany in 2008, in Italy in 2012, in Spain in 2013, and in France in 2016 (de Luca, 2021, p. 97).

[176] Agstner et al., 2020, pp. 370-371.

empirical data – confirmed by the findings of the Small Business Act – have shown. To quote Pollman, the definition of a startup company is of a functional kind: it is a company of new or recent formation, usually with few employees, that aims at developing an innovative service or product and that, for this purpose, is supported by outside investors so as to facilitate its growth and then recoup the investment made through various exit strategies (i.e. sale of the shares, IPO, ect.).[177] Startups find effective financial sustenance thanks to the intervention of so-called business angels and, even more so, thanks to Venture Capital funds. This premise made, part of the legal scholarship contends that the incomplete liberalization of the *Srl* type not only relates to the 2012-2017 reforms' having missed the chance to provide an *ad hoc* discipline that takes into account VC financing practices, but also to not having dulled the sharp edges of those norms of the legal type, gatekeepers of the financial inflexibility of the Italian *Srl*.[178]

As a matter of fact, the reforms that occurred between 2012 and 2017 had also been fostered by the acknowledgment of extremely low growth and innovation rates for Italian enterprises.[179] In particular, the legislative intervention from 2012 – *d.l.* 179/2012 – provided, for startups that adopted the *Srl* form, the possibility, pursuant to article 26, to issue classes of quotas and to issue securities (in derogation of paragraphs 2 and 3 of article 2468 of the Italian Civil Code). This included the possibility of issuing classes of quotas entirely deprived of voting rights, or with limited or conditional voting rights (usually the exclusion or limitation of voting rights is counterbalanced by the provision of a preferential financial position for distributions and/or reimbursements), or with non-proportional voting rights (voting rights that are disproportionate to the amount of capital subscribed to by the quotaholder).

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[177] See Agstner et al., 2020, p. 365, footnote 4.
[178] This is the main thesis in Agstner et al., 2020.
[179] Agstner et al., 2020, p. 373.

The most revolutionary aspect, as it had been read by the scholarship, is also contained in article 26 of *d.l.* 179/2012 and consists in the possibility for a startup that adopts the *Srl* legal form to offer its own quotas to the general public through so-called crowdfunding portals; revolutionary because it goes against one of the founding traditional features of the limited liability company type, as historically configured in Europe (except for the UK).[180] This latter provision, specifically contained in paragraph 5, article 26, however, needs to be coordinated with article 100-*ter T.U.F.* as well as with *CONSOB* Regulation 18592/13 for its concrete implementation. As per other novelties that were brought about by article 26, we find the provisions that allow startups to acquire their own quotas in execution of incentive plans for employees, directors or freelance collaborators (paragraph 6), and those that allow these entities to benefit from a special regime in case of capital reduction due to losses (paragraph 1).

These novelties introduced in 2012 were soon extended, first in 2015, to any *innovative* small-medium undertaking regardless of the legal type (*d.l.* 3/2015) and then, to *all* small-medium undertakings in 2017 (*d.l.* 50/2017). From the viewpoint that is relevant here, it is noteworthy that the company law reforms originally conceived for startups adopting the *Srl* legal form thus became the springboard for the coming to be of different sub-types: one directly touched by the derogations introduced by *d.l.* 179/2012, including resorting to the general public to raise capital by means of crowdfunding portals, and the other, the "traditional" *Srl*, regulated by the norms contained in the Civil Code only. In fact, as a consequence of the reforms that followed first in 2015, and then in 2017, the only model that was excluded from the so-called modernization of company law was that of the "big" *Srl*. This is significant because the reforms that occurred in the 2012-2017 five-year span haven't amounted to a revision of the disciple of the legal type altogether, entailing, as

[180] See Agstner et al., 2020, p. 376.

far as we're concerned, a call for remedial interpretations for the reconciliation between what happens in concrete and the norms governing the type, as we shall see with the issues posed by anti-dilution provisions.

The Italian *Srl* type was originally instituted after the German *GmbH* company type and soon after its inception it took on the discipline of the Italian corporation type, the *Spa*, thus losing those "important spaces of private autonomy" that are a characteristic feature of the *GmbH*.[181] Notwithstanding the dependence on the *Spa* discipline, the Italian lawmaker sought out to establish an autonomous body of norms to be applied to the *Srl* type and this effort resulted in the company law reform that occurred in 2003, however the model of *Srl* that came out of this intervention privileged an administration of affairs that was supposedly to be taking place among a homogeneous class of quotaholders (entrepreneur-quotaholders).[182] For this reason, the 2003 reform is responsible for a series of norms that have been considered imperative ever since and yet exclusively for the protection of the alleged interests of this class; norms thus aimed at preserving the closed ownership structure of the type and at safeguarding the quotaholders' mutual weight within the company.[183] It is no surprise that, before 2012, the so-called principle of the central relevance of the quotaholder ruled uncontested both in the predominant case-law and in scholarly readings.[184]

In a footnote scholars Agstner et al. referring to the major scholarship on the topic, write:

> It is recurrent in Italy to affirm that the "S.r.l." is a "company among negotiators," that is, among quotaholders that are capable of protecting their interests autonomously, making the best use of [what in Italian company law is known as] statutory autonomy [the way in which private autonomy is declined in the *statuto* document, performing the same function as an operating agreement in the US]. If

[181] Agstner et al., 2020, pp. 365-366.
[182] See Agstner et al., 2020, pp. 367-368.
[183] Agstner et al., 2020, p. 368.
[184] See Agstner et al., 2020, p. 369.

> this assessment pertains solely to the Italian system, then it is valid; otherwise, under a comparative lens, if we take as a point of reference the Delaware *Limited Liability Company*, then this kind of assessment is no longer valid.[185]

Overall, as the scholars underline, the Italian system would seem to have admitted a kind of dual-use of the *Srl* type after the 2012-2017 reforms.[186] The five-year span, in fact, had brought about the crumbling of the "centenary" dualism of German origin between a company type that is open and one that is closed to the market. Thus, after such reforms, we must conclude that, structurally speaking, the typological distinction can no longer be based upon whether or not it is possible for a company to resort to the general public to raise capital, since certain *Srl*s now can do so.

According to one scholarly direction, the legal discipline of the *Spa* type should be applied to *Srl*s either in case of gaps within the proper legal discipline, or whenever the relevant norms apply inadequately to the subtype open to the market.[187] According to this reading, however, the distinction between different classes of quotaholders – entrepreneur-quotaholders and investor-quotaholders – is relevant only in the sense that investor-quotaholders (considered as such those who'd become quotaholders via crowdfunding) shall be subject to the discipline provided for the *Spa*, while the former (entrepreneur-quotaholders) to the discipline provided for the *Srl*.[188] In the scholarly literature, this kind of approach is known as *à la carte* approach, whereby, depending on the phenomenon considered, one would latch on the applicable discipline hither from the *Spa*'s, hitherto from the *Srl*'s.[189]

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[185] Agstner et al., 2020, p. 358, footnote 9.
[186] See Agstner et al., 2020, p. 377.
[187] See Agstner et al., 2020, p. 399.
[188] Agstner et al., 2020, pp. 399-400.
[189] See Agstner et al., 2020, p. 400.

According to yet another scholarly direction, the open *Srl* sub-type has been *de facto* assimilated to the *Spa* type and, for this reason, it now requires the extension of norms thus considered "trans-typical," with the dual purpose of filling in gaps within the *Srl* discipline as well as applying those norms of the *Spa* type that are designed to offer a protection to investor-shareholders in general. In this way, the norms in the *Srl* legal discipline that are catered around the principle of the quotaholder's central relevance would be teleologically replaced.[190]

Scholars Agstner et al. highlight how both approaches offer an "adaptable" interpretation that departs from the provisions of the Civil Code to then look at the new *Srl solely as crowdfunded*.[191] In doing so, these two approaches 1) argue for the supervened inadequacy of the norms contained in the Civil Code to regulate the phenomenon taken into account, 2) and affirm the need for an analogical application of imperative norms of the *Spa* type. Instead, since the 2012-2017 legislative interventions haven't brought about an organic reform of the *Srl* type altogether, we are to read the intent of the lawmaker as encompassing, through the hermeneutics of a remedial interpretation of certain norms, the *concrete* and *effective* way in which startup enterprises, which take one the *Srl* legal form in the vast majority of cases, are funded – not through crowdfunding portals, but thanks to the financial contribution of Venture Capital investors[192]. This premise is important for the argument that will follow concerning resisting solutions that seem inadequate to the concrete interests of the parties involved in the peculiar financing relationship that takes place

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[190] *Ibid.*
[191] Agstner et al., 2020, p. 401.
[192] Providing empirical data, Agstner et al. report the findings of the *Politecnico di Milano*: at the end of June 2019 there were only 401 enterprises that had activated authorized crowdfunding campaigns ever since the introduction of this possibility in Italy and for a total amount of 82,7 million euros of capital raised – in face of 1,19 billion euros raised through VC operations in the sole year between July 2018 and July 2019. The crowdfunding situation in the rest of Europe does not look much brighter, with the Cambridge University Center for Alternative Finance reporting that the amount of capital raised through a crowdfunding-like mechanism is less than 500 million euros (Agstner et al., 2020, p. 397, footnote 173).

between a startup and its VC investors. In other words, the incoherence of the discipline, a result of the non-organic reforms, may be overcome via the questioning of the imperative nature of certain norms of the Civil Code.[193] The purpose of this approach is thus to critically evaluate the various impediments to the free declination of the parties' private autonomy and to make sense of the *voluntas legis* also taking into account the current socio-economic phenomena.[194]

On the relationship between socio-economic type and normative type, Zanzarone writes that, once the emergence of a certain company type is appraised empirically (that is, the emergence of a socio-economic archetype), perhaps because already prevalent in business practices and relations, then the socio-economic type becomes the parameter for reconstructing the rationale (or *ratio*) of a certain legal regime, which in turn shall be interpreted according to it.[195] This explains how the socio-economic type is therefore likely to become the hermeneutic criterion – as per Zanzarone – that identifies the goals pursued by the norm, its reasons to be (again, its *ratio*), and as such, a tool to reconstruct the *voluntas legis* (what the norms intend and therefore provide for). For Scano, the considerations on the derogable or inderogable nature of certain norms of the *Srl* should be carried out on the plane of the interests involved.[196]

[193] This is the thesis in Agstner et al., 2020. See p. 402 as reference.
[194] *Ibid.*
[195] For reference see Agstner et al., 2020, p. 399, footnote 176.
[196] For a comprehensive account of the typological evolution of the *Srl* see SCANO, A. D. (2020). Il "Tipo." In IBBA, C., and MARASÀ, G. (eds.). *Le Società a Responsabilità Limitata: Vol. 1.* Milano: Giuffrè Francis Lefebvre.

2. Admissibility of Anti-dilution Provisions According to the Notarial Council of Milan: Recommendation n. 186, December 3rd, 2019

According to Recommendation n. 186/2019 by the Notarial Council of Milan, clauses in the bylaws or operating agreement of *Spa* or *Srl* companies that provide for the obligation, in case of future capital increases against payment, with or without the recognition of pre-emptive rights, to assign for free a number of newly issued shares or quotas to the holders of a certain privileged category (or to one or more *Srl* quotaholders) are legitimate. That, supposing future capital increases are deliberated at a lower price than what established in the clauses, thus preventing the dilution of the protected category even if the beneficiaries won't participate in the new capital increases. It is interesting to notice how the Recommendation ratifies the legitimacy of anti-dilution provisions contained in company bylaws or operating agreement, with no mention of shareholders or quotaholders' agreements.

This is significant given that, in the Italian legal system, "statutory" clauses (provisions contained in company bylaws or operating agreement) have a stronger legal force than clauses contained in a shareholders or quotaholders' agreement. The reason is that company bylaws or operating agreement are subject to a regime of legal publicity, whereas shareholders or quotaholders' agreements aren't (except for in the case of a listed company). As a consequence of the regime of legal publicity, statutory provisions bear legal validity *erga omnes*, meaning, they are effective against third parties as well; whereas, the provisions of shareholders or quotaholders' agreements are binding merely on the parties involved. Thus, the fact that the Notarial Recommendation makes no reference to shareholders or quotaholders' agreements is, on the one hand, irrelevant, provided that by means of endorsing their legitimacy in statutory documents, which bear legal effects against third parties, it is by extension legitimizing them in the agreements

that have a bearing only on the parties involved. On the other hand, the fact that the Recommendation mentions only the statutory documents is relevant with regard to the prohibition of leonine pacts, whose violation justifies a sanction of nullity by the court.

Indeed, as the case-law of the Italian Supreme Court has demonstrated in *Cass. N.* 17498, the violation of the prohibition of leonine pacts shall be evaluated by the court with regard to the provisions of the company bylaws (or its operating agreement), for only these have a bearing against third parties. That is, if the provisions contained in the statutory documents, in fact, are found to be violating the prohibition concerning leonine pacts (pursuant to article 2265 of the Civil Code), only this engenders the grave consequences that follow a judgment of nullity and that justify the court's intervention on the parties' private autonomy and freedom of contract. However, the Notarial Recommendation, by means of confirming the legality of anti-dilution provisions contained in statutory documents, is validating what many authors have already been claiming and advocating for (for instance, cited in the Recommendation's bibliographic endnotes we find: Calvosa, Ferri, Ferro-Luzzi, Formica, Lo Iacono, Marcoz, and others).

Among the reasons for the admissibility listed in the bibliographic footnote, we find the following doctrinal remarks: 1) the validity of these provisions doesn't touch on the relationship between a company and third parties; 2) there is no violation of the prohibition of leonine pacts since the functioning of these provisions pertains to the content of company stakes and the beneficiary still partakes in profit and losses in proportion to the shares or quotas assigned to her; 3) the shareholder/quotaholder not providing contributions is not put in a position that is much different from that of a donee, which is widely accepted (provided that the shares or quotas have been entirely liberated). Instead, *contra* a non-proportional attribution of shares or quotas to

shareholders or quotaholders who don't provide any contribution the bibliographic footnote cites Campobasso.

In the motivation, the Notarial Council describes anti-dilution provisions as responding to the need shareholders or quotaholders have to regulate their own positions with respect to future operations like capital increases. In particular, the need to protect one's investment through anti-dilution provisions may arise after an investor subscribes to a minority stake at a price that is based off of a certain value appreciation of the company and then, with time's passing, the company has to resort to capital increases deliberated at an issuance price involving a lower value appreciation. In this event, two opposing interests might collide: on the one hand, that of the majority shareholders/quotaholders to be able to freely determine additional capital increases (with or without the recognition of pre-emptive rights) eventually at lower prices than the value appreciation which the minority shareholder/quotaholder's investment was based off of; on the other, that of the minority shareholder/quotaholder to maintain her company stake, or, at least, its perspective value, regardless of the participation in new capital increases (in other words, the minority shareholder/quotaholder's interest in not being diluted). Taken all of this into account, the Council identifies the function of anti-dilution provisions to be precisely this mitigation of opposing needs between majority and minority shareholders/quotaholders.

The motivation attached to the Recommendation also distinguishes between full ratchet and weighted average anti-dilution provisions in the following terms: with the first, the amount of newly issued shares or quotas assigned to the beneficiary of the provision will *even out* the price originally paid by the protected shareholder/quotaholder with the subscription price for the new capital increase; with weighted average clauses, the amount assigned to the beneficiary will, instead, *average* the price originally paid with the one expected for the new capital increase. Then

the motivation also reiterates how the legitimacy of such clauses lies in the provisions allowing company bylaws or operating agreement to determine the instances of non-proportional attribution of shares or quotas (pursuant to articles 2346 and 2468 of the Civil Code). However, these provisions still require the total amount of contributions made to be equal to the amount of capital increase carried out in the relevant operation, and that also taking into account the shares or quotas assigned to the protected shareholder/quotaholder in execution of anti-dilution provisions.

The motivation, in reference to this, talks about an instance of "extreme" non-proportionality—contrary to the scholarly reading the present work adheres to—because the shareholders or quotaholders benefitting from anti-dilution provisions don't have to provide any contribution whatsoever for the subscription to the newly issued shares or quotas. Regardless of the alleged extreme character of the non-proportionality, the Notarial Council recognizes the legitimacy of all the instances in which the subscribers do provide some contributions, but also of those in which subscribers don't provide contributions in any form.

The reasoning for preferring the more permissive thesis with regard to a non-proportional attribution of shares or quotas descends, 1) from a literal interpretation of the relevant norms that do not contemplate any explicit limitation on the non-proportionality of the subscriptions; 2) from the consideration that it is a matter that concerns the internal relationship among shareholders or quotaholders, not being there any interest of third parties that would need to be protected. Having said that, it is worth mentioning that, nonetheless, we have encountered, in the course of the analysis conducted in the present work, the possibility that the interests of the beneficiary of anti-dilution provisions collide with third parties'. Indeed, in case of capital increase reserved to third parties with, on the one hand, the exclusion of shareholders or quotaholders' pre-emptive rights,

and, on the other, the enforcement of anti-dilution provisions to the benefit of a select shareholder or quotaholder, we come up against a situation of trilateral bargaining.

3. Formal and Substantial Obstacles

The theme of new possibilities of raising capital has been dealt with by the Italian legislator only under the profile of allowing the *Srl* sub-types that came out of the 2012-2017 reforms to issue categories of quotas. As a result, the obstacles that the execution of VC financing contracts may encounter are: 1) the provision contained in article 2482-*bis* of the Italian Civil Code that establishes, in case of exclusion of quotaholders' pre-emptive rights, the recognition of their right of withdrawal; 2) the various normative provisions that may hinder the introduction of anti-dilution clauses; 3) the imperative nature of certain norms from the discipline of the *Srl* contained in the Civil Code and the analogical application of the limitations contained in the discipline of the *Spa* type for the issuance of categories of shares; 4) the application, or as qualified by some scholars, "the excessive dilatation" of the prohibition of leonine pacts; 5) the interpretation of the relevant discipline in light of an assumed principle of "fair value appreciation of the quotaholding position," such that any pactional pre-determination of the amount owed to the withdrawing, dragged, or redeemed quotaholder that is supposedly less than is penalized with invalidity.[197]

If these obstacles concern the execution of VC contracts, when it comes to the employability of anti-dilution clauses, scholars Agstner et al. underline the following potential issues: 1) dilatation of the prohibition of leonine pacts, 2) possible limits to the non-proportional

[197] See Agstner et al., 2020, p. 414.

distribution of quotas in case of capital increase, 3) the imperative rule of necessary equivalence between the contributions made and the amount of legal capital pursuant to article 2464 of the Civil Code, 4) the qualification of the rights following anti-dilution provisions as either individual rights of the quotaholders, or as rights that pertain to a category of quotas.[198] From a practical stance, the scholars also underline how the effectiveness of such clauses depends on whether or not, pursuant to article 2481-*bis*, the right of withdrawal in case of exclusion of subscription rights may be preventively derogated from by private autonomy.[199]

While most of these aspects will be dealt with in the course of this chapter, with regard to issue *iv.*, the rights introduced by anti-dilution clauses may be qualified either way as individual rights ("particular rights" of the quotaholder), pursuant to paragraph 3 of article 2468 of the Civil Code, with the consequence that there would need to be a unanimous deliberation for both their introduction and modification, or as rights that pertain to a special category of quotas, which according to the same doctrine[200] and to Recommendation n. 186 by the Notarial Council of Milan entails their transferability.

In addition to the four obstacles of a formal or substantial kind identified by Agstner et al., scholar Awwad also brings to the fore the question of inequality between founders and new subscribers in the context of a trilateral bargaining situation.[201] Apropos of this matter, however, she underlines how the issue of inequality may be raised only with regard to pre-existing quotaholders and not for future ones as well.[202] That is corroborated, indeed, by the regime of pre-emptive rights themselves, in that they protect the interests of those who already are shareholders

[198] Agstner et al., 2020, pp. 421-422.
[199] Agstner et al., 2020, p. 422.
[200] See Agstner et al., 2020, p. 423.
[201] Awwad, 2021, p. 181.
[202] Awwad. 2021, p. 182.

or quotaholders to maintain their respective company stake for every operation of capital increase. Somewhat connected to the issue of inequality is the matter of evaluating the financial impact that anti-dilution clauses may have, a financial impact that is not of an easy assessment, given that it is, to a degree, linked to unpredictable variables (i.e. how the enterprise will go, the likely distribution of dividends, the circulating categories of shares or quotas, etc.).[203] Indeed, the possible asymmetry in terms of information and familiarity with these complex contracts inevitably affects the negotiation of the clauses. Additionally, from the founders' perspective, the employment of this type of provisions may inhibit their interest in the enterprise, given the "progressive loss of weight within the company," which, Awwad underlines, may negatively affect the research of future financing rounds, even if in the company's interest.[204]

What's more, a pathological use of these clauses against founders and other ordinary shareholders/quotaholders may configure for them a dilution equated to a "progressive expropriation."[205] In this case, like in other instances of expropriation, the company stake is assimilated to a *res*.[206] However, like for the consequences engendered by drag-along provisions, the regulation of conflicting interests is validly entrusted to private autonomy. Nonetheless, the reserve that scholar Awwad has is that, while in the instance of drag-along provisions the situation is equated to a winding up of the company that is equally endured by shareholders or quotaholders, with full ratchet anti-dilution clauses specifically there is no homogeneity of consequences, thus determining an imbalance in the relations among shareholders/quotaholders that has the potential to function as a means of pressure.[207]

[203] Awwad, 2021, p. 190.
[204] *Ibid.*
[205] *Ibid.*
[206] Awwad, 2021, p. 191.
[207] Awwad, 2021, p. 192.

4. The Central Relevance of the Quotaholder: When a Protective Principle Becomes a Constraint

Butturini has argued that despite the law has equated the principle of the central relevance of the quotaholder to that of the contractual relations among quotaholders, very often the latter principle seems to disappear in favor of limitations on private autonomy derived from the former.[208] According to this scholar, on the contrary, central relevance of the quotaholder and contractual relations among quotaholders ought not to conflict with one another, rather, they shall be coordinated under a unitary framework aimed at removing the limitations unjustifiably hindering private autonomy. Otherwise, the paradox set forth is that of a company where the quality of quotaholder can represent a constraint for the quotaholder herself.

As already noted, Agstner et al. argue that the *Srl* that came out of the 2003 company law reform was catered exclusively around the interests of entrepreneur-quotaholders, with the pre-eminence that the principle of the central relevance of the quotaholder would have gained as a consequence, a principle soon elected as normative fulcrum of the limited liability company type. Notwithstanding their critique, it is worth noting that this is a protective principle, one that is attached to the subjective relevance of the quotaholders in a limited liability company type, a subjective relevance that would characterize it and distinguish it from the corporation type, *Spa* (once again, the so-called typological argument). The way in which said principle of the quotaholder's central relevance is declined entails that, whenever there is a modification that affects the quotaholders in their interest in maintaining unaltered their mutual rights and weight

[208] See Agstner et al., 2020, p. 368, footnote 54.

within the company, such change requires a unanimous consent or, at the very least, the consent of the quotaholders affected by the modification.[209]

In particular, this emerges from article 2481-*bis* of the Italian Civil Code, which establishes mandatory pre-emptive rights in case of capital increase unless differently provided in the operating agreement, but in any case the quotaholders' right of withdrawal (except in the circumstance of losses bringing the capital below the legal minimum). Among other articles of the Italian Civil Code where the principle also emerges, we find: article 2481-*ter* – which establishes, in case of free capital increase by means of allocating reserves to capital, that the quotaholding position of each member shall remain unaltered; article 2482-*quarter* – which establishes, in case of capital reduction due to losses, that the quotaholding position of each member shall remain unaltered together with each member's respective rights; article 2468, paragraph 4 – which requires, for modifying individual quotaholding rights, the consent of the affected quotaholders, a provision that can be derogated from if the operating agreement so provides, in which case the prescribed consent is substituted by granting the quotaholder a right of withdrawal pursuant to article 2373; article 2466, paragraph 2 – which establishes the auction sale of the defaulting quotaholder's quota instead of having a pro-quota assignment to the other quotaholders, unless explicitly provided in the operating agreement. Particularly indicative of and significant for said principle are, additionally, articles 2473 and 2473-*bis*, which establish that, in case of withdrawal or exclusion of a quotaholder, her quota can be purchased by a third party *exclusively* upon unanimous consent of the other quotaholders.

However, the new paradigms resulting from the reformative interventions of 2012-2017 seem inadequate in face of the norms contained in the Italian Civil Code that are still informed by

[209] Agstner et al., 2020, p. 393.

the idea of a "partnership with limited liability,"[210] examples of which were just provided. In fact, these norms are incompatible with the ever so present need for a legal discipline that may be derogated from by the private autonomy of the parties, either in the company's operating agreement or in the quotaholders' agreement, when other types of interests deserving of protection emerge.

5. The Relation Between Anti-dilution Provisions and Leonine Pacts

Interestingly, Agstner et al. ask whether a further obstacle to the reception of anti-dilution provisions employed in VC practices is represented by the doctrine that sees the prohibition of leonine pacts, enshrined in article 2265 of the Civil Code for "simple companies" (*società semplici*), as a general principle of company law, one therefore applicable to all company types.[211] Somewhere in the middle between a conservative and a progressive reading is the scholarship judging only weighted average anti-dilution provisions as non-elusive of the prohibition contained in article 2265, for a certain degree of dilution would still be endured by founders, VC investors, and new subscribers alike; whereas full ratchet clauses would transfer the cost of every single decrease in the company value to the non-beneficiary shareholders/quotaholders.[212]

According to Agstner et al., on the other hand, either anti-dilution clause – whether full ratchet or weighted average – does not violate the prohibition of leonine pacts.[213] Indeed, instead of a constant and absolute exclusion from the company profit or losses, as the relevant case-law

[210] For reference see Agstner et al., 2020, p. 396.
[211] Agstner et al., 2020, p. 429.
[212] See Awwad, 2021, p. 181, footnote 19.
[213] Agstner et al., 2020, p. 422.

has clarified needs to be the case for the provision to fall under the scope of a leonine pact, in case of anti-dilution provisions, one should more properly speak of a transfer of the business risk.[214] Specifically, the dilution undergone by the founders in place of VC investors benefitting from these provisions would be attributable to the founders' poor management of the company, and wouldn't amount to an *a priori* agreement to prevent the investors from losing their investment should the company do badly.[215] Notwithstanding that, Italian case-law has also notably downsized the operativity of the leonine pacts prohibition (illustrative of this has been *Cass. N.17498/2018*).

For scholars Agstner et al. the financial flexibility needed for startups or innovative SMEs is clearly incompatible with interpretations that excessively dilate the prohibition of leonine pacts. Their argument goes as follows: a different allocation among investors and founders of the business risk results is not a leonine agreement.[216] Indeed, in this event, there is no absolute exclusion from the company losses, preventing *ex ante* any partition of the economic result of the enterprise – rather it'd simply be a non-proportional partition of risk.[217] In effect, should the business not go so well, the investor would still *lose the value of her investment* and, even though she may recoup the value of her contribution thanks to liquidation preferences, this does not amount to realizing, *ex ante*, the situation sanctioned by the prohibition.[218]

Additionally, Agstner et al. do not adhere to the thesis according to which at the base of the prohibition of leonine pacts is the necessity to avoid a dissociation between risk and power, such that the legitimacy of anti-dilution clauses would be contingent on a total exclusion of the beneficiary from any form of administration of the company.[219] *Contra* is de Luca's note to *Cass.*

[214] For reference *Ibid.*
[215] This thesis emerges from Agstner et al., 2020, p. 422; p. 430.
[216] Agstner et al., 2020, pp. 429-430.
[217] See Agstner et al., 2020, p. 430.
[218] *Ibid.*
[219] For reference *Ibid.*

17498/2018.[220] The assumption made by this reasoning is that if the beneficiary was given the power to orient the activity of the managers in a direction that is most favorable to her, she'd find herself in a situation of permanent conflict of interests, and she'd be more prone to an irresponsible exercising of her prerogatives, which in many authors' reading (including de Luca's), is the rationale behind the prohibition of leonine pacts.

However, Agstner et al. discard this argument, for they see conditioning the legitimacy of anti-dilution provisions on a hypothetical scenario of abuse of administrative powers as non-justifiable. Not to mention that it'd just further hinder the reception of VC practice in Italy, which is mostly based on contractual instruments that in our system are atypical, but that are representative of interests deserving of protection pursuant to article 1322 of the Civil Code. As a matter of fact, possible abuses by investor quotaholders can be fought against through the many instruments already offered by Italian company law, such as the provisions concerning the abuse of quotaholders' rights, the one on the activity of direction and coordination, and, finally, the one on the liability of managers.

The interpretation maintained by scholars Agstner et al. is at least partly followed by the cited case-law (*Cass. N. 17498/2018*) concerning the validity of put options at a predefined price, on the grounds of 1) positive law's *favor* for the undertaking's atypical financing techniques; 2) of an already intervened disentanglement of the "power-risk" pair; 3) and the qualification of entrepreneur-quotaholders for all the parties involved.[221] This judgment, *Cass. N. 17498/2018*, is inscribed in the case-law current that is more inclined to uphold the parties' private autonomy, especially in consideration of those stakes acquired for investment purposes—and, consequently,

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[220] See DE LUCA, N. (2019). Il Socio "Leone." Il Revirement della Cassazione su Opzioni Put a Prezzo Definito e Divieto del Patto Leonino. *Banca Borsa Titoli di Credito, fasc. 1.* Available from De Jure Banche Dati Editoriali GFL, pp. 1–34.
[221] Agstner et al., 2020, pp. 432-433.

to restrict the inquisition on contractual clauses that is carried out invoking principles or norms whose imperative nature has by now become at least questionable.

In particular, the Supreme Court of Cassation in the judgment n. 17498/2018 ruled in favor of the appeal, presented by the company DeA S.p.A., against the second instance judgment of the Milan Court of Appeal that had confirmed the judgment of nullity of the shareholders' agreement between DeA and the company Sopaf S.p.A.. The agreement between the two companies regarded the concession of a put option in favor of DeA with respect to a company stake amounting to 14,99% of the share capital of Banca Bipielle Net S.p.A.. The first instance judgment (confirmed by the Milan Court of Appeal) had ruled for the nullity of the agreement, judging it elusive of the prohibition of leonine pacts enshrined in article 2265 of the Civil Code. DeA appealed to the Supreme Court to overrule the judgment on the basis of five points of law. In the meantime, some territorial courts were adhering to the course taken by the first and second instance judgments in similar cases, while other courts were veering towards another direction.[222] The Supreme Court ended up upholding the appeal and remitting the judgment to the Milan Court of Appeal.

The Supreme Court recognized the rationale behind the prohibition of leonine pacts, invoked by the judgments of first and second instance as the base for the nullity of the shareholders' agreement, to specifically lie in the safeguarding of the *causa societatis*, and it did so by recalling some of its previous rulings (*Cass. N. 8927, 29 October 1994* and *Cass. N. 1686, 22 June 1963*). In particular, the exclusion of a shareholder/quotaholder from the company profit or losses is seen as contrasting with the general interest in a correct company administration, assuming it would induce such shareholder/quotaholder to lose interest in a profitable management

[222] For reference see de Luca, 2019, p. 3; pp. 21-22.

and to be careless. In simpler words, the prohibition of leonine pacts should be intended as a "norm of necessary responsibilization of the shareholder in face of the powers attributed to her."[223]

However, the Court reiterated how the exclusion from the company profit or losses would need to be a situation that is "constant and absolute" for it to fall under the prohibition pursuant to article 2265 and to reverberate on the *status socii.* In recalling in particular *Cass. N. 8927*, the Supreme Court underlined how the shareholder or quotaholder's exclusion from the company profit or losses represents a situation that is absolute and constant when contained in provisions of the company statute documents. That is because only provisions of the statute documents have a real effect towards the company, whereas provisions contained in extra-statutory documents such as shareholders' agreements (*patti parasociali*) *latu sensu* bear effects only for the parties involved, thus not amounting to any relevance from the viewpoint of the company as a collective entity. However, this "immunity of shareholders' agreements" from the prohibition of leonine pacts is criticized by de Luca, who believes that this conclusion represents a "simplistic solution" and we shall second that in light of the too formalistic approach that this solution entails.[224]

Additionally the Court touched on the subject of the business risk transfer, which, in the scholarly interpretation that this work follows, as said, represents the reason why anti-dilution provisions shouldn't fall under the scope of the prohibition of leonine pacts. With regard to the business risk and a possible violation of the prohibition of leonine pacts, represented, in the case at hand, by the put option in favor of DeA, the Court stated how, "no significance can in this sense be ascribed to the transfer of risk between a shareholder and another or a third party that is purely internal, as long as it doesn't alter the structure and functioning of the social contract."

[223] de Luca, 2019, p. 4.
[224] See de Luca, 2019, p. 6; endnotes 6 and 7; p. 16.

Furthermore, the general clause contained in article 1322 of the Civil Code on freedom of contract and private autonomy subordinates the legitimacy of atypical agreements to the verification that they fulfill interests deserving of protection within the legal system. Indeed, citing one of the Court's previous rulings (*Cass. N. 22950, 10 November 2015*), the positive limit to freedom of contract is to be found in the merit of the interests pursued. The test regarding the merit of the interests pursued, as recalled in *Cass. N. 4628, 6 March 2015*, consists in evaluating the interests that are *concretely* pursued by the parties through the contract. In the case at hand, the Supreme Court proceeded to ratify the parties' agreement, constituting this one a valid exercising of their private autonomy and freedom of contract, in light of both parties also being entrepreneur-shareholders. Regarding the merit of the interest pursued in the financing of the enterprise, the judgment recites:

> In the moment of a company incorporation, or when one intends to proceed with its relaunching by means of a particular economic operation, the contribution of further capital, other than that available to the shareholders who conceived of the project, may become essential, even as a *condicio sine qua non* for the business project that is planned.

Indeed, in such cases, alongside the many financing forms that the lawmaker and business practice have devised, i.e. equity instruments such as preferred stocks, deferred shares, multiple voting shares, etc., or debt instruments like structured bonds, or the numerous financial instruments that can be issued by a company, the parties may still come up with different agreements alongside "the prerogative of exiting the company without this requiring its winding up." Here, specifically, we have the Supreme Court recognizing and validating the exit right of an investor.

In terms of the *favor* of the legal system for a company's atypical financing methods, the ruling also goes on to say how it's been widely highlighted already that the lawmaker, especially after the 2003 company law reform, has veered toward favoring a plurality of funding techniques,

so as to allow the realization or the strengthening of a collective economic enterprise without recourse to the traditional channels of bank lending. That is even truer considering the 2012-2017 reforms and, to this end, the Supreme Court mentioned the example of debt securities and participative financial instruments, as well as the possibility given to startups to create categories of quotas endowed with different administrative and economic rights, or even participative financial instruments provided with administrative rights. On top of that, there is also a normative *favor* for new financing forms in situations of company crisis, as per the provisions of the Italian bankruptcy law.

One of the corollaries important in the context of our discussion is the scission between business risk and power. Indeed, those not bearing the business risk can still be awarded the exercising of certain prerogatives as the case at hand and other instances would have proven (i.e. when it comes to rights of lien on, usufruct, and seizure of the shares). However, de Luca rightfully points out that the norms regarding rights of lien, usufruct, or seizure of the shares do not fail to present some critical issues.[225] Apropos of the "risk-power" pair, the Court underlined how, albeit the prohibition of leonine pacts is often traced back to it under the assumption that the relation between risk and power in the enterprise is indissoluble, the pair has in fact been put in crisis over and over, for example, by participative financial instruments and, more in general, by all the instances where subjects other than shareholders may exert influence over the company governance. Furthermore, the disentanglement of the "risk-power" pair does not necessarily comport that one of the parties will be careless in the exercising of her prerogatives. The ruling reads:

> It is true that in the various instances recalled, one might say that the "risk-power" relation is not always or not entirely excluded: but these instances have been

[225] de Luca, 2019, p. 8; endnote 14; p. 26.

> recalled here because indicative of a trend and development of the legal system that it wouldn't be fair for one to ignore as a general reconstructive canon of the system of limited liability companies [*società di capitali*] and of the principles regarding it in the current historical moment.

With regard to the case at hand, the Supreme Court upheld the agreement between DeA S.p.A. and Sopaf S.p.A. that had recognized a put option in favor of DeA with respect to 14,99% of the share capital of Banca Bipielle Net S.p.A. as a legitimate exercising of the parties' private autonomy and freedom of contract in relation to the purchase operation that involved the bank (Bipielle). Indeed, in the reading given by the Court, the provision of a put option with regard to the Bipielle stake acquired by DeA (and that, in case of exercising the option, was to be bought back by Sopaf at its purchase price plus interests) represented an alternative financing mechanism; as such, the application of the discipline regarding leonine pacts was not justifiable, nor did it comport, by all means, DeA's disinterest in Bipielle's profitable management. As a matter of fact, the transfer of risk that had occurred did not entail the total and absolute exclusion of the investor from the company profit or losses, but it simply constituted a guarantee in exchange for the financial contribution provided in the context of Bipielle's acquisition. As such, as the ruling reads, "it proves to be an interest in the financing of the company enterprise, deserving of protection according to article 1322 of the Civil Code, whose merit is demonstrated by the fact that this participatory financing is correlated to a strategic operation of strengthening and increasing the company value."

As this instance shows us, anti-dilution provisions (under which, as it's been argued, put options may fall *latu sensu*) ought not to pose an issue regarding the prohibition of leonine pacts pursuant to article 2265 of the Civil Code.

6. Remedial Interpretation. A Case for the Negotiability of Exit Rights for the Successful Implementation of Anti-dilution Provisions

In general, the possibility of negotiating exit rights is key to the successful implementation of the protective mechanisms used in VC practice, as we've seen, for instance, with liquidation preferences. Not least, the negotiability of exit rights, especially in the form of the right of withdrawal granted by the discipline of the Civil Code, is essential to the concrete functioning of anti-dilution provisions, whose purpose is that of protecting the value of the investment into the startup against a poor management of the company on the part of the founders.

The quotaholders' right of withdrawal, which is considered non-derogable in the Italian system, pursuant to paragraph 3 of article 2473 of the Italian Civil Code, confers upon the withdrawing quotaholder the right to obtain the reimbursement of her stake, taking into account the market value that such stake holds at the moment of the withdrawal. Additionally, the non-derogable nature outstretches to include the legal criterion for the stake's value appreciation, so that clauses that predetermine the amount owed to the quotaholder in case of withdrawal are invalid if lower than the actual value of the stake.

The matter of the possibility for private autonomy to derogate from the criteria established for the value appreciation of the withdrawing quotaholder's stake in article 2473 has long been debated. Indeed, while the lawmaker expressively allows for such derogations when it comes to the *Spa* (pursuant to letter *f*, paragraph 1, article 2437 of the Civil Code), there is no such explicit solution with regard to *Srl* companies, thus making this possibility all the more controversial.[226] The reason for its contentiousness lies in the assumed imperative character of the right of

[226] For a comprehensive discussion of the right of withdrawal for *Srl* quotaholders see FRIGENI, C. (2020). Il Diritto di Recesso. In IBBA, C., and MARASÀ, G. (eds.). *Le Società a Responsabilità Limitata: Vol. 1.* Milano: Giuffrè Francis Lefebvre.

withdrawal awarded to *Srl* quotaholders by the discipline of the Civil Code (thus, excluding contractual instances provided in the operating agreement). What's more, the assumed imperative nature of the right of withdrawal would seem to outstretch to include the norm establishing the criteria for the value appreciation of the quota with a view to its liquidation. On the other hand, the more "progressive" authors who admit the derogability of the legal criteria for the value appreciation of the quota still maintain the necessary recognition of the right of withdrawal for the dissenting quotaholders[227]—which may still pose a potential issue as far as we're concerned.

Capital increase is one of the terrains that is most likely to yield conflicts among quotaholders, particularly for the tension between VC financing practices and the discipline contained in the Civil Code. When it comes to capital increase for *Srl* companies, indeed, the Civil Code embraces a strong notion of the principle of the quotaholder's central relevance, which includes the interest that quotaholders have in maintaining unaltered their mutual weight within the company.[228] However, according to Agstner et al., the weight that each quotaholder has in the company needs to be the result of free negotiations among the parties.[229] Additionally, the alternative between pre-emptive rights and withdrawal rights dictated by article 2481-*bis* of the Civil Code may culminate in a hold-up issue, with dissenting quotaholders taking advantage of the delicate situation represented by the need to raise capital for the company.

For this reason, scholars Agstner et al. argue for the derogable nature of the article and base their line of reasoning on these grounds: paragraph 1 of article 2481-*bis* of the Civil Code concludes establishing that the quotaholder dissenting from the operation of capital increase shall be granted a right of withdrawal pursuant to article 2473 of the Civil Code, which, on the one hand,

[227] For reference see Frigeni, 2020, pp. 1072-1073.
[228] See Agstner et al., 2020, p. 415.
[229] *Ibid.*

delegates the regulation of the terms and conditions for the exercising of the right of withdrawal to the operating agreement, on the other, it lists the imperative instances in which the right of withdrawal must be recognized, with no mention of operations of capital increase reserved to third parties.[230] Therefore, the literal elements – so the scholars argue – cancel each other out, allowing for the possibility of affirming the derogable nature of article 2481-*bis*, that is, the derogable nature of the right of withdrawal that may thus be subject to the free negotiation of the parties.[231] However, in case this argument may result unconvincing for some, the scholars also prospect the alternative of recognizing the derogable nature of the right of withdrawal in granting the possibility of its *ex ante* renunciation in the operating agreement at the time of company incorporation.[232] On this occasion, the quotaholders would relinquish their abstract right of withdrawal *a priori*, as, in this way, it wouldn't conflict with any general interest or interest of third parties.[233]

Indeed, the imperative nature of the right of withdrawal could have perhaps been justified in the past through the expansive force of the principle of the quotaholder's central relevance, which, as this chapter has hopefully made a case for, is now obsolete after the 2012-2017 reforms. Certainly, from the viewpoint of a startup that – as it is almost always the case – needs to resort to VC funding, the imperative nature of the right of withdrawal in instances of capital increase reserved to third parties essentially amounts to a veto right; whereby a dissenting quotaholder may purposefully hinder the company's recourse to financing rounds that would witness the entry of new investors.[234]

[230] Agstner et al., 2020, p. 416.
[231] *Ibid.*
[232] *Ibid.*
[233] See Awwad, 2021, p. 187.
[234] See Agstner et al., 2020, p. 417.

This specific declination of the right of exit that is the right of withdrawal represents also a substantial impediment to the successful implementation of those anti-dilution mechanisms dear to VC financing practices. Needless to say, the conundrum that a non-negotiable right of withdrawal would lead to may very well contrast with everybody's initial interest in making the procurement of financial resources feasible. Therefore, without an adequate re-interpretation of article 2481-*bis*, such as the one offered by scholars Agstner et al. and elucidated above, the provisions therein contained represent an obstacle to the concrete financing of startups adopting the *Srl* legal form.

Following this analysis, the problem that still remains the most evident is the one posed by paragraph 1 of article 2481-*bis* of the Civil Code. Indeed, the dilution that a non-beneficiary quotaholder may undergo as a result of full-ratchet or weighted average anti-dilution clauses may very well induce her to invoke, just as she would in case of capital increase reserved to third parties, her right of withdrawal, which could fundamentally undermine the functioning of such provisions. For this reason, it is all the more necessary to recognize the non-imperative nature of the quotaholder's right of withdrawal – either making it freely negotiable between the parties, or at least renounceable in the operating agreement at the time of a company's incorporation.[235]

[235] This argument is proposed by Agstner et al., 2020, p. 424.

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