

## Ratchet and conversion of shares

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**The possibility to create shares with a conversion right, specifically used for ratchet mechanisms, is a source of endless possibilities in order to create a fair and evolutive equilibrium amongst shareholders.**

### Description

The *ratchet* is a mechanism consisting of creating shares of a specific category and to which is attached, in case of issuance of new shares at a subscription price lower than that at which these specific shares were subscribed, a right to have these shares automatically converted into a greater number of ordinary or preferential shares, determined on the basis of a ratio between the initial subscription price and the new subscription price.

The basis for this mechanism is thus a conversion system of shares of a determined category into ordinary shares or into another category of shares, without capital increase and therefore through levelling the accounting par value or the nominal value of all shares at the time of said conversion.



### Purpose

The *ratchet* mechanism was originally conceived in a context of « start-up » or « high-growth » companies acting in innovative sectors, where the valuation of the company is generally a sensitive and is not an exact science. The negotiations between the company, the founders and the investors are therefore made easier, as the *ratchet* mechanism makes it possible to protect said investor, should a further investment round show that the valuation of the company at the time of the subscription by said investor was indeed excessive.

The conversion mechanism can however be used for many other purposes:

- the conversion may result in a multiplication but also in a division of the number of shares;
- the conversion of preferential shares may be automatic after a certain period of time;
- the mechanism can be used to ensure the holding by a founding shareholder (s) of a determined percentage of share ownership notwithstanding capital increases;
- the conversion may be conditional upon the achievement of certain milestones by the founders, or the failure to achieve said milestones, etc...

## Lawfulness

This conversion technique is lawful and authorised under Belgian law\*.

Under Belgian law practice, the issuance of warrants has sometimes been preferably used for implementing the conversion. Such instruments have however raised issues where the warrant holder must exercise his/her rights as the value of the company significantly declined. The issuance of warrants is also heavier from a technical point of view and not so much in line with the objectives pursued by the shareholders.

The conversion mechanism may also apply to LLCs (« SRL » / « BV ») under the new Code of Companies and Associations.

## Implementation

In practice, the implementation of the mechanism merely consists of:

- organizing the issuance of a category of shares to which is attached a conversion mechanism should determined conditions be fulfilled;
- empowering the board of directors of the company to have the fulfilment of the conditions, the effective conversion and the resulting amendments to the articles of association in due course recorded in a material deed, pursuant to the initial decision creating the concerned shares.

\* For further details: T. TILQUIN and V. SIMONART, « Le "ratchet" », in *Mélanges J. Kirkpatrick*, Bruxelles, Bruylant, 2004, pp. 275 and foll.

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