



Fundamental Transaction Adjustments in Warrants and Convertible Securities

Convertible debt and equity securities, such as preferred stock, convertible notes or debentures, and warrants, which we refer to collectively as “convertible securities,” are financial instruments with embedded derivatives. Generally, these securities contain antidilution adjustment provisions that are intended to protect the holder or the issuer from the occurrence of a number of events that could affect the value of the instruments. “Standard” antidilution provisions, including provisions related to stock options, stock dividends, and similar transactions, are found in virtually all such instruments. Other antidilution provisions provide adjustments in connection with mergers, acquisitions, other fundamental transactions, and down-round financings. These are less common and may raise problematic accounting issues.

Standard merger adjustment provisions are provisions that simply state that if a merger, acquisition, or similar transaction occurs, the holder of the convertible security will be entitled to receive upon the exercise or conversion of the derivative security the same consideration that the holder would have received had the derivative security been exercised or converted prior to the transaction. They are intended to prevent the holder from being affected differently by the transaction when compared to other security holders of the same issuer. These provisions are features of most derivative securities and generally do not raise any accounting or other issues.

In addition to standard merger adjustment provisions, some convertible securities contain provisions designed to provide the security holder liquidity for its investment and to preserve value for the instruments if the issuer completes a fundamental transaction. We refer to such provisions as fundamental transaction provisions. Fundamental transaction provisions require that the issuer repurchase the convertible securities from the security holder for cash. The cash payment is generally based upon the Black-Scholes value of the instrument at the time the fundamental transaction occurs, but could be based on any agreed-upon valuation methodology. If an issuer with outstanding convertible securities with fundamental transaction provisions enters into a fundamental transaction, the cash payment for each convertible security often will be greater than the value of the compensation that the security holder would have been entitled to had the convertible security been exercised for, or converted into, common stock in connection with the fundamental transaction. This is a result of the Black-Scholes valuation used to calculate the cash payment. The benefit to the security holder is even greater when an issuer enters into a fundamental transaction at a lower valuation than its valuation at the time the convertible security was issued. “Down-round” antidilution provisions, provisions that require an adjustment if the issuer issues additional securities at an effective price per share that is lower than the effective price per share of the convertible security, present similar advantages to the security holder. They are designed to guarantee, to some degree, the value of the convertible securities to the holder in the event of a down-round financing by requiring a decrease in the exercise price, conversion price, or conversion rates of the convertible security.

Fundamental transaction provisions are not new. However, the overriding decline in equity values over the last two years, and a general lack of confidence among investors, have led to increased demand for such protections by

investors in PIPE transactions and similar transactions. In earlier years, issuers generally were in a better position to resist.

The Financial Accounting Standard Board's Emerging Issues Task Force Issue No. 00-19, "*Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in a Company's own Stock*" (EITF 00-19), contains explicit guidance regarding the classification and measurements of warrants and instruments with embedded derivatives. EITF 00-19 has been codified as ASC 815-40 under the new codification of the Financial Accounting Standards Board. ASC 815-40-25-1 & 2 provide that generally, a contract that requires net-cash settlement must be classified as an asset or liability on an issuer's balance sheet. ASC 815-40-25-8 provides generally that if a security has a net-cash settlement requirement that is triggered by an event that is not in the issuer's control, the security must be classified as an asset or liability. ASC 815-40-55-2 indicates that an event that causes a change of control of an issuer is not within the issuer's control and, therefore, a contract that requires net-cash settlement upon a change in control must be classified as an asset or liability. Fundamental transaction provisions require cash payments upon a change of control and, therefore, embedded derivatives containing such provisions should be treated as a liability, not equity, under this guidance.

Fundamental transaction provisions may be broken down into two general categories: those that provide an absolute obligation of the issuer to repurchase the convertible security in connection with any fundamental transaction, and those that require a cash purchase of the convertible security, but only to the extent common stockholders are compensated in cash in connection with the same transaction. Based on the guidance discussed herein, issuers have begun taking the position that an absolute obligation to repurchase a convertible security will preclude equity treatment thereof, but that fundamental transaction provisions that allow the holder of the convertible security to receive the same manner of consideration payable to the common stockholders will not preclude equity treatment. This is consistent with ASC 815-40-55-3, which provides that "if a change-in-control provision requires that the counterparty receive, or permits the counterparty to deliver upon settlement, the same form of consideration (for example, cash, debt, or other assets) as holders of the shares underlying the contract, permanent equity classification would not be precluded as a result of the change-in-control provision." ASC 815-40-55-3 further explains that, with respect to any such provision, "if the holders of the shares underlying the contract were to receive cash in the transaction causing the change in control, the counterparty to the contract could also receive cash based on the value of its position under the contract." Note that the valuation of convertible securities being purchased for cash need not be the same as the valuation of the securities purchased from the issuer's common stockholders. Rather, the focus is on the manner or type of compensation.

In structuring PIPEs, registered directs, and other similar transactions, the parties should be aware of the accounting effects of fundamental transaction provisions. Many investors that would otherwise require such a provision understand the burden that issuers face in treating convertible securities with embedded derivatives as liabilities, and may be willing to forgo such protection. However, some investors demand such provisions regardless of the accounting effects for the issuer. An issuer that would prefer not to provide such a provision but feels compelled to do so by investors may be able to avoid liability treatment for the convertible security by including a provision that only provides a cash payment for a fundamental transaction if, and to the extent that, the common stockholders are paid in cash. Issuers should also consider limiting the definition of fundamental transaction in the security. Although it may not help the accounting treatment, issuers may consider limiting the definition of fundamental transaction to include only cash-only mergers, going-private transactions, or transactions in which the stockholders are compensated in securities that are not publicly traded. In any event, an issuer should vet these issues with its external auditors or other accounting experts to ensure they understand the accounting implications before finalizing the terms of any offering of convertible securities, including those issued in PIPE transactions, registered directs, and similar transactions.

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