

ANTI-DILUTION PROVISIONS IN DOWN-ROUNDS

Recently, we have seen companies execute financing deals for which the fair value accounting implications were not properly understood until after deal execution. Worse yet, we have seen situations in which companies were required to restate their financials because they did not properly apply fair value accounting for certain financings with down-rounds. Companies need to understand down-rounds to determine whether they need fair value accounting.

The objective of this alert is to raise awareness of down-round price protection, a provision that may be unknowingly buried in legal documents related to the company's financing activities and which may trigger, for example, liability treatment and fair value accounting of certain freestanding warrants.

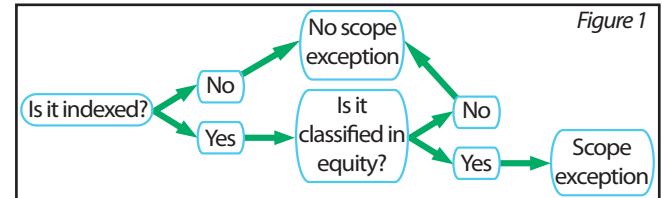
Whenever a company issues equity, a dilution of ownership occurs. Investors do not generally care about dilution as long as stock prices are climbing. But during an economic downturn, a company might issue shares at a price lower than that of a previous issuance (for example, if a company issues preferred shares at \$6 per share in 2007, then in 2008 issues preferred shares at \$5 per share). This is a "down-round".

Down-rounds not only cause dilution of ownership but dilution of investment value. They are more common during economic downturns as companies seek to attract new investment. Down-rounds became more common after the tech bubble burst, and we are now observing another surge in this type of financing. Prior-round investors may have the right to price protection in a down-round. Such protection may be found in issuances of preferred shares, convertible securities, warrants, or rights with warrants. Whenever price protection occurs, common share holders usually suffer most, as they are not protected.

ASC 815 (IN WHICH RESIDES EITF 07-5)

EITF 07-5, *Determining Whether an Instrument (or an Embedded Feature) Is Indexed to an Entity's Own Stock*, which now resides within subtopics 40 and 10 of ASC 815, *Derivatives and Hedging* ("ASC 815-40/10"), became effective January 1, 2009, for calendar year companies. This guidance applies to any freestanding financial instrument or embedded feature that has all the characteristics of a derivative when trying to determine whether it is exempt from treatment as a derivative per ASC 815-10-15.

Down-round price protection is an embedded feature that should be evaluated, first under ASC 815 to determine whether it meets all the characteristics of a derivative, then, if it does, under ASC 815-10-15 to determine whether it meets a scope exception for being accounted for as a derivative. The following figure illustrates the application of ASC 815-10-15.



How can you tell if your down-round price protection is indexed? ASC 815-40/10 established a two step method for evaluating whether equity-linked financial instruments or embedded features are indexed to a company's own stock:

1. Evaluate any contingent exercise provisions
2. Evaluate settlement provisions

The second step generally comes into play with down-rounds. An instrument or embedded feature can only be considered indexed to a company's own stock if the settlement provides that the company will receive or deliver a fixed number of its own equity instruments in exchange for a fixed amount of cash or other financial asset. The key word is "fixed." While there are exceptions, if the strike price or number of shares used to determine settlement are not fixed, the instrument or embedded feature would not generally be considered indexed.

Note that ASC 815-40/10 does not address whether the instrument or embedded feature is classified as equity, but only if the item is indexed for purposes of the first part of the scope exception in Figure 1. If the instrument or feature is deemed indexed, it should still be evaluated in light of other guidance to determine its balance sheet classification before making a final scope exception determination.

SAMPLE LANGUAGE

Conversion Option

If ABC Company, at any time while any of the securities are outstanding, issues or sells (1) any common stock at a price per share that is less than the applicable conversion price then in effect or (2) any common stock equivalents that entitle the holder to subscribe for, purchase or exercise a conversion or exchange right for, shares of common stock at price per share of common stock that is less than the applicable conversion price then in effect, then the applicable conversion rate then in effect shall be adjusted to equal the adjusted conversion rate.

Warrant #1

If the Company shall issue, or be deemed to issue, any additional shares of common stock other than excluded stock for a consideration per share less than \$X (excluding subdivisions, stock dividends, combinations, reclassifications and reorganizations which are specified herein), the warrant price shall be reduced concurrently with each such issuance to the price per share for which such additional shares of common stock were issued.

Warrant #2

If, at any time while this warrant is outstanding, the Company issues common shares, rights, warrants, or securities convertible into common shares which entitle the holder to acquire common shares at an effective price per share that is less than the exercise price in this offering, the exercise price shall be reduced to equal the effective price.

ACCOUNTING EXAMPLES

Freestanding warrants with down-round protection should be classified as a liability and measured at fair value through earnings. A freestanding warrant with down-round protection that is classified as a liability may not always have all the characteristics of a derivative. For example, a nonpublic company whose shares are not readily convertible into cash may issue a warrant with a down-round provision that does not permit net settlement. Such warrants are generally treated as though they do have all the characteristics of a derivative.

For convertible debt and convertible preferred stock, the embedded conversion option would be bifurcated as a derivative and measured at fair value through earnings. Note there are some cases in which an embedded conversion option subject to down-round protection would not be bifurcated as a derivative. In such situations, the contingent reduction in conversion price is considered a contingent beneficial conversion feature under ASC 470-20 (in which resides old EITF 98-5 and EITF 00-27).

IMPACT

If the instrument or embedded feature is deemed indexed, then it is not scoped out of ASC 815-10-15, and it must be treated as a derivative. As such, the instrument or feature should be fair valued through earnings at each reporting period.

In the context of down-rounds, an embedded feature that is not deemed indexed should be bifurcated as an embedded derivative and, in the case of freestanding warrants, be classified as a liability (as the company is liable on day one to make good on its price protection). The host contract should be evaluated separately under both ASC 815-10-15 (old FAS 133 11a) and ASC 815-40/10 (old EITF 07-5).

FOR MORE INFORMATION PLEASE CONTACT

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