

**WARRANTS:
Key Issues and Current Practice**

By

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Due to senior lenders tightening the credit market over the past year, junior capital is playing an increasing role in the capital structure. With the increased need for junior capital and the increased risk to be borne by junior lenders, warrants are again becoming a common component of mezzanine financing transactions. We, therefore, thought this to be an appropriate time to review some of the key issues related to warrants - namely dilution protection and put rights, change of control rights and the original issue discount. Warrantholders, of course, also need to consider various other rights as putative equity holders, such as tag along and voting rights, though we will address those considerations in a future article.

Dilution of Warrant Value

A warrant generally permits its holder to purchase a percentage of a borrower's outstanding ownership interest as of the date of the loan transaction. This percentage generally assumes conversion of all current outstanding options or rights to purchase shares (including an agreed-upon management option pool). There are several ways in which a warrant, or the equity interests into which it is convertible, may be diluted. The three primary dilutive transactions are: (1) share splits; (2) the sale of additional equity interests; and (3) distributions of cash or property.

1. *What happens upon a share split or dividend?* A split of the outstanding equity interests of a borrower into a greater number of outstanding interests (*i.e.*, a stock split) or a dividend of additional shares to existing equity holders (*i.e.*, a stock dividend) decreases the value of a warrant by increasing the number of outstanding equity interests without a corresponding increase in the value of the borrower. On the other hand, a combination of outstanding equity interests of a borrower into a lesser number of outstanding interests (*i.e.*, a reverse split) artificially inflates the value of the warrant by decreasing the outstanding equity interests without a corresponding decrease in the value of the borrower. Because a warrant is generally exercisable for a specific number of shares or based on a set percentage of the outstanding equity interests of the borrower on the date of issuance of the warrant (rather than on the date of exercise), the warrant or other related documents must provide that, in the case of stock splits, stock dividends, reverse splits or similar recapitalization events, the number of equity interests into which the warrant is convertible upon exercise is increased (or decreased) in proportion to all such recapitalization events. This type of provision is included in all warrants and should not be controversial.

2. *What if the borrower subsequently issues additional equity after the issuance of the warrant?* Future issuances of shares at a price below the price of the shares on the date of issuance of the warrant dilute the value of the warrant because such future issuances reduce the overall per share value of any share issued at a higher price.

In addition, issuances of additional shares, whether at a higher or lower per share price at the time of the issuance of the warrant, dilute the percentage of ownership of the borrower that the warrant entitles the holder to purchase. A warrant should address each of these types of dilution.

(a) How should you address dilution resulting from future issuances below the price of the shares on the date of issuance of the warrant? Assume that a borrower was valued at \$100 and that, as of the date of the issuance of a warrant for 10% of the borrower, 100 shares of equity interest were deemed outstanding (75 shares outstanding, 15 shares reserved for a management option pool and 10 shares reserved for issuance upon exercise of the warrant). The per share value upon issuance of the warrant is \$1 and the initial value of the warrant is \$10. If on the next day, the borrower sells an additional 100 shares for \$0.50 per share, the value of the borrower is now \$150. With 200 shares outstanding, the value per share is now \$0.75 and the value of the warrant has been reduced to \$7.50. A warrant should protect against this issue by providing for an adjustment based upon either the “weighted average anti-dilution” or the “full ratchet” method.

The “weighted average anti-dilution” method increases the number of shares into which the warrant is convertible by taking into account the average equity value of all shares, including the subsequently issued shares. One version of the formula would be to multiply the original number of warrant shares by a fraction, (a) the numerator of which is the sum of the number of shares outstanding immediately prior to the date of issuance of the additional shares and the number of additional shares issued and (b) the denominator of which is the sum of the number of shares outstanding immediately prior to the date of issuance of the additional shares and the number of additional shares that the aggregate consideration for the total number of additional shares would have purchased at the original per share price. Keeping with our example above and based on the above formula, you would multiply 10 by the quotient obtained by dividing 200 by 150. Thus, the warrant would now entitle its holder to receive approximately 13.33 shares. That number of warrant shares times the new per share price of \$0.75 would result in a current warrant value of approximately \$10, thereby maintaining the correct value of the warrant. Naturally, doing so will dilute the value of the outstanding shares and the management option pool. However, this mechanism is generally viewed as appropriately balancing the rights of the various parties involved.

Another more aggressive, albeit simpler, option, is the “full-ratchet” formula. Rather than adjusting for the average post additional offering equity value, it adjusts the number of shares to be issued upon conversion of the warrant based solely on the price at which the additional equity was sold. Basically, it lets the warrant holder take advantage of the lowest price paid by the purchasers of the additional shares. In our example, the warrant with a value of \$10 could now purchase 20 shares, as the conversion price would be reduced from one dollar to \$0.50. This adjustment mechanism substantially dilutes the holders of outstanding shares in favor of the warrant holder and is generally used only in specifically negotiated circumstances.

(b) Should a warrant provide for preemptive rights? Although issuances of additional shares above the per share price at the time of the issuance of the warrant do not dilute the value of the warrant, such an issuance, as with any future issuance of shares, will dilute the percentage of ownership of the borrower that the warrant entitles the holder to purchase. Preemptive rights permit an equity holder to purchase a number of equity interests in a subsequent offering to maintain the percentage of equity interests such holder held prior to the subsequent offering. As discussed above, a warrant that provides for weighted average anti-dilution or a full ratchet adjustment protects the warrant holder from diminution in the value of the warrant based on an issuance of additional equity interests. However, the weighted average anti-dilution adjustment mechanism does not provide a mechanism for the lender to maintain its proportionate ownership interest in the borrower. Moreover, even a full ratchet adjustment may not assure a warrant holder that it will maintain its proportionate interest in the company (*i.e.*, an issuance of preferred stock excluded from the adjustment mechanism). Continuing our example above and assuming the weighted average anti-dilution adjustment, the warrant holder's original warrant value was maintained at \$10, but, rather than holding a warrant to purchase 10% of the borrower, it only holds a warrant to purchase approximately 6.66% (*i.e.*, 13.33 of 200 rather than 10 of 100). If it is important to the lender to protect its full upside, the warrant or other equity-related documents should provide the holder with preemptive rights to purchase its pro rata amount of the shares issued in any future offering. In considering the importance of preemptive rights, careful thought must be given to whether any decisions were made with respect to voting thresholds for major corporate decisions of the borrower based on the percentage of ownership reflected in the warrant. Preemptive rights are commonly provided for, and generally not objected to, by borrowers. However, some borrowers will seek to avoid limitations on future issuances caused by preemptive rights. Such rights can cause delays for future investments because of the notice and exercise periods provided to the holder and may discourage future potential investors who wish to acquire an entire class of equity interests.

3. *What if the borrower distributes cash or other property prior to exercise?* There are three main alternatives for protecting a warrant holder against the dilution inherent in distributions of cash or property. First, the warrant could simply prohibit distributions. However, this may overly restrict a borrower during the term of the warrant, which tends to be significantly longer than the term of the loan.

Second, the holder could be entitled to receive all dividends and other distributions on a real-time basis as, and when, they are made. Finally, the warrant could provide that dividends and distributions accrue on an ongoing basis, and that, when the holder exercises the warrant, such amounts become due and payable as if the holder had held the underlying equity interests since the date of issuance. Either of these second two options is a reasonable alternative, with the former favoring the lender at the expense of the borrower because the borrower would have to make distributions to the warrant holder rather than retaining the additional cash for corporate growth. Particular care should be paid to any tax distributions made by a pass-through entity, such as a limited liability company, while the warrants are outstanding. Tax distributions are generally treated as

an advance on future distributions (rather than the payment of an actual distribution), and therefore, a borrower will assert that a warrant holder should not receive a distribution based on a tax distribution. In such a case, warrant holders risk being excluded from significant distributions that could be stripping value from the borrower. The organizational document of the borrower must be drafted carefully to properly address all distribution issues.

Put Rights

Any lender holding a warrant desires certainty that its equity interest in the borrower be liquid. Without the power to force a liquidation of the warrant, a lender may find it difficult to model its expected rate of return. Moreover, many lenders have limited duration funds and need to be reasonably assured that they can cash out their investments in a timely manner in order to distribute returns to their investors. While this could be done in any number of ways, a common mechanism is to provide that the warrant holder may, rather than exercising its warrant for the agreed-upon ownership interest in the borrower, require the borrower to redeem the warrant at a particular time and for a price based on a predetermined formula.

1. *When should a warrant holder be permitted to require the borrower to redeem the warrant for cash?* A determination of when the warrant holder should be permitted to require the borrower to redeem the warrant is a factual matter and should be based upon the lender's investment objectives, the borrower's projected growth targets and the term of the loan. In general, a lender will want to be able to exercise its put rights at any time after the loan has matured because that is the initial time horizon for the intended investment. Moreover, after debt obligations are paid in full, a lender may lose most of its control and informational rights over a borrower, leaving the lender, as with any other minority equity holder, in a precarious position.

For the same reason, consideration should also be given to whether prepayment of the loan, whether mandatory, optional or as the result of an acceleration of the loan, should trigger the put right. The inclusion of these provisions is based on a variety of investment-specific decisions.

Additionally, lenders should consider whether certain major events, such as a change of control transaction, should result in the right of the warrant holder to immediately put the warrant to the borrower. Similarly, a lender should carefully consider whether the transfer of all of a particular owner's interest or group of owners' interest (even if such transfer would not result in a change of control) should also accelerate the put right. For example, in an equity sponsored deal, the transfer by a key member of management or all of management (even if substantially less than a majority of the overall ownership of the borrower) may be an appropriate triggering event because the people on whom the lender is relying to run the business no longer have a direct financial incentive for performance.

2. *What price should the borrower pay to redeem the warrant?* Obviously, exact pricing details are deal specific. However, there are a few commonly used methodologies for determining the price to be paid to redeem the warrant. A multiple of EBITDA, based on a trailing twelve-month period or a multiple twelve-month period, is a common pricing formula. Also, a default alternative of fair market value determined by an independent appraiser should be provided. This alternative provides certainty that the warrant holder receives the true value for its warrant in the event that a current or averaging EBITDA methodology is not reflective of value.

Other Issues

1 *What happens upon a change of control, sale of substantially all assets or liquidation?* As noted above, often a change of control transaction will trigger the put right. However, a warrant should also provide for the right of a warrant holder to receive the consideration to be received by other equity holders of the borrower in the event of a change of control, sale of substantially all assets or liquidation transaction. If a holder has not exercised a warrant prior to such a transaction, the equity interests of the borrower may be of little or no value or may not be exercisable at all. The most common way to address this concern is to provide that the warrant holder be treated as having exercised the warrant immediately prior to such event or for the warrant to automatically convert into shares effective immediately prior to such event. Thus, the holder would be entitled to receive its pro rata amount of the consideration received by the equity holders in the transaction. Such a provision is common in warrants and the borrower should not object to it.

2. *What is original issue discount and how does it relate to a debt transaction involving a warrant?* The Internal Revenue Code requires the lender to ratably include the original issue discount of any debt instrument held by the lender in its taxable income. Original issue discount is the excess of the redemption price of a debt instrument over its purchase price. In a transaction involving a debt instrument and a warrant, the Internal Revenue Code requires that the issue price be allocated between the debt instrument and the warrant based upon the relative fair market value of each. Because valuing a warrant in a private company is difficult and because both the borrower and the lender must report the issue price to the IRS, the documentation of the transaction to which the warrant relates should allocate the value of the overall transaction between the debt instrument and the warrant.

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The aforementioned issues, as well as other issues that are relevant to the holder of a warrant (and potential equity holder), must be considered and negotiated and care must be given to ensure that these and the other rights are properly reflected in the warrant, related transaction documents and the borrower's underlying organizational documents.

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