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JUDGMENT CALL

CAPITAL MARKETS *by* **Peter Papagianakis** *and* **Mauro Viskovic**

An ounce of precision

Two recent cases demonstrate how stock splits can greatly diminish the value of poorly drafted warrants

Issuers and investors alike have paid a steep price for failing to carefully review, analyze and negotiate all aspects of a stock warrant. Two cases in particular, both decided in 2001, illustrate the dire economic consequences of failing to include in the warrant express provisions regarding certain reasonably foreseeable contingencies. In one case, Lohnes v. Level 3 Communications, the investor failed to expressly require in the warrant's antidilution provision an adjustment to the exercise price and the number of shares of stock exercisable under the warrant in the event of a stock split.

The issue distributed, as a dividend to its shareholders, one share of stock for each share held as of the record date.

The stock dividend had the same effect as a 2-for-1 stock split, which dilutes the value of each share by 50% while doubling the number of shares previously held by each shareholder.

Thus, the 2-for-1 stock split did not affect the aggregate value or the proportional ownership of the shares held by the shareholders.

If, however, the exercise price for the warrant and the number of shares exercisable thereunder were not adjusted for the stock split, the warrant's value would be significantly decreased.

In this case, the warrant's antidilution provision expressly required a share and price adjustment upon the occurrence of any of five specific events: capital reorganization, reclassification of stock, merger, consolidation, or the sale of all or substantially all the assets or capital stock of the issuer.

In light of the fact that the antidilution provision did not expressly require an adjustment in the event of a stock split, the warrant holder argued that a stock split qualifies as a capital reorganization or as a reclassification of stock.

The court, however, rejected the warrant holder's arguments.

In rejecting the argument that a stock split is a capital reorganization, the court relied on case law and a preeminent legal dictionary.

It cited two cases, one in Delaware and on in New York, that concluded a spinoff-i.e., shares of a corporation's subsidiary that are distributed to the corporate parent's shareholders- did not qualify as a capital reorganization.

In addition, the court found that the legal dictionary defined a capital reorganization as a transaction that causes a substantial change in a corporation's capital structure.

A stock split, on the other hand, is "mere window dressing" whose effect of a corporation's capital structure is much less substantive than that of a spinoff.

Accordingly, the court held that a stock split is not a capital reorganization.

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Next, the court rejected the argument that a stock split qualifies as a reclassification of stock.

Citing two Massachusetts cases, the court found that a reclassification of stock requires a substantial change in the class of stock (for example, changing shares of common stock to shares of preferred stock) or modifying important rights or preferences linked to stock (for example, changing convertible, nonvoting shares to nonconvertible, voting shares).

The court concluded a stock split does not result in such a substantial change and, therefore, it held that a stock split does not qualify as a reclassification of stock.

In another case, Reiss v. Financial Performance Corp., the issuer failed to expressly provide in the warrant a downward adjustment in the event of a reverse stock split.

This case involved an issuer that effected a 5-for-1 reverse stock split: consequently each shareholder became the owner of one-fifth of the original number of shares owned, but the value of each share increased fivefold.

Two warrant holders, however, argued that the numbers of shares exercisable under their warrants were not subject to a proportionate decrease because the warrants did not contain a provisions for a downward adjustment in the event of a reverse stock split.

The holders would realize a significant windfall by having the right to exercise their warrants at the original exercise price, at time when the value of shares had increased fivefold and to obtain a number of shares that would give them a disproportionately higher percentage ownership of the outstanding shares.

The court had to determine whether to imply a provision in the warrant for a contingent event that was not expressly stated in it.

The court decided it would not imply a reverse stock split adjustment provision.

It found that another warrant, issued about one month earlier, did contain an adjustment provision in the event of a reverse stock split.

Therefore, the court concluded, it would not imply a term in an agreement when the circumstances surrounding the formation of the agreement indicated the parties contemplated the contingent event - but did not expressly include it in the agreement.

The court refused to "save [the issuer] from the consequences of its own agreements and its own decision to perform a reverse stock split."

These two cases illustrate that both issuers and investors should exercise extreme care to ensure that their warrants expressly provide for all reasonably foreseeable contingencies affection their rights and obligations under- and thus the value of- their warrants.

Take heed: An ounce of precision could be worth a ton of cash.

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