ALSTON + BIRD LLP

*Executive Compensation Advisory*

Special Alert

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# Discretionary Anti-dilution Adjustments in Equity Compensation Plans May Lead to Unanticipated Compensation Charges

Major accounting firms recently have interpreted the guidance in FAS 123R in a manner that could lead to significant unanticipated compensation charges in connection with equity restructurings. Common anti-dilution adjustments that had no accounting consequences under APB 25 and FIN 44 could result in substantial additional compensation expense under FAS 123R if they are done on a permissive, rather than mandatory, basis. We urge you to examine your stock plans and agreements today, as amendments may be needed to avoid unintended additional charges.

## Key points to note:

- The guidance relates only to anti-dilution provisions that affect "equity restructurings," which are nonreciprocal transactions between a company and its shareholders that cause the per-share value of the stock underlying an option or similar award to change, such as a stock dividend, stock split, spin-off, rights offering, or large nonrecurring cash dividend. It does not relate necessarily to award adjustments in the case of business combinations, such as mergers and acquisitions, which are often lumped in with equity restructurings in a plan's anti-dilution provisions.
- Anti-dilution provisions are designed to equalize an award's value immediately before and after an equity restructuring.
- Illustrations in FAS 123R are explicit that:
  - Making anti-dilution adjustments to an award *in the absence of a pre-existing anti-dilution provision* is a modification to the award, which triggers a fair value comparison immediately before and after the modification. Any incremental value transferred would be recognized as additional share–based compensation expense.
  - Adding an anti-dilution provision to an outstanding award *in contemplation* of an equity restructuring is itself a modification that triggers a fair value comparison immediately before and after the addition of the provision. The pre-modification fair value is based on the award without the anti-dilution provision, taking into account the effect of the contemplated restructuring on its value. Any incremental value transferred would be recognized as additional compensation expense.
  - Adding an anti-dilution provision to an outstanding award *not in contemplation* of an equity restructuring is not treated as a modification and would not trigger any additional expense.

– Effecting a properly-structured, pre-existing *mandatory* anti-dilution adjustment, while still triggering a fair value comparison, should not result in any additional compensation expense.

- **The accounting firms' position appears to be that having a *discretionary* anti-dilution provision has the same accounting effect as not having one at all**. In other words, if a plan provision permits, but does not require, the company to make equitable adjustments to awards in the event of an equity restructuring (i.e., "The Committee *may* make equitable adjustments to prevent the dilution or enlargement of rights . . ." as opposed to "The Committee *shall* make equitable adjustments to prevent the dilution or enlargement of rights . . ."), then when the adjustment is made, it will trigger a fair value comparison immediately before and after the adjustment. The pre-modification fair value will be based on the award without the anti-dilution provision, taking into account the effect of the contemplated restructuring on its value. This can lead to a substantial incremental expense that must be recognized.

  ***For example:***

  > Assume a company announces that it will effect a 2-for-1 stock split when the stock price is $80. Exercising its discretion under a *permissive* anti-dilution provision in its stock plan, the company's compensation committee elects to adjust outstanding options to equalize their value immediately before and after the split. As a result of the adjustment, an option grant for 100 shares with an exercise price of $30 per share will become an option grant for 200 shares at $15 per share. For purposes of FAS 123R, according to the new guidance, the pre-split fair value of the option grant would be estimated based on the assumption that the market price of the company's stock will be reduced to $40 as a result of the stock split but the grant at that time remains an option on 100 shares with an exercise price of $30. The post-split fair value of the option grant would be estimated based on the assumption that the market price of the company's stock will be reduced to $40 as a result of the stock split but the grant at that time has been converted to an option on 200 shares with an exercise price of $15. Based on otherwise identical Black-Scholes assumptions, the pre-split fair value of the option would be significantly lower than the post-split fair value. This incremental difference would be recognized as an additional charge to earnings.

## What should you do now?

We recommend that companies review as soon as possible the anti-dilution provisions in each equity compensation arrangement, including current and older stock plans under which there are awards outstanding. Consider making adjustments to those provisions *before* there is contemplation of an equity restructuring, in order to limit potential compensation expense.

## A couple of words of caution:

- Recognize that by converting to a mandatory adjustment provision, a company is conferring legal rights to award holders that they did not otherwise have.
- The fix may not be as simple as changing "*may*" to "*shall*" in the appropriate paragraph. It is not uncommon for the paragraph in a plan that deals with anti-dilution adjustments to also cover an array of permissive adjustments in the context of business combinations that do not necessarily entail equity restructurings. In amending the plan, be careful not to be overly restrictive in the company's discretion to make equitable adjustments that are not strictly anti-dilutive in purpose. For example, the compensation committee may be able to retain discretion to decide on a case-by-case basis how to treat equity awards in the context of a business combination, as long as the *anti-dilution* effects of those adjustments are non-discretionary.
- Consult with your auditors before making formal amendments to be sure they agree that the amendment is necessary and, if so, that the proposed revised provision is adequate to avoid unintended compensation expense under the new guidance.
- Confirm that a plan amendment to convert a permissive anti-dilution provision to a mandatory one would not require shareholder approval. For most typical anti-dilution provisions, such a revision would not require shareholder approval under either the Nasdaq or New York Stock Exchange shareholder approval rules.
- Consider whether an amendment to plan anti-dilution provisions will apply automatically to outstanding awards, including whether such amendments will require consent of award holders.
- It is not clear whether the revision of an anti-dilution provision (from permissive to mandatory) would be a "modification" of an outstanding award for other purposes, such as Internal Revenue Code Section 409A or incentive stock options.

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If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following Alston & Bird attorneys who contributed to this *Executive Compensation Advisory*:


Mitchel C. Pahl
(212) 210-9512
mitchel.pahl@alston.com

John B. Shannon
(404) 881-7466
john.shannon@alston.com

Michael L. Stevens
(404) 881-7970
mike.stevens@alston.com

Laura G. Thatcher
(404) 881-7546
laura.thatcher@alston.com

Kerry M. Tynan
(404) 881-4983
kerry.tynan@alston.com

David E. Brown, Jr.
(202) 756-3345
david.brown@alston.com

Dennis O. Garris
(202) 756-3452
dennis.garris@alston.com

Gary C. Ivey
(704) 444-1090
gary.ivey@alston.com

Bryan E. Davis
(404) 881-7591
bryan.davis@alston.com

James S. Hutchinson
(212) 210-9552
jamie.hutchinson@alston.com

Mark F. McElreath
(212) 210-9595
mark.mcelreath@alston.com


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ALSTON + BIRD LLP

www.alston.com

**Atlanta:** One Atlantic Center • 1201 West Peachtree Street • Atlanta, Georgia, USA, 30309-3424 • 404-881-7000 • Fax: 404-881-7777
**Charlotte:** Bank of America Plaza • 101 South Tryon Street, Suite 4000 • Charlotte, North Carolina, USA, 28280-4000 • 704-444-1000 • Fax: 704-444-1111
**New York:** 90 Park Avenue • New York, New York, USA, 10016-1387 • 212-210-9400 • Fax: 212-210-9444
**Research Triangle:** 3201 Beechleaf Court, Suite 600 • Raleigh, North Carolina, USA, 27604-1062 • 919-862-2200 • Fax: 919-862-2260
**Washington, DC:** The Atlantic Building • 950 F Street, NW • Washington, DC, USA, 20004-1404 • 202-756-3300 • Fax: 202-756-3333



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