Avoiding Liability Treatment on Warrant Issuances within SEC Guidance and FASB Accounting Standards (ASC 815)

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When developing and maintaining an efficient capital structure, stock warrants may offer companies in various stages of a life cycle a number of advantages. Warrants may be particularly beneficial to companies facing liquidity challenges or choosing to restructure, when common stock may be difficult to price due to volatility. Under such circumstances, warrants packaged with common shares can create additional incentives for investors. However, applicable Financial Accounting Standards Board ("FASB") accounting standards and interpretation of U.S. securities law by the Securities and Exchange Commission ("SEC" or "Commission") present a trap for the unwary, as warrants issued by a public company in a registered offering are often required to be treated as a liability under generally accepted accounting principles ("GAAP"), notwithstanding the common understanding of warrants as a component of shareholders' equity.

GAAP TREATS CERTAIN REGISTERED WARRANTS AS LIABILITIES

Under the criteria set forth in ASC 815, a warrant that requires, explicitly or implicitly, the settlement in registered shares should generally be classified as a liability, not as a component of equity. Determining whether a warrant requires settlement in registered shares necessitates an analysis of both the terms of the warrant instrument and applicable securities laws. In particular, even if the warrant instrument is silent as to whether delivery will be in the form of registered or unregistered shares, the predominant interpretation of securities laws requires issuers to assume that investors in registered warrants have bargained for settlement in registered shares. Because warrants are settled at a future date subsequent to issuance and the Company does not control all of the preconditions to continued S-3 eligibility, the Company cannot guarantee the effectiveness of its registration statement at the time of settlement and therefore, GAAP would normally consider the warrant to be a liability and not an equity derivative, on the theory that the Company would be obliged to cash-settle the warrant in the absence of an effective registration statement or exemption from registration.

The rationale underlying this treatment was articulated in a 2006 speech by Stephanie Hunsaker, the Associate Chief Accountant for the SEC. Ms. Hunsaker commented that warrants should be treated as liabilities that should be marked to market quarterly under GAAP, when an issuer is not in control of "[t]he events or actions necessary to deliver registered shares . . . ."[1] The Commission's guidance, which was ultimately adopted by accounting firms as authoritative, explained that there are a variety of situations where the issuer of warrants will not qualify for equity treatment, including (1) "if the warrant agreement requires delivery of registered shares, [and] (2) does not specify how the contract would be settled in the event the company is unable to deliver registered shares . . . ."[2] In situations where a contract either expressly or implicitly requires an issuer to deliver registered shares at settlement, GAAP requires liability treatment on the balance sheet, because "further registration and prospectus delivery requirements . . . are outside of the control of the company."[3]

A COUNTERINTUITIVE AND PROBLEMATIC RESULT

The treatment of warrants as liabilities is highly counterintuitive, as warrants are traditionally thought of as equity instruments, often come attached in units with shares of common stock, and require an issuer to have a sufficient number of authorized shares reserved. The result is also highly undesirable, as warrants classified as liabilities create a costly distraction to a company each quarter, as the changing value of the underlying stock requires the instruments to be marked-to-market, and distorts a company's earnings by creating artificial, unrealized, noncash gains and losses that appear on the income statement. Swings in unrealized gains and losses resulting from mark-to-market accounting treatment will only become more extreme during periods of high stock volatility, thereby potentially exacerbating such volatility. Notwithstanding the tax implications that may ensue, growing companies and those that are strapped for cash are particularly sensitive to unwelcome distortions of the balance sheet, and may choose to forego issuing warrants altogether when it otherwise might be a practical financing alternative.

In addition to such concerns, potential liability treatment afforded to warrants can be overlooked at the time of an offering, and potentially remain unknown until an annual audit following issuance. Issuers eligible for shelf registration on Form S-3 may be tempted to issue warrants available under a previously-filed "universal" shelf registration statement, which will typically include warrants among other potential "off-the-shelf" registered securities. However, issuing warrants pursuant to a universal shelf will ultimately require the delivery of registered shares at settlement, potentially resulting in unwanted liability treatment under applicable accounting guidance.

AVOIDING ADVERSE ACCOUNTING CONSEQUENCES ASSOCIATED WITH WARRANTS

To avoid the adverse consequences of warrant liability treatment, equity treatment of warrants under GAAP can often be retained through a few alternative methods.

PIPE Transactions. One means of avoiding adverse accounting consequences associated with an offering of warrants, would be offering warrants through a private issuance of public equity (PIPE) transaction under Section 4(a)(2) of the Securities Act, notwithstanding the availability of shelf registration. By issuing warrants pursuant to a PIPE, a company will defer registration requirements, and will individually negotiate the instruments with a small number of sophisticated investors. The warrants delivered to investors would be restricted, and therefore only available for resale under limited circumstances pursuant to Rule 144 under Section 4(a)(1) of the Securities Act. Offering warrants through a PIPE will likely ensure that shares settled in connection with the warrants may be unregistered upon delivery, thereby affording them equity-treatment under ASC 815. Companies choosing the PIPE route, will generally need to provide warrant holders with registration rights for the common stock underlying the warrants to provide investors with appropriate liquidity.

Limitations of Warrant Settlement. Another means of preserving equity treatment of warrants is to expressly provide in the terms of the registered warrant that (1) the warrant cannot be exercised except during periods when an effective registration statement is available or (2) the issuer is not required to pay cash if it cannot deliver registered shares upon settlement. These provisions have the technical effect of limiting investors' liquidity, but are otherwise attractive to facilitate an offering of warrants on a registered basis.

Net share Settlement. Another alternative to preserve equity treatment is to provide for "net share settlement" or "cashless exercise" settlement of registered warrants, pursuant to which the exercise price is deducted from the shares delivered upon settlement. Under such a regime, it is arguable that the settlement is exempt from US securities laws since the settlement is not in exchange for new consideration.

If the warrant instrument provides optionality between gross settlement or net settlement, the Company should retain the discretion to choose the method of settlement to preserve equity treatment. If the investor has such discretion, it will likely compromise equity treatment because an investor would have the legal right (if not the practical incentive) to demand a method of settlement that may not be available in the absence of an effective shelf registration.

CONCLUSIONS

While warrants offer companies in need of additional capital an attractive alternative or complement to debt or common equity financing, oft overlooked guidance can result in liability accounting treatment that comes to adversely impact the issuer's balance sheet going forward. Certain issues and considerations are beyond the scope of this brief alert; in the event your company requires assistance on a financing, please contact Kevin E. Manz for additional information and guidance.

[1] Stephanie L. Hunsaker, Speech by SEC Staff: Remarks before the 2006 AICPA National Conference on Current SEC and PCAOB Developments (Dec. 12, 2006), available at https://www.sec.gov/news/speech/2006/spch121206slh.htm/.
[2] *Id.*
[3] *Id.*