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NEW ANTIDILUTION STOCK PLAN AMENDMENT
MAY BE REQUIRED UNDER STATEMENT 123R

As our readers may be aware, outside legal counsel and auditors are alerting companies that the "antidilution" language in their equity compensation plans may need to be amended to avoid a potentially significant accounting cost in the event of a nonreciprocal "equity restructuring," such as a stock split or spin-off. These antidilution provisions either permit or require companies to preserve the value of outstanding equity awards if an equity restructuring occurs. In practice, this most often is accomplished by making equitable adjustments that maintain the outstanding awards' "intrinsic value" and ratio of exercise price (if any) to market price at the time of the transaction.

Companies are being advised to make sure their antidilution plan language is mandatory rather than discretionary, and not to add or modify antidilution provisions "in contemplation" of an equity restructuring. Companies also are being reminded that this issue is limited solely to equity restructurings, and not to exchanges of equity awards in business combinations.

The new accounting rules for equity compensation under Statement 123R treat antidilution adjustments as "modifications" and require additional compensation cost to be recognized for any incremental "fair value" (as opposed to intrinsic value) resulting from the modification. This incremental fair value is measured as the difference between the fair value of the modified award immediately after the antidilution adjustment and the fair value of the original award immediately prior to the adjustment. If the antidilution plan language is not mandatory or is added in contemplation of a restructuring, accountants will value the pre-adjustment award lower than the post-adjustment award, resulting in potentially significant incremental compensation cost.

Statement 123R suggests that "properly structured" antidilution provisions should not result in additional equity compensation cost if the provisions are designed to equalize fair value. However, as noted above, most antidilution provisions are designed to equalize intrinsic value, not fair value. The intrinsic value methodology is perceived to be fair to award recipients and is generally thought to avoid "modification" issues in regard to incentive stock options (ISOs), nonqualified deferred compensation, and stock exchange listing standards. Historically, the intrinsic value methodology also avoided modification accounting that could have resulted in significant compensation cost under the old rules of Opinion 25 and related pronouncements.

In practice, it could be possible for an antidilution provision designed to equalize intrinsic value to produce a modified award with a greater fair value, resulting in incremental compensation cost. This could occur, for example, in a spin-off transaction where the spin-co has a higher estimated stock price volatility and a lower dividend yield assumption than the parent company.

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