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WARRANTS IN BOND-WARRANT UNITS: A SURVEY AND ASSESSMENT

*Henry B. Reiling**

THE publicly owned stock purchase warrant, an instrument of mischief in the early part of this century, has recently reappeared on the American financial stage. The aggressive use of stock purchase warrants in conglomerate financings in the late 1960's suggested to some that the warrant was indeed an irresponsible creation. But more recently, the major 1970 bond-warrant offering by the reputable American Telephone and Telegraph Company imparted a new respectability to the instrument.¹ Moreover, for the first time since the 1930's, the New York Stock Exchange has admitted warrants to trading, and all eleven of the presently listed instruments² were issued by leading companies. The warrant's life cycle in this century—abuse, disuse, misuse, and now a new respectability—makes it appropriate to examine the present implications of its use for the modern financial community.

This Article surveys the warrant in the context of a bond-warrant unit (the typical medium of issuance), and in four main subdivisions assesses (I) the warrant's role in corporate finance, and several major implications and features of its use today for (II) shareholders of the prospective issuer, (III) warrant holder, and (IV) issuer. The present status of the warrant as a highly significant mode of financing requires that particular attention be given to the justification for the issuance of warrants in the light of earlier authoritative criticism, and to the tax consequences and concepts now attending their use. Fortunately, several undesirable features of early warrant use are disappearing because of responsible corporate practice, but certain additional potential abuses need to be foreclosed. Arguably, too,

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1. For \$100 per unit, A.T. & T. offered to shareholders of record on April 10, 1970, rights to purchase a \$100 face amount 8¾% debenture maturing in the year 2000, together with five-year warrants to purchase two shares of common stock at \$52 per share. The total offering involved \$1,569,327,000 in debt and warrants to purchase 31,386,540 shares. In July 1970, underwriters led by Morgan Stanley & Co. sold the unsubscribed units (\$35,931,100 face amount of debt) to the public at \$115.75 per unit. MOODY'S INVESTORS SERVICE, INC., MOODY'S PUBLIC UTILITY MANUAL 1169 (1970).

2. See N.Y. Stock Exchange Transactions, Wall St. J., Dec. 14, 1971, at 33-34; N.Y. Times, Dec. 14, 1971, at 68, 70, 76.

certain concepts and conclusions in the tax area need to be reaffirmed while others should be modified or replaced.

I. ROLE IN CORPORATE FINANCE

In order to identify the premises and framework on which this analysis and its conclusions are based, consideration must first be given to the warrant's characteristics and history, and to the forces contributing to its present popularity.

A. Characteristics

Financial custom has evolved and hardened to the point that a warrant (stock purchase warrant) can be defined as a transferable option created pursuant to an agreement by which a corporation binds itself to deliver corporate securities upon receiving the warrant certificate and a specified consideration (the exercise price) on or before a stipulated date (the expiration date) that is more than one year subsequent to the date of issuance.³ Essentially, then, the warrant is a long-lived option to buy specified corporate securities. For example, in May 1971, Chrysler Financial Corporation issued warrants to purchase 1.8 million shares of Chrysler Corporation's common stock to the public.⁴ Each warrant expired at the end of approximately five years and was exercisable at thirty-four dollars per share, which was roughly ten per cent above the market price ($30 \frac{5}{8}$)⁵ at the time of issuance. Leaving aside considerations of leverage,⁶ it is obvious that the warrant's inherent value depends entirely on the prospect that the optioned security will eventually increase in value beyond the exercise price.

3. See *Bradford v. Crown-Bremson Indus., Inc.*, 255 F. Supp. 1009, 1012 (M.D. Tenn. 1964); *Miller v. General Outdoor Advertising Co.*, 223 F. Supp. 790, 794 (S.D.N.Y. 1963), *revd. on other grounds*, 337 F.2d 944 (2d Cir. 1964); *Tribble v. J.W. Greer Co.*, 83 F. Supp. 1015, 1022 (D. Mass. 1949); J. WESTON & E. BRIGHAM, *MANAGERIAL FINANCE* 647, 649 (3d ed. 1969); Berle, *Convertible Bonds and Stock Purchase Warrants*, 36 *YALE L.J.* 649 (1927).

The terms "warrant" and "stock subscription warrant" are occasionally used as synonyms. This practice is confusing since the latter is also occasionally used as a synonym for "rights" (defined in the text accompanying notes 29-36 *infra*). Happily, the term "stock subscription warrant" appears to be disappearing.

4. These warrants were issued as part of a 90 million dollar financing whereby underwriters sold to the public 90,000 units priced at \$1000 each, with each unit consisting of one 7½% subordinated debenture (face value \$1000) plus warrants to purchase twenty shares of its parent Chrysler's common stock. After approximately three months the warrants could be detached from the debentures and separately transferred. Chrysler Financial Corp., Prospectus, May 11, 1971, at 1.

5. *Id.* at 42.

6. See notes 40-47 *infra* and accompanying text.

Only a modicum of statutory and case law deals with or influences the issuance and characteristics of warrants. For example, the especially relevant Delaware corporation law⁷ does not explicitly mention warrants, although it does expressly authorize the issuance of "rights or options" of any duration.⁸ However, since warrants are options, their issuance is lawful in Delaware.⁹ In Delaware and elsewhere, significant consequences flow from the fact that the owner of an option is not yet an owner of the underlying stock:¹⁰ that is to say, the warrant owner would not have voting rights, rights to dividends, or a claim on assets upon liquidation—unless the warrant agreement itself created such rights. Warrants must be registered along with the underlying stock under the Securities Act of 1933¹¹ and under most state Blue Sky laws.¹² As with other securities, the essential terms and effects must be disclosed; but neither the Securities and Exchange Commission nor such careful state regulatory agencies as those of California and Ohio prescribe terms for the warrant. The investment securities provisions of the Uniform Commercial Code specify no special characteristics for the warrant; its qualification as a "security" is judged by the same criteria as other instruments.¹³

The dearth of law directly influencing the provisions of the warrant¹⁴ permits the relevant parties—the issuer, underwriter, and in-

7. It has been reported that 60,000 to 70,000 companies are incorporated in Delaware. Wall St. J., June 30, 1971, at 1, col. 5. As of Dec. 31, 1966, thirty-five per cent of the corporations whose stock was listed on the New York Stock Exchange were Delaware corporations. Delaware's closest rivals were New York with twelve per cent and New Jersey with six per cent. Arshat & Stapleton, *Delaware's New General Corporation Law: Substantive Changes*, 23 Bus. Law. 75, 93 (1967).

8. DEL. CODE ANN. tit. 8, § 157 (1953). The statutory language "rights or options" could be more precise. Rights are not distinct from options. Rights, warrants, calls and conversion provisions are all options. See notes 29-39 *infra* and accompanying text.

9. *Forman v. Chesler*, 39 Del. Ch. 484, 490, 167 A.2d 442, 445 (1961). See also *Wise v. Universal Corp.*, 93 F. Supp. 393, 395 (D. Del. 1950).

10. See, e.g., *Lisman v. Milwaukee, L.S. & W. Ry.*, 161 F. 472, 477, 480 (E.D. Wis. 1908), *affd. per curiam*, 170 F. 1020 (7th Cir.), *cert. denied*, 214 U.S. 520 (1909). Cf. *Helvering v. San Joaquin Fruit & Inv. Co.*, 287 U.S. 496, 498 (1936) (option to buy real property).

11. 15 U.S.C. §§ 77a-77bbbb (1970); SEC, Securities Act of 1933 Release No. 3210 (April 9, 1947) (letter of Baldwin B. Bane, Director, Corporation Finance Division, regarding registration of certain warrants).

12. See, e.g., CAL. CORP. CODE §§ 25019, 25110 (West Supp. 1972); N.Y. GEN. BUS. LAW §§ 352, 359-e (McKinney 1968 & Supp. 1971).

13. See UNIFORM COMMERCIAL CODE § 8-102(1)(a) & Comment.

14. The listing requirements of the New York Stock Exchange are not law, but they will influence the characteristics imparted to warrants by some issuers. They state, in part, that warrants must be registered, must give a claim on the common stock of the listing company, must not entitle the holder to the privileges of common stockholders (including voting, dividends, pre-emptive rights), and must afford the

vestors—great flexibility in drafting the terms of their contract. On the other hand, financial practice over time has imparted a general profile to warrants.

A warrant typically has the following characteristics:¹⁵ (1) it represents an option on common stock;¹⁶ (2) it possesses a fixed exercise price; (3) it must be exercised with cash; (4) the expiration date is five or ten years subsequent to the date of issuance; (5) it cannot be redeemed by the issuer; (6) it has substantial protection against dilution;¹⁷ (7) it has no voting rights; (8) it has no right to dividends; and (9) it has no claim on assets in liquidation. While instances of voting rights, rights to dividends, and rights on liquidation are virtually nonexistent,¹⁸ there are numerous deviations from the other norms in individual cases. Several issues have lives of fifteen to twenty-five years,¹⁹ and even perpetual warrants are outstanding;²⁰ some issues

usual protection against dilution. New York Stock Exchange, Inc., Company Manual, Sept. 30, 1971, § B6, at B-124.

15. Although the authorities identifying these warrant characteristics relate to publicly traded warrants, these features are also common to privately placed warrants, with two exceptions. First, such warrants possess restrictions on transfer to remain within the "private placement" exemption from registration for "transactions by an issuer not involving a public offering." Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1970). Second, the limited marketability of the privately placed warrant reduces, but does not eliminate, the warrant's leverage value. See note 47 *infra*.

16. In the balance of this Article it will be assumed that the underlying or optioned security is common stock. Any exception will be clearly indicated. The term "common" will often be used as a synonym for "common stock."

17. The warrant agreement typically contains an antidilution provision that operates on the theory that the warrant holder has a claim similar to that of a common stockholder rather than a claim on a fixed percentage of the company. The warrant's claim on common increases when stock dividends or stock splits occur, or when common is made available at less than the exercise price. Ordinarily there is no protection against dilution caused by the issuance of common at less than the warrant's exercise price pursuant to employee stock option plans. See, e.g., The Greyhound Corp., Consent Statement, January 17, 1970, at 80-82 (agreement with General Host Corp. involving Armour & Co.).

18. Arguably, the so-called Series C convertible preferred stock of Kinney Services, Inc., can be styled a voting, dividend-receiving warrant with liquidation rights. Each share of the convertible preferred is entitled to a dividend of five cents per share per year, and it has one-half vote per share. The stock does not permit the acquisition of common during the first six months, but for the next ten years stock can be acquired in either of the following two ways: each share plus \$37 entitles one to a share of common; sixteen shares of Series C entitle the holder to one share of common (no cash is required). After ten years, the warrant feature expires, and common can be acquired only by tendering sixteen shares of Series C. The stock is redeemable, but redemption (at \$2.50 per share) cannot take place for ten years. STANDARD & POOR'S CORP., STANDARD CORPORATION DESCRIPTIONS F-K 8206 (June-July 1971) [Hereinafter STANDARD CORP. DESCRIPTIONS].

19. E.g., Lerner Stores issue of August 1967 (fifteen years), *id.* at L-O 1767 (Dec. 1971-Jan. 1972); Frontier Airlines issue of March 1967 (twenty years), *id.* at F-K 6940 (Feb.-March 1972); Rapid American issue of February 1969 (twenty-five years), *id.* at P-S 7187 (Dec. 1971-Jan. 1972).

20. E.g., Tri-Continental issue of December 1929, *id.* at T-Z 3969 (Feb.-March 1972).

represent a claim on common stock of the issuer's subsidiary or parent;²¹ a few early issues gave a claim on preferred stock; an occasional issue can be called and redeemed by the issuer for a small cash payment;²² and often a warrant will be exercisable at prices varying either upward²³ or downward,²⁴ or by tendering designated outstanding bonds instead of cash.²⁵ Warrants usually trade initially²⁶ on the basis of one warrant per share,²⁷ and they are rarely exercised in advance of the last few days of the warrant's life.²⁸

Conventions of the financial community differentiate warrants from three similar types of options: stock purchase rights, calls, and the conversion feature inherent in convertible securities. A stock purchase right is a written instrument evidencing a privilege that

21. *E.g.*, Chrysler Financial Corp. issue of May 1971, note 4 *supra* and accompanying text.

22. In May 1970, Cayman Corp. issued 100,000 units priced to the public at \$14.50 per unit and consisting of two shares of common and one redeemable warrant. Each warrant was exercisable at \$7.50, expired at the end of five years and was redeemable by the company for \$0.50 any time after thirteen months following issue. Cayman Corp., Prospectus, May 1, 1970, at 1.

23. *E.g.*, Indian Head, Inc., warrant issue of May 1965, STANDARD CORP. DESCRIPTIONS, *supra* note 18, at F-K 6793 (April-May 1972). The warrants were initially exercisable at \$20 per share and expire in 1990. The sliding scale contained in the warrant agreement stipulates that at the end of each five-year period subsequent to the issue the exercise price increases by \$5. Thus, for instance, from 1985 to 1990 the exercise price will be \$40.

24. *See, e.g.*, Wilson Sporting Goods Co., Prospectus, Oct. 22, 1968, at 23. The company reserved the right to reduce the warrants' exercise price (initially \$20.25 per share) on these ten-year warrants by up to one third for not less than twenty-one days.

A provision giving the issuer the right to reduce the exercise price (usually for a limited period of time) is called a "flush" provision. This gives the issuer increased control over its capital structure in that the reduction may prompt exercise of the warrants. Debt or preferred stock might also be eliminated if it can be tendered at par in exercise of the warrants.

25. *See, e.g.*, LTV Aerospace Corp., Prospectus, Aug. 8, 1968, at 22; The Okonite Co., Prospectus, Aug. 1, 1968, at 29-30.

On very rare occasions a warrant is convertible (no cash or security other than the warrant need be tendered) under certain circumstances. For example, MAPCO, Inc., warrants issued in 1964 are exercisable at \$9 per share of common through March 1972; thereafter each warrant may be exchanged for one-half share of common stock, STANDARD CORP. DESCRIPTIONS, *supra* note 18, at L-O 2260 (Aug.-Sept. 1971).

26. Several circumstances typically increasing the number of shares optioned are set forth in note 17 *supra*.

27. *See* New York Stock Exchange, Inc., Company Manual, *supra* note 14, at B-124.

28. A detailed empirical study of warrants listed on the American Stock Exchange found that most remained unexercised until shortly before expiration. S. Kassouf, A Theory and an Econometric Model for Common Stock Purchase Warrants (Ph.D. Dissertation, Columbia University, 1965; Analytical Publishers Co., 1966). *See also* Shelton, *The Relation of the Price of a Warrant to the Price of Its Associated Stock*, FINANCIAL ANALYSTS J., May-June 1967, at 143 (pt. 1), July-Aug. 1967, at 88 (pt. 2). Earlier exercise was found to occur when the common stock appreciated to three or four times the exercise price. *Id.* A major reason for exercising warrants near expiration appears to be the fact that the leverage component of their value, *see* notes 40-47 *infra* and accompanying text, would be lost by an earlier exercise, whereas it can be captured by selling the warrant in the market place.

permits stockholders to purchase shares for a period of days, often at a sum less than the market price at declaration. A major distinction between rights and warrants is the life of the option. Rights generally expire within two to four weeks of issuance,²⁹ whereas warrants expire after a period of a year or more.³⁰ In addition, the exercise price of rights is usually less than the current market price,³¹ but the exercise price of warrants in a public offering is typically equal to or greater than the going price for the common stock.³² Finally, corporations traditionally issue rights separately (unaccompanied by other securities) to existing shareholders at no direct cost to the stockholders,³³ whereas corporations almost always receive consideration for warrants³⁴ and issue them with fixed-income securities as part of an investment unit³⁵ to third parties, who only coincidentally may be shareholders.³⁶ Calls, like warrants and rights, are options to buy stock at a stipulated price, but they typically expire between ninety days and one year from issuance. Moreover, while warrants and rights are issued by the corporation, calls are sold by third parties such as the corporation's stockholders.³⁷ As a consequence of this difference in

29. See A. DEWING, A STUDY OF CORPORATION SECURITIES 414-15 (1934).

30. *Id.* Some statutory law is at variance with financial practice. For example, under the Delaware corporation law, DEL. CODE ANN. tit. 8, § 157 (1953), "rights" and "options" may have any exercise period, and the term "warrant" is not mentioned at all. In case law the terms "rights" and "warrants" are often used interchangeably. See, e.g., *Forman v. Chesler*, 39 Del. Ch. 484, 167 A.2d 442 (1961); *Gibson v. Commissioner*, 133 F.2d 308 (2d Cir. 1943), *petition for cert. dismissed*, 320 U.S. 805 (1944).

31. See B. GRAHAM & D. DODD, SECURITY ANALYSIS 636 (2d ed. 1940) [hereinafter GRAHAM & DODD, 2d ed.]. Unless the rights are exercisable below the going market price, the holder would have little incentive to exercise (other than the retention of his ownership percentage and the avoidance of brokerage commissions) and consequently the financing would fail.

32. In a private placement the exercise price is often below the market price to compensate for the limited liquidity of both the warrant and optioned stock. Cf. note 47 *infra*.

Where the bond portion of the unit is issued at a discount and can be used at face value to exercise the warrants, it can be argued that the effective exercise price of the warrant is less than the stated exercise price. Using this rationale, the exercise price of many warrants in units where the bond can be used to exercise the warrant is less than the common's going market price.

33. There may be an indirect cost extracted by the income tax. See notes 246-49 *infra* and accompanying text.

34. See text accompanying notes 124-30, 197-98 *infra*.

35. B. GRAHAM, D. DODD & S. COTTLE, SECURITY ANALYSIS 656 (4th ed. 1962) [hereinafter GRAHAM & DODD, 4th ed.]; Hayes & Reiling, *Sophisticated Financing Tool: The Warrant*, HARV. BUS. REV., Jan.-Feb. 1969, at 140.

36. The best summary of the differences between rights and warrants appearing in case law is Judge Wyatt quoting Professor Dewing, note 29 *supra*, in *Miller v. General Outdoor Advertising Co.*, 223 F. Supp. 790, 794-95, (S.D.N.Y. 1963), *revd. on other grounds*, 337 F.2d 944 (2d Cir. 1964).

37. B. MALKIEL & R. QUANDT, STRATEGIES AND RATIONAL DECISIONS IN THE SECURITIES OPTION MARKET 6-7 (1969). Naturally, the cost of a call is one parameter affecting the

seller, a warrant, when exercised, affects the corporate balance sheet and operations by generating cash or by eliminating debt, but a call has no effect at the corporate level. The typical conversion feature inherent in a convertible debenture or convertible preferred stock gives the holder the option to acquire a stipulated number of shares of common stock by surrendering the debenture or preferred stock.³⁸ Thus, convertibles, like the warrant, affect the balance sheet. However, unlike the warrant, which is usually exercised with cash and is normally transferable independent of other securities, conversion of a convertible rarely generates cash,³⁹ and the option feature cannot be separated from the debenture or preferred stock.

The leverage possibilities of warrants are one of their prime attractions for investors. A warrant exercisable at twenty dollars has no exercise or intrinsic value⁴⁰ when the underlying common is trading at twenty dollars per share, but if the prospective investor believes the stock's market value will double over the next few years, and if he can acquire the warrants for one dollar each (as we shall see, he probably cannot), a warrant investment will give a dramatically more attractive return than the purchase of common. One thousand dollars will purchase 1,000 warrants for an expected gain of 19,000 dollars when the common doubles.⁴¹ A 1,000 dollar investment in common, on the other hand, would purchase only fifty shares. In this case, the expected gain is only 1,000 dollars.⁴² However, experience has shown that the leverage is rarely as dramatic as portrayed in the

leverage value of a warrant, *see* notes 40-47 *infra* and accompanying text, during the last year of its life. The relationship between the costs of the two types of option would be closest when the warrant's exercise price and the common's market price are close, and the investor therefore does not have to reduce his leverage by paying for any already accrued intrinsic value.

38. *See* A. DEWING, *supra* note 29, at 414. *See also* GRAHAM & DODD, 4th ed., *supra* note 35, at 601.

39. On rare occasions a "convertible" debenture requires a cash payment on conversion. *E.g.*, Nylon Engineering, Inc., 8½% Convertible Subordinate Debentures (Special Series), issued March 6, 1970, due March 6, 1980 (privately placed), Nylon Engineering, Inc., 1969 Annual Report, at 6. This strange security was convertible at \$0.42 per share and the holder was obligated to make additional cash payments of \$5.58 per share.

40. The terms "exercise value" and "intrinsic value" are synonyms used to identify the difference between the exercise price and the market value of the underlying security.

41. One thousand shares of common at \$40 per share equals \$40,000. Since the warrant is exercisable at \$20, it has an exercise value of \$20,000. Subtracting the \$1000 cost of the warrants, the gain is \$19,000 if the warrants are sold. Naturally the holder can exercise the warrant if he so desires. In this event he will receive common stock worth \$40,000 at a cost of \$21,000 (\$1000 for warrants plus \$20,000 exercise price), for a gain of \$19,000.

42. Fifty shares at \$40 per share equals \$2000. Subtracting the \$1000 cost of the common, the gain is \$1000.

above example. Investors attracted by leverage⁴³ will often value publicly traded warrants at between thirty-five and fifty per cent of the exercise price, when the warrant's exercise price and the common's market price are nearly equal and the warrant has a substantial remaining life.⁴⁴ This rule of thumb—which suggests that the warrant in our hypothetical situation would sell for approximately eight dollars rather than one dollar, thus indicating a leverage, premium, or call value of seven to ten dollars⁴⁵—and other more sophisticated valuation techniques⁴⁶ give investors, as well as investment bankers and issuers, a basis for valuing warrants even when the issuer presently has no comparable warrants outstanding, or when the warrants will be part of a private placement.⁴⁷

43. Listed warrants with a life of more than ninety days can be purchased on margin, thereby permitting the especially aggressive investor to add to the leverage already inherent in the warrant. See Securities Exchange Act of 1934 § 7, 15 U.S.C. § 78g (1970), pursuant to which the Board of Governors of the Federal Reserve System issued Regulation T, which governs the extension and maintenance of credit by brokers, dealers, and members of national securities exchanges, 12 C.F.R. §§ 220.1-123 (1972); 2 CCH FED. BANKING L. REP. ¶¶ 32,621-775 (1972).

44. See Hayes & Reiling, *supra* note 35, at 148. When the exercise price and market price diverge, the rule of thumb often used by investment bankers is forty per cent of the exercise price plus or minus (plus, if the common's value is above the exercise price) fifty per cent of the difference between the exercise price and the market price.

These rules of thumb derived from empirical observation summarize the effect of a number of factors, the more important of which are leverage, exercise value, the expectation of the common's future market price, the volatility of the common, the size of the warrant issue and the "thinness" of the market for the warrants, the speculative tone of the market in general, the potential dilution of reported earnings through the exercise of options, dividend yield on the common, the tightness of money (when margin interest rates are high, warrants become relatively more attractive as a leverage medium), and the presence of unusual features such as a redemption provision.

45. The difference between the exercise value of the warrant, *see* note 40 *supra*, and its market price can conveniently be referred to by such interchangeable terms as its "leverage value," "trading value," "call value," or "premium value." There will always be a premium value in the warrant so long as there is sufficient time remaining for investors to recoup the negative intrinsic value, if any, and possibly achieve a capital gain. See Shelton, *supra* note 28, pt. 2, at 93.

46. See S. Kassouf, *supra* note 28; Giguere, *Warrants: A Mathematical Method of Evaluation*, ANAL. J., Nov. 1958, at 17; Samuelson & Merton, *A Complete Model of Warrant Pricing that Maximizes Utility*, INDUS. MANAGEMENT REV., Winter 1969, at 17; Samuelson, *Rational Theory of Warrant Pricing*, INDUS. MANAGEMENT REV., Spring 1965, at 13; McKean, *A Free Boundary Problem for the Heat Equation Arising from a Problem of Mathematical Economics*, INDUS. MANAGEMENT REV., Spring 1965, at 32 (Appendix to Samuelson); Shelton, *supra* note 28; Sprengle, *Warrant Prices as Indicators of Expectation and Preferences*, 1 YALE ECON. ESSAYS 179 (1961); Van Horne, *Warrant Valuation in Relation to Volatility and Opportunity Costs*, INDUS. MANAGEMENT REV., Spring 1969, at 19.

47. Securities issued under the "private placement" exemption, Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1970), generally cannot be immediately resold. SEC Rule 144, 37 Fed. Reg. 596 (1972). The question therefore arises whether the leverage value adheres to privately placed warrants. Given the many factors that influence leverage value, *see* note 44 *supra*, it is reasonable to conclude that the absence of a readily available public market should only affect the amount of the leverage value,

There are three major occasions on which corporations issue warrants.⁴⁸ Each involves the use of the warrant as an adjunct in the transaction. First, and most importantly, warrants are sold for cash to the public or privately placed with institutional investors as part of an incentive-financing package, which consists of one or more warrants and preferred stock, common stock, or, most commonly, bonds.⁴⁹ These warrants are ordinarily nondetachable for a few weeks, but detachable and independently transferable thereafter.⁵⁰ Second, in corporate acquisitions they are issued as part of a financial package in return for outstanding securities of the acquired company.⁵¹ Third,

not its basic existence. Furthermore, the availability of a public market is often only delayed, not foreclosed. Some purchasers have a policy of securing a right to demand registration. See Reiffer, *Restricted Securities from the Point of View of the Potential Buyer*, in *HOW TO USE AND INVEST IN LETTER STOCK* 42-47 (B. Makela ed. 1970).

48. There are two other circumstances of minor significance. Warrants have been issued to stockholders whose other interests are being reduced or eliminated through reorganization under the bankruptcy laws. See, e.g., *In re Erie R.R.*, 37 F. Supp. 237, 247-48 (N.D. Ohio 1940); H. STURGIS, A NEW CHAPTER OF ERIE 17, 25 (1948). On rare occasions warrants have also been sold separately in private placements. E.g., Modular Housing Systems, Inc., INVESTMENT DEALERS' DIGEST, March 9, 1971. In the past few years there appears to have been no instance of a public issue involving only warrants wherein the optioned stock was the issuer's. There have been very infrequent issues involving portfolio stock. See also *Truncate v. Blumberg*, 88 F. Supp. 677 (S.D.N.Y.), *affd. per curiam sub nom. Truncate v. Scully*, 182 F.2d 1021 (2d Cir. 1950) (warrants on parent company's stock issued in consideration of executive employment contracts).

49. The bond-warrant unit is by far the most common of these financial packages. Hayes & Reiling, *supra* note 35, at 139. A distant second in significance is the warrant in combination with preferred stock. *Id.* at 140. Units of common stock and warrants appear least frequently. *Id.*

When an option such as a warrant is issued with a fixed-income security such as a bond or preferred stock, the transaction is often referred to as an "incentive financing" and the option is often styled an "equity option," "equity kicker," or "sweetener." The purchaser of the unit is being given the claim on equity as an incentive to acquire the fixed-income security, which is the dominant capital-producing security, but because of its features and market conditions may be difficult to market by itself. The conversion features in convertible debentures and convertible preferred stock are another type of option on equity or sweetener.

50. The very unusual nondetachable warrant is the equivalent of a convertible security when, as is usually the case, the other security in the unit is the consideration used to exercise the warrant. Immediate detachability is most likely to occur when common is the other security, or when the other security is already publicly traded. The practice of delayed detachment is characteristic of warrants in combination with fixed-income securities. It constitutes an attempt to insulate the elements of the unit from unusual forces while the market gets a "feel" for the new securities and the underwriters complete their distribution. In particular, the practice is directed at blunting the market effect of those who buy the unit to get the warrant and immediately sell the bond, thereby putting downward and perhaps embarrassing pressure (and perhaps costly pressure if the underwriters are "stabilizing" the after market until distribution is finished) on the bond's market price.

51. See, e.g., Gulf & Western Industries, Inc., Prospectus, July 1, 1968, at 1. Gulf & Western unsuccessfully attempted to acquire Allis-Chalmers Mfg. Co. stock through an offer to its stockholders, which included warrants on up to 2.7 million shares of Gulf & Western stock exercisable at \$55 per share.

When used in acquisitions, the warrant is rarely issued by itself. As part of a unit

in connection with an initial or early sales of securities, unseasoned companies often sell warrants at a nominal value to underwriters.⁵²

B. History

The first American warrant, and indeed the first true stock purchase warrant identifiable in Anglo-American finance, was issued by the Illinois Central Railroad in 1852 in conjunction with a sale of bonds to British investors.⁵³ The British origins of warrants are significant. British finance had long evidenced both an appreciation of leverage and the use of options. Indeed, the characteristics associated with warrants and such kindred options on equity as stock purchase rights and convertible securities were extant at an early date. The ancestor of today's convertible security was utilized by the famous East India Company in 1604, when it permitted participants in an early voyage to convert their equity interest into a participation in a subsequent voyage.⁵⁴ Roughly one hundred years later, the use of op-

issued for securities it presents the same basic conceptual questions for shareholders, issuers, and prospective warrant owners as a bond-warrant unit sold for cash.

52. See, e.g., Ikor, Inc., Prospectus, Oct. 1, 1969, at 1; Transmagnetics, Inc., Prospectus, May 27, 1969, at 1. When issued in an underwriting context, warrants usually have lives of only two to five years. In addition, the warrants often are not exercisable for a year or so after the public offering. See, e.g., Transmagnetics, Inc., Prospectus, *supra*.

When warrants are issued to underwriters, the Securities and Exchange Commission usually views the value represented by the warrants as additional compensation to the underwriters. See, e.g., Ikor, Inc., Prospectus, *supra*; Transmagnetics, Inc., Prospectus, *supra*. Because of this compensation dimension, such warrants are outside the ambit of much of this Article. A consideration of the tax treatment of warrants issued to underwriters can be found in Fleischer & Meyer, *Tax Treatment of Securities Compensation: Problems of Underwriters*, 16 TAX L. REV. 119, 141-48 (1960).

53. Putting aside differences in terminology and the presence of a deferred-payment feature, the essence of the financing was that the Illinois Central Railroad sold for \$1000 a unit consisting of one bond with a face value of \$1000 and warrants to purchase five shares of what today would be called common stock. The warrants had an eight-year life, subsequently shortened to three years, and they were exercisable at \$5 per share. See *Van Allen v. Illinois Cent. R.R.*, 7 Bosw. 515 (New York City Super. Ct. 1861). The options on its assessable stock were nevertheless attractive to investors since the "Illinois Central . . . had practically promised in its financial prospectuses that few or no calls would be made on its stock. This promise had been of much importance in inducing British capitalists to purchase Illinois Central Bonds, with which there were stock subscription rights." P. GATES, *THE ILLINOIS CENTRAL RAILROAD AND ITS COLONIZATION WORK* 78 (1934), citing the New York Tribune, June 26, 1852, April 5, 1853.

54. See 2 W. SCOTT, *THE CONSTITUTION AND FINANCE OF ENGLISH, SCOTTISH AND IRISH JOINT-STOCK COMPANIES TO 1720*, at 97-98 (1910).

A subsequent but better-known example of conversion is the request in 1631 by King Charles I of England that the Crown's interest in the New River Company, a London water company, be changed to an annuity; the royal request was honored although no option to convert had either been granted or reserved in the company's charter. 3 *id.* 19-24. Dewing cites this incident as an early example of conversion, A. DEWING, *FINANCIAL POLICY OF CORPORATIONS* 242 n.4 (4th ed. 1941) and the incident has since been ensconced in the literature on convertible securities. The absence of a contractually binding option privilege at the time the owner initially acquired his interest distinguishes these early incidents from present practice.

tions acquired a distinctly modern character. In 1709, the venerable Bank of England introduced what appears to be the first stock purchase rights.⁵⁵ Even the idea of using an equity inducement upon the marketing of a debt issue—the most frequent context in which warrants reach the public today—was successfully tried. In 1698, the Mine Adventurers' Company, owner of a Welsh silver and lead mine, sought to solve working-capital problems by recapitalizing itself. It authorized the issuance of 25,000 units consisting of one par value five-pound, six per cent income bond, plus one nondetachable lottery ticket;⁵⁶ the prizes in the subsequently held lottery were shares of the company's stock. The units were issued to existing stockholders for their stock and were sold by the company to the public at five pounds per unit.⁵⁷

The common use of assessable stock in the seventeenth and eighteenth centuries⁵⁸ operated to postpone the warrant's appearance. Assessable stock took two forms. One permitted directors to call funds from shareholders at the time and in the amount specified in the subscription. The second form required an order from a shareholders' assembly before funds could be called in.⁵⁹ These financing practices made the corporation's access to the promised funds subject to the vagaries of the shareholders' subsequent inclination and ability to pay, but they gave shareholders an investment posture similar to the warrant. The payment of the first installment of the subscription price was comparable to purchasing the warrant. If months or years later a subsequent payment was called, the shareholder could pay if the investment's prospects were attractive. Otherwise the share-

55. The "Old Lady of Threadneedle Street" gave its shareholders the option to increase their holdings of its stock by 15 per cent upon the payment of £15 per share. As with rights today, these "liberties on the call of 15 per cent" expired in several weeks and were publicly traded at a price equivalent to the difference between the issue price of the new and the market price of the old stock. 3 W. SCOTT, *supra* note 54, at 228 & n.2, quoting *The Post Boy*, Dec. 19, 1709.

56. The idea of a lottery with stock as prizes is somewhat astonishing since we have evolved beyond that particular capital-raising device. Such lotteries were, however, not uncommon events in early English finance. See 3 W. SCOTT, *supra* note 54, at 427.

57. The holders of the company's 4800 shares of stock could exchange each share (market value of £17 per share) for either four units or £20 cash. The premium over market was offered since the outstanding stock was to constitute the prizes in the lottery, and the company had to ensure that it would, through either cash or the units, entice a large proportion of the existing stockholders to surrender their stock to the company. As it turned out 4008 shares were exchanged, leaving 8963 units available for sale to the public. Each of the 25,000 lottery tickets gave its holder the chance to win one of 2500 prizes, the prizes ranging from one to fifty shares of the company's stock. 2 W. SCOTT, *supra* note 54, at 444-47.

58. See A. DuBois, *THE ENGLISH BUSINESS COMPANY AFTER THE BUBBLE ACT: 1720-1800*, at 367 (1938); 2 W. SCOTT, *supra* note 54, at 39-40, 217-18.

59. A. DuBois, *supra* note 58.

holder would incur penalty for nonpayment, such as forfeiture⁶⁰ (which was comparable to expiration of the warrant) or loss of dividends.⁶¹ Suits to enforce payment, which, if successful, would have sharply reduced the investor's benefit, were quite infrequent.⁶²

The prospect of assessments in excess of a shareholder's initial payment reduced the attractiveness of long-term options (warrants) on such stock. Absent a specific provision absolving the warrant holder of assessments, the effective exercise price was subject to increase resulting from any assessment between the date of grant and exercise. One may speculate that investors, then as now, would have been unwilling to pay much for a long-term option that in effect permitted the grantor to increase the exercise price in unspecified amounts; the investor's ability to judge future exercise values, and therefore his willingness to impart a leverage value upon the option, would have been limited. Perhaps, too, the corporate incentive to create warrants was obviated by a combination of the attractiveness to investors of the deferred-payment feature of assessable stock and the limited appeal of a long-term option on such stock.

Warrants became an important financial instrument in the mid-1920's.⁶³ By then, American investor interest in fixed-income securities (bonds and preferred stock) had waned as a result of the ravages of inflation⁶⁴ and the observation that bonds and preferred stock did not afford the expected protection in reorganizations.⁶⁵ At the same time, common stocks were appreciating, thereby giving options on common obvious appeal. During that period of speculative excess immediately preceding the panic of 1929, more than twenty per cent

60. *Id.* at 368; 2 W. SCOTT, *supra* note 54, at 14-15.

61. A. DuBois, *supra* note 58, at 368.

62. *Id.* at 368-69. 2 W. SCOTT, *supra* note 54, at 93-95. DuBois states that no common law right of action to enforce a call (assessment) was recognized and that a right to sue, if it existed at all, rested upon the privilege to incorporate granted by Parliament. A. DuBois, *supra* note 58, at 369. One may speculate that the officers of many companies also reasoned that the delay and adverse publicity of litigation would generate funds at too late a date and too high a cost to be helpful.

63. See Garner & Forsythe, *Stock Purchase Warrants and "Rights"*, 4 S. CAL. L. REV. 269-70 (1931). It has been reported that from 1900 through 1915 there was only one instance of a bond-warrant unit financing (1906), and that from 1916 through 1923 there were only twenty-three such instances, with fourteen of these occurring in 1922. W. HICKMAN, *STATISTICAL MEASURES OF CORPORATE BOND FINANCING SINCE 1900*, at 210 (1960).

64. Discussing the causes for the warrant's appearance in the mid-1920's, two pioneer writers on the topic have stated that the purchasing power of a dollar invested in a bond in 1896 had declined to twenty-seven cents by the mid-1920's. Garner & Forsythe, *supra* note 63, at 269.

65. *Id.*

of new bond and preferred financing included warrants,⁶⁶ and some warrant issues, like other securities, acquired astonishing values.⁶⁷ Three factors combined to tarnish severely the warrant's image: the erosion of warrant values during the 1930's and the eventual expiration of the worthless option; the emerging perception that the potential dilution of shareholders' interests by warrants was not adequately appreciated;⁶⁸ and the notoriety of several incidents in which, for questionable reasons, a large number of warrants relative to common stock outstanding were issued.⁶⁹ These factors led investors to prefer less risky securities, and financial managers to disassociate themselves from the public issuance of instruments that were considered mischievous for both shareholders and warrant holders. It was not until the early 1960's, following a period of sustained advance in the stock market, that warrants began reappearing with any frequency.⁷⁰ By 1967, warrants had again become an important financing device.⁷¹ That importance has subsequently increased.⁷²

66. A study by Mr. Clifford C. Keith of new issues of bonds and preferred stock by industrial and utility companies during the eight-month period between June 1, 1928, and January 31, 1929, disclosed that of 120 bond issues 26, or 21.7 per cent, contained stock purchase warrants (28 had conversion features), and of 113 issues of preferred stock 24, or 21.2 per cent, had stock purchase warrants attached (37 had conversion features). Keith, *Convertible Securities and Stock Purchase Warrants*, 2 ROCKY MT. L. REV. 16, 17 n.2 (1929). Hickman reports that from 1924 through 1929 there were 340 instances of bond-warrant unit financings totaling 1.2 billion dollars. W. HICKMAN, *supra* note 63, at 210-11.

67. American & Foreign Power warrants appear to be the most extreme example of extravagant value. With 1.6 million shares of common stock outstanding, the company issued warrants to buy 7.1 million shares of common at \$25 per share. When the price of the common reached 138 in 1929, the warrants had a value of approximately 1.24 billion dollars versus approximately 320 million dollars for the common. The earnings available to the common in 1929 were only 6.5 million dollars. See GRAHAM & DODD, 2d ed., *supra* note 31, at 664-65. The company was recapitalized in 1952 and the warrants were eliminated as having no value, although the company remained solvent. See GRAHAM & DODD, 4th ed., *supra* note 35, at 657.

68. See notes 98-100 *infra* and accompanying text.

69. See, e.g., note 67 *supra*.

70. GRAHAM & DODD, 4th ed., *supra* note 35, at 657. Hickman reports only eight instances of bond-warrant unit financings in the ten-year period from 1934 through 1943. W. HICKMAN, *supra* note 63, at 210.

71. In 1967 public issues of bond-warrant units numbered twenty-six with a value of 304 million dollars, up from eight with a value of 38 million dollars in 1965. In the same year, privately placed bond-warrant units totaled forty-two with a value of 278 million dollars, up from thirty with a value of 164 million dollars in 1965. The 1967 total for all publicly and privately sold issues was sixty-eight, representing a value of 582 million dollars. Hayes & Reiling, *supra* note 35, at 139.

72. See Anreder, *Not Just for Swingers*, BARRON'S, Dec. 7, 1970, at 5, col. 1; FORBES, Feb. 15, 1969, at 26; Berton, *Wall Street Craze: Warrants To Buy Stock Stir Hot Controversy but Win Big Following*, WALL ST. J., May 5, 1969, at 1, col. 6.

The following table gives the volume of bond-warrant units issued from January

C. *The Warrant's Reappearance*

A number of factors coalesced to reintroduce the warrant to contemporary financing. Most of these considerations reflect the demand for all forms of equity options,⁷³ not only units containing warrants. First and most basically, attitudes toward the economy and stock market have been optimistic for the long term, and therefore common stock and options on common stock have had appeal. A second important factor has been tight monetary conditions. Given the scarcity of funds and the attendant high interest rates that have dominated the money markets in the past few years, an option on equity has permitted companies to issue debt at a stated interest rate significantly lower than the rate prevailing in straight debt offerings.⁷⁴ Moreover, as a practical matter, some companies are unable to issue debt in tight monetary periods, even at a high interest rate, without granting an option on equity.⁷⁵ A third impetus for using equity options has been a change in attitude: corporate financial officers and their advisors have desired to utilize more debt in their capital

1968 to August 1971, with statistics compiled under the author's direction from data reported by *Investment Dealers' Digest*:

VOLUME OF BOND-WARRANT UNITS

Year	Public Issues		Private Issues		Total	
	No.	Amount (in millions of dollars)	No.	Amount (in millions of dollars)	No.	Amount (in millions of dollars)
1968	17	243	62	375	79	618
1969	14	290	87	705	101	995
1970	9	1728	81	415	90	2143
1971*	12	326	52	313	64	639

* January through August.

73. The term "equity option" is defined in note 49 *supra*.

74. The low stated interest rate may be desirable for several reasons: to minimize contractual cash outflow commitments, to avoid any suggestion of a weakened credit position which the notoriety of an awkwardly high rate might suggest, or to comply with covenants in some loan agreements that specify the minimum amount by which annual cash inflow must exceed or "cover" annual interest payments.

Note that part of the purchase price in a hybrid financing is being paid for the debt and part for the option feature. The market will demand the same yield from the hybrid debt as from straight debt. See note 125 *infra* and accompanying text. Consequently, it would be incorrect to conclude that the cost of debt capital has been lowered by a hybrid financing.

75. Hayes, *New Interest in Incentive Financing*, HARV. BUS. REV. July-Aug. 1966, at 99.

It has been reported that just prior to the A.T. & T. decision to issue a bond-warrant unit, the Mack Financial debentures of 1990 took dealers two weeks to sell despite a 9½% yield. Chrysler's 8½% debentures of 1995 took nearly as long, and an A.T. & T. affiliate, the Chesapeake & Potomac Telephone Co. of Virginia, had sold only 40% of

structures to further enhance shareholder investments.⁷⁶ The option on equity, or so-called "sweetener," permits this incremental debt to be effectively marketed as subordinated debt.

Another factor that has accelerated the reappearance of options in general and warrants in particular is the unwillingness of investors in new or emerging companies to accept the risks of stock ownership. Debt's superior claim on liquidation is attractive to investors, but the going rate of interest may be an inadequate return for the attendant risk.⁷⁷ The debt-option combination offers the flexibility of a claim on equity should the company prosper, plus some hedge against the company's failure. For dividend-paying companies there are also tax advantages to raising capital with convertible debentures or bond-warrant units instead of convertible preferred or common stock. The new funds will be employed and be contributing to income by the time the option feature is exercised. In the interim, the cost of the money takes the form of interest—deductible for tax purposes⁷⁸—rather than a nondeductible dividend payment.⁷⁹

For some companies, until recently, accounting machinations were another impetus to the warrant's reappearance. Prior to the pronouncements in Accounting Principles Board⁸⁰ Opinion Number

its 8¾% debentures of 2010 when the offering syndicate broke up. See DUN'S REVIEW, May 1970, at 29.

76. Hayes & Reiling, *supra* note 35, at 138-39. The liquidity crisis that hit several companies in 1970, most notably Penn-Central, may delay the trend toward greater use of debt.

77. Theoretically the issuer could keep raising the interest rate on its debt to the point at which lenders would be enticed to assume the risks. Practically, there are severe constraints on this possibility. The issuer and, indeed, the lender will want to minimize interest charges to decrease the prospect of default on interest payments with the attendant possibilities of reorganization in bankruptcy. Accommodating the issuer with an income bond, for example, might be unacceptable to the lender for a variety of reasons, including the reduced probability that interest would be received. In addition, such accommodation might jeopardize the characterization of the funds as debt for tax purposes. Cf. *John Kelly Co. v. Commissioner*, 326 U.S. 521 (1946).

78. See INT. REV. CODE of 1954, § 163.

79. Ignoring considerations other than tax, the individual investor would be indifferent to whether he received dividends (except for the one-hundred-dollar dividend exclusion, INT. REV. CODE of 1954, § 116) or interest. The corporate investor would prefer dividends because of the eighty-five per cent dividend deduction, INT. REV. CODE of 1954, § 243.

80. The Accounting Principles Board (APB) of the American Institute of Certified Public Accountants (AICPA) has the authority to issue opinions on accounting principles that, as a practical matter, constitute a governing standard of professional conduct. The force of these opinions is derived from the fact that the Council of the Institute on October 2, 1964, unanimously adopted a resolution that failure to disclose a material departure from an opinion would be substandard reporting. APB, AICPA, SPECIAL BULLETIN: DISCLOSURE OF DEPARTURES FROM OPINIONS OF ACCOUNTING PRINCIPLES BOARD (1964); APB, AICPA, STATUS OF ACCOUNTING RESEARCH BULLETINS ¶ 1 & app. A (1965) (APB Op. No. 6).

9⁸¹ and Opinion Number 15,⁸² equity options were not reflected in the computation of earnings per share on common stock until the options were exercised.⁸³ An acquisition utilizing preferred stock or debt with equity options enabled the acquiring company to increase its earnings available to common, the numerator in the computation, without increasing the denominator—a weighted average of the number of common shares outstanding during the year.⁸⁴ The aggrandized earnings-per-share figure often contributed quite substantially to an increase in the common's market value.⁸⁵ Today, warrants remain more attractive than convertible securities or common stock in terms of computing earnings per share, but the accounting inducements for their use have been reduced: dilution from warrants now must be reflected, although only as the market price of the stock exceeds the exercise price of the warrant;⁸⁶ in addition, APB Opinion Number 14⁸⁷ requires that bond discount resulting from the issuance of bond-warrant units must be amortized as a deduction from income, thereby reducing the corporation's reported profit.

From the issuer's point of view, the particular force promoting the warrant was the perception that bond-warrant units are a natural extension of the now widely accepted convertible security,⁸⁸ and the related belief that in certain circumstances bond-warrant units offer tax,⁸⁹ cash flow,⁹⁰ and accounting⁹¹ advantages over convertibles.⁹²

81. APB, AICPA, REPORTING THE RESULTS OF OPERATIONS (1966) [hereinafter APB Op. No. 9] (effective for accounting periods beginning after Dec. 31, 1966).

82. APB, AICPA, EARNINGS PER SHARE (1969) [hereinafter APB Op. No. 15] (effective for accounting periods beginning after Dec. 31, 1968).

83. See *Id.* ¶ 8.

84. See AICPA, EARNINGS PER SHARE ¶¶ 5, 7, 8 (1958) (Accounting Research Bulletin No. 49).

85. Cf. Spacek, *Umpiring the Earnings Per Share Results*, NAA MANAGEMENT ACCOUNTING, March 1969, at 9.

86. See text accompanying notes 140-41 *infra*.

87. See APB, AICPA, ACCOUNTING FOR CONVERTIBLE DEBT AND DEBT ISSUED WITH STOCK PURCHASE WARRANTS ¶¶ 13-16 (1969) [hereinafter APB Op. No. 14].

88. Hayes & Reiling, *supra* note 35, at 137.

89. The allocation of cost between the elements of a bond-warrant unit may result in the presence of original-issue discount. See INT. REV. CODE of 1954, § 1232. The issuer may amortize this discount as an interest expense deduction ratably over the life of the bond. Treas. Reg. § 1.163-3(a) (1968). No allocation of value to the conversion feature of a convertible debenture is permitted. See Treas. Reg. § 1.1232-3(b)(2)(i) (1968). The result of this contrast is, in effect, an interest expense deduction in the approximate value of the warrant, whereas the convertible debenture affords no comparable deduction. See note 263 *infra*.

90. See note 132 *infra*.

91. See text accompanying notes 140-41 *infra*.

92. Lavelly, *Comparative Usage of Bond-Warrant and Convertible Bond Issues*, 26 J. FINANCE 796 (1971) (abstract of doctoral dissertation completed at the University of Iowa in 1970).

Furthermore, the warrant may make the debt instrument alluring to a class of investors not historically interested in the issuer's bonds.⁹³ Finally, in certain market conditions—particularly when the outlook is optimistic—the warrant may be more marketable because of its attractiveness to investors:⁹⁴ the exercise price of the warrant can be more easily set at the market price of the common than can the conversion price of a convertible⁹⁵—a feature of at least superficial appeal to investors; the separability of the elements of the bond-warrant unit gives its owner the attractive flexibility to keep one and to dispose of the other element—a feature not available with convertibles;⁹⁶ the usually noncallable character of a warrant allows the holder greater control over its exercise than is available through the typically callable convertible debenture; and the more aggressive investor has the opportunity for a postpurchase leverage advantage in bond-warrant units—in contrast to convertible securities and common stock.⁹⁷

II. SHAREHOLDERS' PERSPECTIVE

A. *Early Criticism of Warrants*

The issuance of warrants has long raised the important and troublesome question whether they serve the shareholders' interest. Graham and Dodd, the ranking authorities on security analysis, were disturbed by the warrant's propensity to sap the market value of com-

93. See DUN'S REVIEW, May 1970, at 29, 30 (quoting Allan G. Mitchell, Vice-President, Finance and Accounting, Philadelphia Electric Co.). Cf. Whittaker, *The Evaluation of Warrants*, INVESTMENT ANALYST (U.K.), Oct. 1967, at 46.

94. A recent tax innovation requiring that cash basis investors annually report as ordinary income a pro rata share of original-issue discount may detract from the future marketability of bond-warrants units. See notes 209-18 *infra* and accompanying text.

95. The interplay between the number of options offered, the market price of the common, and the principle amount of the senior security accompanying the option, favors the bond-warrant unit when the issuer is attempting to limit dilution and respond to the market's desire for an option exercisable near the market price. Because the exercise of a convertible typically exhausts the face amount of the security, the smaller the number of options offered, the higher the conversion price. With warrants, the desired number of options can be made available without driving the exercise price away from the market price of the underlying common.

96. See Hayes & Reiling, *supra* note 35, at 142-43.

97. The Federal Reserve Board presently restricts loans by banks and brokerage houses for the purpose of purchasing or carrying convertible debentures, preferred stock, common stock, warrants, and bond-warrant units; there are no such restrictions on straight debt from which warrants have been detached. For restrictions on credit by brokers and dealers, see Regulation T issued by the Board of Governors, Federal Reserve System, 12 C.F.R. §§ 220.1-123 (1972); 2 CCH FED. BANKING L. REP. ¶¶ 32,621-775 (1972). For restrictions on credit by banks for the purpose of purchasing or carrying margin stocks, see Regulation U, 12 C.F.R. §§ 221.1-120 (1972); 2 CCH FED. BANKING L. REP. ¶¶ 32,811-890 (1972).

mon stock. In their words, "The option warrant is a fundamentally dangerous and objectionable device because it effects an indirect and usually unrecognized dilution of common stock value."⁹⁸ Legal writers in the securities field in the 1920's and 1930's were especially concerned with protecting existing shareholders' rights in accumulated surplus and corporate control; they also noted the absence of an intrinsic or exercise value for the warrants and the related problem of consideration.⁹⁹ As two authorities observed:

The very nature of the warrant is the idea of getting something for nothing. In the hands of non-shareholders, it is a means of "lying low" while others risk money in an enterprise, and then reaping some benefit.¹⁰⁰

More recently, even "practitioners of the warrant, conglomerate chieftans and cynical Wall Streeters have dubbed them 'funny money' and 'Castro pesos.'"¹⁰¹

The foregoing does not suggest either legal liability for issuing warrants or liability for issuing them at improper prices; their issuance is statutorily authorized,¹⁰² and courts have understandably shied away from the difficult problem of valuing warrants.¹⁰³ The commentators do, however, raise the more basic policy question whether issuance should be statutorily authorized at all, and, if so, whether restraints are necessary to forestall abuse and to align the warrant more closely to the shareholders' interest.

At first glance much of the criticism appears to have merit. Consider, for example, the LTV Aerospace bond-warrant unit financing of August 8, 1968. For \$1,000 the purchaser acquired one twenty-year 6 3/4 per cent debenture with a face amount of \$1,000, plus thirty ten-year warrants exercisable at the common's then current market price of \$28.50 per share.¹⁰⁴ By definition, the warrant had no exercise value¹⁰⁵ at issue. It is an understandable—though erroneous—initial impression that the \$1,000 purchase price is the consideration for the bond while little or nothing has been paid for the seemingly worthless warrant. And yet, in exchange, the warrant holder has a "claim" on the values already paid in and created, and

98. GRAHAM & DODD, 2d ed., *supra* note 31, at 645.

99. See Berle, *supra* note 3, at 651, 658-61. See also Garner & Forsythe, *supra* note 63, at 271-74, 277-78.

100. Garner & Forsythe, *Stock Purchase Warrants and "Rights"*, 4 S. CAL. L. REV. 375, 384 (1931).

101. See DUN'S REVIEW, May 1970, at 29.

102. See note 8 *supra* and accompanying text.

103. See *Wise v. Universal Corp.*, 93 F. Supp. 393 (D. Del. 1950).

104. LTV Aerospace Corp., Prospectus, Aug. 8, 1968.

105. The term "exercise value" is defined in note 40 *supra*.

on those to be created by the effects of business effort and chance. For ten years, a portion of the product of the common stockholders' assets are under the claim of the warrant holder. Management has seemingly granted a ten-year free ride.

With the exception of an Erie-type reorganization,¹⁰⁶ Graham and Dodd were quite uncompromising in their condemnation of warrants.¹⁰⁷ On the other hand, Professor Berle concluded that the shareholders were adequately protected. Reasoning that the value of the stock depended upon an accumulation within the surplus account, he was satisfied that if the exercise price was fixed at an ascertainably fair rate at the time the warrant was created, the stockholder had ample protection given the existence of the following three factors: (1) the corporation could distribute the surplus as dividends and thereby preclude the warrant holder from acquiring a right to it when he became a stockholder; (2) the stockholders themselves must authorize the warrants and will therefore have assented to the diminution of their rights; and (3) most importantly, the stockholders were protected by pre-emptive rights.¹⁰⁸

Social values and financial perceptions have advanced since these early writings on warrants and largely destroyed the premises on which they are based. Among other developments, the emergence of federal securities legislation,¹⁰⁹ the enormous growth in the public's ownership of corporate equities,¹¹⁰ and the expansion of legal doctrines giving shareholders greater redress against corporate officers¹¹¹ serve to underline the shift in social attitude in the direction of providing greater protection to investors. A realistic perception of the significance of control also appears to have emerged. The propensity of most shareholders of publicly owned corporations to approve management initiatives¹¹² places effective control in management, and suggests that the control implications of issuing warrants would

106. The optioned stock was that received in the reorganization by former bondholders. See *In re Erie R.R.*, 37 F. Supp. 237, 247-48 (N.D. Ohio 1940).

107. See text accompanying note 98 *supra*.

108. Berle, *supra* note 3, at 658-61. But see *id.* at 665-66 (regarding shareholder authorization of warrants).

109. Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb (1970); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78hh (1970).

110. In 1970 ownership of listed, unlisted, and investment company shares involved approximately 31 million individuals, or 15.1 per cent of the population. As recently as 1952 there were only 6.5 million shareholders, constituting 4.2 per cent of the population. *Share Ownership Goes to New, Big Heights*, THE EXCHANGE, July 1970, at 15, 16-17 (published by the N.Y. Stock Exchange).

111. See, e.g., Fleischer, "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146 (1965); Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 COLUM. L. REV. 1361 (1965).

112. A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 83 (rev. ed. 1968).

be of very limited concern to that great majority of shareholders who did not possess or aspire to a major block of the corporation's stock. In addition, the determination of whether the warrant's terms are fair is now perceived to involve more than an assessment of the exercise price. The life of the warrant is comparable in importance to exercise price.¹¹³ Furthermore, the thesis that stockholders must authorize warrants is also suspect. Today, warrants are statutorily authorized, and shareholders need not approve their issuance unless a charter provision so provides or the optioned stock is governed by pre-emptive rights.¹¹⁴ The historic balance sheet analysis, which focuses on the significance of surplus to stock values, overlooks the significance of dividend policy¹¹⁵ and financial leverage in the capital structure.¹¹⁶ While modern writers disagree about what investors really capitalize as part of the stock-valuation process,¹¹⁷ there has been a definite shift from the balance sheet approach to an assessment of future earnings and dividends. One can generalize that the value of corporate stock is presently perceived to be the present value of all future dividends and future reinvested earnings available to that stock.¹¹⁸ Thus, a comparison of the surplus accounts and market values of IBM, Xerox, U.S. Steel, and Chrysler will show the speciousness of the premise that the value of a stock depends on the surplus account. Moreover, the distribution of surplus solely to thwart the warrant holder would have adverse effects on working capital and corporate momentum that would likely make the cure more painful than the malady.¹¹⁹ Finally, the argument that shareholders are protected by pre-emptive rights loses force when it is noted that a de-

113. See notes 127-32 *infra* and accompanying text.

114. See, e.g., CAL. CORP. CODE § 1104 (West 1955); DEL. CODE ANN. tit. 8, § 157 (1953); OHIO REV. CODE ANN. § 1701.16 (Page 1964).

115. See Miller & Modigliani, *Dividend Policy, Growth, and the Valuation of Shares*, 34 U. CHI. J. BUS. 411 (1961); Friend & Puckett, *Dividends and Stock Prices*, 54 AM. ECON. REV. 656 (1964).

116. See Durand, *The Cost of Capital, Corporation Finance, and the Theory of Investment: Comment*, 49 AM. ECON. REV. 639 (1959); Solomon, *Leverage and the Cost of Capital*, 18 J. FINANCE 273 (1963). But see Modigliani & Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958).

117. Mao identifies four different theories of stock valuation which are based on different assumptions but which are mathematically equivalent under conditions of certainty, rationality, and a perfect capital market. Each focuses on future events and specifically upon either future earnings, the projects generating those earnings, or uses of those earnings. J. MAO, *QUANTITATIVE ANALYSIS OF FINANCIAL DECISIONS* 464-503 (1969).

118. See Miller & Modigliani, *supra* note 115; Wendt, *Current Growth Stock Valuation Methods*, FINANCIAL ANALYSTS J., March-April 1965, at 91. See also E. SOLOMON, *THE THEORY OF FINANCIAL MANAGEMENT* 21-23 (1963).

119. It also seems reasonable to speculate that eliminating surplus by capitalizing it through an increased par value or stock dividends would have no adverse effect on the valuation accorded the optioned common. (The ordinary dilution provisions protect the warrant holder against stock dividends.)

creasing number of shareholders in publicly owned corporations possess pre-emptive rights,¹²⁰ and that shareholders have a pronounced tendency to rubber-stamp management proposals,¹²¹ such as the elimination of pre-emptive rights.¹²² In light of these developments, it seems clear that although the issuance of warrants is authorized by state law, a new conceptual framework is needed to justify that authorization.

B. *Conceptual Framework for Issuing Warrants in Bond-Warrant Units*

The issuance of bond-warrant units presupposes a particular set of circumstances: a company wants or needs funds and is unable or unwilling for good business reasons either to borrow from its banks or to issue senior debt.¹²³ Consequently, it contemplates the issuance of either subordinated debt, equity, or a hybrid security. Within this context, a proper analysis of warrants in bond-warrant units requires that cognizance be taken of two critical premises. First, a *unit* has been sold, and therefore an assessment of the warrant requires consideration of its effect upon its companion component. Second, the desirability of issuing a bond-warrant unit is a relative question: is the bond-warrant unit more attractive, particularly in terms of cash flow, accounting, and risk characteristics, than the alternatives of issuing straight subordinated debt, common stock, or another hybrid security such as a convertible debenture? The early writings on warrants evidence limited sensitivity to these premises and their implications.

The early concern that a warrant holder received something for nothing, or, conversely, that the issuer has given up something of

120. "The battle for the owner's right to subscribe to new issues of common stock, or issues convertible into common, continued unabated in 1969 Proxy statement after proxy statement appeared asking for the elimination of pre-emptive rights, . . ." L. & J. GILBERT, THIRTIETH ANNUAL REPORT OF STOCKHOLDER ACTIVITIES AT CORPORATION MEETINGS DURING 1969, at 208 (1970). The authors identify twenty-five major companies that completely eliminated pre-emptive rights in 1969 and only one whose attempt to eliminate failed. *Id.* at 208-15. In addition, two major companies are reported to have shifted from pre-emptive rights to limited pre-emptive rights, *i.e.*, pre-emptive rights which "exclude from their purview international financing . . . stock issued in connection with acquisitions, and options . . ." *Id.* at 208, 215-16. All twenty-three proxy statement attempts to introduce limited pre-emptive rights in place of no pre-emptive rights were defeated. *Id.* at 216.

121. A. BERLE & G. MEANS, *supra* note 112.

122. The grant of warrants by some issuers to underwriters of an initial public offering also minimizes the control shareholders have over the grant of warrants: the public shareholders may be faced with a *fait accompli*. However, here the potential public shareholder's freedom not to buy is an effective defender of his personal interests.

123. For possible reasons for this situation, see notes 75-76 *supra* and accompanying text.

value and received nothing in return, was unjustified. Illustratively, it is reasonable to suppose that had LTV Aerospace issued straight debt instead of bond-warrant units on August 8, 1968,¹²⁴ the straight debt would have sold at face value and commanded a stated interest rate of approximately 8 1/2 per cent¹²⁵ instead of the 6 3/4 per cent actually paid. Assuming each \$1,000 debenture remained outstanding for its twenty-year life,¹²⁶ this would mean that the issuance of the warrants created savings of \$350 per bond and an after-tax saving of \$175 (assuming a 50 per cent tax rate), or \$5.83 per warrant. Using present-value techniques,¹²⁷ each warrant represents a corporate benefit of approximately \$2.18.¹²⁸ Of particular significance is the fact that this benefit will be received regardless of whether the warrant is eventually exercised, and the additional fact that although there is no reduction in the effective interest rate on the debt portion of the unit, there is an annual reduction in debt burden, which reduces the risk of bankruptcy. In addition, if the company prospers and the common's market price rises above the warrant's exercise price by the termination date, the issuer will obtain an additional cash inflow from the exercise of the warrant. A reasonable present value for the exercise price is \$9.18,¹²⁹ making the total of reduced cash outflow on the amount of the debt and increased cash inflow, assuming exercise, equal to approximately \$11.36.

An alternative and preferable method for assessing the interaction

124. The LTV Aerospace financing of August 8, 1968 is described in the text accompanying note 104 *supra*.

125. From September 27, 1968, through October 29, 1968, the bonds traded separately in a range from 77 to 79¾. Using a value of 79, or 790 dollars, as the market's perception of the bonds' value, it was the market's judgment that the subordinated debt of this company should pay interest at 67.50/790 or 8.54 per cent. With the valuation period beginning seven weeks after issue, the market should have acquired a "feel" for the bond. See note 50 *supra*.

126. The bond might be called, but that presupposes either a meaningful increase in the issuer's credit worthiness or a drop in interest rates generally.

127. For a general discussion of the concept and technique of "present value" see, e.g., J. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 53-55, 57-59 (1968).

128. Because the total saving will occur ratably over a twenty-year period of time, while we wish to assess the benefit as of the date of issue, the sum must be discounted to reflect the forgone return in the early years of the saving deferred until later years. Two alternative discount rates may be applied to this type of investment. Utilizing the company's return on total capital, and assuming the 12% rate experienced in 1968 is a representative opportunity rate, the present value of \$5.83 is \$2.18. A second method is based on the company's cost of long-term debt. Using the 8.5% cost on the debt in the bond-warrant unit, this approach indicates a present value of approximately \$3.00 per warrant.

129. The exercise price of the warrants was \$28.50. Since the warrants had a ten-year life, and since warrants remain unexercised until just before expiration, see note 28 *supra*, the present value of this sum is \$9.18, using a 12% discount rate representing the assumed opportunity rate of the average return on total capital. Using a cost of long-term debt assumed to be 8.5%, the present value of the exercise price would be several dollars higher.

of the warrant and its companion component is to recognize in our example that \$790, its fair market value, has been paid for the bond; the bond has therefore been issued at a discount. The \$210 difference between the \$1,000 cost of the unit and the \$790 paid for the bond has been paid for the warrants. Thus, conceptually and practically, capital has been raised for the corporation by the sale of a distinct security, the warrant; the bond and warrant have been sold together merely to maximize the financing utility. Thus viewed, seven dollars, substantially more than the present value of the interest saved, was received for each of the thirty warrants. Since the financial consequences of exercise remain the same, the combined effect of the warrant's sale and exercise has a present value of approximately sixteen dollars.¹³⁰

From the shareholder's legal perspective, his corporation has received consideration for the warrant in the form of lower interest payments on the debt element of the unit, or, alternatively and more correctly, in the form of an allocated portion of the total cost of the unit. From the shareholder's financial perspective, the gross benefit immediately derived from issuance of the warrant includes a reduced risk of default on interest payments plus a monetary effect which, at a minimum, equals the present worth of the after-tax cash interest payments saved over the period the bond is outstanding. Indeed, the gross monetary effect will often exceed the present value after tax of the interest saved. This effect is maximized when the warrant's leverage value permits it to be sold to investors—who are interested in leverage value, not the interest saved by the corporation—for more than the present worth of the interest saved.

While the foregoing considers the interaction of the elements of the bond-warrant unit, the attractiveness of that unit when compared to financing alternatives must also be considered. There is as yet a limited quantum of financial literature directed to this analysis.¹³¹ Nevertheless, reflection suggests that the issuance of subordinated straight debt will be the most desirable alternative in terms of long-run cash flow effects, providing the risks attending high fixed costs are tolerable and the prospects of corporate prosperity are good.

130. The \$16 is composed of the \$7 received immediately plus the \$9 representing the present value of the exercise price.

Several factors interact to contribute to the difference between the \$2.18 present value, after tax, of the cash interest payments saved and the \$7 for which the warrant was sold. The former is influenced by the corporate tax rate and the discount rate, whereas the latter is not. The latter figure further reflects leverage value, while the former does not.

131. Two articles available in the public literature are Schwartz, *Warrants: A Form of Equity Capital*, FINANCIAL ANALYSTS J., Sept.-Oct. 1970, at 87; Hayes & Reiling, *supra* note 35.

While the various equity alternatives commit the issuer to the sale of varying amounts of equity at a price somewhere between the market price at issuance and a premium of ten to fifteen per cent over market, the use of debt enables the company to reserve the sale of common for the future, when it is hoped that higher prices will prevail.¹³² Under varying combinations of assumptions regarding such

132. To illustrate the interaction of some of the factors relevant to an analysis of the cash flows from the several basic financing plans, assume that the following alternatives were available:

1. Fifty shares of common sold at \$20 per share.
2. \$1000 face amount of subordinated straight debt: twenty years to maturity, 8½% interest.
3. \$1000 face amount of subordinated convertible debentures: twenty years to maturity, 6¾% interest, convertible at \$22 per share (10% over market) into 45.4 shares of common. (A convertible preferred financing, from the issuer's viewpoint, is merely a variant of convertible debenture financing.)
4. A bond-warrant unit consisting of (a) \$1000 face amount of subordinated straight debt: twenty years to maturity, 6¾% interest; and (b) twenty-seven warrants: exercisable at \$20 per share, expiring at the end of ten years. The debenture alone would sell for approximately \$790 to give an 8½% yield. Generating \$210 of value through warrants exercisable at the market price of \$20 would require twenty-seven warrants, using the rule of thumb that warrants will be valued at 40% to 50% of the exercise price when the exercise price and market price are the same and the warrant has a long life. See text accompanying note 44 *supra*.

Now assume that management and its advisors consider it highly probable that the company will prosper and the market will recognize this prosperity to the extent that the issuer's common stock will double in price from \$20 to \$40 per share in ten years and will double again from \$40 to \$80 per share between year 10 and year 20. The following table illustrates the amounts and timing of receipt of the capital made available to the company. (In order to maximize comparability the eventual issuance of fifty shares of common is assumed.)

CAPITAL ACCRUING TO ISSUING CORPORATION
UNDER FOUR ALTERNATIVE FINANCING PLANS

	Year 0	Year 10	Year 20
Common stock	1,000	—	—
Subordinated straight debentures	1,000	—	4,000*
			(1,000)
			3,000
Convertible debentures	1,000	—	368†
Bond-warrant unit	1,000	540‡	1,840‡
			(1,000)
			840

* The \$4000 is raised in year 20 through the sale of fifty shares of common at \$80 per share; \$1000 of debt is retired.

† The \$1000 debenture is converted and 4.6 shares of common are sold at \$80 per share.

‡ Exercise of twenty-seven warrants at \$20 at the end of year 10 generates \$540. The \$1840 is raised in year 20 through the sale of twenty-three shares of common at \$80 per share; \$1000 of debt is retired.

Necessary refinements in the foregoing patterns of cash flow would include the following: reduction of the common stock alternative by the dividends, if any, on fifty shares of stock for twenty years; reduction of the straight subordinated debt alternative

factors as short-term and long-term earnings, volatility of earnings, interest costs, and differences between the number of shares immediately issued and optioned, any one of the equity options—common stock, bond-warrant units, and convertible debentures—can be the more attractive. Certainly, in that narrow area in which the risk of issuing hybrids is tolerable but the risk of issuing straight debt is not, there are situations where, because of the premium paid for the option, more dollars can be raised per share of common issued through options than can be raised directly through the sale of common.

The very legitimate concern about the unrecognized nature of dilution¹³³ remains a significant problem today. Management must be sensitive to dilution when selecting financing alternatives and pricing bond-warrant units; a segment of the investing public (which is large enough to influence market prices) has a myopic view of security valuation that focuses very heavily on short-term trends in reported earnings per share.¹³⁴ Recent APB opinions have addressed the problem of the earnings-per-share calculation. APB Opinion Number 9 required corporations to reflect the dilutive effect of warrants and other claims against equity in a new, supplemental "Fully Diluted Earnings Per Share Figure";¹³⁵ APB Opinion Number 15, which superseded Opinion Number 9, extended this treatment of warrants to "Primary Earnings Per Share" by including "common stock equivalents" in the denominator of the computation and by requiring that warrants be identified as common stock equivalents at all times.¹³⁶ Earnings-per-share data are now computed by a "treasury stock" method: the warrants are treated as if they were exercised at the beginning of the accounting period (or at the time of issuance, if later) and as if the funds obtained were used to

by the after-tax interest cost on 8½% for twenty years; reduction of the convertible debenture and bond-warrant unit alternative by the after-tax interest cost on 6¾% for twenty years; adjustment of the convertible debenture alternative to reflect the possibility that the securities may be converted earlier than year 20 if the investor's after-tax dividend income from the common exceeds the after-tax interest income from the debt, or that the issuer calls the debenture; adjustment of the bond-warrant unit alternative to reflect dividend payments on twenty-seven shares for ten years; the adjustment of each alternative by the application of present-value techniques.

One further refinement would be to emphasize that one does not know with certainty the price of the stock at years 10 and 20. In fact, a range of values is possible at any given date, with varying probabilities that any one value will occur. The dynamics of this and other uncertainties would change the relative attractiveness of the financing alternatives.

133. See text accompanying note 98 *supra*.

134. See Delancey, *A.P.B. Opinion No. 15 (Earnings Per Share) from a Lawyer's Standpoint*, 25 BUS. LAW. 419, 423 (1970).

135. APB Op. No. 9, *supra* note 81, ¶ 43.

136. See APB Op. No. 15, *supra* note 80, ¶¶ 35-36.

purchase common stock at the average market price during the period.¹³⁷ The dynamics of these provisions are such that when the market price remains close to the exercise price, little or no dilution is manifest (no purchase is assumed if its effect would be antidilutive). However, as the market price moves above the exercise price, the potential dilution will be reflected in the earnings-per-share computation.

Supplementing APB Opinion Number 15—and partially compensating for that opinion's limited depiction of warrant dilution—is APB Opinion Number 14, which requires that the price of a bond-warrant unit be allocated between its elements; when this results in the bond being issued at a discount, the discount must be amortized over the life of the bond as an interest expense deduction.¹³⁸ Thus, as provided in APB Opinion Number 14, the issuance of warrants in bond-warrant units affects earnings, and then the reduced earnings are used to compute earnings per share under the procedures set forth in APB Opinion Number 15. These innovations, combined with the percolation effect of information from the security analyst to less sophisticated investors, seem calculated to increase markedly the awareness of potential dilution. Nevertheless, the recognition of potential dilution remains an important topic since the issuance of warrants has no effect on the denominator in the earnings-per-share computation unless and until the stock's market price has moved above the exercise price, and even then the effect will depend upon how far above the exercise price the market price has moved.¹³⁹ Only thoughtful consideration of the issuer's balance sheet and its accompanying footnotes will give a clear picture of the potential dilution from warrants.

An additional and ongoing problem is the need to recognize that accounting principles depict differently the dilution of the several financing alternatives. Whereas the amount of dilution from warrants and the time at which it is shown varies with the common's market price, the sale of common stock immediately increases the denominator in the earnings-per-share computation by the number

137. *Id.* The treasury-stock method of reflecting use of proceeds is modified if the number of shares obtainable upon exercise of options exceeds twenty per cent of the number of common shares outstanding at the end of the computation period. *Id.* ¶ 38.

138. APB Op. No. 14, *supra* note 87, ¶ 16.

139. Using the facts of the example in note 132 *supra*, as the common appreciates from \$20 to \$40 to \$80, the dilution from the sale of common will be fifty shares in each instance; whereas the warrant with an exercise price of \$20 will show no dilution at \$20 per share, 13.5 shares of dilution at \$40 per share [$27 \text{ shares} \text{ minus } (27 \times 20)/40$], and 20.3 shares at \$80 [$27 \text{ shares} \text{ minus } (27 \times 20)/80$]. See APB Op. No. 15, *supra* note 82, ¶¶ 35-36.

of shares issued.¹⁴⁰ As with the issuance of common stock, the dilution associated with convertible debentures is also depicted immediately. They are treated as converted in the fully diluted earnings-per-share figure, which arguably is the financial statistic most significant for security analysts; conversion is assumed for purposes of the primary earnings-per-share figure if, at the time of issuance, the convertible debenture has a cash yield, based on its market price, of less than two thirds of the then current bank prime interest rate.¹⁴¹

While concern with the manner by which dilution is disclosed remains a problem, albeit much reduced from earlier periods, this should not blur the realization that the various financing alternatives usually commit a company to meaningfully different degrees of dilution. For example, raising capital through the sale of common stock requires the issuance of more stock over the life of the financing than is required to raise the same amount of capital by issuing straight debt¹⁴² or by issuing debt with an equity sweetener.

In terms of risk to the issuer, the bond-warrant unit and the convertible debenture represent an intermediate position between straight debt on the one hand, and convertible preferreds, straight preferreds, or common stock on the other; the bond in a bond-warrant unit generally has a lower annual fixed charge than a straight-debt offering and consequently slightly hedges the risk of default. On the other hand, the bond-warrant unit represents a significantly greater risk than an immediate sale of preferred stock, which generally has a commitment to future redemption but no unequivocal commitment to annual dividends, or than an immediate sale of common stock, which has no unequivocal commitment to either annual payments or redemption.

Another aspect of risk relevant to the issuer and its stockholders is the potential injury to the issuer's reputation through use of warrants. Investor suspicion of companies issuing warrants was a reasonable response to the boom-and-bust trading experience that warrants previously experienced, and to the fact that certain firms issued a large number relative to their common stock outstanding¹⁴³ with the result that a large portion of the issue's market value was perceived to reside in the more risky warrants.¹⁴⁴ Major variables affecting this trading phenomenon included such economic and financial

140. APB Op. No. 15, *supra* note 82, ¶¶ 14-15.

141. *Id.* ¶¶ 33, 41.

142. *See* note 132 *supra*.

143. *See, e.g.,* note 67 *supra*.

144. *See* text accompanying notes 63-70 *supra*.

cial factors as the estimated prospects for the economy, the industry, and the company, plus such provisions of the warrants as their exercise price and duration.¹⁴⁵ A shareholder's best interest would seem to be served if his company has a reputation for being financially sound and responsible. To the extent that this is true, and to the extent that warrants continue to be perceived as speculative securities, shareholders' interests will be advanced when management limits warrants to a modest percentage of the outstanding common stock.¹⁴⁶ Management should also exercise its control over contract terms to stipulate a moderate life—approximately five years—for its warrants so that their volatility can be kept within acceptable limits; if management forecasts of earnings and market values are ultimately shown to be conservative, the unexpectedly high warrant values will be kept under control by the nearing expiration date. A five-year life would also increase the financial benefits indirectly received by existing shareholders.¹⁴⁷ Moreover, a five-year life should not detract from the instrument's leverage value since the best available evidence indicates the warrant retains a substantial and predictable leverage or premium value as long as there are more than two years to expiration;¹⁴⁸ a three-year margin of error should optimize the chances for this leverage to be imparted. Indeed, from the existing shareholder's perspective, long-lived warrants are decidedly undesirable. The longer the life, the greater the possibility for volatile price movements and the lower the present value of the exercise price. Thus, in ordinary circumstances¹⁴⁹ the issuance of perpetual warrants, fifty-

145. Comparable reasons underlie the New York Stock Exchange's decision in the 1930's not to list warrants. Three reasons have been given: warrants have no intrinsic value; they were volatile in price; they became nearly worthless when the price of the common fell far enough below the exercise price. *THE EXCHANGE*, March 1970, at 18 (published by the N.Y. Stock Exchange). The last reason mentioned would reflect economic assessments covering the economy, industry, and company. Volatility would be the consequence of an interaction between economic factors, exercise price, and life. The first argument seems more a reason why the warrants could become worthless than a separate argument.

146. With regard to the appropriate maximum percentage of warrants outstanding, personal judgment presently has considerable room in which to function. Use of and attitudes toward warrants are evolving, and it is extremely difficult to isolate empirically investors' reactions to the percentage of common stock represented by warrants from other significant factors affecting attitudes. In the A.T. & T. and Chrysler offerings, notes 1 & 4-5 *supra* and accompanying text, warrants represented approximately 5.6 and 3.6 per cent respectively of the outstanding common.

147. The examples in the text accompanying notes 129-30 and in note 132 *supra* assumed a ten-year life. A five-year life would increase the present value of the future savings derived by the issuer from the warrant.

148. The reduction in leverage value or premium has been found to begin in the third year from expiration with most of the reduction occurring in the last two years of the warrant's life. Shelton, *supra* note 28, pt. 2, at 93.

149. This analysis presumes the continued validity of the two-year rule, note 148

year warrants, or even twenty-year warrants would be highly questionable.

A final aspect of the conceptual framework for using warrants is the instrument's emergence as an independent security and the implications of this development. There has been a shift away from viewing the warrant only as a mechanism for selling common stock and toward recognizing it as a distinct, though hybrid, security. Certainly, it is the reality of bond-warrant unit financing that corporations are raising capital by selling warrants to the public. Moreover, the capital raised upon both issuance and the possible subsequent exercise is permanent; there is no commitment as in a convertible debenture to repay funds at a future date. A quarter of a century ago in a reorganization context, the SEC anticipated the tone of present developments by wisely going beyond traditional common-stock and preferred-stock designations to refer to warrants as "in effect a junior equity security."¹⁵⁰ Current accounting practice lends credence to this junior equity status. Warrants are deemed "common stock equivalents"¹⁵¹ for purposes of computing earnings per share, and, whereas they previously received mention only in footnotes to the balance sheet, they are now treated as part of the capitalization of the company, although they are not as yet segregated in financial statements.¹⁵² Finally, the courts are recognizing the warrant as a junior equity. Judge Tyler of the Southern District of New York, the nation's major finance law jurisdiction, recently held in *Entel v. Guilden*¹⁵³ that section 17(e) of the Investment Company Act of 1940¹⁵⁴ creates a private right of action that may be brought by holders of an investment company's warrants for the benefit of the company. He discussed the warrant as follows:

[W]arrants are used . . . as a separate form of equity in corporations. Presumably, this usage stems from a desire of the investment community for what here has been called "distilled stock", offering

supra and accompanying text, and the related willingness of the market to impart a meaningful leverage value which the issuer can anticipate in his pricing decision.

150. *In re Childs Co.*, 24 S.E.C. 85, 121 n.9 (1946). The question was whether the prohibition against issuance of nonvoting stock by a corporation in a bankruptcy reorganization under what is now 11 U.S.C. § 616(12)(2) (1970) foreclosed the issuance of warrants.

151. See text accompanying note 136 *supra*.

152. Proceeds from sale of the warrant are added to paid-in capital. APB Op. No. 14, *supra* note 87, ¶ 16.

153. 223 F. Supp. 129 (S.D.N.Y. 1963).

154. 15 U.S.C. § 80a-17(e) (1970).

more risk and more potential gain per dollar than common stock. The creation of varied modes of investment—different sized bundles of rights—which are calculated to encourage the total flow of capital into corporate aggregations should be facilitated in a society which depends largely upon the gathering of private capital to achieve economic expansion. . . . The facts that warrants traditionally, albeit somewhat loosely, have been deemed more akin to options than to shares of stock . . . should not bar this court from assessing the features of these warrants which render them essentially equity securities¹⁵⁵

Entel was subsequently interpreted to have held that the warrant represented an "ownership interest" in the company, based on the fact that a warrant holder contributes capital and assumes the financial risk of warrant values, which fluctuate with the common stock's value.¹⁵⁶

This evolution toward a perception of the warrant as a distinct equity security is reasonable, desirable, and likely to continue. This new perception has ramifications particularly for the holder, but also for the issuer and its shareholders. While shareholders possess the right to authorize the issuance of the classic equity securities, they typically have no similar right under state corporate law to authorize warrants.¹⁵⁷ It seems proper that shareholders should possess this right, especially since the issuance of perpetual and very long-term warrants appears to be undesirable; the warrant, although somewhat tamed, remains a remarkably flexible instrument, possessed—as has been demonstrated earlier in this century—with unique possibilities for misuse. In addition, to avoid the compulsion for open market purchases of common stock and to protect stockholders from the argument that authorization of warrants implicitly authorizes the issuance of the underlying common stock, warrants should not be issuable unless authorized (but unissued) common or treasury stock is reserved at issuance for the warrants' subsequent exercise.

III. HOLDER'S PERSPECTIVE

From the holder's perspective, characteristics of warrants can be conveniently discussed under three headings: finance, corporate law, and taxation.

155. 223 F. Supp. at 132.

156. *Verrey v. Ellsworth*, 303 F. Supp. 497, 500 (S.D.N.Y. 1969).

157. A few states require that shareholders approve the issuance of warrants when at the time of grant there is inadequate authorized but unissued stock available to satisfy the warrants should they be exercised. *See, e.g.*, OHIO REV. CODE ANN. § 1701.16 (2) (Page 1964).

A. *Financial Characteristics*

Although the financial characteristics of warrants have already been considered generally, three features are particularly relevant to holders and can usefully be emphasized. The most prominent reason for investors to select bond-warrants is to "have their cake and eat it too." The bond gives both a high probability of cash income and some protection against loss of principal, while the warrant gives a claim on equity that is valuable if the company prospers. The investor, by purchasing two very separate and distinct securities, is thus hedging against the occurrence of opposite significant events—disaster or considerable success—while sacrificing if the performance is in the middle range. The second and third notable financial features focus on the relationship between the warrants and the company's success as reflected in its common stock. The common stock underlying the warrant must have appreciation possibilities, and the warrant must have a life of sufficient duration to permit stock appreciation to surpass the warrant's cost and to return a profit. If the normal characteristics are present,¹⁵⁸ the common will have to appreciate forty to fifty per cent before a purchaser, or succession of purchasers viewed as a single entity,¹⁵⁹ can break even on the investment. According to the best available research, warrant holders appear to view two years as the requisite period in which this appreciation must be accomplished. The leverage value begins to fade rapidly when the remaining warrant life reaches two years,¹⁶⁰ and consequently from this point to expiration the appreciation needed to cover the leverage portion of the warrant's cost is steadily reduced. If the warrant's life is too short, if appreciation possibilities for the common are modest, or if special features such as a redemption or call provision detract from the warrant's appeal, there should then be a reduction in the leverage value that the issuer must anticipate in its pricing decision and that the holder must perceive the warrant to merit.

B. *Corporate Law Characteristics*

From the late 1920's to the late 1960's, there was limited public issuance and exercise¹⁶¹ of warrants, and state legislatures gave little

158. See notes 15-18 *supra* and accompanying text.

159. The warrant's leverage value permits individual purchasers to sell at a profit before the intrinsic value is enough to cover his cost. However, each successive purchaser must perceive the appreciation possibility or he should be unwilling to make the purchase, thereby depriving the earlier purchaser of the market willing to impart a leverage value.

160. See note 148 *supra*.

161. See notes 67-69 *supra* and accompanying text. There appears to have been a

statutory attention to the instrument. In addition, there is a dearth of recent state law cases, and the few that have been decided add little to the law's earlier profile. The basic posture of state corporate law governing warrants, therefore, remains unchanged since the early 1930's.¹⁶² Understandably, none of the rights of common stock owners accrue to the warrant holder by virtue of his warrant ownership.¹⁶³ Thus, at present, the warrant's legal rights still depend solely on its contract.¹⁶⁴

The instrument's rapid appearance and disappearance early in the century probably explain much of the statutory neglect. The early concept of a warrant holder as something of a corporate parasite has probably delayed the development of legal principles increasing his protection. However, one recent case suggests greater sensitivity to the warrant holder's vulnerable position. In *Stephenson v. Plastics Corp. of America*,¹⁶⁵ a corporation issued warrants and subsequently adopted and implemented a plan whereby it transferred a portion of its assets to a new subsidiary in exchange for the subsidiary's stock; the parent then distributed the subsidiary's stock to the parent's shareholders and to those warrant holders exercising before a specified date. In a suit by warrant holders who exercised their warrants before expiration but nine months after the specified date, the Minnesota supreme court reversed the lower court's dismissal of the suit on the pleadings. In remanding the case, the court noted the elaborate efforts in the warrant agreement to anticipate changes that might affect the rights of warrant holders and saw "a general intent that the option rights of persons in the position of these plaintiffs should not be diminished."¹⁶⁶ This interpretation of the contract to find a broad and protective principle based on a perception of general intent is meaningful when contrasted to other particularly severe decisions.¹⁶⁷

limited exercise of the warrants issued in the late 1920's because of the lower market values generally experienced in the 1930's and 1940's, caused by the Depression and the limitation on profits associated with the Second World War. Many warrants must have expired by the time the optioned stock regained its exercise price.

162. For a discussion of the law at this point in time, see Berle, *supra* note 3; Garner & Forsythe (pts. 1-2), *supra* notes 63 & 100.

163. *Van Slyke v. Norris*, 159 Minn. 63, 198 N.W. 409 (1924). *Accord*, *Gay v. Burgess Mills*, 30 R.I. 231, 74 A. 714 (1909); *Chaffee v. Middlesex R.R.*, 146 Mass. 224, 16 N.E. 34 (1888).

164. *Bradford v. Crown-Bremson Indus., Inc.*, 255 F. Supp. 1009, 1012 (M.D. Tenn. 1964); *Tribble v. J.W. Greer Co.*, 83 F. Supp. 1015, 1022 (D. Mass. 1949); *Stephenson v. Plastics Corp. of America*, 276 Minn. 400, 150 N.W.2d 668 (1967).

165. 276 Minn. 400, 150 N.W.2d 668 (1967).

166. 276 Minn. at 418, 150 N.W.2d at 681.

167. *See, e.g.*, *Bradford v. Crown-Bremson Indus., Inc.*, 255 F. Supp. 1009 (M.D. Tenn. 1964); *Parkinson v. West End St. Ry.*, 173 Mass. 446, 53 N.E. 891 (1899).

In contrast to the limited evolution of state law, notable development has occurred under federal law. In a reorganization under the bankruptcy law¹⁶⁸ or the Holding Company Act,¹⁶⁹ the warrant's claim on equity may command some value depending upon whether there is an expectation that the market price of the common will exceed the exercise price in the foreseeable future.¹⁷⁰ More significantly, even though the SEC does not treat the warrant as common stock,¹⁷¹ both the SEC and a leading lower court have taken the position that the warrant is at least a junior equity security.¹⁷²

The increasing incidence of warrants in public hands,¹⁷³ the growing respectability of issuers,¹⁷⁴ the custom of providing certain provisions in warrant agreements,¹⁷⁵ and the realization that given a judicious choice of terms the warrant holder is giving not token but very valuable consideration to issuers of bond-warrant units, all coalesce to suggest that legislatures, governmental agencies, and stock exchanges might usefully do more to assist and precede the courts in taking action that will minimize the prospect of abuse to warrant holders and maximize the intelligent handling of warrants by their owners.

As a minimum *quid pro quo* for the leverage phenomenon that the issuer can count on when pricing his package to the public, issuers should be required to accord the holder protection against dilution. An antidilution provision may protect different interests: it may provide the warrant holder with a claim on a fixed percentage of the total underlying shares, or assure the position of the warrant holders relative to the common stockholders.¹⁷⁶ The older "percentage" view, which has several variations, requires an adjustment in the number of shares optioned whenever additional stock is sold, and modification of the option price whenever shares are issued at a price above or below the option price.¹⁷⁷ The "market price" approach

168. Chandler Act, 11 U.S.C. §§ 501-676 (1970).

169. Public Utility Holding Co. Act of 1935, 15 U.S.C. §§ 79-79z-6 (1970).

170. *Niagara Hudson Power Corp. v. Leventritt*, 340 U.S. 336, 343-44 (1951); *In re Electric Power & Light Corp.*, 176 F.2d 687, 691 (2d Cir.), *petition for stay of dissolution denied*, 337 U.S. 903 (1949).

171. *In re United Corp.*, 232 F.2d 601, 609 (3d Cir. 1956); *Blau v. Hodgkinson*, 100 F. Supp. 361, 373-74 (S.D.N.Y. 1951).

172. *In re Childs Co.*, 24 S.E.C. 85, 120-22 (1946); *Entel v. Guilden*, 223 F. Supp. 129, 132 (S.D.N.Y. 1963). *Accord*, *Verrey v. Ellsworth*, 303 F. Supp. 497, 500 (S.D.N.Y. 1969).

173. See notes 71-72 *supra*.

174. See notes 1-2 *supra* and accompanying text.

175. See notes 16-28 *supra* and accompanying text.

176. Compare Kaplan, *Piercing the Corporate Boilerplate: Anti-Dilution Clauses in Convertible Securities*, 33 U. CHI. L. REV. 1 (1965), with Ratner, *Dilution and Anti-Dilution: A Reply to Prof. Kaplan*, 33 U. CHI. L. REV. 494 (1966).

177. This approach gives the warrants a claim on a percentage of equity, at the

operates from the premise that the option holder should be treated as if he were a common stockholder; consequently, an adjustment in the exercise price and the number of shares optioned is appropriate only when existing common stockholders are directly benefited at the expense of the option holder, as, for example, when common stock dividends are paid or stock is sold to current stockholders in a rights offering at a price below the then-current market price. As to the effect of these theories, it is certainly true, as at least one court has suggested, that adjusting the exercise price is much more modest protection than protecting the claim on a percentage of the equity.¹⁷⁸ The market price provision appears to be customary today, and in the usual situation its more limited protections appear to be justified. The percentage approach would give warrant holders a greater benefit than that possessed by holders of common stock without pre-emptive rights, whereas comparable treatment of warrants and common stock regarding respective claims on a percentage of the company is more equitable for at least two reasons. First, since the warrant is now viewed as a junior equity security, it should not have characteristics that give it preferred status. Second, the shifting to the market theory from the percentage theory parallels the general movement away from pre-emptive rights for common stock with its attendant removal of the stock's claim on a fixed percentage of equity.

Additional protection against dilution is assured by requiring issuers to provide holders of registered warrants with the corporate information ordinarily provided to stockholders such as annual and quarterly financial statements, proxy statements, and any other communications sent to shareholders.¹⁷⁹ This information is desirable

time of issuance, equal to the number of shares that the warrants could then purchase if immediately exercised, divided by the sum of the shares outstanding and the shares underlying the warrants.

178. *Merrit-Chapman & Scott Corp. v. New York Trust Co.*, 184 F.2d 954 (2d Cir. 1950), *cert. denied*, 340 U.S. 931 (1951). The court observed:

If the corporation were at liberty to declare stock dividends without making provision for warrant holders, the percentage of interest in the common-stock capital of the corporate enterprise which the warrant holders would acquire, if they thereafter purchased the shares subject to warrants, could be reduced practically to the point of extinction. Of course part of the injustice could be avoided by reducing the price to be paid for each share purchased under the warrants, but the privilege the warrant holders originally had of acquiring a definite proportional interest in the common stock capital of the corporate enterprise would be lost without recourse unless their contract with the corporation contained some provision to protect it.

184 F.2d at 957.

179. *See, e.g.*, American Telephone and Telegraph Co., Prospectus, April 13, 1970, at 20; Chrysler Financial Corp., Prospectus, *supra* note 4, at 22-23; Greyhound Corp., Consent Statement, *supra* note 17, at 80; LTV Aerospace Corp., Prospectus, *supra* note 25, at 26.

since a warrant's value resides in its claim on the underlying common stock, and information giving insight into the evolving value of the common is therefore very important to the warrant holder. Indeed, because a warrant holder will be wiped out by a market price below his exercise price—whereas the perpetual life of the common stock permits its owner to persevere, albeit impatiently, through a period of depressed stock prices—information germane to the value of the common is arguably more significant to the warrant holder than to the common stockholder.

C. *Tax Characteristics*

In attempting to identify and comment upon major issues arising from warrant use today, several reasons dictate that particular attention be given to the impact of federal income taxation upon the warrant's owner. All warrant holders, except perhaps tax-exempt charities who are unlikely owners, are affected by the tax laws. At the same time, several controversial tax principles relating to warrants have recently been in a state of flux and are presently less than optimal in their consequences, the rationale for tax treatment of the exercise of warrants needs to be modified, and the force of that rationale must be compared with the rules governing conversions.

The manner in which warrants are treated in the Internal Revenue Code is indicative of the curious pragmatism that characterizes tax statutes. The Code addresses itself to options in three contexts in which a warrant will often be involved: corporate-acquisition indebtedness,¹⁸⁰ original-issue discount,¹⁸¹ and wash sales.¹⁸² And yet, despite its considerable and increasing specificity, the Code is silent with regard to such important and frequent events as exercise, reorganizations, and short sales.¹⁸³

1. *Issuance of Bond-Warrant Units*

Section 1232, entitled "Bonds and Other Evidences of Indebtedness," governs issuance of bond-warrant units. This provision was adopted by Congress as part of the Internal Revenue Code of 1954¹⁸⁴

180. INT. REV. CODE of 1954, § 279.

181. INT. REV. CODE of 1954, § 1232.

182. INT. REV. CODE of 1954, § 1091.

183. See INT. REV. CODE of 1954, § 1233.

184. For a very competent treatment of section 1232's implications beyond bond-warrant units, see Kimmelfield, *Original Issue Discounts: Convertible Debentures and Warrants; Package Deals*, N.Y.U. 21ST INST. ON FED. TAX. 1451 (1963); de Kosmian, *Original Issue Discount*, 22 TAX LAW. 339 (1969). An able discussion of the implica-

in an effort to restrict the then favorable tax treatment accorded straight bonds possessing an original-issue discount—that is, those bonds with an issue price¹⁸⁵ or cost to the initial purchaser less than the redemption price at maturity.¹⁸⁶ Prior to 1954, there was a strong possibility that the original-issue discount on a bond that qualified as a capital asset in the taxpayer's hands could be taxed at capital-gain rates, with recognition of any gain being postponed until the bond was either sold or redeemed.¹⁸⁷ This treatment was available even if the discount was clearly attributable to a low interest rate.¹⁸⁸ Section 1232 changed this state of affairs. Under this provision, if original-issue discount exists, the taxpayer is required to recognize the amount of that discount as ordinary income when the bond is sold or redeemed at maturity.¹⁸⁹ The feeling that the discount was

tions of the 1969 amendments and the shift to current taxation of original-issue discount may be found in Landis, *Original Issue Discount After the Tax Reform Act of 1969*, 24 TAX LAW. 435 (1971).

185. The definition of "issue price" varies, depending upon whether the bonds are sold in a registered public offering or in a private placement under section 4(2) of the Securities Act of 1933, 15 U.S.C. § 77d(2) (1970). For public offerings, issue price is "the initial offering price to the public . . . at which price a substantial amount of such bonds or other evidences of indebtedness were sold," while for private placements, issue price is "the price paid by the first buyer of such bond." INT. REV. CODE of 1954, § 1232(b)(2). No mention is made of the governing definition when the issue is not registered with the SEC for reasons other than the private placement exemption. For example, exemption from registration might be claimed under the intrastate offering exemption of section 3(a)(11), 15 U.S.C. § 77c(a)(11) (1970).

186. INT. REV. CODE of 1954, § 1232(b)(1). Original-issue discount must be distinguished from the discount on a purchase in the so-called "after market" (the market for the security existing after issue). This after-market or market discount arises when the price paid by the subsequent purchaser is less than the bond's face value (ordinarily the redemption price at maturity). A bond with original-issue discount may have more, less, or no market discount. The gain attending market discount is usually taxed as capital gain. Rev. Rul. 60-210, 1960-1 CUM. BULL. 38, 39.

187. *Commissioner v. Caulkins*, 144 F.2d 482 (6th Cir. 1944), *affg.* 1 T.C. 656 (1943). See also *Paine v. Commissioner*, 236 F.2d 398 (8th Cir. 1956), *revg.* 23 T.C. 391 (1954) (capital gain treatment if notes are sold shortly before maturity).

Prior to 1934, retirement of a bond was not a sale or exchange and consequently gain or loss was ordinary in nature. Section 117(f), enacted by the Revenue Act of 1934, made redemption of most bonds a sale or exchange. Capital gain possibilities under the 1939 Code in relation to section 1232 of the 1954 Code are discussed in Zafft, *Discount Bonds—Ordinary Income or Capital Gains?*, 11 TAX L. REV. 51 (1955).

188. *Commissioner v. Caulkins*, 144 F.2d 482 (6th Cir. 1944), *affg.* 1 T.C. 656 (1943). For example, had Buyer purchased for \$900 a 3% corporate bond redeemable at face value (\$1000) in twenty years, the \$100 gain realized at redemption would have been taxed as a long-term capital gain.

189. INT. REV. CODE of 1954, § 1232(a)(2)(B). Gain in excess of original-issue discount, if any, received capital gain treatment.

The adoption of section 1232 may have had an impact on judicial attitude toward cases litigated after its adoption but involving issues controlled by the 1939 Code. In several of these cases the courts explicitly declined to follow *Caulkins* and taxed the discount element of the bondholder's gain on sale or retirement as ordinary income. See, e.g., *Commissioner v. Morgan*, 272 F.2d 936, 940 (9th Cir. 1959); *Rosen v. United*

"a form of interest income"¹⁹⁰ was the rationale for the shift from capital gains to ordinary-income treatment.¹⁹¹ Although nowhere specified, it appears that the "yield theory," long accepted in the financial community, underlies this approach. According to this theory, a bond sells at a discount because the stated interest rate on the bond is lower at the time of purchase than the going rate in the market place for bonds of similar character.¹⁹² In other words, over the remaining life of the bond the combination of stated interest and appreciation (which will be equal to the discount) should give a return equivalent to the going rate for bonds of similar quality as of the time of purchase.¹⁹³ Congress apparently reasoned that since under the yield theory the discount is a substitute for interest,¹⁹⁴ and since interest is taxed as ordinary income,¹⁹⁵ original-issue discount should be a permanent quality of the bond and should be treated as ordinary income.¹⁹⁶

States, 288 F.2d 658, 662 (3d Cir. 1961). In the Tax Reform Act of 1969 Congress specified that original-issue discount must be recognized ratably over the life of the bond, not just upon sale or redemption. INT. REV. CODE OF 1954, § 1232(a)(3).

190. S. REP. NO. 1622, 83d Cong., 2d Sess. 112 (1954).

191. The shift was not a complete one. Section 1232 embodies a de minimis rule, which applies if the original-issue discount is less than $\frac{1}{4}$ of 1% multiplied by the number of years to maturity. INT. REV. CODE OF 1954, § 1232(b)(1). In this circumstance the general rule of section 1232 (a)(1) is operative. It treats retirement as an exchange and, reflecting prior law, provides capital gain treatment for corporate debt.

192. E. WILLETT, FUNDAMENTALS OF SECURITIES MARKETS 121 (1968).

193. *Id.*

194. Original-issue discount appears to fit within the general definition of interest as "compensation for the use or forbearance of money." *Deputy v. Du Pont*, 308 U.S. 488, 498 (1940). Moreover, the Senate Finance Committee referred to the deduction the issuer receives as a consequence of original-issue discount as comparable to interest expense. S. REP. NO. 1622, 83d Cong., 2d Sess. 112 (1954). However, the phrase "comparable to interest" may indicate Congress intentionally stopped short of considering such discount as the direct equivalent of interest. This impression is reinforced by the statutory treatment accorded bond discount for two similar securities: government bonds with a stated interest but issued at a discount, and noninterest-bearing obligations issued at a discount and redeemable for fixed amounts increasing at stated intervals (U.S. Government Series E bonds, for example). In neither situation is the discount styled interest in the Code. See INT. REV. CODE OF 1954, §§ 454, 1232(a)(2)(B). A similar caution was evidenced by the Supreme Court's discussion of discount under the 1939 Code in *United States v. Midland-Ross Corp.*, 381 U.S. 54 (1965). The Court held that "earned original issue discount, like stated interest, should be taxed under Section 22(a) as ordinary income." 381 U.S. at 58. But it apparently did not consider them equivalents since it observed that the discount "serves the same function as stated interest." 381 U.S. at 57. On the other hand, the Treasury refers to original-issue discount on U.S. Government and corporate bonds as interest. Treas. Reg. § 1.61-7(c) (1957). It has also long taken this position with regard to municipal bonds. G.C.M. 10542, XI-1 CUM. BULL. 18 (1932); I.T. 2629, XI-1 CUM. BULL. 20 (1932). See de Kosmian, *supra* note 184, at 344. Furthermore, with regard to nonresident aliens and foreign corporations, the Treasury treats original-issue discount as interest for tax treaty purposes. Rev. Rul. 68-333, 1968-1 CUM. BULL. 390, based on T.I.R. 877 (Dec. 27, 1966).

195. INT. REV. CODE OF 1954, §§ 61(a)(4), 63.

196. As a general rule subsequent holders must report as income the ratable share

Congress realistically took the view that a taxpayer who purchases a bond-warrant unit acquires two separate securities, the bond and the warrant. The taxpayer is required to allocate the cost or issue price of the financial package between its two components in order to determine the cost or issue price of each. The allocation is made by determining what proportion of the unit's total fair market value is represented by each element;¹⁹⁷ this percentage of the unit's cost is deemed to be the issue price of the particular element.¹⁹⁸ If the issue price attributable to the bond is less than the redemption price at maturity, and if the de minimis rule¹⁹⁹ is not operative, the difference—that is, the original-issue discount—must, as a consequence of amendment by the Tax Reform Act of 1969,²⁰⁰ be amortized ratably on a monthly basis²⁰¹ and recognized as ordinary income even by a cash basis taxpayer.²⁰² The computed issue price for each element becomes its basis,²⁰³ and, assuming the warrant is a capital asset in the taxpayer's hands, capital gain or loss will be recognized when the warrant or the stock acquired with it is subsequently sold or exchanged.²⁰⁴ The bond's basis will be adjusted upward as discount income is recognized, thereby reducing the capital gain or increasing the capital loss eventually recognized when the bond is sold or exchanged.

Congressional treatment of bond-warrant units reflects the notion that a warrant is a separate security that may have considerable mar-

of the discount for the period they hold the bond. INT. REV. CODE of 1954, § 1232(a)(3). An exception to the rule exists for those who subsequently purchase the bond at a premium; no income is recognized. INT. REV. CODE of 1954, § 1232(a)(2)(C)(ii). The general rule is also modified if the subsequent purchase of the bond is made with a market discount smaller than the original-issue discount. Here the smaller market discount is amortized as ordinary income. INT. REV. CODE of 1954, § 1232(a)(3)(B).

197. When the fair market value of the warrant is not "readily ascertainable" within the meaning of Treas. Reg. § 1.421-6(c) (1966), the issue price of the bond must be determined in a different manner. The taxpayer must identify an assumed price at which the bond would have been issued had it been issued independent of the unit. Reasonable criteria for making this determination are provided. Treas. Reg. § 1.1232-3(b)(2)(ii)(a) (1968).

198. INT. REV. CODE of 1954, § 1232(b)(2).

199. See note 191 *supra*.

200. Pub. L. No. 91-172, § 413(a), 83 Stat. 609.

201. INT. REV. CODE of 1954, § 1232(a)(3)(A).

202. INT. REV. CODE of 1954, § 1232(a)(3). Prior to the 1969 amendment, section 1232 provided that the cash basis taxpayer would recognize ordinary income when the bond was either sold or redeemed, and the amount then recognized would depend upon the period of time the bond was owned and the quantum of gain: the taxpayer recognized as ordinary income that percentage of original-issue discount equal to the percentage of time that the taxpayer held the bond between original issue and redemption.

203. Treas. Reg. § 1.1012-1(d) (1971).

204. INT. REV. CODE of 1954, § 1223(3); text accompanying note 223 *infra*.

ket value even if it has no exercise value, and the additional judgment that the value embodied in the warrant is essentially a substitute for the foregone interest.²⁰⁵ Perhaps, an argument can be made that, because the issuer included the warrant in lieu of a cash interest payment,²⁰⁶ the warrant's value should be taxed as imputed interest when received. However, viewing the warrant as indirectly creating an interest liability through the bond discount provision is more realistic and conceptually appropriate; it is consistent with the purchaser's perception that he has acquired two distinct securities²⁰⁷ and the reality of the issuer's position: warrants (and possibly stock through exercise) are being sold in addition to the interest that is being saved.²⁰⁸

The eminently reasonable yield and unit concepts are, however, wedded to a very questionable recognition provision. This provision is likely to hinder the sale of bond-warrant units by making the bond portion of the unit—which would usually possess an original-issue discount—less attractive to investors than bonds not having such a discount. It seems an unwarranted inroad on the integrity of the cash method of reporting income to require a cash basis taxpayer to pay income tax on imputed interest when he will receive the cash representing that interest only when the bond is subsequently sold or redeemed: the owner of a twenty-year bond with original-issue discount who holds it to maturity, for example, will pay his tax on a ratable portion of the discount in year one but the cash representing that interest would not be received until year twenty. From a present-value point of view, this recognition provision is very harsh.²⁰⁹ Moreover, this treatment goes beyond other areas, such as, for example, the installment sale provisions,²¹⁰ where interest has also been imputed: if a deferred-payment sales contract makes no provision for interest or specifies an unrealistically low rate, a portion of the deferred payments is deemed ordinary interest income rather than part of the sales price,²¹¹ but unlike the situation under section 1232, the imposition of tax on imputed interest coincides, with few ex-

205. See notes 104-05 & 124-30 *supra* and accompanying text.

206. See notes 124-25 *supra*.

207. See notes 86-97 & 152 *supra* and accompanying text.

208. See note 130 *supra* and accompanying text.

209. Using a 5% discount rate, the \$10 of income taxed in year 1 but only received in year 20 has a present value of only \$3.77. Thus, a taxpayer in a 40% marginal tax bracket is paying more in tax (\$4.00) than the value of what he will receive.

210. INT. REV. CODE of 1954, §§ 453, 483.

211. INT. REV. CODE of 1954, § 483(a); Treas. Reg. § 1.483-1(c) (1966).

ceptions, with the receipt of each deferred payment.²¹² The recognition of imputed interest under section 1232 is also inconsistent with the treatment specified by Congress for the closely analogous situations of interest-bearing government bonds issued at a discount and noninterest-bearing government obligations issued at a discount; in both cases, the taxpayer holding such bonds is permitted to postpone reporting the discount as income until sale, exchange, or redemption.²¹³

Three reasons apparently combined to prompt congressional adoption of the annual recognition of imputed income amendment to section 1232. The annual-recognition provision seeks to avoid the nonparallel treatment of deductions and income resulting from original-issue discount, for the discount is available to the issuer ratably over the life of the bond, whereas a cash-basis holder ordinarily would not recognize the income until the bond was sold or exchanged. Second, Congress desired to make bondholders more aware of the ordinary-income character of original-issue discount: the House Committee believed that many holders would fail to report the original-issue discount at the time of disposition; even if it was reported, the discount was likely to be reported as a capital gain, rather than ordinary income. The third reason, dependent upon the first two, was to discourage the use of bonds in corporate acquisitions.²¹⁴

None of these declared reasons appear to justify the amendment. The second and third reasons are particularly weak. It is not self-evident why the creation of multiple annual tax events in lieu of one tax on disposition solves the problem of cognizance of an ordinary-income responsibility. Either way, an initial awareness of one's "interest" responsibility is necessary, and the medium of education actually selected for registered bonds—annual corporate notification to the taxpayer²¹⁵—seems equally appropriate whether tax is due at disposition or annually. Neither is the acquisition argument persuasive. As the staff report prepared for the Senate Finance Committee observed when summarizing the arguments for and against the House Bill, the "provision at best, is an artificial way to discourage corporate mergers."²¹⁶ The mismatched timing in the recognition of in-

212. See INT. REV. CODE of 1954, § 483(c).

213. INT. REV. CODE of 1954, §§ 454, 1232(a)(2)(B).

214. H.R. REP. No. 413, 91st Cong., 1st Sess. 109 (1969); S. REP. No. 552, 91st Cong., 1st Sess. 147 (1969).

215. See INT. REV. CODE of 1954, §§ 6049(a)(1)(C), 6049(c).

216. *Hearings on H. R. 13270, the Tax Reform Act of 1969, Before the Senate Comm. on Finance*, 91st Cong., 1st Sess., pt. 1, at 73.

come and deductions appears the strongest argument of the three. However, even here one must doubt whether the postponement in receipt of revenue is sufficiently great to justify this deviation from the general rule that the amount of any item of gross income shall be included in gross income for the taxable year in which it is received by the taxpayer,²¹⁷ and from the associated general rule that taxable income shall be computed under the method of accounting by which the taxpayer regularly computes his income.²¹⁸ The imputed-income provision is, in a very practical present-value sense, a major deviation from the sound and equitable principle implicit in the cash method of accounting: taxpayers should not be required to pay a tax on income not yet available to them.

2. *Methods of Disposition and Their Significance*

A warrant can be eliminated or disposed of in three basic ways: expiration, sale, and exercise. The tax consequences of these events, as well as the effect of using the warrant in wash sales, short sales, and corporate acquisitions, depend upon the basic conceptualization of the warrant. For example, is acquisition of the warrant treated as the acquisition of the underlying property, or is the warrant perceived to be an independent asset? The answers to these kinds of important questions are presently provided by statutory doctrines, judicial formulations, and occasionally by Treasury pronouncements. Very few questions of disposition are answered by authority directed specifically to warrants. Usually, resort must be made to general comments about options, or other specific types of options such as rights; this use of analogy is significant because exercise of the different kinds of options on equity are governed by different theories with disparate origins, and these theories occasionally produce meaningfully diverse tax consequences. For example, exercise of a warrant to buy portfolio stock owned by the issuer of the warrant, as opposed to the issuer's own stock, appears to be a nontaxable event,²¹⁹ whereas exercise of a convertible security in similar circumstances is presently treated as a taxable event.²²⁰ Basic perceptions and theories are important, for theories governing one type of option may be transferable to others; when the evolution of the law produces such a

217. INT. REV. CODE of 1954, § 451(a).

218. INT. REV. CODE of 1954, § 446(a).

219. See text accompanying notes 227-35 *infra*, discussing the purchase theory.

220. See *Rose v. Trust Co.*, 77 F.2d 355 (5th Cir. 1935); *Prescott v. Commissioner*, 76 F.2d 3 (5th Cir. 1935); *Estate of H.H. Timken*, 47 B.T.A. 494 (1942), *affd. on other grounds sub. nom. Commissioner v. Timken*, 141 F.2d 625 (6th Cir. 1944); *Birmingham Fire Ins. Co.*, 10 P-H B.T.A. Mem. ¶ 41,583 (1941).

transfer, different tax consequences may occasionally be transferred as well.

Section 1234 of the Code directs that the classification of an option as a capital or noncapital asset shall be determined derivatively by reference to the character the underlying property would have in the taxpayer's hands.²²¹ Since warrants are options within the meaning of section 1234,²²² their sale by a taxpayer in whose hands they are capital assets will produce long-term gain or loss if the warrant has been held for more than six months;²²³ the amount of the gain or loss is the difference between the adjusted basis of the warrant and the amount realized on its sale.²²⁴ With regard to the expiration of warrants, that event has been accommodated to the Code's basic structure by treating it for recognition and holding-period purposes as a sale or exchange occurring on the day of expiration.²²⁵

3. *Exercise of the Warrant*

a. *The purchase theory and the continuing-offer premise.* In contrast to expiration and sale, there is no statutory provision dealing directly with the exercise of options in general or warrants in particular. One type of option, the employee stock option, does receive specific statutory attention. Section 421(a) states the general rule that no income shall result upon exercise. The absence of a statutory grant of tax-free status to the exercise of other options, including warrants, necessitates resort to the general language of sections 1001 and 1002. The former provides that gain is "realized" from dealings in property upon a "sale or other disposition."²²⁶ Sections 1001(c) and 1002 then command the "recognition" of gain or loss whenever a "sale or exchange" occurs unless it is "otherwise provided" elsewhere in the Code. The absence of a specific nonrecognition provision makes the threshold question of realization especially significant.

It is a well-established general rule that the exercise of rights and warrants does not precipitate the imposition of a tax. *Palmer v. Commissioner*²²⁷ so held with regard to rights and *Miles v. Safe De-*

221. INT. REV. CODE of 1954, § 1234(a).

222. Cf. William H. Bateman, 40 T.C. 408 (1963); E.P. Raymond, 37 B.T.A. 423 (1938); Rev. Rul. 56-406, 1956-2 CUM. BULL. 523, 525.

223. INT. REV. CODE of 1954, §§ 1222(3)-(4).

224. INT. REV. CODE of 1954, §§ 1001, 1011.

225. INT. REV. CODE of 1954, § 1234(b).

226. INT. REV. CODE of 1954, §§ 1001(a)-(b).

227. 302 U.S. 63, 71 (1937).

*posit & Trust Co.*²²⁸ had earlier so indicated in dictum.²²⁹ The theory of these cases was that exercise of an option is essentially a purchase of the underlying stock.²³⁰ Given this perception, it followed that the profit, if any, inherent at the time of purchase of the stock is not realized and recognized until the subsequent sale or other disposition of the purchased property.

While it is true that stock has been purchased, it is also true that the option has been eliminated. Arguably, this surrender of the option to the issuer is a "disposition." In *Palmer* and *Miles*, the Supreme Court did not expand upon its purchase rationale to explain why of the two events, elimination of the option and acquisition of the stock, the tax focus should be upon the second rather than the first. An intellectual bridge between the two events was subsequently built by the Fourth Circuit in *Helvering v. Bartlett*:²³¹

An option is but a continuing offer; and, when the offer is accepted, it is merged in the contract which results. We have then, nothing upon which to predicate an assessment of the tax but a purchase of stock by the taxpayer; and it is well settled that such a transaction does not give rise to taxable income until a profit is realized by the sale of the stock purchased.²³²

The "continuing offer therefore purchase" theory was relied upon by the Fifth Circuit in *Commissioner v. Cummings*²³³ when it subsequently concluded that exercise of warrants issued in a bond-warrant unit was also not a taxable event.²³⁴ *Palmer*, *Bartlett*, and *Cummings*, especially the latter two, concluded that gain had not been realized. Since it is evident that no "sale"²³⁵ of an option occurs

228. 259 U.S. 247, 252 (1922).

229. Exceptions to this general rule are discussed in notes 245-49 *infra* and accompanying text.

230. *Palmer v. Commissioner*, 302 U.S. 63, 67 (1937); *Miles v. Safe Deposit & Trust Co.*, 259 U.S. 247, 252 (1922). A similar perception of warrants is contained in other bodies of law. For purposes of section 16(b) of the Securities Act of 1934, 15 U.S.C. § 78p(b) (1970), stock is deemed to be bought upon exercise of the warrant, not acquisition of the warrant. See, e.g., *Blau v. Hodgkinson*, 100 F. Supp. 361 (S.D.N.Y. 1951).

231. 71 F.2d 598 (4th Cir. 1934).

232. 71 F.2d at 600. See also *Oscar E. Baan*, 51 T.C. 1032 (1969).

233. 77 F.2d 670 (5th Cir. 1935).

234. The theory appears to fit and govern the exercise of calls, although no cases or Treasury pronouncements discuss the reason why the exercise of a call is a nontaxed event. Cf., e.g., Rev. Rul. 58-234, 1958-1 CUM. BULL. 279.

235. The Supreme Court in *Commissioner v. Brown*, 380 U.S. 563 (1965), analyzed the term "sale" and observed:

A "sale" . . . is a common event in the non-tax world; and since it is used in the Code without limiting definition and without legislative history indicating a contrary result, its common and ordinary meaning should at least be persuasive of its meaning as used in the Internal Revenue Code. . . .

"A sale, in the ordinary sense of the word, is a transfer of property for a fixed

on exercise, the courts by implication held that exercise is not a "disposition" of property within the meaning of the predecessors of sections 1001(a) and (b). Consequently, under the continuing-offer rationale it is unnecessary to consider the subsequent statutory recognition question whether an "exchange" has occurred. Moreover, the search for an "otherwise provided" nonrecognition authorization is equally moot.

The nub of the "continuing offer therefore purchase" theory appears to be the common law concept of contracts that an option is essentially a unilateral offer to sell that ripens into an enforceable agreement only when the offer has been accepted in the manner specified in the contract.²³⁶ The heavy reliance by the Fourth and Fifth Circuits upon common law contract theory seems inappropriate. Taxation is much too practical a body of law to permit important questions to pivot on such a theoretical point. The Supreme Court's discussion of the realization issue attending a transfer of stock in terms of whether it was an "appropriate occasion for taxing the accretion"²³⁷ supports a more practical orientation. Indeed, in *Commissioner v. LoBue*²³⁸ an employer's motivation in transferring an option to an employee, and the subsequent transfer of the optioned stock, was central to the Supreme Court's conclusion that the exercise value inherent at the time of exercise was compensation. Realization issues should be especially responsive to factors such as taxpayer convenience, ease of administration, tax avoidance, and the underlying purpose of the transaction.

b. *An alternative to the continuing-offer premise.* An alternative to the continuing-offer justification for the purchase theory is readily available in the financing purposes and realities of warrant offerings. A corporation issues warrants in bond-warrant units for a threefold purpose: as a means of raising capital through sale of an independent security, the warrant; as a means of selling and reducing the stated interest on straight debt, the sweetener; and as a means of raising

price in money or its equivalent," *Iowa v. McFarland*, 110 U.S. 471, 478 [1881]; it is a contract to "pass rights of property for money,—which the buyer pays or promises to pay to the seller . . ." *Williamson v. Berry*, 8 How. 495, 544 [49 U.S. 495, 544 (1849)].

380 U.S. at 570-71 (emphasis original).

236. *Bradford v. Crown-Bremson Indus., Inc.*, 255 F. Supp. 1009, 1012-13 (M.D. Tenn. 1964); Berle, *supra* note 3, at 652. Cf. *United States Freight Co. v. United States*, 422 F.2d 887, 894 (Ct. Cl. 1970); *Morris R. DeWoskin*, 35 T.C. 356, 363 (1960); Rev. Rul. 58-234, 1958-1 CUM. BULL. 279, 281.

237. *United States v. Davis*, 370 U.S. 65, 68 (1962) (emphasis added).

238. 351 U.S. 243 (1956).

capital at a later date through exercise of the warrant.²³⁹ Should the warrants not be exercised, only one facet of this purpose, the subsequent raising of capital by sale of stock, is defeated. However, the issuer's primary financing objective is normally accomplished when initial bond-warrant unit sale occurs. The utility of the cash inflow upon exercise of the warrant is limited due to its postponement, the uncertainty about cash needs at that later date, and the possibility that exercise will be foreclosed by a price drop in the underlying security. Nevertheless, exercise and the attendant raising of capital via a sale of stock is doubtlessly contemplated; since once warrants are issued, all parties' interests are maximized by a strong advance in the market value of the optioned stock, it would be extraordinary for management to desire, and unlikely that such an optimistic breed would expect, stock to sell at a price that would preclude exercise.

From the option holder's viewpoint, exercise, either by the initial or a subsequent option holder, fulfills a twofold purpose: conservation of the economic value represented by the exercise value; and acquisition of the underlying stock for its future economic value. A stock purchase is ultimately necessary to accomplish either purpose. Thus from the perspective of both issuer and purchaser, from the outset a bond-warrant unit offering has the objective of effecting a purchase of stock.

When the warrant is exercised for cash, liquidity considerations lend further practical support to the purchase theory. A portion of the taxpayer's liquid assets are expended to make the purchase, and taxation at exercise would exacerbate this cash drain.²⁴⁰ This should not be the outcome unless overriding reasons, such as the frustration of congressional purposes, compel it. The Supreme Court did impose taxation at exercise in the employee stock option area, but it did so on the grounds that compensation was intended and that the form of compensation actually provided was the free ride on the common.²⁴¹ No compensation motivation exists in the ordinary warrant

239. See notes 123-32 *supra* and accompanying text. If bonds are surrendered to exercise the warrant, no new capital is directly raised. However, the elimination of debt and the increase in common outstanding will improve its chances for raising capital through borrowing.

240. When warrants are exercised by tendering bonds (or other securities) the liquidity argument is much weaker, but still a significant consideration.

241. *Commissioner v. LoBue*, 351 U.S. 243, 248-49 (1956). Congress subsequently legislated rules determining whether warrants and other options are treated as compensation or investment. See Int. Rev. Code of 1939, § 130A, added by Revenue Act of 1950, ch. 994, § 218, 64 Stat. 942. The key provision as amended is now INT. REV. CODE of 1954, § 421.

offering since holders are only coincidentally employees. Perhaps Congress evidenced a critical attitude toward the tax-free nature of exercise when it subjected the exercise value of qualified and restricted stock options to the possibility of a tax by designating it a tax preference item;²⁴² however, only options granted to employees are so treated.²⁴³ This seems to suggest that Congress was responding only to the compensation possibility, which is not inherent in the warrant's normal use. In short, except for warrants granted to employees as a form of compensation, there appear to be no considerations that meaningfully detract from or override the inherent equity of the liquidity argument as support for the purchase theory.²⁴⁴

c. *Exceptions to the purchase theory.* In deciding whether the exercise of options should be a taxable occasion, Congress and the courts carved out two exceptions to the purchase theory. The first involves the previously considered occasional use of warrants as a means of compensation.²⁴⁵ The second is a judicially created dividend rationale that thus far relates solely to rights and would be applicable to warrants only in remote circumstances. The Supreme Court has recently held that when a corporation creates a subsidiary, places assets in the subsidiary, and then sells subsidiary stock to shareholders through the issuance of rights whose exercise price is less than the fair market value of the underlying optioned stock at the time the rights were issued, section 355 will not prevent recognition; and since the "net worth" of the corporation is diminished, the corporation is engaging in a distribution of assets taxable as a dividend under sections 301 and 316.²⁴⁶ The quantum of this dividend was the difference between the amount paid for the shares upon exercise of the rights and the fair market value of the shares at the time when the rights were exercised.²⁴⁷ There is at present uncertainty about whether the dividend income arises upon distribution of the rights or upon their subsequent sale or exercise. The Supreme

²⁴² See INT. REV. CODE of 1954, § 57(a)(b).

²⁴³ See INT. REV. CODE of 1954, §§ 57(a)(b), 422(b), 424(b).

²⁴⁴ Under some circumstances, the issuance of a warrant may give rise to ordinary income under a dividend theory. See notes 246-48 *infra* and accompanying text. Where the dividend rationale is convincing, taxation should occur at issuance, not at exercise. Consequently, a dividend rationale does not detract from the liquidity argument's support for the purchase theory.

²⁴⁵ See notes 241-43 *supra* and accompanying text.

²⁴⁶ *Commissioner v. Gordon*, 391 U.S. 83, 88-91 (1968). The Court also held that the transactions there involved did not come within section 355, but left open the question whether nonrecognition was appropriate under sections 354 or 346.

²⁴⁷ 391 U.S. at 89-90, 98.

Court considers the timing issue an open question,²⁴⁸ but the Treasury has recently adopted the position that income is taxable upon issuance of the rights.²⁴⁹

The dividend theory does not fit the usual situation of warrants issued in bond-warrant units. The income question posed by such units is of an interest, rather than a dividend, nature.²⁵⁰ Moreover, warrants rarely have an exercise price below the optioned stock's market value. In addition, whereas stockholders typically pay nothing for rights, warrant holders pay an allocated portion of the unit's cost for the warrants. It is also significant that recipients of rights are typically stockholders of the issuer, while bond-warrant units are usually sold to a broader class of investors, who might coincidentally be shareholders and thus affected by a dividend theory. However, if a company issued warrants to shareholders independent of a unit, exercisable at less than the common's market value, and without receiving appropriate consideration, the dividend rationale could properly be applied; it is difficult to identify any financing utility to an issuer from such a use.

d. *Application of the purchase theory to convertible securities.* The fact that different rationales may lead to different tax consequences make it meaningful to inquire whether the purchase theory, which governs exercise of warrants, rights, and probably calls, also reaches the exercise of such kindred options as convertible provisions.²⁵¹ Conversion of both convertible debentures and convertible preferred stock is treated as a nontaxable event when the underlying stock is that of the company issuing the convertible. Two different theories are used to justify the common result, and both theories differ in varying degrees from the purchase theory. The Treasury has taken the position, through regulations, that conversion of preferred to the same company's common is a recapitalization and therefore qualifies as a reorganization under section 368(a)(1)(E);²⁵² consequently it is exempted from the general rule of recognition stated in section 1002.²⁵³ In contrast, a conversion of bonds is exempt from

248. 391 U.S. at 89-90. It has been stated that should the exercise value decrease, the dividend would be the lower of the spread at issuance or exercise. *Choate v. Commissioner*, 129 F.2d 684, 687 (2d Cir. 1942).

249. Rev. Rul. 70-521, 1970-2 CUM. BULL. 72.

250. See notes 189-91 *supra* and accompanying text.

251. An excellent discussion of the theories pertinent to exercise of convertible securities is contained in Fleischer & Cary, *The Taxation of Convertible Bonds and Stock*, 74 HARV. L. REV. 473 (1961).

252. Treas. Reg. § 1.368-2(e) (1955).

253. INT. REV. CODE of 1954, § 354(a).

tax on an "open-transaction" theory that results in nonrealization. The Treasury has asserted:

Where the owner of a bond exercises the right, provided for in the bond, of converting the bond into stock in the obligor corporation, such transaction does not result in a realization of profit or loss, the transaction not being closed for purposes of income taxation until such stock is sold.²⁵⁴

The distinction between the reorganization and purchase theories is quite clear. The first depends on a statutory exemption from recognition, the second on a judicially evolved theory of nonrealization. There is not as great a contrast between the open-transaction and purchase theories. Both focus on nonrealization, rather than on non-recognition. Since one theory is the result of judicial development and the other a Treasury product, one is tantalized by the prospect that perhaps different labels represent very similar ideas.

The premise initially underlying the open-transaction theory was stated by the Treasury as follows:

Gain or loss arising from the acquisition and subsequent disposition of property is realized when as the result of a transaction between the owner and another person the property is converted into cash or other property (a) that is essentially different from the property disposed of, and (b) that has a market value. In other words, both (a) a change in substance and not merely in form, and (b) a change into the equivalent of cash, are required to complete or close a transaction from which income may be realized.²⁵⁵

This article was dropped from the regulations with the enactment of subsequent revenue acts, but its conclusion and rationale are still operative,²⁵⁶ having been carried forward initially by explicit Treasury determinations²⁵⁷ and more recently by implication.²⁵⁸ While the conclusion that conversion is a nontaxable event is quite sound, the assertion that it is an event of form rather than substance is suspect.²⁵⁹ A shift from debt to common stock, or, more meaningfully,

254. Treas. Reg. 45, art. 1563 (1920), *amending* Treas. Reg. 45, art. 1563 (1918).
255. *Id.*

256. *Broenen v. Beaunit Corp.*, 440 F.2d 1244, 1246 (7th Cir. 1970), *citing* *Fleischer & Cary*, *supra* note 251; *Bethlehem Steel Corp. v. United States*, 434 F.2d 1357, 1361 (Ct. Cl. 1970), *citing* *Fleischer & Cary*, *supra* note 251.

257. *E.g.*, G.C.M. 18436, 1937-1 CUM. BULL. 101, 102.

258. Rev. Rul. 57-535, 1957-2 CUM. BULL. 513, 516.

259. Treasury Regulation 45 presented two criteria for determining whether a transaction is closed. *See* text accompanying note 255 *supra*. Since the stock underlying a convertible debenture will typically have a market value (especially easy to determine in the case of a publicly traded stock), the conclusion that conversion of a debenture is a nontaxed event appears to rest on the form-versus-substance distinction.

from the fixed-income nonappreciable bond into a variable-income appreciable common stock, is far more than a change in form or appearance, particularly since the conversion is nonreversible. For the security holder, a shift from creditor to shareholder status in a particular company (A.T. & T. for example), with the attendant major change in prospects for annual cash receipts, appreciation, and rights on liquidation, would usually be a much more significant economic event than a shift from bondholder status in that company to bondholder status in an entirely independent but comparable quality company (General Motors for example).

The purchase theory has much to commend it as the conceptual replacement for the open-transaction theory. There is no reason in contract law theory or business practice why the consideration for the "purchase" cannot be viewed as the cancellation of a debt or cancellation of one's rights as a preferred stockholder. Even the refinements of the purchase theory appear to fit. Common sense suggests that a continuing offer is as much embodied in a convertible security as it is in a right or warrant. In addition, the raising of permanent capital is characteristic of each situation. Some intellectual friction does arise because the convertibles have value as a bond or preferred stock independent of the option, whereas the right and warrant trace their value—even the warrant's unique leverage value—solely to the claim on common.²⁶⁰ However, section 171, dealing with amortizable bond premium, supports a perception of the convertible as two securities pasted together. It stipulates that in no case shall the amount of bond premium on a convertible bond include any amount attributable to the bond's conversion feature;²⁶¹ the value of the equity option must be identified and segregated from the bond element. This suggests the treatment of convertibles should parallel that of bond-warrant units: the cost of the convertible might be allocated to its bond and option components, with gain both realized and recognized on the bond feature when the option is exercised. Yet, this argument is undermined by section 1232. That provision implies, and the regulations expressly stipulate, that the conversion feature shall not be valued and subtracted from the se-

260. Fleischer and Cary give brief attention to the possibility of viewing a convertible debenture as directly analogous to a right and concluded that the bond feature is much too significant for the analogy to be drawn. Fleischer & Cary, *supra* note 251, at 489-90. They did not, however, explore the purchase rationale underlying the treatment of rights.

261. INT. REV. CODE OF 1954, § 171(b)(1)(C). By analogy, preferred stock would also have two distinct characteristics.

curity's cost in order to create bond discount.²⁶² A unitary view of the bond is manifested, but the stress is on the bond feature rather than on the option.²⁶³

The exercise of convertibles is presently an intellectual thicket because of those conflicting views of convertible debentures inherent in the Code: section 1232 ignores the option and views the hybrid security as only a debt instrument; section 171 recognizes two distinguishable features. The Supreme Court's purchase theory would not dispel all the present confusion, but it would reduce that confusion by replacing the open-transaction theory and its questionable application of a form-versus-substance distinction with a firmly entrenched judicial doctrine. Yet, although the purchase theory is more appropriate than the open-transaction theory, there exists a potentially better rationale: recapitalization.

e. *Alternatives to the purchase theory.* Although the purchase theory of nonrealization—based on the continuing-offer premise and bolstered by the suggested premise of capital-raising purpose—appears to be soundly based, an assessment of possible alternative theories is appropriate for three reasons. First, reliance on a non-realization theory is somewhat risky. The question of whether a disposition has occurred within the meaning of section 1001 is to a considerable degree a function of whether the imposition of a tax is "appropriate"; since the standards for judging appropriateness are vague, there is considerable room for changes in judicial and Treasury attitude. Second, the emergence of the warrant as a distinct junior equity security²⁶⁴ puts some strain on the purchase theory of non-realization. The modern view that warrants raise permanent capital

262. INT. REV. CODE of 1954, § 1232(b)(2); Treas. Reg. § 1.1232-3(b)(2)(i) (1968).

263. Theoretically, the Treasury's revenues should be about the same for bond-warrant units and convertible debentures despite their disparate treatment under section 1232. With a convertible sold at issue for its redemption price at maturity, the issuer gets no interest expense deduction and the bondholder has no ordinary income. With the bond-warrant unit the issuer will have an annual deduction for original-issue discount and under present law the bondholder would very often, but not always, have ordinary income in a comparable amount; it would occasionally be less than the issuer's deduction.

Congress' handling of convertible debentures avoids the mismatch in revenues and deductions which occasionally accompanies bond-warrant units, and it minimizes administrative burdens to taxpayers and the Internal Revenue Service. It is also consistent with the accounting profession's at least temporary resolution of a considerable controversy concerning whether the issuer should value the option inherent in the conversion feature and deduct any resulting bond discount as an interest expense. These substantial considerations of expediency go a long way toward justifying a provision that is conceptually unjustifiable.

264. See text accompanying notes 150-56 *supra*.

and that a major portion of the warrant's purpose is achieved upon sale of the bond-warrant units, plus the fact that warrants possess trading features unlike other securities—the unique premium or leverage value—combine to give a new significance to the issuance and trading of warrants; the more the warrant is thought of as separate from the common stock, the more “appropriate” it would be to make the warrant's exercise a taxable event. Third, as a consequence of an amendment to section 305, questions have arisen about the present validity of certain aspects of *Palmer*.²⁶⁵ While the purchase theory presently appears to be unaffected by these developments, any re-examination of *Palmer* could be significant.

The open-transaction theory appears to fit warrants, but it is a weak alternative to the purchase theory. A shift to common stock from the warrant, which has value only because of its claim on the underlying common, seems much more like the change in form contemplated by the open-transaction theory than is the conversion from bond to stock presently countenanced by that theory. Nevertheless, the questionable application of the form-versus-substance distinction leaves the force of the open-transaction theory in doubt. In addition, the purchase theory has a stronger judicial anchor than the open-transaction theory: the Supreme Court articulated it and two courts of appeals have refined it, while the open-transaction theory is a Treasury pronouncement and nothing more.

The recapitalization theory governing convertible preferred stock is a second and quite sound alternative. Section 354 provides, in part, that if as part of a “reorganization” as defined in section 368, “stock or securities” of a particular company are exchanged for stock of that company, no gain or loss shall be recognized. Assuming for the moment that exercise of warrants would be a “recapitalization” under section 368(a)(1)(E) and therefore a “reorganization,”²⁶⁶ the critical issue becomes whether warrants are “stock or securities.” Neither term is defined by Congress. It was left to the courts to shape their meaning. While nonassignable warrants to buy stock have been treated as stock on the theory that no other consideration can be received for them,²⁶⁷ the Treasury has taken the position that transfer-

265. See *Gordon v. Commissioner*, 391 U.S. 83, 89-90 n.4 (1968); Carlson, *Taxation of “Taxable” Stock Rights: The Strange Persistence of Palmer v. Commissioner*, 23 TAX L. REV. 129 (1968).

266. See text accompanying notes 295-98 *infra*.

267. Rev. Rul. 66-112, 1966-1 CUM. BULL. 68; Rev. Rul. 66-366, 1966-2 CUM. BULL. 194. These rulings pertain to section 368, but that section is so closely identified with section 354 that the term “stock” should have a like meaning in both provisions.

able warrants are not stock within the meaning of section 354,²⁶⁸ and lower courts have so held.²⁶⁹ Under section 368, which is closely related to section 354, the Supreme Court has held that transferable warrants are not stock.²⁷⁰ The Court reasoned that although the warrants could only be exercised to acquire voting stock, the character of the instrument at the time of the exchange was controlling, and the warrant holder was not then a stockholder.

With regard to the now-critical question of whether the warrant is a "security," the answer, though presently ambiguous, should be affirmative. The Treasury has taken the position that, for purposes of section 354, warrants are not included in the term "securities."²⁷¹ In contrast, the Tax Court has held that transferable perpetual warrants are securities within the meaning of the identical predecessor of section 354(a)(1),²⁷² and it has refrained from deciding whether a later limitation on the general rule of section 354(a)(1) operates to change the characterization of a warrant as a security.²⁷³

The Supreme Court has not had occasion to address itself to this issue, but the Third Circuit in *Neville Coke & Chemical Co. v. Commissioner*²⁷⁴ considered the somewhat analogous question whether debt transferred to the corporation was a security, and propounded the puzzling thesis that the debt instrument must have a proprietary interest prior to transfer to qualify as a security.²⁷⁵ It seems reasonable to anticipate that a court following *Neville Coke* would require that warrants have a similar proprietary interest prior to exercise in order to qualify as a security. No problem should be presented by this requirement. Although not free from doubt, recent developments reinforce the conclusion that warrants represent a proprietary

268. Treas. Reg. § 1.354-1(e) (1955). The Treasury has held that warrants with none of the attributes of immediate stock ownership are not stock for purposes of section 1372. Rev. Rul. 67-269, 1967-2 CUM. BULL. 298.

269. William H. Bateman, 40 T.C. 408, 415 (1963). See E.P. Raymond, 37 B.T.A. 423 (1938). Cf. *Carlberg v. United States*, 231 F.2d 507 (8th Cir. 1960) (Blackmun, J.). So-called "warrants" have been held to be stock for purposes of the foreign personal holding company provisions when they possess important stock characteristics such as rights to dividends and rights to vote at shareholders' meetings. *Estate of Nettie Miller*, 43 T.C. 760, 764 (1965).

270. *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194, 200 (1942). Cf. *Helvering v. San Joaquin Fruit & Inv. Co.*, 297 U.S. 496 (1936) (option to buy real property).

271. Treas. Reg. § 1.354-1(e) (1955).

272. E.P. Raymond, 37 B.T.A. 423 (1938).

273. William H. Bateman, 40 T.C. 408, 415 (1963).

274. 148 F.2d 599 (3d Cir.), cert. denied, 326 U.S. 726 (1945).

275. 148 F.2d at 602.

interest. They have been styled "a junior equity security" by the SEC and a leading federal court.²⁷⁶ In addition, the accounting profession, reflecting the evolving attitude of the financial and accounting communities, now considers them common stock equivalents.²⁷⁷

Qualification as a security should not, however, be governed by a proprietary test. The notion appears to represent an arrant engrafting of the "continuity-of-interest" doctrine,²⁷⁸ which overrides the reorganization provisions, onto the term "securities" as it appears in section 354. Several cases do intertwine problems of definition with the continuity doctrine,²⁷⁹ but other cases follow the more sharply focused and preferable procedure of treating a definitional task separately from the question whether the dominant continuity-of-interest doctrine is satisfied.²⁸⁰

Since "the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses,"²⁸¹ resolution of the question whether a warrant is a security should reflect the terminology of our financial community. This is especially appropriate in view of the extensive, highly developed, and populous nature of that community. The ordinary warrant is a "security" within the meaning of Article 8, Investment Securities, of the Uniform Commercial Code,²⁸² and is a security within the registration provision of the Securities Act of 1933.²⁸³ It is listed on our national securities exchanges,²⁸⁴ and the warrant is discussed in basic texts on security analysis.²⁸⁵ Moreover, in contrast to its position regarding sections 354 and 368, the Treasury itself assumes that a warrant

276. See notes 150-56 *supra* and accompanying text.

277. See note 135 *supra* and accompanying text.

278. See *LeTulle v. Scofield*, 308 U.S. 415, 421 (1940); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378, 386 (1935); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462, 470 (1933); *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332, 334 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951); *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937, 940 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933).

279. *Neville Coke & Chem. Co. v. Commissioner*, 148 F.2d 599 (3d Cir. 1945); *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932).

280. *LeTulle v. Scofield*, 308 U.S. 415 (1940); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951).

281. *Crane v. Commissioner*, 331 U.S. 1, 6 (1947). *Accord, e.g., Commissioner v. Brown*, 380 U.S. 563, 571 (1963); *Hanover Bank v. Commissioner*, 369 U.S. 672, 687 (1962).

282. UNIFORM COMMERCIAL CODE § 8-102(1)(a) & Comment.

283. See note 11 *supra*.

284. See note 2 *supra* and accompanying text.

285. See note 70 *supra*.

is a security for purposes of the wash sale provisions. The wash sale rules provide in brief that no deduction shall be allowed if, within thirty days from the sale or other disposition of "shares of stock or securities," the taxpayer acquires substantially identical stock or securities.²⁸⁶ Revenue Ruling 56-406, which considers whether section 1091 is applicable to a loss sustained "on the sale of warrants of the corporation where common stock of the corporation was purchased simultaneously,"²⁸⁷ defines the circumstances where the loss will be disallowed. The necessary assumption of the ruling is that warrants are stock or securities,²⁸⁸ and, indeed, the Treasury discusses the relative values and price changes that can "make the warrants fully convertible securities."²⁸⁹ Furthermore, the property subjected to the short-sale rules consists only of "stock," "securities," and "commodity futures."²⁹⁰ Since warrants are manifestly not commodity futures and are not stock,²⁹¹ their coverage depends on their being a "security."²⁹²

Departure from a literal reading of statutory language may on occasion be necessary in order to implement the legislative purpose.²⁹³ Possible abuses in the use of warrants, if styled securities, do not appear difficult to handle. Issuance of cash equivalents—such as warrants callable at an early date or short-term warrants on short-term debt—that might threaten to defeat congressional intent can easily be dealt with by analogy to those cases in which short-term debt has been held not to be a "security."²⁹⁴ Significantly, the standard evolving to

286. INT. REV. CODE of 1954, § 1091(a).

287. Rev. Rul. 56-406, 1956-2 CUM. BULL. 523, 524.

288. The Treasury's position is especially significant since the language of section 1091 lends some support to an argument that options, including warrants, are not securities. Congress separately mentioned "stock," "securities," and an "option to acquire" stock or securities in section 1091. The separate mention arguably suggests options and securities are separate. The Treasury's interpretation appears the more reasonable alternative.

289. Rev. Rul. 56-406, 1956-2 CUM. BULL. 523-24 (emphasis added).

290. INT. REV. CODE of 1954, § 1233(e)(2).

291. See notes 268-70 *supra* and accompanying text.

292. There appears to be no case or Treasury pronouncement explicitly discussing the relationship between section 1233 and warrants. However, Treas. Reg. section 1.1233-1(d)(1) (1967) provides that "[i]n general, as applied to stocks and securities, the term [substantially identical property] has the same meaning as the term 'substantially identical stock or securities' used in section 1091" Thus Revenue Ruling 56-406, note 287 *supra*, and its implications become germane. Furthermore, it is not reasonable to suppose that Congress intended short sales of listed warrants to be excluded from section 1233. Inclusion carries the necessary implication that they are stock or securities.

293. See, e.g., *Board of Governors of the Federal Reserve System v. Agnew*, 329 U.S. 441, 446-48 (1947).

294. See, e.g., *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933).

govern these cases places stress on the continuity-of-interest doctrine, not on the term "security."²⁹⁵ Where already outstanding warrants on common stock are being exercised, there are no apparent opportunities for abuse if warrants are considered securities. However, there might be an appropriate distinction between tendering and receiving a warrant in resolving whether there is a continuity of interest.²⁹⁶

An implication of viewing warrants as securities is that if issued as part of a transaction that qualifies as a reorganization under section 368, they would not be treated as other property, or so-called "boot," within the meaning of sections 354 and 356. Therefore, there might be a small increase in the use of warrants, particularly since advance rulings are common in the reorganization area.

It was assumed earlier that exercise of a warrant was a recapitalization within the meaning of 368(a)(1)(E) and therefore a reorganization.²⁹⁷ That assumption now needs to be verified. The term "recapitalization" is not defined in the Code, and the development of its metes and bounds has also been left to the Treasury and judiciary. Generally speaking, it involves "a reshuffling of a capital structure, within the framework of an existing corporation."²⁹⁸ It encompasses exchanges by a corporation's security holders of one class of stock or securities for another class issued by the same corporation.²⁹⁹

Exercise of a warrant would appear to qualify as a recapitalization, although no cases have yet confronted the issue. Exercise of warrants reshuffles the capital structure, for the shares of common outstanding are increased. The business-purpose criterion³⁰⁰ is easily satisfied by the capital-raising consequence of exercise. With regard to continuity of interest, the problem historically troubling the courts and the Treasury has involved situations in which the interest before exercise was arguably more substantial than the interest

(debt was payable within four months); *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933) (fourteen months); *Margorie Fleming Lloyd-Smith*, 40 B.T.A. 214 (1939), *affd.*, 116 F.2d 642 (2d Cir. 1941) (two years).

295. See *LeTulle v. Scofield*, 308 U.S. 415 (1940).

296. See text accompanying note 301 *infra*.

297. See text accompanying note 266 *supra*.

298. *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194, 202 (1942). *Accord*, *United Gas Improvement Co. v. Commissioner*, 142 F.2d 216, 219 (3d Cir. 1944), *cert. denied*, 323 U.S. 739 (1945); *Commissioner v. Neustadt's Trust*, 131 F.2d 528, 529 (2d Cir. 1942).

299. See B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* § 14.17 (3d ed. 1971).

300. See, e.g., *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).

after exercise.³⁰¹ The exercise of warrants is particularly compatible with the continuity test since the warrant holder advances to the position of a full-fledged shareholder with the associated voting and other ownership rights. Indeed, there is not only continuity, but an increase in the warrant holder's interest. Where receipt of warrants would decrease one's proprietary interest—as where common stock was surrendered for warrants—the continuity-of-interest test might preclude qualification as a reorganization.

A possible objection to viewing exercise as a recapitalization might be that the reshuffling associated with recapitalization contemplates not just an increase in one component of a corporation's capital structure, but a decrease in another component as well. Assuming this to be so, the warrant's exercise should still qualify. Accounting practice has moved decidedly in the direction of reflecting warrants in the capital structure of the company, a practice not heretofore followed.³⁰² Moreover, since the term recapitalization has not been defined by Congress and the courts have indicated the term is to be given a broad meaning,³⁰³ evolution in that meaning to include exercise of warrants would seem appropriate.

The recapitalization theory of nonrecognition presently governing the exercise of convertible preferred stock appears to be a viable alternative theory for concluding that exercise of warrants is a non-taxable event.

IV. ISSUER'S PERSPECTIVE

The aspects of warrants that are of particular financial and corporate law significance to the issuer have been identified in prior sections of this Article. Certain tax consequences have also been previously identified, but several important tax points remain and must now be considered. Analysis of these points suggests that issuance and exercise of the warrant element of a bond-warrant unit are nontaxable events to the issuing corporation. Expiration poses a more difficult question, but on balance it should also be a nontaxable event.

Three alternative theories support the conclusion that the is-

301. See, e.g., *LeTulle v. Scofield*, 308 U.S. 415 (1940); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933); *Treas. Reg. § 1.368-1(b)* (1955).

302. APB Op. No. 14, *supra* note 87.

303. See *Commissioner v. Edmonds' Estate*, 165 F.2d 715, 718 (3d Cir. 1948); *Commission v. Neustadt's Trust*, 131 F.2d 528, 530 (2d Cir. 1942); *Alan O. Hickock*, 32 T.C. 80, 87 (1959); *Penfield v. Davis*, 105 F. Supp. 292, 303 (N.D. Ala. 1952), *affd.*, 205 F.2d 798 (5th Cir. 1953).

suance of the warrant element of a bond-warrant unit is a nontaxable event. Under a nonrealization theory, issuance is a nonrealization event by analogy to the purchase theory and its continuing-offer premise;³⁰⁴ essentially, the option is a preliminary and subsidiary event in a transaction ultimately directed toward the sale of stock. Because the accomplishment of this purpose depends upon the warrant's subsequent exercise, the most "appropriate occasion"³⁰⁵ for considering the question of gain (or loss) is either exercise or expiration.

The second theory for viewing issuance as a nontaxable event is found in the exemption from recognition provided by section 1032. That section dictates nonrecognition when a corporation receives money or other property in exchange for "stock" of such corporation.³⁰⁶ Although the legislative history is somewhat skimpy, the congressional purpose behind this provision was apparently to permit corporations to raise permanent equity capital without paying a tax on that equity. Under the modern view that a warrant is a security for raising such permanent equity capital, its issuance is within the ambit of the congressional purpose; permanent capital is raised upon sale of warrants, and neither the subsequent exercise nor expiration changes that fact. The obstacle to the application of section 1032 to the issuance of warrants is the requirement that "stock" be exchanged for the money or property. As elsewhere in the Code, the term stock is not defined in section 1032; as a result, it has fallen to the courts to interpret that section. Some authorities have held that warrants are not stock under sections 354 and 368.³⁰⁷ The significance of these holdings to the issuance of warrants under section 1032 is in doubt, however, given the different purposes of the provisions. The increasing acceptance of warrants as junior equity securities and the apparent purpose of section 1032 not to tax permanent equity suggest that warrants should be viewed as stock for the purposes of section 1032.

The final theory for viewing issuance as a nontaxable event is based on section 118, which excludes from gross income "any contribution to the capital" of the corporation.³⁰⁸ This phrase is not

304. See text accompanying notes 226-44 *supra*.

305. *United States v. Davis*, 370 U.S. 65, 68 (1962). See text accompanying note 237 *supra*.

306. INT. REV. CODE of 1954, § 1032(a).

307. See notes 268-70 *supra* and accompanying text.

308. INT. REV. CODE of 1954, § 118(a).

defined in the Code, but it is clear that both stockholders and non-stockholders can make such a contribution, and it is also apparent that a dominant factor in characterizing a transaction is the motive, purpose, or intent of the contribution.³⁰⁹ The requisite motive under section 118 is different from the motive underlying a gift; but while the expectation of indirect, remote, or general benefits is permissible,³¹⁰ a benefit in the form of the immediate receipt of goods or services negates the idea of a contribution to capital.³¹¹ Concerning situations between the two extremes, it has been observed that the acquisition of an interest in a corporation or the increase of one's equity is evidence of a contribution to capital;³¹² thus, it is permissible to anticipate the future benefit attending a successful investment. The Regulations mention four criteria in determining an acceptable motive for contributions to capital by stockholders: a need by the corporation for additional capital, the voluntary nature of the contribution, the crediting of the contribution to surplus or a special account, and a showing that the contribution was not in consideration for goods or services.³¹³ Given the financing purpose of the corporate issuer of bond-warrant units and the warrant holder's expectation of gain through appreciation in the underlying common stock, all four of the Treasury's criteria would appear to be met. There is no relevant practical difference between a stockholder paying an additional price for stock already owned as compared to a nonstockholder paying that additional price—through the mechanism of purchasing an option—before a possible stock purchase.

Qualification under section 118 apparently would have an important side effect in the typical case where warrants are sold to

309. *United Grocers, Ltd. v. United States*, 308 F.2d 634, 639 (9th Cir. 1962).

310. *Brown Shoe Co., Inc. v. Commissioner*, 339 U.S. 583 (1950); *United Grocers, Ltd. v. United States*, 308 F.2d 634 (9th Cir. 1962); S. REP. NO. 1622, *supra* note 190, at 190.

Although section 118 had no counterpart in prior tax codes, the legislative history evidences the intent to codify then existing law exempting from taxation voluntary contributions for reasons other than the receipt of goods or services. S. REP. NO. 1622, *supra* note 190, at 190. Consequently, analogous cases such as *Brown Shoe* are germane. For a discussion of section 118 and the relevant cases before and after its enactment, see Landis, *Contributions to Capital of Corporations*, 24 TAX L. REV. 241 (1969); Note, *Taxation of Nonshareholder Contributions to Corporate Capital*, 82 HARV. L. REV. 619 (1969).

311. *Detroit Edison Co. v. Commissioner*, 319 U.S. 98, 102 (1943); *Teleservice Co. v. Commissioner*, 254 F.2d 105, 110 (3d Cir.), *cert. denied*, 357 U.S. 919 (1958); Treas. Reg. § 1.118-1 (1956).

312. *United Grocers, Ltd. v. United States*, 308 F.2d 634, 640 (9th Cir. 1962).

313. Treas. Reg. § 1.118-1 (1956).

nonstockholders or to investors who are only coincidentally stockholders. Since at the time of warrant purchase a warrant holder would not thereby become a stockholder, under section 362 the corporation's basis for the property acquired with the money received for the warrant would be reduced by the amount of the contribution.³¹⁴ Should this purchased property be a depreciable asset, the corporation is avoiding tax on the money paid for the warrant at ordinary-income rates in the year of the contribution, but forgoing the depreciation deduction against ordinary income in years subsequent to the warrant's issuance. Thus, qualification under section 118 does not eliminate, but merely postpones, the tax and—since a capital asset may be purchased with the contribution—creates the possibility that the subsequent tax will be at capital-gain rather than ordinary-income rates.

Exercise of a warrant is also a tax-free event to the corporation. Alternative theories again support a common result. The analogy to the purchase theory of nonrealization is feasible, and a contribution to capital has arguably occurred. But section 1032 is more certain than these alternative theories: exercise falls within the plain meaning of the statute; stock has been issued in return for money or other property.³¹⁵

Expiration of the unexercised warrant poses the most difficult problem for the corporate issuer. The Treasury has taken the position that the grantor of an option has ordinary income in the amount of his gain when the option expires unexercised.³¹⁶ As written, this regulation appears to reach the corporate issuer of warrants. However, there are practical and statutory reasons why this regulation, although applicable to writers of calls,³¹⁷ should not be applied to corporate issuers of warrants. In contrast to the corporation that issues warrants, the writer of a call makes no new capital available to the corporation. Consequently, while the call writer has—by analogy to the purchase theory and its continuing-offer premise—the benefit of a nonrealization theory when the call is granted, there is no nonrecognition or exclusion (from gross income) provision exempting from taxation either the grant of a call or its expiration. The corporate issuer, on the other hand, can rely on either section 118 or section 1032 to immunize expiration against taxation.

314. INT. REV. CODE of 1954, § 362(c)(2).

315. INT. REV. CODE of 1954, § 1032(a).

316. Treas. Reg. § 1.1234-1(b). See Rev. Rul. 58-234, 1958-1 CUM. BULL. 279; Rev. Rul. 57-40, 1957-1 CUM. BULL. 266.

317. See text accompanying note 37 *supra*.

Under the previously considered theory that realization did not occur at issuance,³¹⁸ the subsequent event—expiration—marks the end of the transaction and thus would ordinarily trigger realization; it thus poses the question whether a nonrecognition provision is then operative. Section 118 may insulate the transaction from taxation on the theory that the funds previously received for the warrant have been contributed to the capital of the corporation and are therefore excluded from gross income. Arguing that issuance was a nonrecognition event (which presupposes realization) under section 1032³¹⁹ would also make the subsequent expiration a nontaxable event: at the time of issuance, neither the question of realization nor the consideration of recognition had been deferred to expiration. Moreover, expiration itself provides no new funds, and the event in no way changes the corporation's responsibility to the funds already received. Consequently, there is no new realization event at expiration, and the nonrecognition protection already afforded by section 1032 is not terminated since the reasons for the section's application at issuance have not been changed by expiration.

Two problems of tax consequence to the issuer remain to be considered: the treatment of bond-issue discount and use of bond-warrant units in corporation acquisitions. Upon sale of a bond-warrant unit, the funds determined as paid for the bond are not subjected to taxation at the time of receipt.³²⁰ When the issuance of such units results in the bonds being deemed issued with original-issue discount, this discount is usually amortized ratably over the life of the bond as an interest expense deduction.³²¹ A limitation is placed, however, on the issuer's deduction of bond discount when the bond is retired prior to maturity: if the price paid to retire the bond is less than the total of the issue price plus original-issue discount already deducted, the difference is income in the year of the repurchase;³²² on the other hand, if the repurchase price exceeds the issue price as adjusted for the deductible discount, the difference is a deductible expense for the issuer.³²³ It follows from the forgoing

318. See text accompanying notes 304-05 *supra*.

319. See text accompanying notes 306-07 *supra*.

320. See Treas. Reg. § 1.61-12(c)(1)-(5) (1968). Cf. Treas. Reg. § 1.163-3(a) to (b) (1968).

321. Treas. Reg. § 1.163-3 (1968). Cf. Treas. Reg. § 1.61-12(c)(7) (1968). A minor nuisance associated with such discount is the obligation the issuer has to inform the registered owner of the bond of the amount of the discount. INT. REV. CODE of 1954, § 6049(a), (c).

322. Treas. Reg. § 1.61-12(c)(3) (1968).

323. Treas. Reg. § 1.163-3(c)(1) (1968).

that the unamortized discount is deductible neither ratably in the years following retirement, nor in full in the year of redemption.

The second deduction limitation arises when bond-warrant units are used in corporate acquisitions and the debt qualifies as corporate acquisition indebtedness under section 279; interest in excess of the statutorily permitted amount is not deductible.³²⁴ When section 279 operates to preclude the issuer from deducting the stated interest on the bond, it is not clear whether it also prevents deduction of the interest imputed under section 1232. Original-issue discount, while like interest in some respects,³²⁵ seems different from stated interest. It is nowhere styled interest in section 1232, and it is meaningfully different from interest in a financial sense: there is an annual cash outflow for stated interest that is required by contract, whereas there is no disbursement for imputed interest expense. On the other hand, whether the interest expense is imputed or actual, the tax result is the same when a deduction is taken. Moreover, the yield theory, which appears to underlie section 1232,³²⁶ considers the discount as interest in a theoretical sense, and the Treasury, through the Regulations, appears to view the issuer's deduction as interest expense.³²⁷ Finally, Congress' intent in enacting section 279 was to discourage debt-financed acquisitions by denying an interest expense deduction when classic security analysis concepts for determining acceptable debt risk are violated;³²⁸ permitting the deduction would thwart this objective. Thus, the deduction limitation of section 279 should be viewed as applicable to original-issue discount in bond-warrant units.

V. CONCLUSION

Four decades have elapsed since warrants were last used in volume and discussed in detail in legal literature. Their significant use in public financing has made it appropriate to reassess the instrument, especially since the financial, legal, and accounting environment today has changed in some meaningful respects from its state in the early 1930's.

324. INT. REV. CODE of 1954, § 279(a).

325. See note 190 *supra* and accompanying text.

326. See text accompanying notes 192-96 *supra*.

327. Although the Treasury discusses the deductibility by the issuer of bond discount in the regulations under the interest expense provision, Treas. Reg. § 1.163-3 (1968), it is interesting that the discussion nowhere refers to "interest" income or "interest" expense.

328. Compare GRAHAM & DODD, 4th ed., *supra* note 35, at 324-63, with INT. REV. CODE of 1954, § 279(b)-(c).

In view of earlier authoritative criticism of warrant use, the most basic and pertinent question for issuers and their shareholders is whether the issuance of warrants (typically as an element in a bond-warrant unit) is on balance beneficial to their interests. Past criticism of warrants has basically been legitimate but too sweeping. In particular, there has been inadequate perception of the benefits received by existing shareholders. Whereas some early legal writers saw the warrant as a device whereby the holder got something for nothing, the gross benefit received from its issuance in a bond-warrant unit is, at a minimum, the present value, after tax, of the cash interest saved; and the benefit can be substantially higher when the option's leverage value permits its sale at a price in excess of the present value of the cash interest saved. Indeed, the warrant is today a junior equity security issued as a means of raising permanent capital both at initial sale and subsequently at exercise. When compared to financing alternatives, there are circumstances today in which the bond-warrant unit's effect on cash flow, risk, and reported earnings (and through reported earnings, on the common stock's market price) makes that unit the optimal financing choice.

As a consequence of the misunderstanding of the possible benefits of warrants to stockholders, there was inadequate focus on taming the warrant—that is, eliminating its abuses while retaining its benefits. More recently, the financial community—issuers, underwriters, stock exchanges, and accountants—have acted with increasing understanding and wisdom. The quantum of warrants issued relative to the outstanding stock of any particular issuer has remained low. The lives of warrants have usually been kept short, generally within five to ten years. The stated exercise price has usually been at market or above, not below. Somewhat tardily, the problem of potential dilution has been addressed and provisions made for improving disclosure. These practices should be continued. Conversely, the highly questionable use of perpetual and other long-lived warrants and the issuance of large numbers of warrants relative to the outstanding common stock should be avoided. The realization that pragmatically the warrant is a junior equity security argues that state statutory law should require that issuance of all warrants, but certainly those with a life of twenty years or more, be authorized by shareholders in the same manner as common stock and preferred stock.

From the holder's perspective the major legal issues relate to tax treatment, with the desirability of legislative protection of certain basic expectations being a secondary topic. Regarding the latter, too

few cases involving recent warrants have been decided to predict whether modern courts will manifest the hostility of an earlier age or a new amity toward the warrant holder. As cognizance that warrant holders are not necessarily corporate parasites and that the issuance of bond-warrant units can be in the shareholders' interests increases, a willingness to protect the warrant holder's rights seems likely to appear also. By anticipating problems, state legislatures could, through more definitive legislation, assist attorneys in protecting warrant holders from possible abuse. Reputable issuers and their advisors, aware that a warrant holder's rights depend upon his contract, have been at pains to protect him against dilution and changes in corporate circumstances that could terminate or seriously defeat his reasonable expectations without compensation. Investors will come to expect these basic contractual protections, and indeed they probably have done so already. The basic protections should be codified to avoid their inadvertent or intentional omission.

In the income tax area, Congress has for questionable reasons imposed a surprisingly harsh tax burden upon the individual cash-basis purchaser of a bond-warrant unit. The warrant itself is not directly affected, but the bond element of the unit is. One may surmise that as investors come to appreciate their annual-income responsibility for imputed interest on original-issue discount bonds, such bonds will be less attractive to investors relative to bonds without such a discount. This factor, which was intended to reduce the use of units in mergers, will lessen the unit's attractiveness to investors in all circumstances.

The justification for treating exercise of long-term equity options as nontaxable events resides in a variety of theories. The treatment of warrants is well grounded in the purchase theory, which as interpreted appears to owe its force to common law contract theory. The rationale justifying the treatment of exercise as a nontaxable event is a pivotal tax principle, and its underlying rationale should be shifted from common law contract theory to a more practical justification—the purpose and realities of corporate financings. Moreover, should the purchase theory of nonrealization lose vitality, a proper alternative rationale could be found in the reorganization theory of non-recognition presently governing the exercise of convertible preferred stock.

From the issuer's perspective, tax questions are especially relevant. Issuance, exercise, and expiration may be nontaxable events to the corporate issuer of warrants under one or a combination of

theories presented above. These theories have practical as well as theoretical significance since different tax ramifications flow from several of the alternatives.

As one assesses the warrant's basic character, its use today, and the posture of the law surrounding that use, it seems clear that several of the legal implications of issuing, owning, and selling warrants are in a state of flux, while others are tenuously based, or of questionable validity. The time is propitious for Congress and state legislatures to take a fresh look at the instrument and make legislative adjustments that would rationalize and clarify its status. Only this will give direction and meaning to the evolution in the use and perception of warrants that has occurred since the 1930's.