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UPDATE

News of Developments in the Financial Sector and Related Areas

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What is the Difference Between Dilution and Antidilution?

Dilution results in a decrease in the percentage of the outstanding stock of a company represented by a fixed number of shares. For instance, percentage dilution occurs to existing shareholders whenever a company issues shares of its stock to a new shareholder. It also results from the increase in the total number of outstanding shares of the company caused by the sale of new shares. The increase in outstanding shares reduces the percentage of ownership each share represents in the company. Dilution occurs when existing shareholders do not purchase new shares, thereby owning a smaller percentage of the total number of outstanding shares. Antidilution is, obviously, the opposite of dilution and generally will be found in agreements that entitle an investor or shareholder to obtain additional ownership in a company, without additional cost, when a later investor purchases stock of the company at a lower cost per share. Many investors insist on some type of antidilution protection to protect themselves against dilution resulting from future sales of stock at lower prices. Because antidilution provisions may result in protected investors receiving free shares of stock when a future issuance of stock is at a lower price, antidilution provisions disproportionately reduce the percentage of ownership of shareholders who are not protected. Antidilution provisions may occur and be found in a shareholders agreement or in any other agreement between an investor and a company. An example of an antidilution provision would provide that the percentage of a company owned by an investor will not be reduced by some future event such as a stock split. Another example of an antidilution provision may require a company to give an investor free stock if the company sells stock to a later investor at a lower price, resulting in the earlier investor receiving enough free shares to reduce his average cost per share to the price paid by the new investor. Depending on the nature of antidilution provisions, companies will want to consider stipulating an expiration date, since these provisions may hamper a company in its ability to raise additional capital.

Arkansas Usury Law

Hickman v. Courtney is a recent decision by the Arkansas Supreme Court interpreting the Arkansas usury law. The Arkansas Constitution generally provides that the maximum rate of interest on any contract shall not exceed 5% per annum above the Federal Reserve Discount Rate at the time of the contract. The facts in this case reflect that Courtney had been a certified public accountant for over 40 years and, anticipating retirement, decided to sell his accounting firm to Hickman, his employee of approximately 3 years. The parties entered into a loan agreement representing the purchase amount that did not expressly state a rate of interest to be charged but merely provided for an interest rate *at the then prevailing commercial loan rate*. Hickman first discovered that she was being charged a usurious rate of interest when her bank, as part of a loan renewal process, requested that she provide an amortization schedule for her loan with Courtney and a 1099 tax form reflecting interest she paid to Courtney during the year. These documents indicated that Hickman was paying an annual percentage rate of 8.5% on her loan with Courtney. At the time the agreement was entered into by the parties, the maximum interest rate allowed under Arkansas law was 6.25%, *i.e.*, the Federal Reserve Discount Rate at the time the contract was entered into was 1.25%, resulting in the maximum lawful rate of interest under the loan agreement being limited to 6.25% or 5% over the Federal Reserve Discount Rate. Usurious contracts are void as to the amount of unpaid interest, and a borrower may recover twice the amount of interest already paid on the loan. For a contract to be usurious, it must be so at the time it is entered into by the parties. The Court noted that Hickman had the burden of proving by clear and convincing evidence that Courtney possessed the intent to charge a rate of interest that proves to be usurious. The Court held that the circumstances clearly indicated that Courtney intended to charge a rate of interest that proved to be usurious based on (i) his own testimony, which was corroborated by his wife, (ii) a tax return and a 1099 tax form prepared by Courtney reflecting that he was receiving 8.5% in interest on the loan and (iii) his professional background and experience. Courtney also argued that the Arkansas usury law was either unconstitutional or invalid because the Federal Reserve Board ceased using the term *Federal Reserve Discount Rate*. The Court noted that Courtney's argument had no bearing on the outcome of the case since the Federal Reserve Discount Rate was still in existence at the time that the loan agreement was made. As a side note, the Federal Reserve ceased using the term *Federal Reserve Discount Rate* on January 9, 2003. On that date the Federal Reserve began offering three programs to depository institutions which included primary credit, secondary credit, seasonable credit, each with its own interest rate. Under the primary credit program, the Federal Reserve offers its most favorable interest rate. In a Release dated January 9, 2003, by the Federal Reserve regarding the term *Discount Rate*, the Release states, "Because primary credit is the Federal Reserve's main discount window program, the Federal Reserve at times uses the term 'discount rate' to mean the primary credit rate." Because of the elimination of the term *Federal Reserve Discount Rate*, the Attorney General of Arkansas issued Opinion No. 2002-334 (the "Attorney General's Opinion") regarding the maximum rate of interest that can be charged on loans under Arkansas law. The Arkansas Constitution limits the maximum rate of interest on any contract to five percent (5%) per annum above the Federal Reserve Discount Rate at the time of the contract. The Attorney General's Opinion concludes, among other things, that the phrase "Federal Reserve Discount Rate" is equivalent to the Federal Reserve Board's "primary credit" rate which became effective on January 9, 2003, but the issue can be resolved definitively only by an amendment to the Arkansas Constitution or through interpretation by a court. As a result of the Attorney General's Opinion and the Release dated January 9, 2003, by the Federal Reserve regarding the term *Discount Rate,* lenders that are subject to the Arkansas usury law have limited the amounts charged to borrowers to no more than 5% above the primary credit rate. Other court decisions interpreting the Arkansas usury law are available on the *UPDATE* web site at *www.GWBinns.com* under the heading *Cases and Rulings*.

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