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Early Returns From the Fast Act Rule Changes

Earlier this year, the SEC adopted rule amendments designed to modernize and simplify some of Regulation S-K's disclosure requirements pursuant to a directive from the 2015 Fixing America's Surface Transportation Act (the "Fast Act"). *Fast Act Modernization and Simplification of Regulation S-K*, Release No. 33-10618 (Mar. 20, 2019). Many of those rules went into effect for filings made on or after May 2, 2019.

Since the changes have their most significant implications for Form 10-K filings, I looked at some of the filings made after the compliance date to see whether I could draw any initial conclusions about how companies are using the increased flexibility under the rules—and whether they're complying with their new obligations.

Since some of the increased flexibility found in the SEC's new rules was already provided to emerging growth companies and smaller reporting companies, I focused my attention on large accelerated filers. I reviewed the 79 Form 10-K filings made by large accelerated filers that were also operating companies (not pass-throughs or financing vehicles) between May 3 and July 15, 2019.

I focused on the issues that I thought would be relatively transparent from the face of the filings—whether companies caught the new cover page changes, whether they made changes to the description of their properties or opted to provide the more streamlined MD&A disclosure allowed by the new rules, and whether they complied with the new requirement to include a description of securities registered under the Exchange Act as part of their exhibits to the filing.

The results suggest that, so far at least, a relatively small percentage of companies are taking advantage of the streamlined disclosure options available to them under the rule changes, but that a high percentage of filers are overlooking the new exhibit disclosure obligation imposed by the rules.

Changes to the Form 10-K Cover Page

The Fast Act rule amendments made changes that impact the cover page disclosure on Forms 10-K, 10-Q and 8-K. The most notable of these changes—Inline XBRL tagging of cover page data—did not apply to the filings that I looked at. That's because there's a phase-in compliance date for this new requirement—and it didn't apply to large accelerated filers until their first Form 10-Q filing for a fiscal period ending on or after the June 15, 2019.

But the rules made other changes to the cover page of Form 10-K, and companies were required to comply with those rules beginning on May 2, 2019. The revised cover page for Form 10-K requires companies to disclose the title of the class of securities registered under the Exchange Act, the trading symbol, and the exchange or principal U.S. market on which the class is listed. In addition, the SEC removed the checkbox from the cover page of Form 10-K that previously was used to indicate whether there would be disclosure of delinquent Section 16 filers in the 10-K or proxy statement.

The companies whose filings I looked at incorporated the changes to the cover page without a hitch—all 79 included the updates to the cover page with their filing.

Item 102 of S-K– Description of Property

The SEC amended Item 102 to clarify that disclosure about a particular property is only required to the extent that it is material to the company, and that property information may be disclosed on a collective basis. The adopting release did not provide a lot of specifics, so perhaps it is not surprising that few companies made any changes to their description of properties required by Item 2 of Part I of Form 10-K.

I found only three companies—Thermon Group, Symantec and Logitech—that significantly revised their properties disclosure in comparison to prior years. Thermon and Logitech replaced lengthy, tabular disclosures about properties with much more abbreviated narratives, while Symantec eliminated its relatively abbreviated 2018 disclosure altogether. Under Item 2 of its 2019 Form 10-K, Symantec simply took the position that, as revised, the disclosure called for by Item 102 was "not applicable."

Item 303 of S-K—MD&A

As part of the Fast Act rule changes, the SEC also revised Instruction 1 to Item 303(a) of Regulation S-K to permit companies to omit the discussion of the earliest of the three years in the MD&A, if they included that discussion in prior filings. Companies that opt to provide the abbreviated disclosure are required to identify the location in their prior filing where the discussion of that period can be found.

Due to the emphasis that the SEC has traditionally placed on MD&A as the cornerstone of the periodic disclosure system, my assumption was that companies would be unlikely to provide the abbreviated disclosure now permitted under Item 303. While my assumption was broadly correct, 17 companies did opt to omit the discussion of the earliest year in their filing. That's more than 1-in-5, which is a fairly impressive early adoption rate considering the sensitivity of MD&A disclosure to most companies and most lawyers.

Item 601 of S-K—Exhibits: Description of Securities

The Fast Act rule changes made several modifications to Item 601 of Regulation S-K. Most of these, such as the ability to omit schedules from all material agreements and to redact confidential information from exhibits without first filing a confidential treatment request, make life easier for filers.

But the rule changes also added Item 601(b)(4)(vi) to Regulation S-K, which requires companies to include as an exhibit to their Form 10-K a brief description of all securities registered under Section 12 of the Exchange Act. That description is required to contain the information specified in Item 202(a)-(d) and (f) of Regulation S-K. Prior to the adoption of these new rules, that information was typically only required in registration statements.

This new requirement is one that a lot of companies appear to have overlooked—in fact, 33 out of the 79 filings that I reviewed did not contain the required description of securities. At least one of those that did include the exhibit purported to incorporate the information by reference to disclosure in a Securities Act registration statement.

While incorporation by reference makes intuitive sense, it is something that the SEC specifically disallowed in the adopting release. The adopting release notes a comment letter from Davis Polk to the effect that the inability to incorporate this information by reference if it hasn't previously been filed under new Item 601(b)(4)(vi) would impose a burden on issuers of multiple classes of registered debt that was far beyond the 0.5-hour paperwork burden referenced in the proposing release. (See footnote 182 of the adopting release.) But the SEC adopted the rule as proposed anyway, so companies need to actually prepare a new description of those registered securities and physically file it as an exhibit to their Form 10-K in order to comply with the new requirement.

Some Takeaways

There are a few lessons that companies that have yet to file their first post-Fast Act Form 10-K can take from these early filers:

1. If you get the cover page wrong, you'll feel very lonely.

2. Take a hard look at your disclosure about properties. While few companies have decided to revise their previous disclosures in response to the new rules, those that have seem to have taken a cleaver to them. If you read the provisions of the adopting release addressing the changes to Item 102 of Regulation S-K, there seem to be a number of reasons that might justify this kind of radical approach by many more companies. A lot of property disclosure continues to be dreary boilerplate that's both useless to investors and a pain in the neck to keep current. Companies should take a look at the changes made by the three pioneers I identified above and give some thought to whether similar changes might be appropriate to their own disclosures.

3. If you are going to take the plunge and provide abbreviated MD&A disclosure, it's pretty clear from the early returns that you won't be alone. However, you should be meticulous when it comes to the requirement to identify the location of the earliest year's disclosure. A few companies appear to have neglected to do that.

4. It's surprising how many companies overlooked the need to file the new description of securities exhibit. But then again, maybe it isn't. After all, the Fast Act changes were pitched as "disclosure simplification," so it's easy to miss the fact that they also impose some new obligations on filers. Here are a couple more to keep in mind:

   – I've already mentioned the new Inline XBRL requirements that large accelerated filers will need to comply with in their first Form 10-Q filing made after June 15, 2019. Accelerated filers will need to comply with these requirements in their first post-June 15, 2020 filings, and all other filers will need to comply a year later.

   – Most companies are aware that the five-year sunset on information incorporated by reference has been eliminated, and that information incorporated by reference no longer needs to be filed as exhibit. But there's a quid pro quo: companies are now required to hyperlink to the location of material incorporated by reference from an EDGAR filing.

   – The new rules also changed the caption for Item 405 disclosure from "Section 16(a) Beneficial Ownership Reporting Compliance" to "Delinquent Section 16(a) Reports" and changed the caption for Item 401(b) information that's included in Part I of Form 10-K to "Information about our Executive Officers."

   These new requirements aren't rocket science, but the experience of early filers—many of whom are pretty sophisticated and experienced—suggests that they're easy to miss.

Unpacking Stock Splits

A few weeks ago, I was looking through our Q&A Forum on TheCorporateCounsel.net—which is where I get most of my ideas for articles—and noticed a lot of questions concerning stock splits and stock dividends. I wondered why we had so many questions on this topic. At first glance, declaring a stock dividend or a split seems like pretty basic corporate law blocking and tackling, but the more I looked into this topic, the more issues I spotted.

Forward stock splits and reverse stock splits involve an intricate number of overlapping state corporate law, accounting, tax, securities, and stock exchange compliance issues. After rummaging through those issues for a time, I began to understand why there were so many questions—and why it may be a good idea to try to address them through an article in *The Corporate Counsel*.

Stock Split v. Stock Dividend: What's the Difference?

At the most basic level, it's probably easiest to conceptualize a stock dividend as a means of increasing the number of shares outstanding by issuing new, unissued stock, while a stock split accomplishes the same objective by subdividing shares that are already issued and outstanding into a greater or lesser number.

While you end up in the same place regardless of whether you do a forward stock split or a stock dividend, there are technical differences between the two that can be important. These involve shareholder approval requirements, the impact on treasury shares, the manner in which fractional shares are dealt with, and the accounting treatment of the two alternatives.

State Law Shareholder Approval Requirements. Assuming a company has a sufficient number of authorized but unissued and treasury shares to cover the amount of the stock dividend, state corporate laws typically don't require shareholder approval. That's not the case with a stock split—at least in Delaware. That's because a stock split technically involves subdividing currently outstanding shares into a greater number of shares, and Section 242(a)(3) of the DGCL requires a company to amend its certificate of incorporation to reflect such a split.

Actually, it's more confusing than that, for two reasons. The first is that the Delaware statute never uses the phrase, "stock split." Instead, Section 243(a)(3) says that:

> "a corporation may amend its certificate of incorporation, from time to time, so as … [t]o … subdivid[e] or combin[e] the outstanding shares of any class or series of a class of shares into a greater or lesser number of outstanding shares. …"

That language covers forward and reverse stock splits, which you would not necessarily pick up on if you were reading it cold. But that's not the only source of confusion in the statutory language—as you can see, it says a corporation "may" amend its certificate to effect one of the enumerated events.

Most lawyers always assumed that under Delaware law, a reverse stock split would require an amendment to the company's certificate of incorporation, since, as Potter Anderson's John Grossbauer put it in response to a question on our Q&A Forum, under Delaware law, "there is no mechanism by which the board can change outstanding shares into fewer shares." But the statute's use of the word "may" and the functional similarities between stock splits and stock dividends left some lawyers questioning whether a shareholder-approved charter amendment was necessary to approve a forward split.

That uncertainty was resolved in *Blades v. Wiseheart*, C.A. No. 5317-VCS (Del.Ch. Nov. 17, 2010), where then-Vice Chancellor Strine made it clear that, the word "may" notwithstanding, forward splits require a company to amend its certificate of incorporation in strict conformity with the procedures laid out in Section 242.

Treatment of Fractional Shares. Fractional shares resulting from a stock dividend are customarily handled in one of three ways contemplated by Section 155 of the DGCL and comparable provisions of other state corporate statutes. That statute allows, but doesn't require, a company to issue fractions of a share. If it opts not to issue fractional shares, Section 155 says that it must either arrange for the disposition of fractional interests by those entitled thereto, pay in cash the fair value of the fractional shares, or issue scrip or warrants entitling the holder to receive a full share upon the surrender of such scrip or warrants aggregating a full share.

In contrast, stock splits sometimes provide for the rounding up of a fractional share into the next largest whole share—which is something that Section 155 does not appear to contemplate. This alternative is possible for a stock split because Section 242(a) of the DGCL says that if the certificate is amended to reclassify or subdivide shares into a greater or lesser number of shares, the amendment may include "such provisions as may be necessary to effect such change, exchange, reclassification, subdivision, combination or cancellation."

Most lawyers view this grant of authority to implement the stock split contemplated by the amendment as being sufficient to encompass a provision to allow fractional shares resulting from the reverse split to be rounded up into a whole share. In practice, this rounding is baked into the amendment effecting the reverse split, and the authority to reclassify shares through an amendment and incorporation of the rounding concept into the amendment itself addresses any concerns about whether the shares issued are fully paid.

What About Treasury Shares? Because treasury shares are not deemed to be outstanding, they do not receive any shares issued in a stock dividend. In practice, most companies effect share "splits" by issuing share dividends, because this typically does not require shareholder approval (unless additional authorized shares are necessary). However, treasury shares may get different treatment if a company uses a stock split to effect the increase. That's because the same statutory flexibility that allows companies to round-up fractional shares in amendments to the certificate of incorporation filed in connection with stock splits allows them to include treasury shares in the shares that are to be included in the split.

Accounting for Dividends and Splits. Stock dividends are usually accounted for by debiting retained earnings and crediting capital stock and paid-in capital. The amount of these corresponding accounting entries depends on the size of the dividend. Since, unlike cash dividends, there is no net change in the shareholders' equity account, these accounting entries merely reshuffle things by decreasing retained earnings and increasing capital stock and paid-in capital by an equal amount.

The only substantive change resulting from a stock dividend is to the book value of each share of stock—since more shares are outstanding, each share has a lower book value than it had before the dividend.

The amounts that get reshuffled in the shareholders' equity account vary depending on whether the stock dividend is large or small. For small stock dividends (those involving less than 20%-25% of the outstanding shares), the amount credited to paid-in capital will be based on the market value of the stock. For larger dividends, the amount credited to capital stock or paid-in capital will be the par value of the stock. The theory underlying the differing accounting treatment is that small stock dividends do not typically affect the market price of the outstanding shares, while large ones do.

Companies have greater flexibility when it comes to the accounting treatment of stock splits. Since share splits are effected by dividing the outstanding shares of a company into a greater number of shares, a company that does not want any impact on its shareholders' equity accounts can proportionately reduce the par value of each share so that the aggregate par value or stated capital of the company remains unchanged. If the company does not care about having the share split reflected on its account balances, it can leave the par value or stated value per share unchanged.

Companies Need "Surplus" To Pay Dividends

Another consideration when choosing whether to issue a stock dividend or a stock split is the requirement for Delaware corporations to have lawful funds to pay dividends. Section 170 of the DGCL says that a Delaware corporation may pay dividends out of its "surplus" or its net profits for the current or previous fiscal year. So, in order to be able to pay a stock dividend, a company must have enough surplus or net profits to cover the aggregate par value of the shares being distributed.

Legal capital requirements can be an issue when declaring a cash dividend, particularly if the transaction involves adding leverage to the company's balance sheet. But they are not typically an issue for stock dividends. Section 173 of the DGCL requires the board to allocate only an amount represented by the par value of the shares paid as a dividend to capital. Since that's the case, a stock dividend would only create an issue under legal capital requirements if the aggregate par value of the shares being issued would exceed the amount of the company's surplus.

While legal capital is not usually an issue, it will impact the board's actions, because it will be necessary to determine that sufficient surplus exists to pay the dividend and sometimes to determine how much to allocate to capital. This entire exercise is not necessary when it comes to a stock split. Unless the board so elects, there is no impact on capital or surplus when a company engages in a stock split, because it does not trigger the same statutory provisions that would apply to the payment of a dividend.

Do You Have Enough Shares?

Since the biggest reason to do a stock dividend instead of a split is the ability to avoid the need for shareholder approval of a charter amendment, one of the first issues that needs to be considered is whether there are enough authorized and unissued shares to fund the dividend. If not, then you are going to need to ask your shareholders to authorize more.

How Much is Enough? When evaluating this question, it is important to factor in not only the number of shares outstanding, but the number of shares that the company is committed to issue under the terms of any equity compensation plans or under the terms of any other contractual obligations to issue shares, including upon conversion of convertible securities and the exercise of warrants. These arrangements typically contain terms providing for the adjustment of exercise prices or conversion rates, and frequently also provide for adjustment of the number of securities that can be acquired, if the company declares a stock dividend or split prior to their expiration.

In addition to considering outstanding contractual obligations to issue additional shares, companies needing to go to shareholders to seek an increase in authorized shares should also think about their potential need for additional shares for financings, acquisitions and other corporate purposes. Companies do not want to make seeking shareholder approval of a charter amendment authorizing more shares an annual event, so potential longer-term needs should be considered.

What do Proxy Advisors Think? Proxy advisor recommendations will play an important role in determining whether a company can muster sufficient support to increase the authorized shares.

ISS's policies provide that it will generally support a proposal to increase the authorized number of shares where the primary purpose of the increase is to issue shares in connection with a transaction on the same ballot that warrants support.

When it comes to authorizing an increase in shares for general corporate purposes, ISS takes a case-by-case approach that factors in the company's past performance, disclosure regarding the purpose for which the shares will be used and the "specific and severe" risks that shareholders will face if the increase is not approved.

For most companies that satisfy its criteria, ISS will recommend a vote to approve a 100% increase in authorized shares to be issued for general corporate purposes, although that amount may be lower depending on how many authorized and unissued shares the company already has and its total shareholder return performance.

Glass Lewis has criteria that apply specifically to increases in authorized shares for the purpose of funding stock splits. These focus on the historical and current stock prices, as well as "some absolute limits on stock price that, in our view, either always make a stock split appropriate if desired by management or would almost never be a reasonable price at which to split a stock." Glass Lewis's criteria for evaluating proposed increases relating to potential financings or acquisitions focus on the company's historical acquisition practices and its ability to obtain alternative forms of financing.

Directors' Fiduciary Duties

Ordinarily, a board's decision to declare a stock split or stock dividend will be evaluated under the business judgment standard of review. The same is generally true for a reverse split that is undertaken in an effort to maintain a stock exchange listing or to otherwise enhance trading in the company's stock. However, absent appropriate procedural protections, a court may apply heightened scrutiny under the "entire fairness" standard if a reverse stock split is undertaken to "squeeze out" minority shareholders or otherwise provide disparate benefits to controlling shareholders. See, *e.g., Reis v. Hazelett Strip-Casting Corp., et al.*, C.A. No. 3552-VCL (Del. Ch. Jan. 21, 2011)

Reverse Splits: Appraisal Rights & Fair Value of Fractional Shares

Because a reverse stock split may be used to accomplish the same result as a squeeze-out merger, some states extend appraisal rights to shareholders who dissent from a proposed reverse stock split. See, *e.g.*, Section 302A.471 of the Minnesota Business Corporation Act. In contrast, Delaware does not allow for appraisal rights in connection with a reverse stock split, and the determination of the "fair value" of a fractional share contemplated by Section 155 of the DGCL is not governed by the same standards that apply to the determination of fair value in an appraisal proceeding under Section 262 of the DGCL. In the absence of a reason for a court to apply enhanced scrutiny, the business judgment rule would apply to the board's decision concerning the fair value of a fractional share. *Applebaum v. Avaya, Inc.*, 812 A.2d 880 (Del. 2002)

Federal Income Tax Treatment of Splits & Reverse Splits

As a general matter, Section 305 of the Internal Revenue Code provides that distributions of stock that do not affect shareholders' proportionate ownership interests in the company don't involve a taxable event for federal income tax purposes. Shareholders simply receive more shares that evidence the same ownership interest in the company that they held prior to the transaction. Similarly, shareholders' overall basis in the stock for tax purposes does not change, but their per share basis is subject to adjustment to reflect the issuance of the additional shares. The new shares are deemed to have been acquired at the same time as the original shares for purposes of determining any applicable capital gains holding period.

Similarly, a reverse stock split is typically a non-taxable event to shareholders, with the exception of cash in lieu of fractional shares. For federal income tax purposes, a shareholder receiving a cash payment in lieu of a fractional share generally will recognize short-term or long-term capital gain or loss, depending on such shareholder's holding period for the stock. The amount of that gain or loss will be equal to the difference between the amount realized and the shareholder's basis in the fractional share. Shareholders receiving cash in lieu of fractional shares in a forward split or dividend would also recognize gain or loss in the same manner.

One caveat—bear in mind that if you are considering a reverse split as part of a squeeze-out of minority shareholders, the cash in lieu of fractional shares will be a significant component of the transaction, and the tax consequences to shareholders may be significant.

Federal Securities Law Compliance

In addition to state corporate law issues, stock splits and stock dividends also raise compliance issues under both the Securities Act of 1933 and the Securities Exchange Act of 1934. There are general disclosure issues that implicate both statutes, but there are also issues unique to each of them.

Securities Act issues revolve around whether there is a need to register the issuance of the shares in the transaction, as well as the impact of the split or dividend on the status of shares covered by existing registration statements. Exchange Act issues include potential Form 8-K triggering events and compliance with the proxy rules if shareholder approval is necessary.

Do You Have to Register the New Shares? The first question that arises under the Securities Act is whether the shares to be issued in the dividend or split need to be registered. The answer to that question is usually no, but the reasons differ. Forward splits and stock dividends are generally regarded as not involving a "sale" of a security within the meaning of Section 2(a)(3) of the Securities Act.

As the Second Circuit once put it, "[a] stock dividend does not distribute property but simply dilutes the shares as they existed before." *Hafner v. Forest Laboratories, Inc.*, 1964 U.S. Dist. LEXIS 8892, at *13 (S.D.N.Y. 1964), aff'd, 345 F.2d 167 (2d Cir. 1965). That's a position that the Staff appears to have endorsed in Securities Act Sections CDI 103.01:

> Question: If a company declares a dividend that is payable in either cash or securities at the election of the recipients, does the declaration of the dividend need to be registered under the Securities Act?
>
> Answer: No, as there is no sale of the dividend shares under the Securities Act. [Nov. 26, 2008]

In addition, both stock splits and reverse stock splits are explicitly excluded from Rule 145, which deems other reclassifications requiring shareholder approval to involve an "offer" or "sale" of a security within the meaning of Section 2(a)(3) of the Securities Act.

But there are some complications involved in reverse stock splits that are not present in forward splits or dividends. In particular, when companies engaging in a reverse split have rounded up fractional shares to the next highest share, the Staff has sometimes commented on what exemption was relied upon for the exchange of a fractional share for a full share.

However, companies have successfully addressed these comments by arguing that, to the extent the rounding transaction involved a sale of securities, it was exempt under Section 3(a)(9) of the Securities Act, which provides an exemption for an exchange of a security by an issuer with its existing security holders exclusively where there is no commission or remuneration is paid for soliciting such exchange. Here's an excerpt from one response letter:

> In our case, whole shares of the issuer are being exchanged with our existing security holders for fractional shares of the same issuer in compliance with Section 3(a)(9). If any portion of the whole shares being exchanged for fractional shares would be considered additional consideration for the exchange (*e.g.*, in a 20-1 split, for those security holders who would exchange less than 20 shares for a whole share), Regulation 230.150 permits payments by an issuer to its security holders in connection with an exchange of securities for outstanding securities without violating the requirements of Section 3(a)(9), when such payments are part of the terms of the offer or exchange. (See also the Staff's prior letter, Calton, Inc. and Subsidiaries (September 30, 1991), where additional shares issued in an exchange transaction were considered "payments" of additional consideration by the issuer).

Letter dated January 4, 2005 from Commodore Applied Technologies to Pamela Long, Assistant Director of the Division of Corporation Finance.

What Needs to be Done for Existing Registration Statements? Another Securities Act issue that needs to be addressed is the effect of a stock split or dividend on the securities covered by outstanding registration statements. To put it simply, the issue is what do you need to do to make sure additional shares issued as a dividend on shares covered by the registration statement are also covered?

The short answer is that Securities Act Rule 416 sets forth the procedure that needs to be followed to reflect the additional shares issued in connection with a forward stock split or stock dividend. Rule 416(a) provides that if the registration statement "purports to register securities to be offered pursuant to terms which provide for a change in the amount of securities being offered or issued to prevent dilution resulting from stock splits, stock dividends, or similar transactions," it will be deemed to cover the additional securities to be issued in connection with that anti-dilution provision.

In order to avail themselves of this language, most registrants include language similar to the following as a footnote to the registration fee table included on the cover page of the registration statement:

> Pursuant to Rule 416 under the Securities Act, this registration statement also covers such additional number of shares of common stock issuable upon stock splits, stock dividends, reclassifications, recapitalizations, combinations or similar events, with respect to the shares of common stock being registered pursuant to this registration statement.

If anti-dilution language is not included in the registration statement, or in the case of a reverse stock split, Rule 416(b) says that companies must file a post-effective amendment to reflect the additional securities or the reduced number of securities covered by the registration statement. Companies that have filed Form S-8 registration statements or that are eligible to forward-incorporate information by reference into their Form S-1 or Form S-3 registration statements may make the necessary adjustments by means of a Form 8-K—in accordance with the undertaking contained in Item 512(a)(1)(iii)(B).

Note that in the case of Form S-3ASRs, neither the antidilution language nor a post-effective amendment will be necessary. That's because Form S-3ASR covers an indeterminate amount of securities, so there is no need to adjust the shares covered by the registration statement.

In addition to the possible need to amend the existing registration statement to reflect the dividend or split, because the declaration of a significant stock dividend or split may well be material information, the prospectus for registration statements relating to ongoing offerings will need to be updated in some fashion (typically by means of a supplement or a Form 8-K filing, in the case of registration statements permitting forward incorporation by reference).

Exchange Act Compliance

8-K Reporting. The decision to declare a stock split or dividend may well prompt the need for a Form 8-K filing. An Item 5.03 Form 8-K will be required if the company's certificate of incorporation is amended (which will always be the case in Delaware with a forward or reverse stock split), and an Item 5.07 Form 8-K will be required to report the results of the shareholder vote. In addition, because a reverse stock split will often result in the conversion of what were formerly common shares into the right to receive fractional shares or cash in lieu thereof, an Item 3.03 Form 8-K is typically filed in connection with these transactions as well.

The announcement of the share split or dividend may be material information, which means that companies seeking a safe harbor for Regulation FD may wish to furnish the press release announcing the split or dividend under Item 7.01. Companies with effective registration statements under the Securities Act may want to file the announcement under Item 8.01, since unlike an Item 7.01 8-K, the information contained in an Item 8.01 8-K will automatically be incorporated by reference into S-3 and S-8 registration statements.

Rule 10b-17 Notice. Declaration of a stock split or stock dividend will require the company to establish a record date for holders entitled to receive the dividend. Exchange Act Rule 10b-17 provides that untimely notice of a dividend record date for any class of publicly traded securities is a "manipulative or deceptive device or contrivance" as used in section 10(b) of the Exchange Act and requires notice to be provided to FINRA or the exchange on which the shares are listed at least 10 calendar days before the record date—and at least simultaneously with the public declaration.

Rule 10b-17 also specifies the information about the dividend that must be included in this notice. Nasdaq and NYSE listed companies have specific rules regarding dividend notices, which are discussed below as part of a more general overview of the exchange rules applicable to stock dividends and splits. OTC companies are required to provide FINRA with a Rule 6490 notice at least 10 calendar days before the record date.

Proxy Rules. If a company needs shareholder approval of an amendment to its charter documents in order to effect a stock split or dividend, it will need to prepare a proxy statement in conformity with Schedule 14A. In addition to any other applicable requirements, a proxy statement soliciting approval of a charter amendment to increase the number of authorized shares will need to include the disclosures specified in Item 11 of Schedule 14 A, which applies to actions taken "with respect to the authorization or issuance of any securities otherwise than for exchange for outstanding securities of the registrant."

If a company needs to obtain approval of a proposed reverse stock split, then it will need to comply with Item 12 of Schedule 14A, which applies to actions taken "with respect to the modification of any class of securities of the registrant."

If action is to be taken with respect to matters under either Item 11 or Item 12 of Schedule 14A, the issuer must also consider the need to provide the financial statements, MD&A, and other information called for by Item 13. However, Instruction 1 to Item 13 provides that notwithstanding its provisions, any or all of such information that is "not material for the exercise of prudent judgment in regard to the matter to be acted upon may be omitted."

The instruction goes on to say that this financial-related information generally is not regarded as material "where the matter to be acted upon is the authorization or issuance of common stock, otherwise than in an exchange, merger, consolidation, acquisition or similar transaction …" As a result, companies typically do not include this information in proxies soliciting shareholder approval for authorizations to increase the number of outstanding shares to facilitate a forward split or stock dividend.

The analysis can be more complicated in situations involving reverse splits. If the proposal involves a reverse split undertaken in connection with a going private transaction, then extensive financial disclosures would be included in the proxy statement, both in order to comply with the requirements of Item 13 of Schedule 14A and to comply with the requirements of Item 13 of Schedule 13E-3. In situations involving reverse splits effected to either address potential delisting situations or to enhance trading, most companies conclude that inclusion of financial-related information called for by Item 13 is not material. See, *e.g.*, Alcoa Inc. Definitive Proxy Statement dated August 17, 2016, https://www.sec.gov/Archives/edgar/data/4281/000119312516683782/d116529ddef14a.htm.

Section 16. Rule 16a-9(a) exempts from both Section 16(a) and Section 16(b) "the increase or decrease in the number of securities held as a result of a stock split or stock dividend applying equally to all securities of a class…" In Section 16 CDI 117.03, the Staff confirmed that Rule 16a-9's exemption extends to reverse stock splits and the disposition of fractional shares incidental to the split "where the cash-out of fractional shares, like the reverse split itself, applies equally to all securities of the class, and there is no choice to receive fractional shares instead of cash." As a result, no Form 4 filing is typically required in connection with stock splits or dividends.

Although not required, the effect of the stock split should be footnoted on the insider's next ownership report. This eliminates any suggestion in the public record that the insider failed to report an acquisition. Similarly, options that have been adjusted via a stock split should be reported on future forms on an as-adjusted basis, with an explanatory footnote.

Going Private. As noted above, reverse stock splits are sometimes used to effectuate a "going private" transaction, In these situations, the company will need to comply with the disclosure requirements of Schedule 13E-3 in addition to those laid out in the proxy rules. In addition to the financial information, compliance with Schedule 13E-3 will require detailed disclosure about various aspects of the transaction.

These disclosures include, among other things, its purpose, alternatives, reasons and effects, the fairness of the transaction, whether it was approved by a majority of independent directors, whether it requires the approval of a majority of unaffiliated holders, and detailed disclosure regarding any oral or written opinions or appraisals received in connection with the transaction and any projections prepared in connection with it.

Stock Exchange Rules

Sections 204.12 and 204.21 of the NYSE Listed Company Manual and Nasdaq Listing Rule 5250(e)(6) require a company give to provide notice to the relevant exchange of any dividend action at least ten calendar days in advance of the record date. In addition, both exchanges consider dividend announcements to be material information requiring public and prompt disclosure.

The NYSE and Nasdaq both permit disclosure by means of any Regulation FD compliant method (although the NYSE encourages the issuance of a press release), and the disclosure is subject to the exchanges' pre-release notification requirements. If a shareholder meeting is required, customary notification requirements applicable to record dates and other information concerning special meetings of shareholders will apply as well.

<u>NYSE-Specific Rules.</u> There are also some wrinkles under the NYSE rules that uniquely impact stock splits and dividends, and these are laid out in Section 703.02 of the Listed Company Manual. The first is a matter of nomenclature—the NYSE does not want listed companies to use the term "dividend" to apply to a stock split unless it involves an issuance that, under GAAP, would result in the amount credited to paid-in capital being determined by reference to the market value of the stock.

In other words, the NYSE only wants the "stock dividend" terminology applied to the smaller issuances—those involving less than 25% of the outstanding shares—that would require this accounting treatment. Larger issuances should be referred to as "stock splits," even if they involve the declaration of a dividend as a matter of corporate law. In these instances, the NYSE wants listed companies to refer to the issuance as a "stock split in the form of a stock dividend."

In the case of a stock dividend, the NYSE requires a company to provide shareholders with a notice accompanying the distribution "advising them of the amount capitalized in the aggregate and per share, the relation of such aggregate amount to current earnings and retained earnings, the account or accounts to which such aggregate has been charged and credited, the reason for issuance of the stock dividend, and that sale of the dividend shares would reduce their proportionate equity in the company."

The NYSE requires a company to file a subsequent listing application with the NYSE at least two weeks in advance of the date when authorization will be needed. In order to facilitate "when issued" trading, the NYSE wants the application filed before the record date, even though not all required information may be available at that time.

<u>Nasdaq-Specific Rules.</u> Nasdaq also has some wrinkles that apply to stock splits and dividends. While Nasdaq typically requires 10 calendar day advance notice of dividends, Rule 5250(e)(2) requires 15 calendar day notice prior to the issuance of any common stock or convertible security in a transaction that may result in an increase of more than 10% of either the total shares outstanding or the voting power outstanding on a pre-transaction basis.

In addition, Rule 5250(e) (1) requires a company to provide notice to Nasdaq no later than 10 days after the occurrence of any aggregate increase or decrease of any listed class of securities that exceeds 5% of the amount of securities of the class outstanding. These notifications must be made on the Notification Form: Listing of Additional Shares—and Nasdaq wants listed companies to file this form as soon as practicable, even if all of the relevant terms of the issuance are not yet known.

As the foregoing discussion suggests, the NYSE and Nasdaq rules lay out a maze of notification and other obligations that listed companies will need to comply with in connection with a stock split or dividend. Companies would be well advised to reach out to their exchange representatives in order to map out a path for complying with these obligations in advance of a decision to move forward with a stock split or dividend.

5 Key Takeaways

Stock splits, dividends and reverse splits may seem to be relatively straightforward transactions, but there are a number of interrelated state law, accounting, securities law and stock exchange requirements that advisors of public companies must keep in mind. Here are five key takeaways:

1. State Corporate Law Issues are Front & Center. A company's ability to declare a stock dividend or a forward or reverse split—and the mechanics of implementing these actions—are first and foremost matters of state corporate law. In order to effectuate any of these actions, strict adherence to corporate law requirements—including shareholder approval of a charter amendment, in some instances—is essential. A misstep here could call into question the validity of the action.

   When thinking about state corporate law issues, bear in mind that there are all kinds of idiosyncrasies in the way states approach technical corporate law issues relating to the payment of dividends and the mechanics of implementing splits. Also keep an eye out for differences in the availability of appraisal rights or the standards of review that may apply to board action. Not every jurisdiction follows Delaware statutory language or judicial precedent.

2. Stock Dividends are Typically Preferable to Stock Splits. In states that require shareholder approval for a stock split, there's seldom a compelling reason to do a forward share split instead of a share dividend. For most companies, the greater flexibility provided in terms of fractional shares, treasury shares and accounting treatment is not sufficient to offset the need to obtain shareholder approval. Assuming that sufficient authorized and treasury shares are available to pay a share dividend in the size desired, that approach is almost always preferable to a stock split.

   The answer might be different for a company with a high par value common stock that is unable to generate additional surplus through an asset write-up. In this situation, the need to allocate to capital an amount equal to at least the aggregate par value of the shares issued as a dividend might create the possibility of impairing capital or restrict the company's ability to pay dividends in future periods. So, in that case, a stock split might be a better approach.

3. Expect Heightened Scrutiny of Some Reverse Splits. A board's decision to declare a dividend or recommend that shareholders adopt a charter amendment to allow a forward stock split would generally be evaluated by a court under the business judgment standard of review. That standard also would likely apply to reverse stock splits intended to avoid delisting by increasing the per share trading price or adopted for other reasons relating to the enhancement of trading activity. But the board's decision to move forward with a reverse split and its determination of the "fair value" of a fractional share may be subject to enhanced scrutiny under the entire fairness standard of review in situations involving minority squeeze-outs or if the reverse split disproportionately benefits affiliated shareholders.

4. Compliance Issues under the 1933 Act & 1934 Act. If you are considering a stock dividend or split, you need to keep in mind potential compliance issues under the Securities Act of 1933 and the Securities Exchange Act of 1934. Because of the potentially material nature of a stock dividend or split, both statutes may impose an obligation on companies to make prompt disclosure of the proposed action. However,

there are also requirements that are specific to each statute that will need to be addressed.

Under the Securities Act, an appropriate exemption from the statute's registration requirements will need to be identified, and existing registration statements may also require attention to reflect the stock split or dividend. A broader range of compliance issues may arise under the Exchange Act. A stock dividend or split may involve multiple Form 8-K triggers. Rule 10b-17's requirements with respect to advance notice of record dates will need to be addressed. If shareholder approval of a charter amendment is required, then compliance with the proxy rules will also be necessary, and if the transaction involves a minority squeeze-out, the company will need to comply with the heightened disclosure requirements applicable to "going private" transactions set forth in Schedule 13E-3.

5. Stock Exchanges Have Complex and Overlapping Requirements. In addition to complying with applicable advance notice requirements for dividend record dates, listed companies undertaking stock dividends or splits will need to comply with additional listing requirements and other notification and disclosure requirements under Nasdaq or NYSE rules. Because compliance with these requirements can be a complicated process, companies should contact their listing representatives in advance of a decision to declare a stock dividend or split.

A Few Words About Delaware's "Legal Capital" Requirements

State law "legal capital" requirements may not typically present much of an impediment to a stock dividend, but they can cause all sorts of headaches when it comes to cash dividends and stock buybacks. Like tonsils and wisdom teeth, these legal capital statutes lost their evolutionary purpose somewhere along the way, and now just cause a lot of trouble at particularly inopportune times.

In their most basic form, legal capital requirements originally required companies to do two things. First, they had to specify the minimum amount of capital for which subscriptions would be obtained from shareholders, and, second, they had to receive payment of some specified portion of that capital commitment before they could conduct business.

The idea was that this would protect creditors by giving them the ability to pursue shareholders to the extent of any unpaid subscriptions for the corporation'sp shares. Over time, this morphed into the "stated capital," "par value" and "surplus" concepts that remain embedded in some state corporate statutes—and that companies have to navigate when they want to buy back shares or declare dividends.

Delaware's Rules on Buybacks & Dividends

Section 160(a) of the DGCL governs a company's ability to repurchase its own shares, while Section 170 addresses the payment of dividends. Both sections generally look at the same thing to determine the amount that a company can distribute to shareholders or use to repurchase shares. However, Section 170 gives companies two bites at the apple when it comes to paying a dividend.

Let's look at the rules governing buybacks first. Section 160(a) says that every corporation may repurchase or redeem its own shares but prohibits any such action when the company's "capital" is impaired or would be as a result of the repurchase. Section 154 of the DGCL says that "capital" is whatever portion of the consideration received by the company for the shares that it issues that the directors determine to be capital—but must at least equal the total par value of the issued shares.

Section 154 says that the directors can increase the company's capital if they want to, and Section 244 establishes procedures for reducing it. So, the capital of a company with par value shares is an amount equal to the total par value of the issued shares, plus whatever additional amount the Board's decided—for some inexplicable reason—to allocate to capital.

Section 154 also defines another important term—"surplus." This is "[t]he excess, if any, at any given time, of the net assets of the corporation over the amount so determined to be capital." "Net assets" means the amount by which total assets exceed total liabilities, and for purposes of this calculation, capital and surplus are not regarded as liabilities. Surplus is an important concept because it essentially defines the amount that a Delaware corporation to use to buy back stock without impairing capital.

In addition to permitting payment of dividends from surplus, Section 170 permits a Delaware corporation to pay a dividend "out of its net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year" Despite this language, a company can't pay dividends if its net assets are not at least equal to the liquidation preference of any outstanding preferred shares.

This second bite at the apple is referred to as Delaware's "nimble dividend rule," and most states do not have a comparable provision.

Valuation of Assets & Liabilities

Keep in mind that when you calculate a company's "surplus," its "total assets" and "total liabilities" are not calculated by reference to their book value. Instead, the Delaware courts say that what's relevant is the present value of those assets and liabilities. See, *e.g.*, *Klang v. Smith's Food & Drug Centers*, 702 A.2d 150, 153-154 (Del. 1997).

As a practical matter, that means that companies can (and do) have valuations performed that will in many cases allow them to "write up" the value of assets to pay a significant cash dividend or repurchase a large number of shares. This is another area where Delaware courts have traditionally been very deferential to valuation decisions and methodologies that appear to have been the result of a sound process—and where they're much more willing to second-guess a process that looks sloppy. See, *e.g.*, *Farland v. Wills*, C.A. No. 4888 (Del. Ch. Nov. 12, 1975).

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6. Navigating ISS & Glass Lewis
7. Clawbacks: #MeToo & More
8. Director Pay Disclosures
9. Proxy Disclosures: 20 Things You've Overlooked
10. How to Handle Negative Proxy Advisor Recommendations
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