INSIGHTS

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FORWARD-LOOKING INFORMATION

Forward-Looking Statements: Safe Harbors Compliance Guidelines

By Carmen M. Fonda, Kirill Y. Nikonov, Jordan D. Jean, and Lauren Fields

The securities law disclosure framework has evolved to encourage;[1] companies acting in good faith to disseminate relevant projections pertaining to their businesses to the general public "without fear of open-ended liability."[2] Sharing financial projections and other information about anticipated events and developments—in press releases, earnings calls periodic filings, and prospectuses of registered offerings—has become a routine practice for reporting issuers, but so have the stockholders' lawsuits alleging that such statements were fraudulent when forward-looking statements did not come to fruition or when they contain an error. Many issuers struggle to effectively leverage relevant safe harbors and craft appropriate safe harbor language, potentially inviting plaintiffs to capitalize on such errors.

Key Takeaways

- Available defenses are not always interchangeable.
- Projections must be non-misleading and be made in good faith, which sometimes means following the Securities and Exchange Commission's (SEC) understanding of such terms, including the guidelines on the manner of presentation of such projections.
- The most straightforward approach to protecting good faith non-misleading projections is to consistently comply with the Private Securities Litigation Reform Act of 1995 (PSLRA) requirements in drafting safe harbor legends.
- Safe-harbor language should be incorporated not only in SEC filings but also in all other forms of communication containing forward-looking statements, including oral communications and social media posts.
- Safe-harbor language must be meaningful, which necessitates regular review of and adjustment to PSLRA safe harbor templates.

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Available Protections

There are three principal defenses available to immunize issuers from liability for forward-looking statements (should the anticipated result not come to pass) and to discourage frivolous litigation by private plaintiffs:

1. Rule 175[3] promulgated by the SEC under the Securities Act of 1933 (Securities Act) and corresponding Rule 3b-6[4] under the Securities Exchange Act of 1934 (Exchange Act);
2. Amendments to the Securities Act (Section 27A)[5] and the Exchange Act (Section 21E)[6] enacted by Congress with the passage of the PSLRA; and
3. The judicially-formulated bespeaks caution doctrine.

The two safe harbor defenses and the bespeaks caution doctrine supplement and do not substitute for each other.[7] Each provides a powerful liability-insulation tool. Issuers that implement them correctly and develop robust compliance practices will enjoy the maximum protection in the event of litigation. Issuers may also wish to use more than one

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approach for protecting their forward-looking statements, layering protections where available.

Rules 175 and 3b-6

Enacted under the Securities Act and the Exchange Act, respectively, Rules 175 and 3b-6 shield issuers (excluding registered investment companies) from liability for forward-looking statements contained in documents *filed* with the SEC. That means that forward-looking statements are devoid of the safe harbor protection:

- in oral statements (other than those affirmed in SEC *filings*);
- in documents *furnished* rather than *filed* with the SEC (such as information *furnished* under Items 2.02 and 7.01 of Form 8-K); and
- in documents that are neither *filed* nor *furnished* with the SEC (such as press releases, social media posts, and other documents not posted on EDGAR).

To invoke protection under Rules 175 or 3b-6, a forward-looking statement must be made in "good faith" and with a "reasonable basis," in compliance with the instructions provided in Regulation S-K Item 10(b). Among other things, Item 10(b) of Regulation S-K (in its post-July 1, 2024 iteration)[8] clarifies what constitutes a reasonable basis and gives examples of projections that would be considered misleading (and, therefore, outside the Rules 175 and 3b-6 safe harbor). For example, elective projection of only favorable items or presentation of sales or revenue projections without at least one of the measures of income—net income (loss) or earnings (loss) per share—generally would be considered misleading.

The SEC Staff also generally considers it misleading to present projections based on historical financial results or operational history without presenting the relevant historical financial results or operational history with equal or greater prominence. Although before July 1, 2024, a legend identifying forward-looking statements and containing meaningful cautionary statements would be sufficient to qualify for safe harbor protection, the issuers should be careful to comply with the new presentation rules.

PSLRA Safe Harbor

The PSLRA provides that, "in any private action … based on an untrue statement of material fact or omission of a material fact necessary to make the statement not misleading [an issuer or controlling person] shall not be liable with respect to any forward-looking statement, whether written or oral."[9] In addition to protection from liability, the PSLRA has the corollary effect of a stay of discovery (other than discovery that is specifically directed to the applicability of the safe harbor) in all federal and some state courts.[10]

This bestows a major advantage because the cost of discovery is often the main factor causing issuers to settle, and plaintiffs may seek to use discovery to find a sustainable claim rather than to support claims initially alleged in the complaint. The PSLRA safe harbor is available for both oral and written forward-looking statements regardless of the media. Although providing the most extensive protection, the PSLRA safe harbor is available only to public companies and cannot be invoked by certain issuers or in certain circumstances and transactions:

Excluded Issuers	Excluded Transactions and Circumstances
"Bad actor" issuers[11]	IPOs
Penny stock issuers	Offerings of securities by blank check companies[12]
Investment companies	Roll-up transactions
Partnerships	Going private transactions
Limited liability companies	Tender offers
Direct participation investment programs	Financial statements prepared in accordance with GAAP[13]
	Section 13 filings

A forward-looking statement within the scope of the PSLRA can enjoy the safe harbor protection

if it is (i) made without knowledge that the statement is false or misleading *or*[14] (ii) accompanied by meaningful safe harbor language, which is close to the formula of the bespeaks caution doctrine discussed below[15] and consistent with the requirements of Rules 175 and 3b-6 for cautionary language.

Bespeaks Caution Doctrine

The bespeaks caution doctrine, established, in some form, in every judicial circuit,[16] is a judicially-created defense insulating forward-looking statements from liability. It is an important line of defense if Rules 175 and 3b-6 or the PSLRA safe harbor is not available. In order to enjoy the safe harbor, the statements generally must be accompanied by sufficient cautionary language and be made without intent to deceive investors. Although the exact standards vary from circuit to circuit, forward-looking statements made by issuers and the accompanying legends prepared in compliance with the PSLRA safe harbor are unlikely to fail to meet the requirements of the bespeaks caution doctrine in any circuit.[17]

AQ: What this be better as: safe harbor legending requirements?

Accordingly, compliance with PSLRA safe legending harbor requirements will almost certainly satisfy the cautionary language standards of the bespeaks caution doctrine.[18] Unlike sister safe harbors, the bespeaks caution doctrine is available to both public and private companies. Hence, such legending should be included in any offering materials, regardless of whether the issuer is a reporting company or whether the offering is registered.

Puffery as an Additional Line of Defense

Immaterial statements cannot form the basis of a false or misleading statement supporting a securities fraud claim. Generally, non-specific expressions of optimism that are not objectively verifiable (not subject to being either proved or disproved) are considered to be mere puffery and, therefore, not actionable as a matter of law, because no reasonable investor would rely on such statements. This includes vague statements of optimism, obvious qualitative buzzwords, and other statements not specific enough to be objectively verifiable are considered immaterial by default and, consequently, are not actionable.[19]

As a defense, puffery may give some additional comfort to issuers in freely expressing their general goals and aspirations. For instance, the conclusion that "[at home fitness] is a trend that's here to stay" and the anticipation of a "fantastic year" characterized by "continued momentum in the foreseeable future" as a result of such a conclusion was deemed to be "'textbook cases' of corporate optimism[;]"[20] the description of a drug or an invention as a "breakthrough" is also likely to be considered a puffery.[21] Likewise, statements setting a general demeanor of the narrative, for instance, statements such as "successfully executing our growth strategy" and "do[ing] an outstanding job,"[22] will more likely than not be deemed "puffery."

However, unlike the aforementioned defenses, reliance on a puffery defense should be approached with caution during the review and analysis of an issuer's documents. The effectiveness of a puffery defense heavily depends on specific facts and circumstances as well as potentially subjective interpretation by the trier of fact, evidenced by the wide range of statements that some circuits regard as puffery and other circuits do not.[23] Moreover, to the extent that statements considered puffery are forward-looking, they can likely be protected by the three previously mentioned defenses with a higher degree of certainty.

Despite these considerations, "puffery" provides an additional layer of insulation against potential securities fraud claims, and while not a primary line of defense, it can still be useful in specific situations (for example, in the case of unscripted oral communications). Finally, "puffery" serves as an important reminder that neither the market nor courts expect corporate officials to "present an overly gloomy or cautious picture of current performance and future prospects."[24]

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Maximizing the Safe Harbor Coverage

Issuers should seek to protect each forward-looking statement with the maximum number of available defenses. In an ideal-case scenario, all three protections may be invoked (but see below whether it is worth *filing* a document to rely on Rules 175 and 3b-6). To achieve this effectively, consider the following strategies.

A PSLRA-Compliant Safe Harbor Legend Will Be Sufficientf For All Three Safe Harbors

The PSLRA safe harbor offers the broadest protection and an important procedural advantage—a stay of discovery—making it an optimal starting point. It should always be invoked when available. Compliance with the PSLRA legend requirements and ensuring that the forward-looking statements are made in good faith lay the foundation that meets the criteria of both remaining defenses. The bespeaks caution doctrine's protection is assured if the cautionary statement language aligns with the PSLRA safe harbor requirements.

Similarly, a PSLRA-compliant safe harbor legend meets the criteria of Regulation S-K Item 10(b) for Rules 175 and 3b-6.[25] Therefore, the forward-looking statement safe harbor compliance exercise should always start with the preparation of a PSLRA-compliant safe harbor. In situations where the PSLRA is not applicable (for example, in the case of an initial public offering (IPO)), simply removing the reference to the PSLRA in the legend, while keeping the rest unchanged, is the only necessary modification of the legend.

Evaluating the Benefit of *Filing* Documents to Obtain Rules 175 and 3b-6 Protection

Forward-looking statements accompanied by a PSLRA-compliant statement or legend and made in good faith will likely be protected under the bespeaks caution doctrine. If such a forward-looking statement is made in a document *filed* with the SEC, it will also automatically receive protection under Rules 175 and 3b-6. For instance, if the issuer is not eligible for the PSLRA safe harbor protection because it is a limited liability company, its forward-looking statements (made in good faith and accompanied by a PSLRA-compliant legend) in Forms 10-Q and 10-K will be protected under Rules 175 and 3b-6 because periodic reports are *filed* with the SEC.

Analogously, an issuer desiring to include forward-looking statements in its IPO prospectus (Real Estate Investment Trusts (REITs), for example, commonly include projections showing future cash available for distribution in the so-called "magic page") can simply prepare a PSLRA-compliant safe harbor legend without the PSLRA reference[26] to enjoy the protection of Rule 175 because the IPO prospectus is *filed* with the SEC.

The next consideration is whether to invoke the protection available under Rules 175 and 3b-6 when the forward-looking statement does not otherwise need to be *filed*. Specifically, the question is whether it is worth applying the protection of the rules to a forward-looking statement, thereby subjecting the statements to liability under Section 18 of the Exchange Act. For instance, an issuer ineligible for the PSLRA safe harbor wishes to discuss its future plans in a press release.

Unless the press release is filed with the SEC, the issuer can rely solely on the bespeaks caution doctrine to protect its forward-looking statements. The issuer may elect to file the press release under Item 8.01 of Form 8-K, thereby availing the forward-looking statements in the press release of the protection of Rules 175 and 3b-6, but will face increased risk of exposure to private lawsuits under the higher liability standard of Section 18 of the Exchange Act. This decision is not straightforward, and issuers not eligible to rely on the PSLRA may wish to engage in further examination of the bespeaks caution doctrine case law in the applicable judicial circuit.

General Compliance with the Requirements of the PSLRA Safe Harbor Legend

The requirements of the PSLRA safe harbor legend for both oral and written statements are comprised of two components:

1. Forward-looking statements should be meaningfully identified; and
2. The legend must contain "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."

Neither component can be effectively addressed with boilerplate language.[27] Resorting to a generic approach will jeopardize the availability of both the PSLRA safe harbor and the bespeaks caution doctrine.

Create a Template of the PSLRA Safe Harbor Legend

Although boilerplate PSLRA safe harbor language may be ineffective, a *de novo* preparation of the PSLRA safe harbor language for each instance is neither feasible nor sensible. Instead, issuers should develop at least one adaptable template for any oral or written forward-looking statements and edit it as necessary to fit the circumstances. Different formats might necessitate slight modifications to comply with the safe harbor requirements. Therefore, it is advisable to prepare templates for:

- periodic filings (easily adjustable into a prospectus-related template);
- press releases;
- social media posts; and
- oral presentations.

In special circumstances, such as a registration statement in connection with a merger and the corollary Rule 425 filings, additional tailored templates may be necessary.

Avoiding Misuse of the PSLRA Safe Harbor Legend

While it might seem straightforward, it is crucial to avoid the inclusion of the PSLRA safe harbor language in documents or oral presentations that do ***not*** contain forward-looking statements. This practice, though it may not directly affect the specific document, can lead to allegations that the issuer is not meaningfully employing the PSLRA safe harbor, thus potentially exposing unrelated statements to vulnerability under "boilerplate" attacks.

Identifying Forward-Looking Statements

The key issue in identifying forward-looking statements in a document or oral speech with the intent of ensuring PSLRA protection is whether the boilerplate-esque disclosures such as "all statements, other than statements of historical facts are forward-looking statements" and "you can identify forward-looking statements by the use of words such as 'may,' 'will,' 'expect,' 'anticipate,' 'estimate,' 'believe,' 'continue,' or other similar words" are sufficient to meet the statutory requirements. While specific facts and circumstances (including different SEC forms) of each disclosure can influence this determination, some general guidance can be offered.

Examples of Forward-Looking Words and Phrases Are a Better Approach than a Negative Definition

Purported identification of forward-looking statements by means of a negative definition (that is, stating the forward-looking statements are statements other than "the statements of historical fact") may not be optimal. This method places the burden of identification on investors and, therefore, appears to be inconsistent with the statutory intention of presenting investors with meaningful information.

Listing examples of words and phrases typically used in forward-looking statements is usually sufficient for periodic reports and registration statements. Based on the SEC's stance expressed in its *amicus curiae* brief submitted in *Slayton v. American Express Co.*,[28] a disclaimer stating that "[t]he words 'believe', 'expect', 'anticipate', 'optimistic', 'intend', 'aim', 'will', 'should' and similar expressions are intended to identify such forward-looking statements" is typically enough to meet the statutory requirement. Issuers should remember that forward-looking statements may be identified by a variety of words and expressions, including such terms as "on

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track," "target," "forecast," "future," "upcoming," and many other, similar expressions, leading to an extensive and potentially cumbersome list of examples. Being overinclusive, however, is not problematic in this context.

Consider Increased Specificity in Certain Circumstances

A thorough list of keywords should be sufficient for the purpose of prospectuses, where identification of each forward-looking statement is impractical. In the context of periodic reports on Forms 10-K and 10-Q, such lists may be additionally "strengthened" by the identification of items of the periodic reports where forward-looking statements are most likely located (business, MD&A, legal proceedings, disclosure controls and procedures).

For press releases, current reports on Form 8-K, and similar documents with disclosures focused on an event or a topic, adding a specific sentence to identify particular forward-looking statements or their categories is prudent. For example: "This press release contains forward-looking statements relating to, among other things, the stages of the development of our new technology." This practice is also advisable for oral presentations, where identifying forward-looking statements can be more challenging for investors.

Identifying Important Factors

The second requirement of the PSLRA legend is to meaningfully convey information about factors that could cause actual results to differ from those projected. The starting point is usually the issuer's risk factors.[29] The key question is whether the cautionary statement needs to represent all important factors or emphasize those most likely to impact actual results. Ironically, case law, on the one hand, suggests that including the entirety of the risks possibly affecting the company makes the cautionary language so general as not to be meaningful[30] but, on the other hand, indicates the importance of referencing all factors that subsequently caused the issuer's forward-looking statements not to come to fruition,[31] thereby tempting the drafter to reference as many risk factors as possible.

It is still possible to focus the reader's attention on the most relevant risks without jeopardizing the protection of the PSLRA safe harbor. For example, the forward-looking disclosure on Form 8-K limited to the timing of a merger should include risks related to the closing conditions (such as the ability to obtain in a timely manner regulatory approvals, stockholders' approvals, the ability to maintain a required cash balance, etc.), but should not include the risks about the post-merger company (such as synergy and post-merger lawsuits), because such risks would not be apposite to the forward-looking statements.

Provide an Extensive List of Risks with a Focus on Company-Specific and Event-Specific Risks

Analogously to the identification of forward-looking statements, the approach to the identification of important risks should be determined by the type of filing or the format of the document or speech. For broad-scope documents like prospectuses and periodic filings, reference to most, if not all, relevant risk factors as bullet points seems appropriate, if not necessary. However, for more focused communications like press releases or oral statements on specific topics, listing every possible risk factor relevant to the issuer's business could make the cautionary language too generic, and therefore ineffective.

Emphasis should be placed on warnings that pertain to the issuer and the event in question.[32] For example, a press release about a merger should highlight risks directly related to the transaction, rather than an exhaustive list of all potential risks: "extreme weather conditions" should likely not be among the risks pertaining to the consummation of a merger. Additionally, "identifying important risks" does not necessarily mean copying and pasting the titles of all risk factors to the safe harbor legend: concise language is much more meaningful and user-friendly.

Combine Incorporation by Reference and the Disclosure of the Most Important Risks

In the case of oral forward-looking statements, the PSLRA provides that reference to a readily available written document containing the risks is appropriate, but it does not explicitly address written statements. Referencing periodic filings in the PSLRA safe harbor for written forward-looking statements is expressly permitted in at least one circuit.[33] Although we wholeheartedly agree with such a position, it appears advisable to include the most critical risks directly in the cautionary statement legend and refer to less significant risk factors contained in the issuer's periodic reports (which is exactly what the issuer in the cited case did).

Update in a Timely Manner Important Risks When Circumstances Change

The efficacy of templates is essential for ensuring that forward-looking statements are protected under the PSLRA. However, lessons learned from case law[34] emphasize the importance of updating the cautionary language with changing circumstances, particularly concerning the risks referenced.

Specifically, risks identified in the cautionary language must be current, accurate, and relevant. For instance, following the development of a customized template for Rule 425 filings in connection with a merger, it is vital to regularly revise and update such template: once certain approvals have been received, the risk associated with the failure to receive these approvals should no longer be included in subsequent Rule 425 filings.

Misleading Cautionary Statements Are Never Meaningful

The SEC[35] and courts[36] have consistently highlighted that cautionary language describing risks must not present known events as hypothetical: when risks already realized are described as merely potential risks, such misrepresentation renders the cautionary statement under the PSLRA meaningless.[37] Doing this may disqualify the PSLRA language as not meaningful. For example, in the context of a merger agreement, an issuer's reference to *potential* defaults under existing loan agreements, if the issuer is aware that entering into the merger has led to *actual* defaults on those loans, renders the safe harbor legend meaningless and may render the PSLRA insulation unavailable.

Other Considerations

No Need to Isolate Forward-Looking Statements from Present-Tense Narratives, but Intentional Mixing Will Not Alter the Nature of Statements Either

The decisions in *Wochos v. Tesla, Inc.*[38] and *In re Quality Systems, Inc. Securities Litigation*[39] emphasize that the PSLRA does not require a clear-cut separation between forward-looking statements and those relating to current or past events in order to shield the forward-looking statements from liability; conversely, statements about the future can involve both non-actionable forward-looking elements and potentially actionable non-forward-looking components. Notably, these and other cases also confirm that the classification of a statement as "forward-looking" is based on its substance and not merely on its tense.[40] Thus, the reaffirmation of future objectives, even when articulated in the present tense, remains protected as a forward-looking statement under the PSLRA. Even if intertwined with a protected forward-looking statement, an inaccurate or misleading statement of historical fact remains actionable.[41]

The Location of the PSLRA Legend Can Be Accommodated to Preferences

A board of directors frequently has a preference as to where to locate the cautionary language in periodic filings. For example, there is a point of view that cautionary language should be a standalone item, should not be included within MD&A, and should be located at the front of a periodic report so as "not to distract the investors" from reading the "body" of a periodic report.

Any such preference of the board of directors can be accommodated without the danger of jeopardizing

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the safe harbor, and the placement of the PSLRA safe harbor to the front of the periodic report or immediately preceding MD&A are both viable. We would caution, however, against placement of the PSLRA safe harbor language in the "back of the book" or in another unusual location, as one may argue that such placement may render the safe harbor language not meaningful.

Hyperlink the Legend if the Media Does Not Permit Its Inclusion

When social media platforms or other media limit the number of symbols or otherwise render the inclusion of a PSLRA safe harbor legend impossible or impractical, the legend should be prominently provided through an active hyperlink. Although this practice has not been expressly blessed by the SEC, we do not see the reason why the SEC would oppose this, especially considering the analogous approach permitted with Rule 134 legends.[42]

While the legend can be included in a series of sequential posts (for instance, on X), a hyperlink will better ensure that the legend will be attached to the statement in case of reposting or other dissemination, which will not be the case with sequential messages. Issuers may choose to combine both methods—sequential messaging and hyperlinks—if they find it does not compromise the aesthetic qualities of the message.

SAFE Harbor Language for Oral Statements

When dealing with speeches and other oral communications—scripted and unscripted—that include forward-looking statements, additional considerations must be taken into account to ensure compliance with the PSLRA safe harbor requirements.

Covered Speakers Do Not Include Underwriters

For oral statements, the PSLRA safe harbor protection is intentionally[43] limited to statements made by the issuer or a person acting on the issuer's behalf, and statements made by underwriters on behalf of the issuer are not covered by the PSLRA safe harbor.

Statement About the Document with Additional Information Must Accompany Oral Forward-Looking Statement

In addition to the identification of particular forward-looking statements and the risks associated therewith (which is a requirement for both oral and written statements), oral forward-looking statement legends must include a statement that additional information concerning factors that could cause actual results to differ materially from those in the forward-looking statement is contained in a readily available written document, and such document must be identified. This requirement suggests that even if a speech is not scripted, the PSLRA oral legend should be (unless there is absolute confidence in the speaker's ability to recall and articulate all required disclosures accurately).

Format and Timing of the PSLRA Legend May Potentially Render the Legend Meaningless

Logistical planning for announcing PSLRA legends is essential. For instance, if forward-looking statements are intended only for a Q&A session following a formal adjournment of an annual meeting, it may be inappropriate to announce the safe harbor legend before the meeting begins or state in such legend that oral forward-looking statements will take place during the annual meeting. Additionally, for unscripted speeches, clearly defining the topics to be discussed beforehand allows for the crafting of the safe harbor language in a meaningful way, ensuring the legend identifies relevant risks without being overly broad or generic.

Notes

1. 17 C.F.R. § 229.10(b) (2024).
2. Securities Litigation Reform Act, H.R. Rep No. 104-369, at 32 (1995) (Conf. Rep.).
3. 17 C.F.R. § 230.175 (2024).
4. 17 C.F.R. § 240.3b-6 (2024).
5. 15 U.S.C. § 77z-2.

6. 15 U.S.C. § 78u-5.
7. Securities Litigation Reform Act, H.R. Rep. No. 104-369, at 46 (1995) (Conf. Rep.).
8. The final rules (relating to the offering of securities by special purpose acquisition companies (SPACs)) are available at *https://www.federalregister.gov/documents/2024/02/26/2024-01853/special-purpose-acquisition-companies-shell-companies-and-projections*.
9. 15 U.S.C.A. § 77z-2(c)(1); 15 U.S.C.A. § 78u-5(c)(1).
10. *See generally* Ocampo v. Williams, No. 21-CIV-03843, slip op. at 9 (San Mateo Cal. Super. Ct. July 25, 2022; Louis Loss, Joel Seligman & Troy Paredes, Securities Regulation 11.D.4, fn. 530 (6th ed. 2021).
11. A "bad actor" for PSLRA purposes means any issuer who, within the three-year period prior to making the forward-looking statement, was convicted of any felony or misdemeanor described in 15 U.S.C.A. § 78o-(b)(4)(B) or was the subject of a judicial or administrative decree or order arising out of a governmental action (i) prohibiting future violations of the antifraud provisions of the securities laws, (ii) requiring that the issuer cease and desist from violating the antifraud provisions of the securities laws, or (iii) determining that the issuer violated the antifraud provisions of the securities laws.
12. This term now includes SPACs solely for the purposes of the PSLRA due to the amendments to Securities Act Rule 405 and Exchange Act Rule 12b-2 made by the SEC as a part of "new rules and amendments to enhance disclosures and provide additional investor protection in initial public offerings by special purpose acquisition companies" adopted on January 24, 2024 and effective as of July 1, 2024. The final rules are available at *https://www.federalregister.gov/documents/2024/02/26/2024-01853/special-purpose-acquisition-companies-shell-companies-and-projections*. As the SEC stated the purpose of such amendments as to align the IPOs and de-SPAC business combinations, the amendment impacts solely de-SPAC transactions. Post de-SPAC companies will not be impacted by the amended rules.
13. Which means that issuers should take care to locate forward-looking statements in MD&A rather than notes to financial statements, and when, as is common, similar disclosure is contained in both MD&A and financial statements notes, to remove any forward-looking statements from the notes.
14. We do not believe that it would be proper to convey any statement with knowledge that such statement is false or misleading; however, the plain language of the statute, as well as interpretation by courts, is unambiguous with regard to the prongs: *either* of them would technically suffice to shield a forward-looking statement. *See* Wochos v. Tesla, Inc., 985 F.3d 1180, 1190 (9th Cir. 2021) ("As we explained in *Quality Systems*, the use of the disjunctive term 'or' between subclauses (A) and (B) confirms that 'a defendant will not be liable for a false or misleading statement if it is forward-looking and *either* is accompanied by cautionary language *or* is made without actual knowledge that it is false or misleading.'") (emphasis in original).
15. The PSLRA is frequently called the "codified" bespeaks caution doctrine.
16. *See* Harold S. Bloomenthal & Samuel Wolff, Securities and Federal Corporate Law § 15:32 (2d ed. 2023).
17. *See id.* § 15:30.
18. *See* Thomas Lee Hazen, Treatise on the Law of Securities Regulation § 12:73 (2d ed. 2023).
19. *See* Lloyd v. CVB Fin. Corp., 811 F.3d 1200, 1207 (9th Cir. 2016) ("vague, optimistic statements by [the company's] officials are not actionable.").
20. Robeco Cap. Growth Funds SICAV - Robeco Glob. Consumer Trends v. Peloton Interactive, Inc., 665 F. Supp. 3d 522, 540 (S.D.N.Y. 2023).
21. *See, for example*, Yan v. ReWalk Robotics Ltd., 973 F.3d 22, 33 (1st Cir. 2020) (the court concluded that "the word 'breakthrough' is simply a puffed-up qualitative expression of the product's novelty").
22. In re Razorfish, Inc. Sec. Litig., No. 00 CIV. 9474 (JSR), 2001 WL 1111502, at *3 (S.D.N.Y. Sept. 21, 2001).
23. *See* § 28:22. Puffery post-PSLRA, 2 Sec. Law Handbook § 28:22 ("many courts think they can (and sometimes they can) recognize puffery when they see it").
24. Robeco Cap. Growth Funds SICAV - Robeco Glob. Consumer Trends v. Peloton Interactive, Inc., 665 F. Supp. 3d 522, 540 (S.D.N.Y. 2023).

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25. *See* 17 CFR § 229.10, available at *https://www.ecfr.gov/current/title-17/chapter-II/part-229*.
26. If explicit reference to the PSLRA is inadvertently included, the issuer will likely receive the following comment from the SEC: "Section 27A(b)(2)(D) of the Securities Act of 1933 and Section 21E(b)(2)(D) of the Securities Exchange Act of 1934 expressly state that the safe harbor for forward-looking statements does not apply to statements made in connection with an initial public offering. Please either delete any reference to the Private Securities Litigation Reform Act, or make clear each time you refer to the Private Securities Litigation Reform Act that the safe harbor does not apply to initial public offerings."
27. *See* Securities Litigation Reform Act, H.R. Rep No. 104-369, at. 43 (1995) (Conf. Rep.):

    > The first prong of the safe harbor protects a written or oral forward-looking statement that is: (i) identified as forward-looking, and (ii) accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in the statement. "Under this first prong of the safe harbor, boilerplate warnings will not suffice as meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in the statement. The cautionary statements must convey substantive information about factors that realistically could cause results to differ materially from those projected in the forward-looking statement, such as, for example, information about the issuer's business. As part of the analysis of what constitutes a meaningful cautionary statement, courts should consider the factors identified in the statements. "Important" factors mean the stated factors identified in the cautionary statement must be relevant to the projection and must be of a nature that the factor or factors could actually affect whether the forward-looking statement is realized.

28. Slayton v. Am. Exp. Co., 604 F.3d 758 (2d Cir. 2010).
29. The PSLRA mandates the identification of the risks that may cause forward-looking statements not to come to fruition. This is technically a concept that is distinct from "risk factors," material factors that make an investment in the registrant or offering speculative or risky. *See* 17 C.F.R. §229.106 (2020). In the context of drafting the PSLRA safe harbor legend, distinguishing between these two concepts seems overly metaphysical and perhaps unnecessary. Nonetheless, it is important to recognize that not all risk factors applicable to a company's business as a whole may be relevant to the specific forward-looking statements. Therefore, a listing of all risk factors should be reviewed, and most likely trimmed, with this in mind.
30. Southland Secs. Corp. v. INSpire Ins. Sols., Inc., 365 F.3d 353, 372 (5th Cir. 2004) ("The requirement for 'meaningful' cautions calls for 'substantive' company-specific warnings based on a realistic description of the risks applicable to the particular circumstances, not merely a boilerplate litany of generally applicable risk factors."); Lormand v. U.S. Unwired, Inc., 565 F.3d 228, 244–48 (5th Cir. 2009).
31. Lopez v. CTPartners Executive Search Inc., 173 F. Supp. 3d 12, 25 (S.D.N.Y. 2016) ("Plaintiffs may establish that cautionary language is not meaningful 'by showing, for example, that the cautionary language did not expressly warn of or did not directly relate to the risk that brought about plaintiffs' loss.'") (internal citation omitted); In re Weight Watchers Int'l Inc. Sec. Litig., 504 F. Supp. 3d 224, 253 (S.D.N.Y. 2020).
32. This language must be both "extensive and specific" and must contain "substantive company-specific warnings." Gray v. Wesco Aircraft Holdings, Inc., 454 F. Supp. 3d 366, 392 (S.D.N.Y. 2020) (internal quotations and citations omitted). *See also* Gluck v. Hecla Mining Co., 657 F. Supp.3d 471, 485 (S.D.N.Y. 2023) ("These warnings, when read together, caution investors of the very risks that Plaintiffs allege ultimately occurred—namely that the Nevada Mines were not in the condition they were initially thought to be and that the cost of operating those mines would ultimately be higher than expected.").
33. In re Odyssey Healthcare, Inc. Sec. Litig., 424 F.Supp.2d 880, 886 (N.D. Tex. 2005).

34. In Sgalambo v. McKenzie, 739 F. Supp. 2d 453, 478 (S.D.N.Y. 2010), the court disfavored the "disclaimer appended to every [issuer] statement issued during the Class Period" because although "this disclaimer mentioned myriad, general factors—such as natural gas prices or environmental hazards—that might cause actual results to differ from [the issuer's] projections, the disclaimer provided no company-specific information, failed to link any specific projections to specific risks, and remained constant throughout the Class Period, even as the risks confronting [the issuer] changed."
35. *See* Brief for the SEC as Amicus Curiae, Slayton v. Am. Exp. Co., 604 F.3d 758 (2d Cir. 2010), available at *https://www.sec.gov/files/litigation/briefs/2010/slayton0110.pdf*.
36. Wang v. Cloopen Grp. Holding Ltd., 661 F.Supp.3d 208, 230 (S.D.N.Y. 2023) ("the lead plaintiff adequately alleges that the [issuer's] warnings regarding the future risk of declining customer retention were misleading, in view of the then-existing but omitted fact of the steep 4Q 2020 decline in the net customer retention rate.").
37. The requirement for *risk factors* is identical—one more reason to treat risk factors and risks in the PSLRA legend in a similar manner for drafting purposes.
38. Wochos v. Tesla, Inc., 985 F.3d 1180 (9th Cir. 2021).
39. In re Quality Sys., Inc. Sec. Litig., 865 F.3d 1130 (9th Cir. 2017).
40. *See* Jaeger v. Zillow Grp., Inc., 644 F. Supp. 3d 857, 869 (W.D. Wash. 2022) ("To fall under the PSLRA's safe harbor, the statement must be forward-looking in substance, not merely in form").
41. *In re Quality Sys., Inc. Sec. Litig.*, 865 F.3d at 1141 ("We hold a defendant may not transform non-forward-looking statements into forward-looking statements that are protected by the safe harbor provisions of the PSLRA by combining non-forward-looking statements about past or current facts with forward-looking statements about projected revenues and earnings.").
42. *See* Securities Act Rules C&DI 110.01, available at *https://www.sec.gov/corpfin/securities-act-rules.*
43. *http://www.gpo.gov/fdsys/pkg/CRPT-104hrpt369/pdf/CRPT-104hrpt369.pdf*.

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EXECUTIVE PAY

Can Improved Communication About Executive Compensation Pay Off?

By Sharon Podstupka

In developing carefully calibrated executive compensation programs, compensation committees aim to drive business priorities, as well as attract, retain, and incentivize their leadership teams. But do they place equal emphasis on explaining how these programs align to long-term organizational goals or the potential wealth-creation opportunities they offer? If this communication is mediocre, boards could be overlooking a chance to strengthen leaders' focus on pay and performance and enhance the impact of the compensation strategy.

Pearl Meyer's "On Point Survey: Clearly Communicating Executive Pay" examines how boards and their management teams educate participants about executive compensation opportunities.[1] Specifically, the survey asked if boards and their management teams believe that executives understand how their compensation is structured and delivered. It also asked if boards and management teams believe executives appreciate the value of their compensation and how it compares to the compensation of their internal colleagues and external peers.

The resulting data indicate that there is some misalignment between directors and management about the effectiveness of communicating executive pay plans. For example, directors view the perceived value of total target direct compensation (TTDC) favorably compared to management: 52 percent and 29 percent rated the value as "high," respectively. Directors (32.3 percent) are also more likely than management (16.7 percent) to believe that executives' understanding of their TTDC opportunities is "excellent."

What shapes these value perceptions and individuals' understanding of their compensation opportunities? It all comes down to planful communication efforts and how everyone talks with one another about pay programs, pay philosophy, and progress toward goals. The data show that while the majority of survey respondents view overall communication about TTDC positively, there is still significant room for improvement: 20 percent rated the quality of TTDC communication as just "fair" and only 20 percent rated it as "excellent."

Digging deeper into TTDC, the real issue for compensation committees is just how well executives do—or do not—understand their incentive plans, and in particular, their long-term incentives (LTI). The news is not dire, but it does signal a significant opportunity for improvement. Consider that executives are likely, based on their position, well versed in corporate financials. Yet just over a quarter of the surveyed executives feel that they have an "excellent" understanding of the LTI program.

Yes, these plans can be complex and overlap previous years' plans, further complicating a clear picture. But at the heart of any well designed LTI program is a tie to the most important corporate performance metrics. These plans are presumably carefully constructed with the goal of incentivizing executives to drive the organization's long-range strategy, they are vetted by shareholders and proxy advisors, and much of the communication about them is mandated and highly regulated (at least for public companies). That's in addition to the time and expertise that goes into their development and disbursement.

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It seems logical, then, that a significant amount of effort and reinforcement would go into the communication of these plans to their participants, yet less than half of respondents (47 percent) indicated that there is a regular cadence for communicating progress toward LTI goals, while almost 70 percent say that they have regular communication regarding short-term incentives (STI). (One positive point is that when progress toward STI and LTI goals is communicated, it is overwhelmingly shared in person.)

Most importantly, a path toward better understanding was laid out by the survey respondents. Almost half indicated that they would like more information on progress toward goals and 45 percent would like more detail overall regarding their plans. Thirty-eight percent noted that increased frequency in communications, more opportunity for questions and discussion, and more transparency about the goal-setting process would be beneficial.

Ultimately, this information gives leadership teams and board members a chance to synchronize their views and reevaluate how they talk about executive pay programs. Devoting time to evaluate the existing pay communication strategy, and if warranted, formulating a new approach that better illustrates the opportunity and value of the pay program will be well worth the effort.

Note

1. *https://pearlmeyer.com/insights-and-research/research-report/on-point-survey-clearly-communicating-executive-pay.*

Relative TSR Awards: Challenges and Trade-Offs Using Stock Price vs. Monte Carlo Calibration Methods

By Szu Ho, Ira Kay, Joadi Oglesby, and Ben Stradley

Thousands of companies, including more than 70 percent of the S&P 500 companies, grant performance stock units (PSUs) with relative total shareholder return (TSR) or stock price performance-vesting conditions. These incentives can be very motivational, help align management rewards with shareholder returns, and are strongly favored by some investors and proxy advisors. Nevertheless, differing perspectives on the value of these awards, affecting the sizing of grants, may impact the motivational power of these grants.

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Companies granting relative TSR-PSUs are faced with the dilemma of how to determine the number of shares being granted. This question comes up often as compensation committees and/or management wonder if the grant date value being delivered is aligned with the intended grant value.

Choosing market stock price (either as of the grant date or average toward the grant date) or a Monte Carlo valuation to determine the number of shares being granted can be more complex than one would think, given each calibration approach typically results in a different number of shares. This Viewpoint is intended to help inform companies of the various trade-offs, and it can be used as a general guide to help companies decide which approach makes the most sense for their circumstances.

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The Case for Relative TSR Plans

The increasing prevalence of relative TSR performance metrics in performance-based equity awards is driven by multiple factors, with a principal factor being the preferences of major institutional investors and proxy advisors when evaluating alignment between executive pay and performance. For example, Vanguard considers a company's "three-year total shareholder return and realized pay over the same period vs. a relevant set of peer companies" for evidence of pay and performance alignment.[1] Both Institutional Shareholder Services (ISS) and Glass Lewis use various relative financial and/or TSR performance metrics in their pay-for-performance evaluations to support their recommendations to companies' say-on-pay proposals.

In this context, many companies perceive TSR awards as a means to simultaneously align their compensation with an investors' perspective on performance and conform to known pay-for-performance evaluation frameworks. Further, the introduction of TSR awards has also become a common action taken in response to unfavorable say-on-pay results.

From the Board's perspective, TSR plans can create strong alignment with shareholder interests while mitigating challenges with setting multi-year financial or operational goals (particularly within volatile industry sectors) or achieving "apples-to-apples" relative performance comparisons among peers arising from differences in the timing and comparability of reporting.

These factors have contributed to making relative TSR the most prevalent relative performance metric companies use to determine PSU award payouts. TSR is often used as a standalone weighted performance metric but may also be used as a payout modifier. Most often, the subject company's TSR performance is compared to constituents of a general stock index (for example, S&P 500), an industry specific stock index, or a custom TSR performance peer group selected by the company.

Valuation and Disclosure of TSR and Other Market-Conditioned Awards

Central to the question of the calibration and motivational effect of TSR awards is their valuation. These valuations, and ultimately the proxy-reported values of these awards, is dictated by accounting guidance, which treats awards subject to market conditions (for example, TSR, stock price) fundamentally differently from those tied to absolute financial and operational metrics.

For restricted shares, or performance shares subject to financial or operational metrics, the valuation of these awards is generally equal to the stock price on the grant date. Other aspects of the design, including the performance measurement period and minimum/maximum award payout opportunities generally have no bearing on the valuation of the award. Assuming a $10 stock price, in this case all awards and plan variations are valued equally. If you make the goal harder/easier: $10. If you increase/decrease the payout opportunity: $10. If you shorten/lengthen the performance period: $10. As a result, there is little friction when revising incentive designs or shifting between restricted stock and PSUs.

By comparison, the valuation of awards subject to market conditions must consider the effect of those conditions when determining the award value for accounting/disclosure purposes, which is often accomplished using a Monte Carlo valuation methodology. In contrast with financial/operational PSU awards which are valued based on the grant date stock price, market-conditioned awards are valued based on their expected payout value. This results in valuations which are often higher than the stock price on the date of grant (for example, $12 valuation relative to $10 grant date stock price).[2]

Importantly, as plan provisions change, so may the valuation. If you make the goal easier or increase the payout opportunity, the valuation may increase (for example, $13). Conversely, if you make the goals harder, or reduce the payout opportunities, the valuation may decrease (for example, $11). This

can significantly impact the proxy-reported value of these awards and may significantly change the motivational impact of awards when transitioning to/from market-conditioned awards.

Further, proxy advisors ISS and Glass Lewis both use grant date stock price for performance-based full-value stock awards (that is, PSUs or performance stock awards). When measuring compensation and conducting quantitative pay-for-performance assessments:

- ISS values all performance-based awards using the grant date stock price and the target payout opportunity. This results in parity between the valuation of PSUs with financial/operational metrics and market-based metrics (for example, TSR). Under this framework, this may result in lower valuations for TSR awards than is reported by companies in their proxy statements.[3]
- Glass Lewis uses the same approach as ISS when valuing performance-based stock awards.[4] In addition, Glass Lewis considers a measure of realized pay in their evaluations, which emphasizes the value of awards when earned rather than when granted (as is generally reflected in the proxy).

Tradeoffs When Calibrating Awards

Relative TSR PSUs often are granted to top executives, with a pre-determined $ target or intended $ grant value. Given differing views on the "value" of TSR awards, companies often debate the proper method to deliver as they seek to balance the views of award recipients with disclosure requirements and investor perspectives.

Our experience and research suggest market practice is roughly evenly split between those which convert target grant values to a number of PSU using either (i) the stock price approach, or (ii) the accounting/Monte Carlo approach. Exhibit 1 illustrates the financial differences between these two approaches.

There are advantages and challenges in using each granting approach which should be considered based on each Company's priorities, valuation objectives, and resources available. In Exhibit 2 we summarize several of these key advantages and challenges.

Given the advantages and challenges of each granting approach, there is no singular or correct method. For companies that currently grant relative TSR PSUs, there may not be a compelling reason for change in the near term.

For companies considering adding relative TSR as a PSU performance metric, management and compensation committees should decide which conversion approach best suits the objectives of the Company.

For example, if a company emphasizes communication and value perception with PSU to participants, the stock price approach may be the preferred

Exhibit 1—Relative TSR PSU Conversion Illustrative Example

Converting Approach:	Stock Price	Monte Carlo/Accounting Value
(a) Target/Intended Grant Value	**$1,200,000**	**$1,200,000**
(b) Converting Value per Share	$10.00 (grant date stock price)	$12.00 (based on Monte Carlo simulation)
(c) # of Target PSUs Granted (a)/(b)	120,000	100,000
(d) Accounting Value per Share	$12.00	$12.00
(e) Proxy Tabular Disclosure Value (c) x (d)	**$1,440,000**	**$1,200,000**

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Exhibit 2—Relative TSR Awards Granting Approach Comparison Summary

Approach	Description	Advantages	Challenges
Stock Price	• Uses stock price on grant date or an average stock price over a multi-day period leading up to grant date	• Easier to understand and communicate to award receivers; consistent with approach used for converting financial performance PSUs or time-vesting RSUs/restricted stock awards (RSAs) • Consistency with equity value used by ISS and Glass Lewis in their Pay-for-Performance quantitative assessment	• May result in inflated grant values shown on the summary compensation table and the grants of plan-based awards table that do not match the stated target grant value • Can be vulnerable to stock price changes, if using the grant date stock price (a stock price at a point of time), which may not reflect true value of shares
Monte Carlo / Accounting Value	• Uses Monte Carlo simulation (based on multiple variables) to determine the accounting value, which is almost universally greater than the actual share price on grant date	• Accounts for risk by incorporating various risk factors, such as stock price volatility, price change correlation and market risk free rate, etc. • Allows for flexibility and a more nuanced approach by taking into account multiple variables, including both the upside and downside potential as well as the actual stock performance leading up to the grant date • Consistent between the proxy disclosed equity value and intended target grant value	• Administrative complexity-Monte Carlo valuation requires a specialized expert to run the model • Relies heavily on the assumptions used in the model, which may fluctuate over time • Challenging to communicate to participants given the complexities of the Monte Carlo valuation model

choice. This most likely will result in a higher proxy-reported value for the award than the value that may have been communicated to the participant as their intended target opportunity.

In contrast, if a company emphasizes consistency between the intended target opportunity and its accounting and proxy reported values, the Monte Carlo approach may be the preferred choice.

Notes

1. *See* the 2024 Vanguard Proxy Voting Policy for U.S. Portfolio Companies.
2. Similarly, option valuation relies on expected payout value. For example, an option with the exercise price set at the current market price would have $0 intrinsic value at grant but still have a positive grant date value based on expected value in the future.

3. For stock options, ISS also has a different approach than what most companies use to value their options. ISS uses a full-life / term approach and price volatility within a shorter period of time compared to an expected life approach and price volatility over a longer period adopted by most companies when calculating option value. This often results in a higher option value than what is reported by companies in proxy statements.
4. Glass Lewis typically uses company disclosed values for options / stock appreciation rights, which differs from the ISS approach stated above.

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SPIN-OFFS

Leveling Up: Key Threshold Considerations for Structuring Tax-Free Partial Spin-Off Transactions

By Keerthika Subramanian

Once considered uncommon corporate reorganization transactions pursued by smaller, less well-known companies in varying degrees of financial distress, tax-free spin-offs have become more mainstream and prominent in recent years among financially sound, blue-chip public companies across a range of industries, such as pharmaceuticals/healthcare, consumer retail products and industrials/manufacturing.

The latest blue-chip public company rumored to be exploring a potential tax-free spin-off is FedEx Corporation (FedEx). In FedEx's recent fourth quarter 2024 earnings call in June 2024, FedEx CEO Raj Subramaniam announced that FedEx's management, board of directors and external advisors were conducting an assessment of the future role of FedEx Freight, the less-than-truckload (LTL) unit of the multinational transportation conglomerate, in the company's portfolio structure.[1]

This news prompted widespread speculation among Wall Street LTL analysts that FedEx may soon divest FedEx Freight, the company's best performing business, following the completion of the strategic review in December 2024.[2] While the assessment remains ongoing as of the date of this publication, it is widely anticipated that FedEx may pursue a tax-free spin-off with respect to FedEx Freight as early as 2025 in order to maximize shareholder value.[3]

The speculation surrounding the potential divestiture of FedEx Freight underscores the recent rise of divestitures, and in particular, tax-free spin-offs, in the LTL industry. The divestiture of FedEx, if completed, would represent the latest in a series of recent divestitures in the LTL industry, such as XPO, Inc.'s recent spin-off of its LTL business from its brokered transportation business and TFI International Inc.'s expected spin-off of Daseke, Inc. and other truckload holdings.[4] If consummated, FedEx's spin-off of FedEx Freight would represent one of the largest spin-offs completed recently, with analysts estimating that FedEx Freight would command an approximately $50.0 billion market capitalization as a standalone public company.[5]

Given this expected significant market capitalization, a tax-free partial spin-off, a specific type of spin-off transaction in which FedEx would continue to retain an ownership stake in the freight business once it is spun off into an independent, standalone public company, would be particularly advantageous as it would allow FedEx to effectively "level up." FedEx would stand to benefit from the robust financial performance of the standalone freight business at a time when FedEx is trying to rebound from lackluster first quarter fiscal year 2025 results.

FedEx/FedEx Freight is just one of many recent suitable candidates for tax-free partial spin-offs. Nevertheless, tax-free partial spin-offs remain poorly understood in the marketplace. This article provides an overview of tax-free partial spin-offs, including the business rationale for pursuing such transactions, and offers key threshold considerations for Parent Entity (as defined herein) personnel and advisors to heed when structuring these complex transactions.

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Overview

Tax-Free Spin-Offs

In a tax-free spin-off, a public company (Parent Entity) spins off a subsidiary (Subsidiary) by distributing (via a dividend) the Subsidiary's common stock to the stockholders of the Parent Entity. Subsidiary typically is a private, wholly owned subsidiary of Parent Entity. Following the consummation of the tax-free spin-off, Parent Entity and Subsidiary exist separately and independently of one another, and Subsidiary becomes a publicly traded company owned entirely by the stockholders of the Parent Entity—Parent Entity does not retain an ownership stake in Subsidiary. Assuming certain criteria are satisfied (as discussed herein), these transactions often qualify as tax-free distributions under Section 355 of the Internal Revenue Code of 1986, as amended (IRC) and are therefore advantageous transactions to Parent Entity stockholders from a tax perspective.

Tax-Free Partial Spin-Offs

Tax-free partial spin-offs are substantially similar to conventional tax-free spin-offs, but differ in one critical respect: in a tax-free partial spin-off, Parent Entity retains an ownership stake in Subsidiary following the consummation of the tax-free partial spin-off. As a result of its ownership stake in the spun-out Subsidiary, Parent Entity stands to financially benefit if the spun-out Subsidiary performs well as an independent public company.

Business Case

There is no single overarching business rationale for pursuing tax-free partial spin-offs, but in general, the most suitable candidates for tax-free partial spin-offs are Parent Entities who have high performing Subsidiaries. Parent Entities may pursue tax-free partial spin-offs for a variety of reasons, but in all cases, Parent Entities stand to gain from its ownership stake in the spun out high performing Subsidiary assuming the spun out high performing Subsidiary continues to perform well following the consummation of the tax-free partial spin-off. The business case for pursuing tax-free partial spin-offs is perhaps best captured by the acronym **"LEVELING UP,"** as explained below.

Liability Management and Liquidity

Partially spinning off high performing Subsidiaries can help distressed and/or highly levered public companies manage their debt burdens. There was a surge in corporate borrowing during the height of the COVID-19 pandemic as companies opportunistically borrowed due to historic low interest rates. Additionally, companies in certain industries adversely impacted by the COVID-19 pandemic, such as travel/leisure, incurred significant debt to shore up their liquidity levels.

Many of these COVID-19 era debt issuances are coming due between 2025-2028—a phenomenon known as the "maturity cliff." Due to challenging conditions such as the prevailing high-interest rate environment and continued market volatility, conventional debt and equity capital financings may be inopportune. Accordingly, tax-free partial spin-offs represent a timely, compelling alternative for companies seeking to manage significant upcoming liabilities and enhance liquidity, while still allowing them to benefit from the strong future performance of the Subsidiary. Any gains realized from equity ownership stakes in the spun-out Subsidiary can be used to reduce leverage and shore up liquidity.

Efficient Management

Partially spinning off high growth Subsidiaries can also result in more efficient management at the Parent Entity level because Parent Entity management can focus on overseeing a streamlined, smaller business as opposed to managing a more expansive business enterprise.

Value Creation

Partially spinning off strong performing Subsidiaries can also maximize shareholder value by allowing such Subsidiaries the opportunity to disentangle from slower-growth business lines within the

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Parent Entity, thereby allowing such high performing Subsidiaries to realize higher valuations. Through their ownership stake in the spun-out Subsidiary, Parent Entities will stand to benefit from such higher valuations.

Establish Defense against Takeovers

Partially spinning off high growth Subsidiaries can also help Parent Entities thwart takeovers as Parent Entities may become less compelling acquisition targets after a high growth Subsidiary is spun out.

Lower Costs and Regulatory Burden

Partially spinning off high performing Subsidiaries may result in lower costs for both the Subsidiary and the Parent Entity. For example, the partial spin-off of a high growth Subsidiary in a capital-intensive industry may help lower costs for the Parent Entity, while still allowing the Parent Entity to benefit from the strong performance of the Subsidiary following the consummation of the tax-free partial spin-off. Similarly, lower costs can be achieved by reducing regulatory burden for both the Parent Entity and high performing Subsidiary alike.

Incentivize Management

Partially spinning off high growth Subsidiaries may help incentivize officers and employees to establish more appropriate compensation packages that reflect compensation metrics more narrowly tailored and germane to the Subsidiary.

Nimble Financing

Partially spinning off strong performing Subsidiaries enables more nimble financing by the Subsidiary. For example, by disentangling from a relatively poor performing Parent Entity, Subsidiaries with strong prospects can approach future capital raising activities with more agility and alacrity, thereby delivering benefits to not only the Subsidiary, but also the Parent Entity which retains an ownership stake in the spun-out Subsidiary.

Good Governance

Partially spinning off high growth Subsidiaries can promote good governance by eliminating conflicts and tensions between business lines, thereby minimizing distractions at the management levels of both the Parent Entity and the Subsidiary. An environment marked by less conflicts will allow both the Subsidiary and Parent Entity to solely focus on executing on business imperatives.

Utilize Equity as Acquisition Currency

Struggling and/or financially distressed Parent Entities seeking to partially spin off a high growth Subsidiary can leverage equity stakes in the spun-out Subsidiary as future acquisition currency.

Public Reputation

A partial spin-off can enhance the public reputation of a Parent Entity. A Parent Entity with a lackluster marketplace reputation or stale branding can refurbish its image in the marketplace by partially spinning out a high performing Subsidiary. Investor buzz surrounding the announcement can boost the fortunes of both the Parent Entity and Subsidiary alike and any gains achieved by the spun-out Subsidiary will improve not only the bottom line of the Parent Entity, but will also augment Parent Entity's reputation among investors.

Similarly, by becoming a standalone, independent public company, a promising Subsidiary can enhance its stature in the marketplace in a more immediate and dramatic fashion than it would have had it remained entangled with an underperforming Parent Entity.

Key Threshold Considerations

Set forth below is a non-exhaustive list of significant, preliminary considerations that should be heeded by Parent Entity personnel and advisors when structuring tax-free partial spin-offs.

1. Engage Skilled Advisors Early

Engaging skilled advisors early is crucial for effective transaction structuring. At least 12-18 months in advance of commencing work on a tax-free partial spin-off, boards and management should retain legal counsel, auditors and other advisors, including, but not limited to, experienced investment bank and tax advisors who have demonstrated experience advising on tax-free spin-offs and in particular, tax-free partial spin-offs. Additionally, such advisors should have a strong understanding of the industry or industries, as applicable, in which the Parent Entity and Subsidiary operate.

2. Assess Tax-Free Distribution Eligibility

One of the primary advantages of a partial spin-off is that it can be classified as a tax-free distribution under Section 355 of the IRC. In order for a partial spin-off to qualify as a tax-free distribution, it must be structured properly. Great care should be taken by advisors to ensure that the proposed transaction adheres to the requirements promulgated by the Internal Revenue Service. Set forth herein is a non-exhaustive list of requirements advisors should heed when structuring tax-free partial spin-offs.

The requirements below assume that the Subsidiary is a US entity. First and foremost, the transaction must be driven by proper business purpose which may include, but is not limited to, the following: (i) achieving cost savings, (ii) enabling borrowing, (iii) enabling a stock offering, (iv) providing employees with equity interests, (v) enabling acquisitions, or (vi) addressing competitive concerns. Notably, a desire to reduce federal income taxes is not considered a valid business purpose.[6]

Second, advisors should verify and confirm that the Parent Entity and Subsidiary have engaged in an active trade or business for the immediately preceding five-year period before the contemplated tax-free distribution. Relatedly, Parent Entity and Subsidiary must continue to participate in such active trade or business following the consummation of the tax-free distribution.[7]

Third, the proposed transaction cannot be used as a device to facilitate the distribution of earnings and profits.[8]

Fourth, Subsidiary must be controlled by the stockholders of the Parent Entity which can be achieved by ensuring that Parent Entity stockholders own: (i) 80 percent of the total combined voting power of all classes of stock entitled to vote; and (ii) 80 percent of the total number of shares of each other class of stock of the spun-out Subsidiary.[9]

Fifth, there must be demonstrated continuity of interest. The historic stockholders of Parent Entity must have a continuing interest in both the Parent Entity and the Subsidiary following the consummation of the transaction.[10]

Failure to adhere to the foregoing requirements could result in the transaction losing tax-free status, thereby eliminating a key advantage. Accordingly, advisors should conduct a comprehensive review of a proposed transaction's eligibility for tax-free distribution status. Additionally, advisors should verify and confirm that (i) there was no purchase of 50 percent or more of the stock distributed in the transaction within the immediately preceding five-year period,[11] and (ii) there has been no acquisition of 50 percent or more of an equity interest in either the Parent Entity or Subsidiary in a plan involving the distribution.[12] There are strict timing requirements at play in connection with the foregoing requirements.[13]

Accordingly, advisors should exercise caution in ensuring compliance and/or evaluating the applicability of safe harbors available under IRC Section 355(e).[14] Advisors should also be mindful of these requirements when determining the percentage of the Parent Entity's ownership stake in the spun-out Subsidiary.

3. Evaluate if Registration under the US Federal Securities Laws Is Necessary

In addition to assessing whether a proposed transaction meets the tax-free distribution eligibility requirements discussed above, Parent Entity personnel and advisors should evaluate the applicability

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of the US federal securities laws when structuring a tax-free partial spin-off. In general, per the Staff of the Securities and Exchange Commission (SEC), a spin-off transaction not preceded by an initial public offering that satisfies the criteria discussed herein typically will not require registration under Section 5 of the Securities Act of 1933, as amended (Securities Act).

The spun out Subsidiary's stock must be registered pursuant to Section 5 of the Securities Act unless the following threshold criteria are met: (i) there must be no consideration paid by Parent Entity stockholders for shares of the spun out Subsidiary's stock; (ii) the distribution must be made on a pro rata basis; (iii) Parent Entity must provide sufficient information about the proposed transaction to its stockholders via the filing of an information statement and Form 10 with the SEC; and (iv) the proposed transaction must have a proper business purpose.[15]

The foregoing criteria represent threshold criteria; additional requirements may apply if Parent Entity required the Subsidiary from a third party. It is critical that Parent Entity personnel and advisors carefully ensure adherence to the foregoing criteria—if the conditions described above are not met, the proposed transaction will implicate Section 5 of the Securities Act and the transaction must be registered with the SEC.

Conclusion

Tax-free partial spin-offs offer compelling benefits to ailing and financially sound Parent Entities alike as they allow Parent Entities to effectively "level up," as discussed herein. Nevertheless, there is little guidance available on how to properly structure these transactions. Parent Entity personnel and advisors should heed the threshold considerations discussed herein when structuring these complex transactions.

Notes

1. *https://investors.fedex.com/news-and-events/investor-news/investor-news-details/2024/FedEx-Reports-Higher-Full-Year-Diluted-EPS-of-17.21-and-Adjusted-Diluted-EPS-of-17.80/default.aspx.*
2. *https://www.wsj.com/articles/trucking-experts-project-spinoff-of-fedexs-freight-business-7129e046.*
3. *Id.*
4. *https://www.truckingdive.com/news/fedex-explores-options-freight-division-possible-LTL-trucking-shakeup/719951/.*
5. *https://www.wsj.com/articles/trucking-experts-project-spinoff-of-fedexs-freight-business-7129e046.*
6. IRS Rev. Proc. 96-30; Treas. Reg. § 1.355-2(b).
7. Treas. Reg. § 1.355-3.
8. Treas. Reg. § 1355-2(d).
9. IRC §§ 355(a)(1)(A), 368(c).
10. Treas. Reg. § 1.355-2(c).
11. Internal Revenue Code, § 355(d).
12. Internal Revenue Code, § 355(e).
13. Internal Revenue Code, § 355(e).
14. Internal Revenue Code, § 355(e).
15. SEC Staff Legal Bulletin No. 4 (September 16, 1997).

SHAREHOLDER ACTIVISM

Starboard Goes Precatory

By ***Michael R. Levin***

We remain convinced more investors will pursue a new(er) way of pressuring portfolio companies through an innovative shareholder proposal mechanism. Activist investor Starboard Value just recently became the next activist to do this, at News Corp (NWSA).

Starboard will solicit its own proxies for this proposal, the latest proponent and first hedge fund activist to do so. Earlier this year, we saw the first such situation in many years, at Warrior Met Coal (HCC). There, the United Mine Workers (UMW) succeeded in winning support for several precatory proposals through its own solicitation.

Starboard disclosed it submitted a precatory proposal to NWSA, requesting it collapse its long-standing dual-class share structure. (The Murdoch family controls 41 percent of the votes while owning only 14 percent of the shares.) Starboard will follow the same process as UMW at HCC.

We're intrigued that Starboard wants to do this, as the specific proposal seems doomed to fail. We surmise Starboard has other motives, though. That a prominent investor like Starboard adopts this approach bodes well, too.

A Proposal Like Many Others

Investors have of course complained about dual-class structures for a very long time. Numerous shareholders have proposed to eliminate them at many companies. NWSA shareholders even voted in 2016 whether to disband its dual-class structure. Then, almost 90 percent of the non-Murdoch shares voted in favor, with not quite 50 percent of all shares supporting. NWSA didn't do anything about its dual-class shares then.

NWSA could ignore the earlier proposal because it was precatory. Shareholders submit hundreds of proposals for voting at annual general meetings (AGMs) each year. Almost every one of those are merely advisory, urging the company to take one or another course of action: write a report, adopt a goal, or amend governing documents like bylaws. They form the core of environmental, social, and governance (ESG) activism at AGMs. Why shareholders do it this way, and how companies respond, are subjects for another post. Suffice it to say companies may legally ignore what shareholders vote to support. NWSA did exactly this with the previous dual-class share vote.

A Process Like Only One Before It

As far as we can tell, previous shareholder proposals to eliminate dual-class shares were submitted as a proposal for the company to include on its proxy statement. These are also known as Rule 14a-8 proposals, for the relevant Securities and Exchange Commission (SEC) rule. Those hundreds of ESG proposals are 14a-8 proposals, including at least a few seeking to eliminate dual-class shares. They all follow the same well-trod path, and relatively few win material support from shareholders.

Instead of a 14a-8 proposal, Starboard will solicit proxies itself. It will follow the same process it would use for board elections. There, an activist contacts shareholders, using its own proxy materials and proxy solicitor, to collect votes. It does not rely solely on the company and its proxy materials and proxy

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solicitor. These are known as Rule 14a-4 proposals, again for the relevant SEC rule.

Any shareholder that wants to elect directors at a company follows 14a-4, happens many times every year. First UMW and now Starboard will use it to promote support for a precatory proposal. A handful of shareholders have done this before, none since 2010.

A Proposer Unlike Others

Starboard has abundant experience with proxy contests and 14a-4. After all, it's the activist that elected an entire new board of directors at Darden Restaurants several years ago.

To our knowledge, Starboard has not submitted a shareholder proposal at a portfolio company. Almost all activist funds avoid precatory proposals and the 14a-8 process. We don't expect it or any hedge fund like it to submit ESG proposals anywhere.

We don't quite know why Starboard submitted a precatory proposal at NWSA. We have some ideas why it did so as a 14a-4 proposal rather than a 14a-8 proposal. We surmise Starboard submitted a precatory proposal because it couldn't submit a binding one. To recapitalize from dual-class to single class takes many steps, changes to numerous governing documents, and approvals from regulators, state domicile officials, and various shareholders. The process needed for shareholders to themselves amend bylaws, the certificate of incorporation, and other governing documents would become much too complicated for an outsider.

Why submit any proposal? Starboard likely thinks it helps increase pressure on the company, especially as a 14a-4 proposal. Even if NWSA ignores a favorable shareholder vote, which they almost certainly would do, it would likely need to explain its decision to irate shareholders.

Why submit a 14a-4 proposal? Starboard might have missed the 14a-8 proposal deadline, which was June 6. Perhaps it decided to submit a proposal only a few weeks ago. It could submit a 14a-4 proposal between July 18 and August 17.

Also, Starboard avoids the hassles of 14a-8 proposals, including getting through the SEC no-action process. It would need to accept the reality of soliciting proxies itself, rather than going on the company proxy statement. Even then, UMW showed a way around that, and how a 14a-4 proposal can pressure a company in unique ways.

At HCC, UMW compelled the company to include five proposals in the company proxy statement. It then needed to solicit many fewer shareholders. Under 14a-8, the company can decide to include only one proposal.

At NWSA, Starboard may simply force the company to negotiate, somehow, over demands to eliminate dual-class shares, or perhaps other unknown demands. You see, if Starboard solicits proxies itself, then it alone knows how a possibly significant percentage of the shareholder base votes. It will have the proxies, and NWSA won't.

NWSA might not risk losing control over counting a portion of the votes. After all, a few years ago most shareholders not named Murdoch voted against the Murdoch family. With some effort Starboard could do even better, and put itself in the position of gaining some control over the next AGM.

Most importantly, if a 14a-4 proposal is good enough for both the UMW and Starboard, we expect many other shareholders to consider it seriously for the coming year.

SEC ENFORCEMENT

SEC Dismisses In-House Proceedings Against Accountants Following *Jarkesy*

By Henry Klehm III, Kevin M. Comeau, Sarah L. Levine, David Peavler, and Evan P. Singer

The US Supreme Court recently held in *SEC v. Jarkesy* that the Securities and Exchange Commission's (SEC) in-house administrative proceedings violate the Seventh Amendment's right to jury trial to the extent they adjudicate claims that are "legal in nature," such as fraud charges and civil penalties. *Jarkesy* did not directly address, however, other kinds of enforcement actions the SEC historically adjudicates in-house, including proceedings under Rule 102(e) of the SEC Rules of Practice, which is the SEC's primary tool for regulating the professionals appearing before it.

Among other things, Rule 102(e) empowers the SEC to censure or bar professionals found to have engaged in "improper professional conduct," which, for accountants, can include repeated violations of applicable professional standards. But Rule 102(e) proceedings can only be brought administratively.

The SEC seems now to believe that *Jarkesy* precludes litigating Rule 102(e) proceedings administratively. In August 2024, the SEC dismissed two contested Rule 102(e) proceedings against accountants who allegedly failed to conduct audits in accordance with professional standards. The SEC previously had moved to stay each case pending a decision in *Jarkesy*.

Notably, while one of the cases involved a claim for civil penalties thus plainly implicating *Jarkesy* the other sought only remedial and cease-and-desist relief. It may also be significant that each accountant had sued the SEC in federal court to challenge its use of administrative proceedings.

The SEC has yet to announce a policy against litigating contested Rule 102(e) proceedings administratively and the agency's barebones motions to dismiss the two cases provide no greater clarity but such a policy could have significant ramifications. Rule 102(e) is one of the SEC's most potent weapons, since an SEC censure or bar can cripple a professional career, and the SEC has leveraged the threat of litigating before its in-house courts to secure significant settlements against all types of professionals.

But if that threat no longer exists, then parties may be less inclined to accept the agency's settlement terms, and the SEC may choose to pursue only the most serious cases in federal district court. In either case, the SEC's ability to regulate the professionals who appear before it will likely be substantially diminished.

Henry Klehm III, Kevin M. Comeau, Sarah L. Levine, David Peavler, *and* **Evan P. Singer** *are attorneys of Jones Day LLP.* **Alexis K. Desire** *also contributed to this article.*

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