KAYE SCHOLER

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M&A and Corporate Governance Newsletter

Director Compensation Receives Scrutiny in Recent Delaware Chancery Court Decision

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A decision issued last month by Chancellor Bouchard of the Delaware Chancery Court in *Calma v. Templeton*[1] reminds us that care must be taken by a board in all decisions regarding director compensation. A stockholder challenged awards of restricted stock units granted to eight non-employee directors of Citrix Systems Inc. (Citrix). The majority of the director compensation consisted of these RSU awards under a plan approved by a majority of Citrix's disinterested stockholders in "informed and uncoerced votes."

The plan in question covered awards not just to non-employee directors, but also to officers, employees, consultants and advisors. The only limit on compensation imposed under the plan was that no beneficiary could receive

IN THIS ISSUE

[1] C.A. No. 9579-CB (Del. Ch. April 30, 2015).

more than one million shares or RSUs per calendar year; there were no further limits set on compensation under the plan for non-employee directors. At the time the action was filed against the directors, one million RSUs were worth over $55 million, based on Citrix's stock price. Plaintiffs therefore alleged that defendants must establish the entire fairness of the RSUs granted to the eight non-employee directors, because the plan itself had no "meaningful limits" on the annual stock-based compensation that non-employee directors could receive under the plan.

Defendants argued that the awards were ratified as a result of the stockholder approval of the plan. Chancellor Bouchard disagreed, holding that the omnibus approval of a plan "covering multiple and varied classes of beneficiaries" did not constitute ratification by the stockholders. There was no ratification because Citrix did not seek or obtain stockholder approval of any action "*bearing specifically on the magnitude of compensation to be paid to its non-employee directors*."

Absent stockholder ratification, the standard of review for the RSU grants was entire fairness, because the grants were self-dealing transactions. Chancellor Bouchard concluded that it was "reasonably conceivable" that the total compensation received by the directors was not entirely fair to Citrix, and that the defendant directors were unjustly enriched by those awards, although he determined that the RSU awards did not constitute waste. He refused to dismiss the counts relating to breach of the duty of loyalty and unjust enrichment.

Review Standard

This was not a case where disinterested directors approved the compensation of other directors. In such a case, Delaware law would apply the business judgment rule to the decision regarding director compensation. Rather, here, the Compensation Committee approved both awards to the members of the committee as well as to the other non-employee directors. "[D]irector self-compensation decisions are conflicted transactions that 'lie outside the business judgment rule's presumptive protection.'" Chancellor Bouchard concluded that the plaintiff rebutted the presumptive business judgment standard of review.

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Stockholder ratification is an affirmative defense to an alleged breach of the duty of loyalty. Defendant directors argued that the approval by the stockholders of the plan constituted ratification. Plaintiffs countered that the plan approved by the stockholders had no "meaningful limits" on the total equity compensation the directors could receive. Chancellor Bouchard considered "whether advance stockholder approval of a compensation plan with multiple classes of beneficiaries and a single generic limit on the amount of compensation that may be awarded in a given year is sufficient to establish a ratification defense for the RSU awards that were granted to Citrix's non-employee directors." After reviewing 60 years of Delaware precedence, he concluded that it was not sufficient.

In particular, he noted that then-Vice Chancellor Strine, considering an argument that the upfront stockholder approval of the general terms of an equity compensation plan without any director-specific limits on compensation was a "ratification" of subsequent grants made under the plan, had squarely rejected the argument:

> When uncoerced, fully informed and disinterested stockholders approve a specific corporate action, the doctrine of ratification, in most situations, precludes claims for breach of fiduciary duty attacking that action. But the mere approval by stockholders of a request by directors for the authority to take action within broad parameters does not insulate all future action by the directors within those parameters from attack.[2]

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The directors' conduct would thus be reviewed under ordinary principles of fiduciary duty and the review was not limited to a waste standard. Similarly, in a 2012 decision the Chancery Court reviewed a plan under which there were multiple classes of beneficiaries and there was a generic limit on compensation any one beneficiary could receive per fiscal year, which for RSUs was up to 1.25 million units; the court found that each of the directors could have received 875,000 RSUs worth about $21.7 million per recipient under this limit.[3] The court rejected the stockholder ratification defense, noting "there must be some meaningful limit imposed by the stockholders on the Board" and *"[a] stockholder-approved cart blanche to the directors is insufficient;"* the *Slager* court held that "*if a board is free to use its absolute discretion under even a stockholder-approved plan, with little guidance as to the total pay that can be awarded, a board will ultimately have to show that the transaction is entirely fair*."[4]

Chancellor Bouchard held that, where the plan in question did not specify any amounts or director-specific ceilings for equity compensation that Citrix directors would or could receive independent of the generic annual limit applicable to all the varied classes of beneficiaries under the plan, the upfront stockholder approval of the plan's generic limits on compensation for all beneficiaries did not establish a ratification defense.

Chancellor Bouchard also noted that he had previously held that in the case where a plan did not set forth a specific compensation that directors could receive, ratification was still available if the stockholders voted in favor of the specific awards.[5] He found, that although Citrix stockholders voted in favor of amendments to the plan to increase the total number of shares available under the plan and to ratify, confirm and approve the plan, the stockholders were not specifically asked to ratify the RSU grants granted to the non-employee directors. The prior grants were

[2] *Sample v. Morgan*, 914 A.2d 647, 663 (Del. Ch. 2007) (emphasis in original).

[3] *Seinfeld v. Slager*, 2012 WL 2501105, at *10 (Del. Ch. 2012).

[4] *Id.* at *12.

[5] *Cambridge Retirement System v. Bosnjak*, 2014 WL 2930869 at *8 (Del. Ch. 2014).

disclosed, but because Citrix did not seek stockholder approval of either the earlier grants or proposed grants, the ratification did not reach those grants.

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Court Concludes It Is Reasonably Conceivable That Grants Were Not Entirely Fair

Where the entire fairness standard of review applies, the director defendants have the burden to show that the decision to grant the RSU awards was the product of both fair dealing and fair price. The parties framed this issue as to whether the awards in question were entirely fair as a question of whether these awards were in line with those of a peer group of companies. The parties disagreed as to the proper "peer group." Citrix argued that the peer group should be the 14 companies identified by Citrix as its peer group in its SEC filings. The plaintiff argued that the appropriate peer group should be limited to 5 of the 14 companies selected by Citrix, based on comparable market capitalization, revenue and net income metrics.

Chancellor Bouchard concluded that plaintiff raised "meaningful questions" as to whether the companies identified in the Citrix peer group with considerably higher market capitalization, revenue and net income (e.g., Amazon.com, Google and Microsoft) should be included in the peer group for this purpose, and therefore refused to grant the motion to dismiss as to the claim of breach of fiduciary duty. The claim of unjust enrichment was treated in the same manner under established Delaware precedence.[6]

Conclusion

Boards must proceed carefully with respect to director compensation. Stockholder ratification is available for either past or prospective compensation awards, so long as the stockholders are asked to approve specific grants or director-specific limits or ceilings on awards. Absent stockholder approval of specific grants, the plans should contain realistic limits, including sub-limits for various classes of participants, particularly directors. Limits articulated as dollar amounts, rather than share amounts, are preferable in this context. If stockholder ratification can be established, then a particular award is only subject to review for waste of corporate assets—a very high burden for plaintiffs.

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[6] Chancellor Bouchard did dismiss the claim of waste. He observed that the complaint did not plead "the rare type of facts" from which it is "reasonably conceivable that the RSU awards are so far beyond the bounds of what a person of sound, ordinary business judgment would conclude is adequate consideration to the Company." "Bare allegations that the alleged [compensation grants to directors] are excessive or even lavish . . . are insufficient as a matter of law to meet the standard required for a claim of waste." *In re 3COM Corp. Shareholders Litigation*, 1999 WL 1009210, at *5 (Del. Ch. Oct. 25, 1999).

Compensation can be approved by a disinterested committee of directors for other non-employee directors.[7] If the entire fairness of director compensation must be established, care must be taken to provide evidence of fair process and fair price. In this regard, the courts will consider the reasonableness of the process by which such compensation is granted, including the decision as to the size of the grant. Details such as the composition of the peer group of companies to which such compensation is being compared may come under scrutiny under the entire fairness review.

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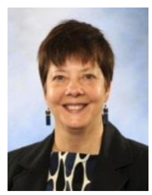
Indicia of fair process might include use of an independent compensation consultant both to assist in constructing the appropriate peer group and to review the various elements of director compensation against the peer group for benchmarking purposes. The board should consider whether use of the compensation committee's independent compensation consultant for review of executive compensation would in any way compromise the independence of that consultant, and in any case should be comfortable with the experience and judgment of the consultant retained to allow the board to establish an appropriate record for the decisions on director compensation.

Stockholder ratification is the safest means to remove director compensation from further scrutiny, and this case gives a valuable roadmap to the proper method to obtain such ratification.



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[7] Particular care must be taken with respect to certain types of compensation, such as for special committees. If all the independent directors are also members of the special committee, there would be no disinterested directors to approve compensation for the committee. Directors should generally avoid approving their own individual compensation. One method often employed is to compensate special committees consistent with the cash compensation paid to other committees.

Renewed Regulatory Interest in Antitrust Issues Arising in Innovation Markets

Philp A. Giordano Counsel and **Kristin Millay** Associate

The $12 billion proposed acquisition of Tokyo Electron by Applied Materials was one of the larger M&A deals proposed in recent years. Notably, the deal unraveled in the face of opposition from federal antitrust authorities, despite the fact that direct competition between the parties was not significant. The government objected that the transaction would significantly reduce competition it anticipated would occur between the two companies in the near future. The move marks a renewed interest by antitrust enforcers in competition in so-called "innovation markets" that has the potential to affect any company with a large intellectual property portfolio. It also underscores the need for high technology firms to seek legal counsel early in the process of negotiating a merger or acquisition to avoid the potentially fatal consequences of failing to anticipate the issue.

Tokyo Electron and Applied Materials are two of the largest firms that design and make tools used to fabricate computer chips. Their tools are used at different stages in the manufacturing process, so competition between them based on their current product lines is minimal. That would normally indicate to antitrust enforcers that the transaction would not result in a significant loss of competition and therefore should clear antitrust review. Instead, the government focused on a more abstract form of competition: the race to design and produce the next generation of tools—those that would be used to fabricate the next generation of microchip technology. Antitrust authorities do not typically focus on competition to innovate because the analysis is largely speculative. But innovation rivalries are given more weight, and can raise competitive concerns, when there is concrete evidence of the direction new products will take, such as when an industry has laid out a specific timetable for moving to a next generation technology.

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FTC and DOJ guidelines define an "innovation market" as consisting of "the research and development directed to particular new or improved goods or processes, and the close substitutes for that research and development."[1] If the agencies identify such a market, then their analysis becomes a question of how competitive that market is and the degree to which the proposed transaction would reduce competition within it. With respect to next generation chip fabrication tools, Tokyo Electron and Applied Materials' patents, technological capabilities and other assets made them the leading companies in the competition to develop such

[1] Dep't of Justice and Federal Trade Comm'n, Antitrust Guidelines for the Licensing of Intellectual Property (April 6, 1995), available at http://www.usdoj.gov/atr/public/guidelines/0558.htm.

tools, in the DOJ's view. After reviewing the proposed deal, which involved the issuance of a second request for information from the parties under the Hart-Scott-Rodino Act, the DOJ conditioned its approval on the divestiture of a range of assets. The parties were unwilling to divest all of the assets identified by the government, and the government was unwilling to settle for a more modest divestiture. Ultimately, after approximately 18 months and significant expense, the parties abandoned the deal rather than try to resolve the dispute in a court of law.

The FTC and DOJ guidelines indicate that the agencies may pursue an action where a merger consolidates certain capabilities or assets, such as patents for various technologies, that are likely to reduce the amount of competition in the market or the ability of other companies to engage in the research and development needed to develop competing technologies. These guidelines indicate that the factors relevant to the agency's assessment include the number of potential innovators in the market, the combined market share of the two parties (assuming a meaningful measure of market share can be found), and the intellectual property profile of the parties. If the agencies believe that a proposed merger or acquisition will reduce competition in an innovation market, they may require divestiture or compulsory licensing of the patents or other assets to improve the position of a third competitor and thereby preserve the pre-existing level of potential competition.

A government suit to preserve an innovation market is not without its own risks. It must forecast the abilities of various contenders to develop competing products, rather than rely on evidence of actual competition. Moreover, standard evidentiary tools like market definition and market shares can be harder to estimate for innovation markets because by their nature these markets are not fully formed and sales of a traditional good have not yet occurred. Consequently, the government may have difficulty developing evidence sufficient to meet its burden of proof regarding market power and other elements of its antitrust claims. However, even if the government's ability to prevail in court is uncertain, the delay and expense associated with its investigation of the proposed transaction can be very burdensome, i.e., as the failed Tokyo Electron acquisition illustrates, the parties may end up wasting their resources cooperating with an investigation if the deal is eventually abandoned.

Consequently, it is just as important to lay the analytical ground work regarding likely effects on competition when a transaction implicates an innovation market as when a deal involves the more typical issue of significant consolidation in an existing market. Deal counsel could identify third-party competitors that have the expertise to enter the market based on their own intellectual property and research and development efforts and assess whether the coming technological transition gives them a significant new opportunity to do so. Evidence of such potential can be particularly compelling if entrants have successfully penetrated related markets in past years. Moreover, large customers often back promising new entrants, so counsel might investigate whether any have initiated plans to do so and encourage government attorneys to seek evidence of such plans. Counsel might also focus on the parties' own intellectual property portfolio. The combined portfolio may not have significant potential to block the research and development efforts of other entrants, particularly if the parties must license their technology to comply with standard essential patent pool obligations. Counsel could seek to substantiate these claims through a variety of evidence, including internal party documents and testimony of industry experts, and make their case based on that evidence through in-person meetings with government investigators and the submission of white papers.

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Because innovation markets present nuanced but potentially critical issues of antitrust law, and because of the additional evidence necessary to address anticipated regulatory concerns, firms that compete in technological markets or own significant intellectual property portfolios should seek legal counsel regarding these issues early on in the process of negotiating a transaction.

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Delaware Rapid Arbitration Act: A New Alternative for Cost-Effective Dispute Resolution

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As its name suggests, the Delaware Rapid Arbitration Act (DRAA)[1] is a new arbitration statute that is intended to give Delaware business entities a process for resolving business disputes in a rapid and efficient manner. It represents a response to a Third Circuit ruling that a prior arbitration statute, which provided for confidential arbitration using sitting Chancery Court judges as arbitrators, violated the First Amendment.[2] The DRAA is an enabling statute, and does not foreclose parties from selecting another form of arbitration. The DRAA became effective on May 4, 2015.

The DRAA is available to resolve disputes among businesses, one of which must either be a Delaware entity or have its principal place of business in Delaware. It is expressly not available where one of the parties is a consumer.[3] To create a binding arbitration agreement under the DRAA, the parties must enter into a written agreement that provides that it is governed or construed under the laws of Delaware without regard to principles of conflicts of laws, and the agreement must reference the DRAA.[4] This can take the form of a detailed agreement that satisfies the foregoing requirements and also sets forth matters such as the procedural arbitration rules the parties will follow, the place of arbitration, the choice of arbitrators, the scope of discovery and the timing, nature and appealability of awards. Alternatively, the parties can merely insert a simple clause in another agreement, such as the following:

> "The parties agree to arbitrate any and all disputes arising under or related to this agreement, including disputes related to the interpretation of this agreement, under the Delaware Rapid Arbitration Act."

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The choice of law provision in the agreement should provide that the arbitration provision is governed by Delaware law, without regard to principles of conflicts of laws. This simple approach relies on the default provisions under the DRAA, including for example those governing the appointment of arbitrators, and the ability of arbitrators to issue interim orders regarding discovery, as described below. The DRAA authorizes the Delaware Supreme Court, in consultation with the Court of Chancery, to publish procedural arbitration rules that will serve as default rules unless an

1 Chapter 58, Title 10 of the Delaware Code, available at: http://legis.delaware.gov/LIS/lis148.nsf/EngrossmentsforLookup/HB+49/$file/Engross.html?open. Unless expressly provided otherwise, all section references in this article are to this title and Chapter of the Delaware Code.

2 See *Delaware Coalition for Open Government, Inc. v. Strine*, 894 F. Supp. 493 (D. Del. 2012), aff'd, 733 F.3d 510 (2013).

3 "Consumer" is defined under Title 6 §2731 of the Delaware Code as "an individual who purchases or leases merchandise primarily for personal, family or household purposes."

4 §5803(a).

agreement of the parties provides for different rules.[5]

Arbitrators can either be designated by the parties, or appointed by the Court of Chancery on petition by one of the parties. An arbitrator appointed by the Court of Chancery can only be a person selected under or pursuant to the parties' agreement, a person expert in any nonlegal discipline described in an agreement or a member in good standing of the Delaware bar for at least 10 years.[6] Unless the arbitration agreement provides otherwise, an arbitrator may administer oaths and compel the attendance of witnesses and the production of books, records and other evidence. An arbitrator can only issue subpoenas and award commissions to permit a deposition if provided for by agreement.

Arbitrators have the power to grant any legal or equitable remedy appropriate in the sole judgment of the arbitrator.[7] Unless provided otherwise by agreement, an arbitrator's fees and expenses are borne as provided for in the final award.[8]

The DRAA promotes rapid arbitration in a number of ways. It provides that any issues regarding the scope of arbitration are to be determined solely by the arbitrator and not the courts.[9] This removes the ability of the parties to delay proceedings by initiating litigation over the scope of arbitrability. The DRAA generally also divests courts of the power to enjoin arbitration.

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The DRAA provides a significant economic incentive for arbitrators to issue final awards on a timely basis. The DRAA requires arbitrators to issue final awards within 120 days of their acceptance of appointment, subject to an extension of up to 60 days by agreement of the parties.[10] If an arbitrator fails to issue the final award prior to the statutory deadline, the arbitrator's fees must be reduced by 25 percent if the final award is less than 30 days late, 75 percent if the final award is between 30 and 60 days late, and 100 percent if the final award is more than 60 days late. These reductions can be modified or eliminated only if exceptional circumstances exist.[11]

The DRAA further promotes the issuance of timely awards by providing that parties are deemed to have waived the right to make interim challenges to the arbitrator's rulings and orders. While an arbitration is pending, parties are also prohibited from amending the terms of the arbitration agreement to alter the arbitration procedures without the arbitrator's written consent.[12]

The DRAA provides parties with the ability to waive the right to appeal awards. Where the parties do not waive this right, appeals must be brought directly to the Delaware Supreme Court within 15 days of the final award. The

5 §5804(a). Draft model rules have been prepared by Richards, Layton & Finger and are available at the following link: http://www.rlf.com/DRAA/ModelRules.

6 §5805(b).

7 §5807.

8 §5806(b).

9 §5803(c).

10 §5808.

11 §5806(b).

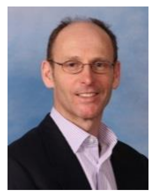
12 §5803.

Supreme Court only has the ability to vacate, modify or correct the final award in conformity with the Federal Arbitration Act. Parties have the ability to provide instead for appeals to one or more appellate arbitrators. [13] Providing for appeals to appellate arbitrators is a potential way for parties to preserve the confidentiality of the arbitration during the appeal. Supreme Court proceedings are typically not conducted on a confidential basis.

The DRAA is likely to be used by parties that value speed, limiting costs and preserving confidentiality.

The DRAA also speeds up enforcement of arbitration awards by eliminating the confirmation process. Arbitration awards typically have to go through the step of being confirmed by courts in order to commence enforcement proceedings. Under the DRAA, this happens automatically five business days after the period for challenge has lapsed or, if appellate review is not provided for, after the award has been issued.[14]

The DRAA is likely to be used by parties that value speed, limiting costs and preserving confidentiality. For example, it may be suitable to resolve periodic disputes between parties that are in a long-standing commercial relationship. It may also be useful to resolve disputes between venture capital funds and their portfolio companies, or disputes among investors in portfolio companies. The DRAA will not be suitable for complex disputes that cannot be resolved in under six months. The DRAA also cannot be imposed on parties who have not agreed to it. For example, it could not be imposed on nonconsenting shareholders, as a way to curtail shareholder strike suits, pursuant to an arbitration provision inserted into a company's charter or bylaws. For private M&A deals, parties may wish to consider the relative merits of the DRAA, compared to other dispute resolution mechanisms, for post-closing indemnity and earnout disputes.



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[13] §5809.
[14] §5810(a).

Legislation Proposed to Increase Rule 701 Disclosure Threshold

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On March 26, 2015, a bill was introduced in the U.S. House of Representatives to increase to $10 million the disclosure threshold for privately held companies under Rule 701, the federal securities law exemption for compensatory equity issuances, and to index the threshold for inflation. If the bill becomes law, it would ease the disclosure burden on privately held companies that issue equity compensation awards such as stock options, restricted stock and restricted stock units to employees and other service providers.

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Background

The Securities Act of 1933 prohibits the offer or sale of securities unless the security has been registered with the Securities and Exchange Commission or an exemption from registration is available. In the compensation context, the principal exemption relied upon for the issuance of equity-based incentives by privately held companies is Rule 701. Rule 701 provides an exemption for offers and sales of securities to a privately held company's employees, directors, officers and consultants pursuant to a written compensatory benefit plan The aggregate sales price of the securities offered or sold in reliance upon Rule 701 within a 12-month period cannot exceed the greater of $1 million, 15 percent of the total assets of the company and 15 percent of the outstanding amount of the class of securities being offered or sold.

Existing $5 Million Disclosure Threshold

Even if a privately held company may rely on Rule 701, certain disclosure requirements may be triggered depending upon the aggregate sales price of the securities being offered or sold in reliance upon Rule 701. If the aggregate sales price exceeds $5 million within a 12-month period, the company must provide to the employee or other service provider a summary of the material terms of the compensatory benefit plan, information about the risks associated with the securities and financial statements of the company that comply with Generally Accepted Accounting Principles (GAAP).

One practical challenge associated with complying with the disclosure requirements is that because the disclosure requirements apply to all offerings within the applicable 12-month period, they may be applied on a retroactive basis. For example, if a company offers securities with an aggregate sales price of $3 million on January 1 and makes an additional offering of $3 million on July 1 of the same year, the company would have to comply with the disclosure requirements with respect to both offerings (assuming that the company tracks its offerings for Rule 701 purposes on a calendar year basis), even though the company may not have known on January 1 that there would be an additional offering later in the year. Thus, if there is any possibility of exceeding the $5 million threshold as a result of additional offerings later in the applicable 12-month period, some companies comply with the disclosure requirements for all offerings in an abundance of caution. On the other hand, some companies consciously avoid exceeding the $5 million threshold because of the administrative burden associated with the disclosure requirements and because of concerns about protecting confidential information and avoiding liability under the antifraud provisions of federal securities laws.

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Proposed Changes

The Encouraging Employee Ownership Act, H.R. 1675, which was introduced by Representative Randy Hultgren and co-sponsored by Representatives John Delaney, Michael Fitzpatrick and Jared Polis, would mandate an increase in the disclosure threshold from $5 million to $10 million and would index the threshold for inflation every five years. Privately held companies that make a conscious decision to stay below the $5 million threshold would be well served to closely monitor the status of the bill. Privately held companies that may grant equity awards valued at between $5 million and $10 million for Rule 701 purposes in a 12-month period should also monitor the status of the bill to avoid making unnecessary disclosures to participants if the higher threshold is adopted.

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