2022 Insights

Skadden

A collection of commentaries on the
critical legal issues in the year ahead.

’22

Editorial Board

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Needs of Strategics, PE Firms and SPACs Led to Record US M&A Levels, Likely To Sustain Dealmaking in 2022

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Takeaways

- The record level of M&A in 2021 was widely dispersed across industries and was driven by the strategic needs of companies to add technology and adapt to the pandemic, and was supported by strong markets.
- While SPAC IPO and de-SPAC activity declined over the course of 2021, these vehicles have raised more than $138 billion that is waiting to be deployed in business combinations.
- Private equity firms were a major contributor to the boom, accounting for about 20% of all M&A, and their "dry powder" makes it likely they will remain a major driver of activity.
- Potential brakes on dealmaking — such as higher interest rates and an evolving regulatory landscape — do not currently appear to pose a serious threat to continued high M&A levels.

The ongoing economic recovery from the pandemic, fed by fiscal and monetary stimulus in developed countries, set the stage for a historic year of deal activity in 2021. Notwithstanding episodic disruptions from COVID-19, 2021 saw a record $5.9 trillion in announced M&A transactions.[1] In the U.S., the aggregate value totaled $2.6 trillion, an 82% increase over 2020.

This unprecedented activity spanned all types of transactions, including strategic acquisitions and divestitures, private equity investments and business combinations led by special purpose acquisition companies (SPACs). The activity was driven by the strategic needs of corporates and the investment mandates of financial sponsors, facilitated by strong equity markets, healthy balance sheets plus readily available financing through equity issuances and borrowings at historically low interest rates, growing sums of private capital "dry powder," and healthy boardroom confidence.

Strategic M&A: Dealmaking Across Most Sectors

Strategic M&A activity was strong across almost all industries in 2021. After the initial shock of the pandemic, businesses around the globe adapted to, and better managed, the resulting disruptions, capitalizing on opportunities to improve operations, adopt new technologies and grow revenues. Companies have identified strategic needs to adjust product portfolios and technological and geographic platforms to today's environment, and have embraced M&A as an efficient means to these ends.

Many companies also undertook divestitures and spin-offs as they continued to streamline their operations. Evolving corporate strategies, increased reliance on technology across virtually all industries and the continued benefits of scale in a competitive global economy are likely to sustain high levels of M&A in 2022.

- **Technology.** U.S. technology, media and telecom accounted for over 5,200 transactions and more than $1.1 trillion in value in 2021, increases of 71% and 34%, respectively, compared to 2020. The intense dealmaking resulted in significant part from the acceleration during the pandemic of existing trends toward the adoption of remote work, digital health care, fintech and e-commerce. Activity is likely to remain high in 2022, as innovations in technology continue at elevated

[1] Sources for the data in this article include Deal Point Data, PitchBook, Refinitiv and SPACInsider.

levels and an array of businesses take advantage of increased opportunities to apply new technologies.

- **Health care.** Pharma, biotech and the broader medical care sector contributed significantly to the M&A numbers for 2021, with the focus on new technologies and medicines, vaccines and other health care solutions. Strong tailwinds suggest that M&A activity in the industry will remain robust in 2022 — continued interest by established companies in development and commercialization of novel treatments, the acceleration in health care technology applications during the pandemic and a heightened focus on public health and telemedicine. In 2021, this sector generated $325.3 billion in aggregate M&A in the U.S., compared to $194.9 billion in 2020.
- **Financial services.** As noted above, the pandemic accelerated the adoption of fintech and e-commerce services, and provided opportunities for revamping finance and banking business models through digitization and tech-enabled additions to existing platforms. In addition, as insurers absorbed pandemic-related losses, many turned to M&A to diversify their risks and business models, expand market share and achieve synergies and efficiencies. As a result, activity in the financial services sector was strong in 2021 and is expected to continue to be robust throughout 2022. In 2021, the industry saw $360.5 billion of M&A in the U.S., up from $150.1 billion the year before.

SPACs: Despite Disruptions, Billions in 'Dry Powder'

The SPAC market was a roller-coaster in 2021. Following a record 2020, SPAC IPO and de-SPAC activity remained strong in the first three months of 2021, with 298 IPOs priced and 97 announced de-SPACs (mergers of target companies with SPACs). Things slowed significantly in the second and third quarters due to regulatory and accounting issues, and changing investor sentiment. The fourth quarter saw a rebound, but deal levels were still below those in the first quarter, with 163 SPAC IPOs priced and 61 de-SPAC transactions announced.

Nonetheless, compared to 2020, the number of SPAC IPOs priced and announced de-SPAC transactions more than doubled in 2021. SPACs priced a record-breaking 613 IPOs, a 147% increase over 2020's 248, and announced an unprecedented 267 de-SPAC transactions, a 178% increase over the 96 in 2020.

As of December 31, 2021, over 500 SPACs collectively were holding in trust over $138 billion in IPO proceeds — "dry powder" — and were seeking an M&A target. This dynamic has heightened competition for targets, which in some cases required creative deal structures. We expect to see increasing financial and structuring innovations to facilitate continued transactions by SPACs.

The SPAC market faces pressure from both market forces and regulators. Shareholders have increasingly decided to redeem shares prior to the completion of the de-SPACs, and the market for private investment in public equity (PIPE) financings, a crucial source of additional capital to fund de-SPACs, tightened. These developments have forced dealmakers to reevaluate target prices and look for alternative ways to fund de-SPACs. In addition, more de-SPAC deals were terminated in 2021 than in previous years, although the 2021 termination rate did not meaningfully increase compared to 2020 or 2019, given the greater number of announced deals in 2021.

The SEC has made clear that it will continue to scrutinize SPAC disclosures and accounting practices, and the agency is slated to propose new rules for SPACs in 2022. (See "SEC Expected To Introduce Host of New Rules in 2022, Enhance Enforcement." In addition, see our January 6, 2022, client alert for recent developments in Delaware, "Court of Chancery Issues SPAC-Related Decision of First Impression.")

Despite these challenges, SPACs seem to be addressing a market need, and we are cautiously optimistic that de-SPAC activity will remain strong in 2022, given the number of SPACs seeking targets and the staggering amounts of dry powder they hold. (See "Choppy Market for SPACs and PIPEs, Competition for Targets Spurs Deal Innovations.")

Private Equity: Increased Activity, Evolving Capital Raising and Potential Challenges

As noted above, PE-backed M&A activity remained strong in 2021, continuing the momentum exhibited in the second half of 2020, with an aggregate U.S. value of $1.2 trillion, over 50% above the previous record from 2019. Of all U.S. PE deal activity in 2021, 22.5% was in the information technology sector, 16.6% in health care and 8.9% in financial services.

As of December 31, 2021, global PE firms held over $1 trillion in dry powder, and a number of the major PE firms are also in the process of raising new, larger flagship funds, which is likely to sustain the pace of PE M&A activity in 2022.

Like other M&A market participants, PE firms faced highly competitive markets as they deployed capital on acquisitions in 2021. However, sponsors demonstrated their flexibility, pursuing an array of different deal types, from clubbed mega deals to minority investments, and everything in between, as well as portfolio company add-on and tuck-in acquisitions.

Notably, PE firms continued to find opportunities involving SPACs. Some PE managers became SPAC sponsors while others considered SPACs as potential exits for their portfolio companies.

Competition for attractive targets, concerns over the economic outlook during an unpredictable pandemic and the potential for increased borrowing costs are all factors that could have some impact on private equity activity this year. However, given the growing amounts of committed capital at their disposal and the attractive debt financing terms available, PE is expected to play a major role in the M&A market in 2022.

Shareholder Activism Update

Activists were a significant factor in 2021's M&A landscape, and many of their campaigns had an M&A-related thesis, whether they were pushing for sales or breakups of public companies, or to sweeten or scuttle announced deals.

Activists continue to blur traditional lines, pivoting from advocating sales or opposing announced acquisitions, to launching full-blown hostile takeover offers coupled with proxy contests or consent solicitations. Additional activist opportunities may open up if companies that undertook de-SPAC transactions see shifts in their investor bases and underperform market expectations. As more traditional investors allocate capital to the activist asset class and special single-opportunity funds are formed, it is likely that significant capital will continue to be available for activist funds.

Other developments of note include the rise of ESG activism and the SEC's planned adoption of universal proxies. While these may not have a meaningful impact on M&A-themed activism, their consequences are not yet fully understood. (See "Activism Landscape Continues To Evolve.")

Factors Likely To Shape Dealmaking in 2022

The current strength of the M&A market is undeniable, and conditions suggest that it will carry through the year. However, a number of factors could potentially inhibit or influence merger activity and trends:

- **Pandemic effects.** Additional disruptions from COVID-19, such as facility limitations or closures in industries where remote work is not feasible, and ongoing supply chain disruptions, could curtail economic growth and reduce both consumer and C-suite confidence.
- **Political and regulatory factors.** Political criticism of large companies and mergers has been increasing globally, and in the U.S. and Europe in particular. Economic nationalism and national security and competition regulation are growing in many jurisdictions. In the U.S., the Biden administration and antitrust regulators have pursued novel regulatory theories and declared policies of heightened scrutiny and enforcement, mirroring a global trend. The perception of political and regulatory impediments could deter companies from some deals, although in most cases, these regulatory initiatives are likely to affect the timing more than the substance of transactions. (See "Biden's Broad Mandate Has Altered the Antitrust Landscape, Making Merger Clearance Process Less Predictable," "Deal Uncertainty Increases as Merger Control Authorities Gain Discretionary Powers of Review" and "CFIUS Goes Global: New FDI Review Processes Proliferate, Old Ones Expand.")
- **Economic uncertainties.** For the moment, concerns over a heated economy and inflation expectations, and the prospect of increasing interest rates, have for the moment replaced apprehension over the duration of the economic cycle, unresolved trade issues and equity market volatility as the prime bogeymen. All of these could affect the perceived attractiveness of transactions.
- **Valuations and asset prices.** Steep valuations of both public and privately owned assets, as well as competition for attractive targets, could at some point dampen the interest of some buyers or result in a value disconnect between sellers and buyers more generally.
- **Environmental, social and governance (ESG) issues.** ESG considerations now figure prominently with many investors, not only as policy goals, but also from a legal perspective, given new and proposed ESG-focused rules and regulations. The impact of these and emerging regulations is not yet fully understood. However, it may affect M&A and investment decisions, depending on how vocal investors are and what form new regulations take.

While all of these concerns merit attention, at this time none appear to be an immediate threat to strong M&A activity in 2022. The strategic need of corporations to grow earnings and optimize business platforms remains a powerful driver of dealmaking, fueled by ample balance sheet cash and readily available financing. PE buyers, other private capital sources and SPACs hold substantial capital, which they remain eager to deploy, particularly if asset prices come down. Absent significant disruption, these factors should continue to support significant transaction levels this year.

Choppy Market for SPACs and PIPEs, Competition for Targets Spurs Deal Innovations

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Takeaways

- While the SPAC IPO and PIPE markets were challenging in 2021, the enormous amounts of capital already raised should drive merger activity in 2022.
- As more shareholders choose to redeem shares and potential PIPE investors scrutinize terms, dealmakers have been forced to reevaluate target prices and look for additional ways to fund de-SPACs.
- The SEC has made clear that it will continue to scrutinize SPAC disclosures and accounting practices, and the agency is slated to propose new rules for SPACs this year.

The 2021 SPAC market was a roller-coaster. Following a strong 2020, transactions accelerated in the first three months of 2021, with 298 SPAC IPOs priced and 97 de-SPAC transactions (mergers of target companies with SPACs) announced in that quarter alone. After that, activity slowed significantly in the second and third quarters of 2021. The fourth quarter of 2021 saw a rebound, though still below the level in the first quarter, with 163 SPAC IPOs priced and 61 de-SPAC transactions announced. Nonetheless, compared to 2020, the SPAC IPOs priced and de-SPAC transactions announced in 2021 more than doubled. SPACs priced a record-breaking 613 IPOs, representing a 147% increase over 2020's 248, and announced an unprecedented 267 de-SPAC transactions, representing a 178% increase over 2020's 96. As of December 31, 2021, SPACs collectively were holding in trust over $138 billion in IPO proceeds — "dry powder" — and over 500 were seeking an M&A target.

Through the first quarter of 2021, private operating companies looking to go public through a de-SPAC could expect to receive substantial cash from both the SPAC's trust account and a concurrent private investment in the public equity (PIPE). In some cases, the sum raised in the PIPE exceeded the IPO proceeds. That began changing in the second quarter, as more investors opted to redeem their shares prior to the completion of the de-SPAC and the PIPE market tightened. In the fourth quarter, on average, SPACs returned over 60% of the amount they held in trust, up from 53% in the third quarter, 22% in the second quarter and just 10% in the first quarter. The average PIPE was smaller relative to the amount raised in the IPO compared to earlier last year. In addition, there were more terminations of de-SPAC deals in 2021 than in previous years, although the 2021 termination rate did not meaningfully increase compared to 2020 or 2019 given the greater number of announced deals in 2021.

Despite this widely reported slowdown in the SPAC market and the heightened regulatory scrutiny discussed below, we are cautiously optimistic that de-SPAC activity will remain strong in 2022, given the significant number of SPACs searching for targets and the staggering amounts of dry powder. We also expect increasing deal innovation in light of market pressures.

Stepped-Up Regulatory Scrutiny

Since the U.S. Securities and Exchange Commission (SEC) issued disclosure guidelines for SPAC IPOs and de-SPACs in December 2020, the agency has continued focusing on SPAC filings and transactions.

In an April 8, 2021, statement, Acting Director of the Division of Corporation Finance John Coates discussed potential liability risks for SPACs and questioned whether the safe harbor for forward-looking statements under the Private

Securities Litigation Reform Act of 1995 (PSLRA) applies to the projections of targets in de-SPAC transaction disclosures. While his remarks do not have the force of law, they reflect the SEC's concerns about the use of projections in de-SPAC transactions.

The SEC has also targeted SPAC accounting practices. The Division of Corporation Finance and the Office of the Chief Accountant of the SEC jointly issued a statement on April 12, 2021, outlining the staff's view that terms common to many SPAC warrants may require that the instruments be classified as balance sheet liabilities. Most SPACs had treated these as equity, so the pronouncement forced many to reassess their accounting. Ultimately, most SPACs restated their financial statements and related disclosures.

The accounting treatment of public shares subject to redemption also attracted SEC attention. Through comment letters and in discussions with auditors, the agency required that these be classified as temporary equity. Again, this differed from conventional practices, under which a portion of the public shares were accounted for as permanent equity. Consequently, most SPACs restated their financial statements and related disclosures.

The SEC's rulemaking agenda calls for the commission to propose amended rules governing SPACs in April 2022. Practitioners will be watching closely. (See "SEC Expected To Introduce Host of New Rules in 2022, Enhance Enforcement.")

In addition, the Financial Industry Regulatory Authority (FINRA) has set its sights on SPACs. In October 2021, FINRA launched an examination sweep covering member firms' SPAC offerings and the services provided to the entities and their affiliates.

PIPE Market Challenges

As noted above, potential PIPE investors have been scrutinizing de-SPAC valuations more closely. This has resulted, in some cases, in a reduction of the target's purchase price.

As PIPE capital has been harder to find and shareholder redemption rates have risen, SPACs have looked for alternative ways to show market support and/or raise additional cash. Some are bringing in their own buyers for all or significant portions of PIPEs. This can include a "pre-PIPE" process in which the SPAC essentially tests the PIPE market with some investors before launching the formal process, and/or a "PIPE upsize" process in which the PIPE is enlarged with existing investors after the de-SPAC transaction is announced.

Another alternative is support from a strategic investor that is not a traditional PIPE investor, via either a cash contribution or commercial arrangement.

To further incentivize potential investors, in some cases PIPE transactions have included convertible debt, convertible preferred equity or warrants in addition to or instead of common stock.

Any such incentives should be analyzed carefully, not only from commercial and contractual perspectives, but also for their impact on the market's view of the target valuation.

As long as the market for PIPE funds remains competitive, we expect to see creative incentives and structures continue.

Litigation

SPACs have also drawn attention from plaintiffs' law firms. Before many de-SPAC transactions close, some shareholder-plaintiffs raise objections like those routinely seen in conventional public company mergers. Plaintiffs may, for example, assert disclosure-based claims under Section 14(a) of the Securities Exchange Act, or breach-of-fiduciary-duty claims under state law and seek additional disclosures. There have also been a growing number of federal securities lawsuits under Section 10(b) or 11 of the Securities Exchange Act after de-SPAC closings where the resulting company's stock price has fallen. Framed as class actions, these cases highlight the need for SPACs to conduct and document robust due diligence on any target. In addition, see our January 6, 2022, memorandum for recent developments in Delaware, "Court of Chancery Issues SPAC-Related Decision of First Impression."

The Search for Targets

As the surge in SPACs and total dry powder has heightened competition for targets, creative deal structures have emerged. For example, some SPACs have considered combining two private companies to create one public-company-ready business, or teaming up with other SPAC sponsors to conduct a single transaction between one target and multiple SPACs.

Many SPACs are now looking at targets outside the U.S., including in Asia and Europe. (See "SPACs Considering German Targets Face Unique Challenges.")

We also expect SPACs to seek mergers with divisions of public companies. For the parent, this may be an attractive alternative to a traditional sale, IPO, spinoff or split-off.

Given the number of SPACs in the market and their competition for targets, we expect to see more transactional innovations.

Will Europe's M&A Boom Survive Stricter Regulation, Shareholder Resistance and COVID?

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Takeaways

- Although deal flow continues to be strong, stricter antitrust and national security reviews may pose obstacles for some mergers.
- Financial sponsors remain very active, and with more corporate divestitures appearing likely, are expected to remain prominent players — but increased public scrutiny and shareholder resistance could prove to be stumbling blocks.
- Measures taken to tame inflation could cool the appetite of some buyers.

European M&A activity surged in 2021, ending fears that a dip during the initial months of the COVID-19 pandemic would be a precursor to a longer slump. Both deal volume and values climbed steeply, powered in no small part by financial sponsors.

But, amid the headline-grabbing figures, challenges emerged that caused some transactions to fall through, and may give dealmakers pause as they look ahead this year.

Changing Regulatory Landscape

Investors and corporations are accustomed to assessing the probability of deals meeting conditions for antitrust and financial services approvals, but the increasingly interventionist approach of regulators, as well as the introduction of new foreign direct investment regimes in Europe, may alter the calculus.

While Nvidia's proposed purchase of U.K. semiconductor maker Arm is still live, it is a recent example of a high-profile transaction that has hit potential stumbling blocks with regulators — in this case, from three jurisdictions. The U.K.'s Competition and Markets Authority (CMA) announced an in-depth review on both antitrust and national security grounds. The European Commission said it would likewise conduct a detailed antitrust analysis. Meanwhile, in the U.S., the Federal Trade Commission sued to block the takeover, alleging the "combined firm would have the means and incentive to stifle innovative next-generation technologies."

A CMA order to Facebook (now Meta) to sell Giphy after the purchase was complete may also signal a shift in regu-lators' attitude toward to acquisitions of startup technology companies by large ones. Transactions may no longer be exempt from regulatory review simply because they do not present traditional antitrust concerns, such as significant market overlap. This may be especially true where startups are acquired before growing enough to establish themselves as competitors in the market. In this case, the CMA found that Giphy was considering expanding its advertising services to countries outside the U.S., and the acquisition could potentially remove a competitor to Facebook's own display advertising services in the U.K. Meta has appealed the order. (See "Deal Uncertainty Increases as Merger Control Authorities Gain Discretionary Powers of Review.")

Newly adopted national security review processes in many countries could also pose new obstacles. (See "CFIUS Goes Global: New FDI Review Processes Proliferate, Old Ones Expand.")

Shareholders Not Swayed by Price Alone

In the competitive landscape seen over the last 18 months or so, public company boards have taken a hard-nosed approach, successfully playing bidders off against each other, and forcing them to pay higher multiples for the most sought-after assets. However, in some cases, the high bidder nonetheless failed to secure the target.

For instance, Advent International and GIC came very close to prevailing with their $8 billion proposed buyout of Swedish biotech company Sobi, with approximately 83.7% of shares tendered to an offer representing a 35% premium. But the bidders needed 90% acceptance to allow a compulsory purchase of the remaining shares (known as the "squeeze-out"), and they walked away.

Before recommending a bid, boards have also been required to weigh the increased public scrutiny of deals and — particularly where private equity bidders are involved — stakeholders' concerns about securing a longer-term future for the business.

In the U.K., for example, the proposed takeover of mutually owned life insurer LV by Bain Capital prompted significant pushback from both pro-mutual LV members and politicians, who questioned the rationale for the deal and the choice of Bain. While LV's management argued that Bain's offer was the only option that offered both an "excellent financial outcome" for members and support for investment and employees, critics attacked the plan to demutualize LV. They deemed the offer to members insufficient, questioned the benefits that would be received by management and argued that the deal would allow Bain to extract assets that had been accumulated over years as a mutual insurer. Opponents also sought clarity about why an offer from fellow mutual Royal London was not pursued. Ultimately, only 69% of LV's members who voted at the meeting convened to approve the deal supported it, below the 75% threshold required for the sale to proceed.

These cases notwithstanding, new opportunities also emerged in 2021, in part due to the disruption caused by the pandemic. Corporate boards sought to make their companies more efficient and refocused their strategic priorities, in some cases, pushed by activist shareholders. This led to an increase in carve-out transactions. Private equity featured prominently in auctions for these assets, including the sale of Unilever's global tea business to CVC Capital Partners and the disposal of Lonza's specialty chemicals division to Bain Capital and Cinven. This is likely to continue in 2022.

Environmental, Social and Governance (ESG) Considerations

The pandemic intensified the focus on ESG considerations, with the United Nations Climate Change Conference (COP26) contributing to this in Europe. The preferences of limited partners, consumers and employees for "ESG-positive" companies became an increasingly significant factor in M&A, as it was reported that some sellers saw bidders pull out of potential acquisitions due to ESG concerns. That may lead other sellers to reconsider bringing assets to the market if they have not addressed any ESG concerns.

Conclusion

The current wave of M&A shows no signs of abating. Sellers will no doubt seek to take advantage of frothy valuations before the market turns, and investors will eye the prospect of higher financing costs if inflation fears lead central banks to adopt more hawkish stances on interest rates. Thus, there are incentives for both buyers and sellers to make hay while the sun shines.

SPACs Considering German Targets Face Unique Challenges

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Takeaways

- German technology and mid-cap growth companies may find a combination with a U.S. SPAC appealing, but must prepare to meet public capital market requirements.
- Arranging adequate PIPE funding is crucial to the success of a de-SPAC combination, and German targets may be able to tap local institutions for support.
- PIPE shares and shares issued to the target shareholders at the time of the de-SPAC combination cannot be traded until a new SEC registration takes effect, which can take several weeks.
- Though combining with a SPAC is often portrayed as a simpler alternative to an IPO for a public-ready target, cross-border transactions are at least as expensive and time-consuming.

The enormous sums raised in SPAC IPOs in the U.S., and the competition to invest that capital during the SPAC's limited life, are contributing to record M&A activity in Europe, including Germany. Although German equity capital markets are at all-time highs, institutional investors favor large-cap companies for their liquidity, and small- and medium-sized technology and growth companies are valued more cautiously in Germany than in the U.S. Increasingly, they have been looking to access the U.S. capital markets and are therefore also open to offers from U.S. SPACs, which have been approaching multiple European IPO targets. Typically the buyers aim for valuations between $500 million and $1 billion. (For a discussion of the U.S. SPAC market, see "Choppy Market for SPACs and PIPEs, Competition for Targets Spurs Deal Innovations.")

A SPAC combination (a so-called de-SPAC transaction) is frequently viewed as a less risky and more efficient approach to access capital markets than an IPO. However, that is often not true, especially when the target is European, because implementing such combinations requires the European company to become U.S. capital-markets-ready, PIPE (private investment in public equity) financing must be arranged and complex holding company structures may need to be created.

Below are legal and practical lessons learned from transactions involving German targets in 2021.

Establish a structured process to identify a suitable SPAC partner. Currently, more than 450 U.S. SPACs are pursuing an acquisition target before the end of 2022 or early 2023. Not all combinations are suitable, and potential German targets should define criteria and implement a structured selection process. Companies should consider buyers' geographic or sector focuses, as well as a SPAC's size, PIPE strategy and adviser team. Other important issues are the willingness of SPAC founders to invest in the PIPE, the availability and size of earnout warrant or share structures for the target's current shareholders, as well as the quality of the SPAC's shareholder base, as an indicator of potential redemption levels.

Select an appropriate structure. Combining a U.S. SPAC with a German company poses challenging corporate law and governance issues because corporate law in Germany imposes more technical requirements and is less flexible than in the U.S. or other European jurisdictions.

One solution is the so-called "double dummy" structure, where both the U.S. SPAC and the German operating company become subsidiaries of a newly established parent, most often formed under Dutch or Luxembourg law, which is closer to U.S. law. Nonetheless, each de-SPAC involving a German target is still bespoke and involves several restructuring steps, mergers and capital increases in a number of jurisdictions.

In addition, since American and German shareholders are subject to very different tax regimes, a successful transaction requires careful tax planning from an early stage. Ideally, the SPAC and the German target should share a common understanding of the fundamental deal structure before they enter into the letter of intent and agree to exclusivity.

Prepare for a comprehensive and lengthy PIPE process. The additional capital from institutional investors provided by a PIPE financing in connection with the combination is crucial to a successful de-SPAC. Raising capital from third parties validates the valuation of the target and ensures that, even if there is a high level of redemptions by the SPAC's shareholders, there is adequate cash available to the target following the combination.

German targets can often draw on their local investor bases for the PIPE, even as international institutional investors have been scrutinizing PIPEs more carefully. Marketing efforts for the PIPE take place prior to the signing of the merger agreement and remain confidential, which is a key advantage versus an IPO, but the target investor base for PIPEs is substantially the same as that for an IPO; investors who would not participate in an IPO of the German target will most likely be equally hesitant to invest in the PIPE for a de-SPAC merger.

When de-SPAC transactions involving German targets fail, it is typically due to an unsuccessful PIPE fundraising. It is therefore vital for the SPAC and the target to develop a mutual understanding as early as possible — ideally by the letter-of-intent stage — regarding the best way to attract PIPE investors.

Focus on the capital-market-readiness of the German target. Ensuring that the private target is ready for the public equity markets is essential. It must be able to comply with the auditing, accounting and internal control standards for foreign private issuers, including preparing financial statements in compliance with standards set by the U.S. Public Company Accounting Oversight Board (PCAOB). It must also implement and follow market-standard internal control and compliance processes and establish risk management and governance structures.

In practice, this means that it is necessary to perform thorough due diligence and prepare disclosure documents comparable to those required for a conventional IPO before the transaction is marketed to PIPE investors and the American registration process commences. If weaknesses in the company's processes and structures are first identified by PIPE investors or regulators, that could significantly delay the de-SPAC transaction, or result in its termination.

Using the de-SPAC to finance an acquisition is challenging. At least one de-SPAC transaction involving a German target has been used to finance a large cross-border acquisition of another business. When structuring such a transaction, the parties need to prepare for the possibility that redemptions by initial SPAC shareholders could leave the company formed by the de-SPAC with insufficient funds to pay the cash portion of the purchase price and meet the minimum cash condition for the combined entity.

If there is a risk of a cash shortfall, it will be even more important to execute a successful PIPE transaction. As further protection, the M&A buyers should build in flexible consideration options so they can substitute additional equity for cash consideration depending on the available cash at the de-SPAC closing.

The target and the SPAC may also seek irrevocable voting agreements from significant SPAC shareholders, committing them to support the de-SPAC transaction and not exercise their redemption rights.

Shareholders of the target may also be called on to provide an additional PIPE commitment in the event of high redemption levels. Properly structured, these arrangements can backstop and de-risk the transaction.

The combination of the completion of a de-SPAC and a large acquisition raises complex financial history issues and may require pro forma financials, further complicating the transaction. Close cooperation is needed among the auditors of the SPAC, the German SPAC target and the M&A target of the German SPAC target to take into account potentially different fiscal years, applicable auditing standards and other complexities. Since the de-SPAC requires registration with the Securities and Exchange Commission (SEC), any such M&A documentation by the German SPAC target should provide for a flexible closing date and the M&A parties should stay away from unrealistic long-stop/drop-dead deadlines.

These transactions inevitably are costly and time-consuming. A combination between a U.S. SPAC and a German target is generally more complex structurally and more document-intensive than the conventional U.S. IPO process. In most cases, it will require at least five or six months to implement. Depending on the time required for the German target to prepare PCAOB-level audited financials (assuming it qualifies as an FPI) and to ensure the German target's internal systems are ready for the U.S. public markets, as well as the corporate restructuring, merger and capital increases required to incorporate a typically utilized Dutch or Luxembourg holding company, the de-SPAC of a German target can also take nine or 12 months. Consequently, the transaction costs for the German SPAC target will likely far exceed those for a traditional U.S. stock exchange listing. If the de-SPAC by the German target coincides with a simultaneously executed M&A transaction by it, the overall transaction costs will run even higher.

Share trading remains restricted after completion of the de-SPAC. Unlike in a typical non-U.S. de-SPAC merger or IPO, the new shares issued in connection with the SPAC merger to existing shareholders of the German target and new PIPE shareholders of the combined entity remain restricted by U.S. law at de-SPAC closing because they are not included on the registration statement on Form F-4 for the de-SPAC merger. In order for such shares to become publicly tradeable they must first be registered with the SEC on a registration statement on Form F-1 (for an FPI), which registration typically takes place within 30 days of the de-SPAC closing and, depending on the extent of SEC review, can take a few weeks to become effective.

The public trading restriction applies to all newly issued shares to German target shareholders and new PIPE shareholders. In addition, the existing shareholders of the German target typically have a six-month lockup, with some limited exceptions. German companies and investors may not be familiar with the required additional SEC registration process and the delay in the ability to publicly trade, so the legal constraints' restrictive implications should be explained well in advance of the de-SPAC closing.

Activism Landscape Continues To Evolve

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Takeaways:

- ESG activist campaigners are likely to continue asserting themselves.
- Companies that have merged with SPACs and whose stock prices have slumped will be at risk for activist pressure.
- Watch for more activist firms to adopt private equity-like approaches, offering to buy the targets of their campaigns.
- The impact of shifts in voting regulations and policies at institutional investors is hard to predict but could be significant.

While the number of shareholder activist campaigns in the U.S. remained flat in 2021 compared to 2019 and 2020, going into 2022, companies should anticipate that activism will continue being a powerful lever for certain opportunistic shareholders seeking to extract value and produce "alpha" returns. Specifically, companies should look out for an uptick in activist campaigns focused on ESG issues, and activist campaigns may be launched against "de-SPACed" companies that are underperforming and companies with depressed stock prices.

In addition, we may continue seeing a blurring of the lines between traditional shareholder activism and private equity strategies. Changes in voting strategies at institutional investors could shift the balance in some contests.

ESG: Lessons From ExxonMobil and Shell

ESG activism took center stage, with more ESG shareholder proposals in the first half of 2021 than all of 2020. The most prominent activist event of the 2021 proxy season was the campaign against ExxonMobil by Engine No. 1, which successfully secured three board seats while only holding a 0.02% stake in the company — a surprisingly low ownership percentage for a successful proxy fight.

This was the first time that ESG issues were key to a contested election, and Engine No. 1's success stemmed in part from the support of passive institutional investors as well as the proxy advisory firms Institutional Shareholder Services (ISS) and Glass Lewis, which displayed an increased focus on and support for ESG activism. (See our June 16, 2021, article "What the Exxon Mobil Shareholder Votes Mean.")

In the coming proxy season, companies should be wary of so-called "Trojan horse" campaigns, where activists combine ESG initiatives with traditional activism campaigns, *e.g.,* a breakup or sale of a company or the nomination of a slate of directors. By pressing both sets of issues, an activist can appeal to the growing concern over ESG factors by institutional investors and, consequently, garner support for their more traditional, non-ESG proposals. A recent example of this is Third Point's campaign against Royal Dutch Shell, where the fund called for the breakup of the oil company into two stand-alone companies, one of which, Third Point argued, could make aggressive investments in renewables and other carbon-reduction technologies.

In anticipation of their 2022 annual meetings and upcoming advance notice windows, companies should conduct a comprehensive review of their ESG policies, posture and disclosures in order to anticipate and respond to any potential threats from activists with an ESG thesis.

2022: The Year of 'SPACtivism'?

According to Deal Point Data, in 2021, there were nearly 200 "de-SPACs" — mergers of operating companies into special purpose acquisition companies (SPACs). Some of the resulting companies will likely begin seeing a dramatic change in their ownership structures due to expiring lockups for sponsors (typically 12 months) and insiders selling off a portion or all of their shares, some of which may be acquired by activists. With the number of de-SPACed companies in the market, at least some will inevitably underperform, creating an opportunity for activists to put forth a value-creation thesis, whether it be a change in management, sale or breakup of the company, or some other idea.

"SPACtivism" is not limited to de-SPACs. According to SpacResearch, nearly 580 SPACs are currently seeking targets and a combined $155 billion must be deployed over the next two years. In addition, according to Goldman Sachs, as of September 2021 over 90% of active SPACs were trading below their IPO price. With the deadlines for these SPACs to seek business combinations looming and the Securities and Exchange Commission imposing stricter regulations, SPACs' stock prices may further decline. That could create an opening for activist investors to buy SPAC shares below their IPO price and exercise redemption rights, forcing a return of the IPO proceeds held in trust at the original IPO price. (See "Choppy Market for SPACs and PIPEs, Competition for Targets Spurs Deal Innovations.")

M&A-Related Activism Turns Hostile

According to Lazard's "Quarterly Review of Shareholder Activism," 45% of all activist campaigns in the first three quarters of 2021 had an M&A-related thesis, with activists pushing for a sale or breakup of a company, or the scuttling or sweetening of announced deals.

Activists continue to blur the lines of traditional M&A-related campaigns, pivoting from opposing potential acquisitions and proxy contests to oust board members to launching full-blown hostile takeovers. One example is Carl Icahn's campaign against Southwest Gas' proposed acquisition of Questar Pipeline. That evolved into a contentious proxy contest to replace Southwest's entire board coupled with a tender offer for all shares of the company.

In addition, 2021 saw the final chapter of the CoreLogic situation, which ended in a sale of the real estate data company to Stone Point Capital and Insight Partners. It began in 2020 when Senator Investment Group teamed up with Cannae Holdings, a strategic buyer, on an unsolicited proposal to acquire CoreLogic. After their proposal was rejected, they persuaded shareholders to elect three new directors to the CoreLogic board.

Throughout 2022, companies can expect more activists to pursue private equity-like strategies. When an activist shareholder threatens to launch an M&A-related campaign, companies should establish a clear strategy for responding if the activist aims to buy the company.

Universal Proxy Cards May Facilitate Shareholder Activism

On November 17, 2021, the SEC voted to adopt new rules requiring companies (other than registered investment companies) to include all nominees (*i.e.*, both company and dissident nominees) on a universal proxy card for contested director elections, effective for all relevant shareholder meetings held after August 31, 2022. (See our November 19, 2021, client alert "SEC Mandates Universal Proxy Cards in Election Contests.")

Traditionally, during a contested election, shareholders who were not voting in person had to choose between the company's and the challenger's proxy cards, with their competing slates of directors. The SEC's new "a la carte" rule may make it easier for dissident shareholders to obtain board representation by allowing shareholders to select nominees from both slates on the same proxy card.

It remains to be seen whether the universal proxy card will result in an uptick in contested elections. But companies will need to consider the potential shifts in how activists approach contested elections, including with regard to the number of candidates they propose and how they communicate their preferred candidates. Companies will also have to consider the impact of a "split decision" by ISS and Glass Lewis, which would make election outcomes more difficult to predict.

Shifting Voting Trends at Index Funds

BlackRock announced that, beginning in 2022, it will give its largest investors (*e.g.*, pension funds and endowments) the ability to cast votes tied to their investments on matters including board seats, ESG proposals and "say on pay."

If other large index fund firms follow suit, it would result in a shift in voting power from the passive index funds to their larger investors, and would likely cause shareholder proposals and contested election outcomes to be less predictable. It could also become harder for companies to influence the voting decision-makers and to predict how large blocks of shares will be voted. In order to mitigate such volatility, companies will need clear and concise business strategies and robust communication and shareholder engagement plans in advance of the coming 2022 proxy season and going forward.

See "Institutional Investors, Activists and Legal Reforms Begin Altering Japanese Corporate Governance."

Institutional Investors, Activists and Legal Reforms Begin Altering Japanese Corporate Governance

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Takeaways

- Shareholder activism continues to gain momentum in Japan as domestic institutional investors become increasingly receptive to shareholder proposals and board nominees.
- Even when activist proposals are ultimately rejected, the growing percentage of affirmative votes may impact the attitudes of target boards in future negotiations over governance matters.
- In 2021, a substantial number of unsolicited tender offer attempts were successful. Companies introduced protective measures (*e.g.*, the Japanese version of poison pills), but their effectiveness remains unclear, as court rulings have varied when defenses were challenged.
- The Japanese foreign direct investment regime could still be a barrier to hostile tender offers and foreign activists, because of government efforts to "protect national economic security" in so-called "core designated business sectors."

Activism Gathers Momentum as Institutional Shareholders Become More Receptive

The rise in shareholder proposals in Japan, including by activists, continued in 2021 (see also our 2020 *Insights* article on the trend). Notably, some of these proposals, including elections of outside directors nominated by shareholders, won the support of the required shareholder majority.

Japanese institutional shareholders, responding to 2017 and 2020 revisions of the Stewardship Code, have increased disclosures about their voting policies and actual votes. Even institutional shareholders with categorically passive investment strategies are keen on accountability to their own investors, who now often welcome constructive engagement with companies in which the institutions hold stakes.

Some asset managers have disclosed detailed guidelines on the types of shareholder proposals for which they will generally vote, and a substantial number of institutional shareholders have supported proposals consistent with their policies. In short, institutional shareholders can no longer be counted on to vote against proposals simply because they do not come from management.

Companies Slowly Open Door to Talks With Activists

Until recently, Japanese companies were generally perceived to have little incentive to negotiate and strike agreements with activist shareholders, even when activists nominated or recommended outside directors. However, we have seen several cases in recent years where companies negotiated and eventually reached accords with activists. In one example, the target company agreed to put forward an activist-nominated outside director as part of the board proposal for its shareholders meeting.

The background and terms of such settlements have generally not been made public, so the trend cannot be confirmed. With growing support from institutional investors, however, shareholder proposals are likely to gain momentum. In addition, constructive negotiations over shareholder rights matters are now a feasible option for both stockholders and target companies.

Unsolicited Tender Offers Face Poison Pills, Subject to Court Scrutiny

Another recent trend has been the increase in unsolicited tender offers for, and open-market attempts to build major stakes in, publicly traded Japanese companies, a substantial number of which succeeded. In 2021, we also saw boards of targeted companies vote to install the Japanese version of poison pills in response to ongoing or threatened tender offer or market-buying attempts. Some of these poison pills were challenged in courts, with varying outcomes.

Japanese law offers a relatively wide range of protective measures against unsolicited tender offers, including the Japanese version of poison pills, which may be introduced even after an attempted tender offer begins. The overall structure of such poison pills is similar to the U.S. practice, but in Japan it is commonly understood that some form of shareholders' endorsement is required, such as by a shareholder vote with a simple majority to introduce or trigger poison pills, depending on the situation.

Courts tend to determine whether such tactics are enforceable on a case-by-case basis. The 2021 decisions were split, with the outcome apparently depending on, among other factors, when the board contemplated the defense or whether it won an affirmative vote at a shareholder meeting. There are still only a limited number of decided cases in Japan to provide insight into the viability of poison pills. Companies should proactively assess the enforceability of pills on a case-by-case basis when introducing them considering the factors discussed in the precedents.

Foreign Direct Investment Regime May Be Used Against Foreign Activists and Others

As described in detail in our 2020 *Insights* survey, Japan's foreign direct investment regime, the Foreign Exchange and Foreign Trade Act (FEFTA) and other relevant regulations and ordinances were significantly amended in 2019 and 2020. In introducing the revisions, the government clarified that it did not intend to preclude activities by activist shareholders.

However, the government's application of FEFTA since then has been widely criticized, and the government ministers responsible for administering FEFTA are alleged to have abused their discretion regarding investment activities by non-Japanese activists. In particular, the Ministry of Economy, Trade and Industry appears especially interested in protecting sensitive technologies (*e.g.*, national defense, nuclear power generation, semiconductor, telecommunication and cybersecurity) from foreign activist shareholders who tend to make significant acquisitions and exercise voting rights.

Given the ministers' broad discretion under FEFTA, it is still unclear to what extent they will interfere with activities by foreign activist investors or proposed transactions by foreign investors involving a target company in the so-called "core designated business sectors." (See "CFIUS Goes Global: New FDI Review Processes Proliferate, Old Ones Expand.")

The Japanese government's efforts to "protect national economic security" are also manifested in the ongoing development of relevant new legislation, which is expected to be submitted to the Diet in 2022. Additionally, new prime minister Fumio Kishida, when forming his initial cabinet in October 2021, appointed a new minister in charge of the "national economic security" of Japan. In conjunction with these governmental efforts, FEFTA may be a tool for Japanese authorities to constrain foreign activists targeting domestic companies engaged in "core designated business sectors." As such, analyzing any impact of FEFTA is critical from the perspective of both the foreign investors and Japanese target company.

Private Equity and Sovereign Wealth Interests Converge in US Real Estate

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Takeaways

- PE activity, both fundraising and investing, has exploded.
- Sovereign wealth and foreign government pension funds have grown in sophistication, built out in-house capabilities and become increasingly focused on real estate, and U.S. property is a particularly attractive asset class from a control, return, tax and diversification perspective.
- We are seeing increasing collaboration between these foreign investors and PE firms in the U.S. real estate market, and a trend toward co-investment and co-GP arrangements.
- As a result, U.S. real estate deal activity seems unlikely to abate anytime soon.

Private Equity and Real Estate

After a brief slowdown early in the COVID-19 pandemic, private equity (PE) deal activity rebounded in the second half of 2020, and that momentum built in 2021. By the middle of 2021, PE accounted for 30% of all M&A activity, PE deal volume was at its highest level since 2006-07 and there were more $10 billion-plus buyouts than in any year since 2007.

For the near-term, PE activity seems likely to continue to skyrocket. PE firms were estimated to have amassed $3.3 trillion in unspent capital, or "dry powder," by mid-2021, and fundraising continues to trend upward, with new funds launched in 2021 reportedly seeking to raise over $500 billion. Since fund terms often limit the time in which capital can be deployed, we expect to see the trillions of dollars invested in the short to medium term.

A sizeable portion of the dry powder is earmarked for real estate, which is viewed as a hedge against inflation. According to Bloomberg, PE funds had over $280 billion in committed capital for real estate deals at the end of 2021, an 11% increase from a year earlier and 57% more than at the end of 2019.

In recent years, the PE industry has devoted more attention to real estate as an alternative investment. Returns have been attractive, and the asset class is appealing to those investors seeking to deploy capital for long periods. This contrasts with corporate buyouts where investments often are realized in three or five years, leaving investors to find new places for their capital. Commercial, industrial, medical office and life-sciences real estate have remained favorite subsectors and, more recently, residential property (both single- and multi-family) has joined that mix.

Another driver of PE activity in the real estate industry is the general trend of consolidation and proliferation of large real estate portfolios, resulting in large complex trades.

Foreign Government-Linked Investors and Real Estate

While traditional investments such as equities and fixed income investments have historically formed a substantial part of the assets held by sovereign wealth funds and foreign government pension pools (together, sovereign equity), there has been a trend over the last 10 years toward alternative assets, including real estate. Sovereign equity investors typically have long investment horizons and large amounts of capital to deploy; as such, long-term investments in the real estate sector are not only attractive, but desirable.

The size, stability and sophistication of the U.S. real estate market has made it a natural place for sovereign equity to place funds for long periods of times. Sovereign equity investors have increased their allocations to U.S. real estate given its strong performance, according to the Sovereign Wealth Fund Institute.

Unlike a business, where a sovereign equity investor might be looking at minority board seats and they are dependent on management for crucial operational know-how, they can exert greater control over their real estate investments, including major decision rights and advisory board seats.

With increased rights, sovereign equity investors must consider potential regulatory hurdles that can arise as a result of greater control, including interest from the Committee on Foreign Investment in the United States (CFIUS or the committee). Although unlikely to trigger mandatory filings before CFIUS, real estate investments often fall within the national security regulator's voluntary jurisdiction. With an uptick in CFIUS' proactive outreach to investors regarding transactions not voluntarily notified to the committee, CFIUS implications should be considered early in the investment process.

The Intersection of PE and Sovereign Equity: US Real Estate

The goals and attributes of sovereign equity and PE firms create natural synergies between the two, particularly in real estate. PE firms seek large amounts of capital to invest, and sovereign equity investors control and deploy enormous sums of long-term capital. Sovereign equity seeks greater control over their investments, but does not necessarily want the burden of being a sole owner in a foreign market with little to no internalized day-to-day asset management capabilities and few local industry relationships.

Real estate is an area where, working with PE firms, sovereign equity can achieve enhanced returns and exert greater control over investments without having to build deep operational teams or deal with other issues created by direct investing. PE firms provide industry expertise, operational support and access to relationships, while sovereign equity can supply large amounts of capital that allow PE firms to move nimbly when opportunities arrive, without the pressure of deadlines to put fund capital to work.

Collaborating with PE managers can also mitigate other issues associated with direct investing by foreign entities, such as national security reviews. For these reasons, sovereign entities have most often operated in a largely passive role, investing as limited partners in funds.

However, as relationships between sovereign equity and PE firms develop, they sometimes become not just co-investors but also co-GPs, with sovereign equity taking stakes in the sponsors and asset managers with whom they invest, providing the foreign institutions increased upside and reduced fees. As co-GPs with third-party LPs, sovereign equity can share in carried interest and management fees. Not surprisingly, many sovereign equity institutions now have, or are developing, sophisticated in-house deal and legal teams that can underwrite and execute transactions.

As sovereign equity has become more sophisticated and further develops in-house talent, we will likely see them collaborate more with PE firms, especially in asset classes like real estate where both parties can readily achieve their goals.

Strong IPO Demand Offered One Route to Public Markets; Other Companies Opted for De-SPACs or Direct Listings

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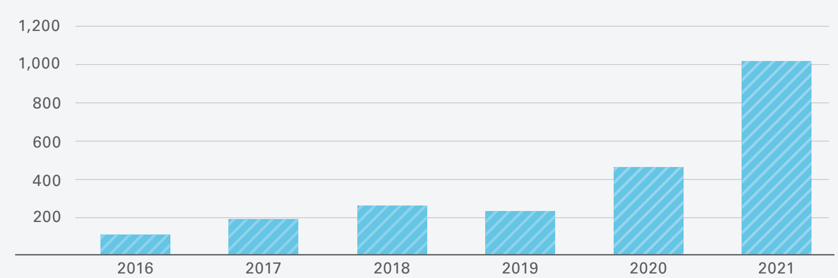
Takeaways

- U.S. IPOs skyrocketed in 2021, with SPAC IPOs and direct listings contributing meaningfully to the increase.
- Along with the rise in IPO activity, companies are receiving more SEC comments on their filings.
- Companies are reaching new investors through stock trading apps, opening up their roadshows to the public and negotiating more flexible lockup agreements.
- Strong tailwinds suggest 2022 will be another big year.

It was a banner year for companies going public in the United States: Over 1,000 companies gained listings on American exchanges in 2021, up from just 118 companies in 2016.

US IPOs



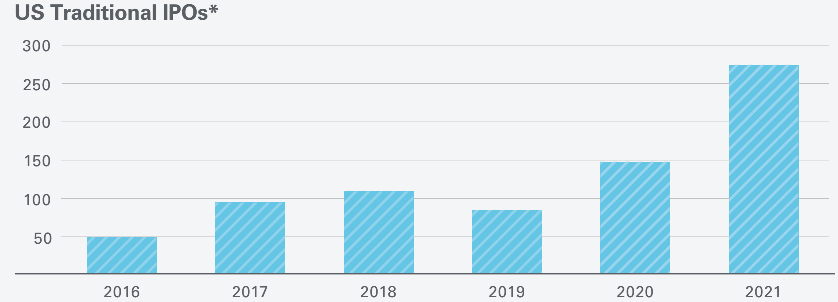
Source: DealPointData

While the number of traditional U.S. IPOs rose in 2020-21, new models of going public also became more mainstream. Special purpose acquisition companies (SPACs) have dominated headlines since 2020 and direct listings increased in popularity. Companies seeking to go public are finding more flexibility than ever to choose the path that best fits their needs.

Traditional IPOs

Conventional IPOs generally involve the company issuing shares to the public for cash. The number of companies going public via a "traditional" $100 million-plus IPO rose to more than 275 in 2021, up from just 49 in 2016.

US Traditional IPOs*



Source: DealPointData. *Traditional IPOs ≥ $100 million.

More SEC Comments

Along with this uptick in activity, we have seen an increase in Securities and Exchange Commission (SEC) scrutiny of IPO disclosures. In 2021, a company could expect to receive an average of 21 SEC comments on its initial IPO registration statement filing, an increase of more than 30% from 2015. Similarly, the average number of comments received during subsequent back and forth with the SEC increased over 30% from 2015. We expect this trend to carry into 2022, with continued SEC scrutiny of topics such as non-GAAP financial measures and "cheap stock" issuances to company insiders.

Virtual Roadshows

Like other transactions, and business practices in general, COVID-19 has affected the IPO process. Historically, a company would conduct a seven- to 10-day roadshow, traveling to major cities in the U.S. and abroad to meet with potential investors. During the pandemic, roadshows turned virtual — with bankers and companies trading conference rooms for Zoom backgrounds. Although some in-person investor meetings resumed toward the end of 2021, we expect a substantial majority of these meetings to continue virtually for at least the first half of 2022 not only because of the recent surge in variant cases, but also since virtual meetings have the ability to reach more investors in a shorter time frame.

Reaching Out to Retail Investors

We saw the target of IPO marketing widen in 2021. Historically, companies and investment banks have focused almost exclusively on meeting institutional accounts during the roadshow, allocating the IPO shares to them in the process. Last year, FIGS, Inc. became the first company conducting a traditional IPO to allocate roughly 1% of its offering to retail investors via the Robinhood and SoFi trading apps. To date, upward of 20 companies, including Rivian Automotive, Inc. and Duolingo, Inc., have followed suit.

Live Q&As Open to the Public

At the same time, companies have adapted the traditional playbook for meeting investors. The availability of new communication technology and widening of the investor pool have led businesses to reimagine their roadshows, introducing "investor days," when management is broadly accessible to any and all potential investors via the internet. For example, Robinhood conducted a live Q&A, available for worldwide streaming, and answered questions submitted by the public, as part of its IPO marketing effort. We expect marketing targeting both institutional and retail investors to become more commonplace going forward.

Less Rigid Lockups

Another trend we have seen is increasing flexibility for companies and their pre-IPO shareholders around underwriting lockup periods. In the past, all pre-IPO shareholders were expected to sign lockup agreements with the underwriters, committing to not sell any of their existing securities for 180 days following the IPO. The downside to this approach was that a significant amount of stock became available for sale on the 181st day post-IPO.

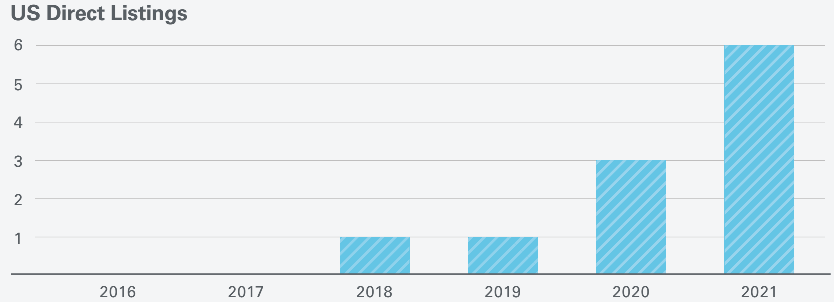
In recent years, the traditional lockup has been watered down, with a significant number of recent IPOs having early release provisions allowing holders to sell their shares within the traditional 180-day lockup period. For example, some of Riskified Ltd.'s shareholders were allowed to sell a portion of their shares in the first two months post IPO. Likewise, some of monday.com Ltd.'s holders were allowed to sell 25% of their shares if the company's share price was at least 33% higher than the IPO price following the release of the company's first post-IPO earnings report. We expect that in 2022 companies will continue enjoying meaningful flexibility in negotiating lockup provisions with the investment banks leading their IPOs — flexibility that was unheard of a handful of years ago.

More Direct Listings

In 2018, Spotify became the first company to conduct a direct listing (in which shares to date have not been issued to the public as they are in traditional IPOs). Since 2018, 12 companies have gone public via direct listings in the United States, half of which occurred in 2021.

A company undertaking a direct listing should expect more comments from the SEC, specifically from the agency's Trading and Markets Division, which oversees the mechanics of direct listings, than those companies opting for traditional IPOs. The 12 companies that have gone public via direct listings since 2016 received an average of 52 SEC comments, compared to an average of 31 for traditional IPOs. Going forward, as companies, investment banks, lawyers and the SEC itself work out the kinks in the direct listing process, we expect the number of comments to come down, moving more in line with the figure for traditional IPOs.

US Direct Listings



Source: DealPointData

SPACs

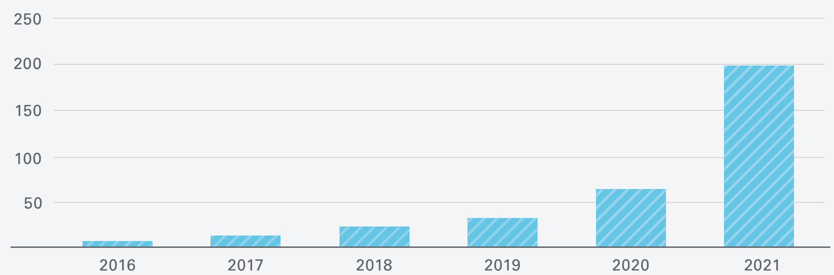
The boom in SPAC IPOs we saw in 2020 continued into the first quarter of 2021. But that activity began to slow significantly in the second quarter, due to market forces and greater regulatory scrutiny of SPACs generally. (See "Choppy Market for SPACs and PIPEs, Competition for Targets Spurs Deal Innovations.")

For public-ready private companies, de-SPACs can still offer important advantages compared to traditional IPOs, including more certain price and value discovery at the beginning stage; the ability to incorporate favorable terms more common to M&A transactions, such as earnouts; and the flexibility to negotiate within the confines of an acquisition agreement. However, while historically, de-SPAC transactions often could move faster than an IPO, a company undertaking a de-SPAC transaction should expect timing more similar to, and in some cases longer than, a traditional IPO process given increased time for deal structuring and negotiations and a greater number of SEC comments. The SEC also has been looking more closely at how projections and related valuations are presented and used in de-SPAC documentation, including whether that type of forward-looking information should be excluded from certain liability safe harbors under the securities laws.

The number of announced de-SPACs in the U.S. increased by over 200% in 2021 relative to 2019. This comes as no surprise given the enormous sums raised through SPAC IPOs in recent years and the 15- to 24-month windows in which SPACs typically must consummate a de-SPAC.

In 2022, we expect to see continued strong de-SPAC activity, since more than 400 SPACs were still looking for M&A targets as of the end of 2021. We also should see SPAC IPOs continue in 2022, although in fewer numbers than 2020-21 given the regulatory environment and the overall SPAC market.

US Completed De-SPACs



Source: DealPointData

Wide-Ranging Reforms of UK Capital Markets: A Watershed Moment?

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Takeaways

- Responding to a decline in the London Stock Exchange's global market share of IPOs and other fundraising, a string of government-commissioned reports prompted proposals to reform the U.K.'s listing rules and other legal requirements.
- The rules now make it more attractive to list SPACs in London, and companies with dual-class share structures will be allowed to list on the Premium Segment. The minimum free float requirement has also been lowered.
- Rules for secondary issuances are also being revisited so companies can raise new equity without cumbersome rights offerings made to all existing shareholders.

Regulatory Reforms Aim To Attract More Listings to London

Following a year in which activity in the London primary equity markets was depressed by the pandemic, global lockdowns and volatility, the London Stock Exchange (LSE) saw more IPOs completed in the first quarter of 2021 than in the whole of 2020. By December 2021, the figure was around three times the previous 12 months. A number of notable technology firms contributed to this wave, including Deliveroo (at a £7.5 billion valuation), Darktrace (£1.7 billion), Wise (£7.95 billion) and Oxford Nanopore Technologies (£3.38 billion).

Nonetheless, over time the U.K. has lost ground to other capital markets, and its withdrawal from the European Union (EU) has created uncertainty about London's future as a global financial center.

Against this background, in March 2021, Lord Jonathan Hill published his review of the U.K. listing regime, with recommendations for reforms. That followed a report the month before by Ron Kalifa, also commissioned by the U.K. Treasury, that put forth proposals to promote fintech. According to those reviews, London accounted for less than 5% of global IPOs between 2015 and 2020, a 40% reduction since 2008. The New York Stock Exchange and Nasdaq accounted for almost 39% in the same period.

Lord Hill's recommendations, aimed at attracting more listings in London and making capital raisings easier, quickly prompted three significant revisions to the rules:

- In August 2021, the U.K. Financial Conduct Authority (FCA) amended the U.K. Listing Rules to accommodate special purpose acquisition companies (SPACs) and, in late November, the first one listed on the LSE.
- In December 2021, the FCA effected a major overhaul of the U.K. Listing Rules to permit dual-class share structures (DCSS) for new listings in the Premium Segment, provided that (1) the structure survives for a maximum of five years and the extra-weighted shares are only held by or on behalf of a director, (2) the maximum weighted voting ratio is 20:1, and (3) weighted voting can only be exercised on removal of a director or after a change of control. The third condition means that DCSS can deter unwanted takeovers.
- Another major reform reduces the free float requirement from 25% to 10%.

Listing Rule Changes Are Well Received

Public responses to the FCA's reforms have been generally positive. Overall, allowing companies with dual-class share structures to be listed on the Premium Segment is seen as making London more competitive as a listing venue by bringing its rules in line with global competitors. New York has long permitted DCSS, and Hong Kong reversed its previous prohibition in 2018, helping attract a wave of Chinese IPOs.

Technology and other high-growth firms ought to welcome relaxation of the "one share, one vote" principle on the Premium Segment, because DCSS effectively act as poison pills against unwanted takeovers at a critical stage in companies' growth by maintaining control with founders. Thus, DCSS should not only attract new listings, but help retain a deep roster of high-quality issuers on the Premium Segment.

The reduction in free float requirements to 10% would have a similar effect and remove barriers for prospective issuers. This reform is very significant because London's previous requirements limited many companies' ability to list there. Lowering the threshold should give the LSE a significant competitive advantage against European exchanges that retain a 25% minimum. Whether the EU matches London's change remains to be seen.

Further Rule Changes Expected for Secondary Issuances in 2022

The first half of 2022 will also bring the U.K. Treasury's Secondary Capital Raising Review, begun in October 2021 in response to Lord Hill's recommendation that secondary fundraising be made cheaper and faster. Proposals included a permanent increase in the preemption limit to 20% and facilitating equity capital raisings without the need for full rights offerings open to all existing shareholders, which can be costly and time-consuming, and introduce uncertainty.

Additionally, the U.K. Treasury's Prospectus Regime Review proposed streamlining prospectuses for secondary issuances, which would make it easier and more attractive for issuers to publish forward-looking information such as profit forecasts.

How Much Will the Changes Alter the Market?

The key question is whether market practices will follow these reforms in 2022.

Listing companies with DCSS serves as an example. The structure, which has always been permitted for a Standard Listing, was used in some notable 2021 IPOs, including Deliveroo, THG and Wise. However, the market was not completely receptive. It was reported in the financial press that some institutional investors did not participate in the Deliveroo IPO because of its DCSS and, about a year after THG completed its initial public offering, its founder announced that he would give up his special share rights, in the wake of concerns about the company's corporate governance.

Investor attitudes — not the permissibility of DCSS — drove these events. Each company experienced unique circumstances, but the market's skepticism about DCSS reflected a common theme.

Similarly, any change to the preemption rights may encounter resistance. They entitle existing shareholders to participate in new fundraisings so they are not diluted, and have been described as "sacrosanct." Thus, even if preemption limits are made less restrictive, market practice may not follow.

The Big Picture: Making London More Competitive

Whether the upcoming reforms result in a boom in U.K. IPOs or capital raisings remains to be seen. The new rules concerning special purpose acquisition companies may have come at the tail end of the SPAC wave. Equity markets could be dampened in the near term by rising interest rates, inflationary pressures and continuing uncertainty around the pandemic. Furthermore, regulatory divergence between the U.K. and EU, particularly regarding proposed changes to the prospectus rules, may make it more difficult for U.K. issuers to raise capital from European investors in the coming years.

Nevertheless, the reforms should enable London to capitalize on future waves of market activity and better compete with other major financial centers. Moreover, regulatory change may help shape investor attitudes, make companies with DCSS more attractive and even increase investor-rights groups' receptivity to lowering the preemption limits.

Above all, the rapid response to Lord Hill's review shows that U.K. authorities are committed to ensuring London remains a key financial center and that the U.K. regulatory environment stays nimble. It is difficult to predict how quickly these reforms will bear fruit, but they provide good reasons to be optimistic for the London market in the long run.

See "Hong Kong Encourages Listings by Foreign Companies, SPACs."

Hong Kong Encourages Listings by Foreign Companies, SPACs

Contributing Partner

Paloma Wang / Hong Kong

Takeaways

- Greater China companies operating in any industry can now obtain secondary listings in Hong Kong, provided they meet market capitalization minimums.
- Recent Listing Rules amendments also allow some companies with weighted voting rights to have primary listings.
- More companies qualify to upgrade from secondary to primary listings.
- SPAC IPOs will be permitted, but with strict investor protections: Shares can only be sold to institutional investors, de-SPAC transactions require full IPO-level disclosure and investors enjoy strong redemption protections.

By late 2020, Hong Kong may have settled into a "new normal" shaped by the pandemic, but 2021 proved to be an unusually eventful year for capital market regulation, as the Hong Kong Stock Exchange (HKEX) sought to make itself a more attractive venue for international companies through new initiatives:

- amendments to the Hong Kong Listing Rules that provide more flexibility for overseas companies to undertake secondary or dual primary listings; and
- a proposal to allow SPACs to go public on the HKEX for the first time.

The changes come at the same time the U.K. Financial Conduct Authority (FCA) is liberalizing its listing rules and encouraging SPACs, in an effort to permit the London Stock Exchange (LSE) to better compete for listings in a global market. (See "Wide-Ranging Reforms of UK Capital Markets: A Watershed Moment?")

More Flexibility for Secondary and Dual Primary Listings

Amended rules that took effect January 1, 2022, open up new opportunities for overseas companies to list in Hong Kong.

New secondary listings. Companies, including those based in Greater China, are permitted to have a secondary listing in Hong Kong regardless of whether their business is considered "innovative" by HKEX (*e.g.*, internet or other high-tech businesses) — previously a threshold condition for Greater China company secondary listings.

The rules set minimum market capitalizations of:

- HK$3 billion for companies with a track record of good regulatory compliance for five financial years on the New York Stock Exchange (NYSE), Nasdaq or the LSE for Greater China companies, or on a wider range of recognized exchanges in the case of companies based elsewhere; or
- HK$10 billion with a track record of good regulatory compliance for two financial years on the NYSE, Nasdaq or the LSE.

Primary listings for weighted voting companies. The new rules also permit dual primary Hong Kong listings by several categories of companies with weighted voting rights (WVRs):

- innovative "Grandfathered Greater China Issuers" — those listed overseas on qualifying exchanges with WVR shares held by individuals on or prior to December 15, 2017, and those with WVR shares held by body corporates on or before October 30, 2020, which do not otherwise comply with HKEX's usually strict criteria for dual-class shares; and
- non-Greater China issuers with WVR or variable interest entity (VIE) structures that do not comply with HKEX requirements.

Previously, such companies could only undertake a secondary listing.

Conversions from secondary to primary listings. HKEX also clarified three routes for secondary-listed issuers to convert to a primary listing:

- **Voluntary conversion.** A company may choose to upgrade from a secondary to a dual primary listing.
- **Overseas delisting.** If a secondary-listed company delists from its overseas exchange, it will automatically be treated as primary-listed in Hong Kong.
- **Trading migration.** If a majority of the trading volume of a secondary-listed company migrates to HKEX, it will be required to convert to a primary listing.

In all these cases, the company will lose the benefit of the automatic Listing Rules waivers granted to secondary-listed companies, such as HKEX's corporate governance and financial reporting requirements and the onerous rules on notifiable and connected transactions. However, companies with noncompliant WVR or VIE structures that upgrade to a primary listing may retain these existing structures.

Opening the Door to SPACs

In another major development, HKEX has introduced new rules allowing SPACs to list, but with a number of significant conditions that may limit Hong Kong's appeal for sponsors.

SPACs have proven extremely popular in the U.S. in recent years, and other major markets, including the U.K. and Singapore, have also introduced rules to facilitate listings. (See "Wide-Ranging Reforms of UK Capital Markets: A Watershed Moment?" and "Choppy Market for SPACs and PIPEs, Competition for Targets Spurs Deal Innovations.") Moreover, some major Asia-based operating companies have chosen to go public through de-SPAC transactions (merging with a SPAC) rather than via traditional IPOs. In light of these developments, there was competitive pressure at HKEX to introduce a SPAC regime.

However, given the unique risks and investor characteristics of the Hong Kong market, HKEX opted for a regime that permits only "the listing of SPACs that have experienced and reputable SPAC promoters that seek good quality de-SPAC targets." As a result, the proposed rules are heavy on investor protection and present significant hurdles for promoters and target companies compared to other jurisdictions.

Among the key features to protect investors:

- Only professional investors will be permitted to subscribe for or trade SPAC securities.
- SPACs will be required to ring-fence 100% of their IPO proceeds in order to refund investors their full pro rata share if they seek redemption. This effectively creates a risk-free structure for investors, while promoters will bear all the expenses in connection with the IPO and operations (including underwriting commissions and taxes).

Aspiring SPAC promoters must meet rigorous eligibility criteria, and SPAC IPOs will be subject to stringent fundraising and distribution requirements, including:

- a minimum IPO fund-raise of HK $1 billion; and
- distribution to at least 75 professional investors, with at least 75% of the shares placed with at least 20 institutional investors.

In the highly competitive market for de-SPAC targets, HKEX's strict requirements may make Hong Kong SPACs less attractive as merger candidates. Much of the appeal of merging with a SPAC is deal and pricing certainty and, for a public-ready company, speed as compared to a traditional IPO. Those attractions may be undermined for Hong Kong SPACs by HKEX's proposals:

- HKEX will treat de-SPAC transactions as new listing applications. A sponsor must be appointed to conduct IPO-level due diligence, a prospectus must be produced and the application will be fully vetted by HKEX. The time required will therefore be comparable to that of a traditional IPO. This is not unlike the regulatory focus in the U.S. on the de-SPAC transaction being the "true IPO" transaction for the target company. SPACs will be required to raise money via a PIPE (private investment in public equity) placement to independent professional investors simultaneous with any de-SPAC transaction, which is intended as an arms-length validation of the valuation. The minimum required size of the PIPE transaction will be subject to a sliding scale based on the de-SPAC target valuation, with a minimum PIPE of at least 25% of the market capitalization of the successor company required where the de-SPAC valuation is less than HK$2 billion to as low as 7.5% where the de-SPAC valuation is HK$7 billion or more. At least 50% must be placed with a minimum of three asset management firms or funds with HK$8 billion in assets under management. Any de-SPAC transaction will thus be conditioned on the ability to price and sell the PIPE deal to external investors, potentially undermining deal certainty.

The SPAC rules came into effect January 1, 2022.

UK, US and Some Asian Jurisdictions Join in Pressing Companies To Diversify Their Boards

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Takeaways

- The FCA is poised to adopt rules requiring companies with equity shares listed on the premium and standard segments of the U.K. main market to report annually on their achievement of gender and ethnic diversity targets.
- This requirement would mirror similar initiatives recently implemented in the U.S. and some Asian countries.
- Influential large institutional investors are publishing their own voting guidelines, which seek to support greater diversity on boards.

In July 2021, the U.K. Financial Conduct Authority (FCA) published a consultation paper, "Diversity and inclusion on company boards and executive committees," laying out proposed diversity disclosure requirements expected to go into effect in early 2022 for U.K.-listed companies.

The paper noted significant gains in gender diversity on boards. In 2011, women represented only 12.5% of U.K. directors at FTSE 100 companies, but by 2020 36.2% of directors were women. However, the level of ethnic diversity remains low. In 2017, after a review found only 2% of directors of FTSE 100 companies were persons of color, the FCA set a target of at least one director of color by 2021 for FTSE 100 companies. A recently published review found that, as of April 30, 2021, 61 FTSE 100 companies reported they had met that target, 18 reported they had not and 19 did not report whether or not they had.

Details of the FCA's Proposed Rules

The FCA paper proposes requiring U.K.-listed companies to include in their annual report a "comply or explain" statement as to whether specific targets for gender and ethnic diversity were achieved in the financial year reported on. If the goals were not achieved, companies would need to explain why they were not and what steps are being taken to reach them in the next financial year.

The proposed goals are:

- at least 40% of the board are women;
- at least one of the chair, CEO, senior independent director (SID) or CFO is a woman; and
- at least one member of the board is from a non-white ethnic minority background.

In addition to being obliged to report on these goals, listed companies would be required to provide data on the gender and ethnic diversity of their boards, senior board positions and most senior executive management.

Companies would also be encouraged to include in their annual report:

- a summary of key policies, procedures and processes to improve the diversity of their boards and executive management;
- any mitigating factors that make achieving diversity more challenging;
- any risks in meeting the targets in the next accounting period; and
- any plans to improve board diversity.

The paper stated that the policy disclosures should apply to remuneration, audit and nomination committees, and cover ethnicity, sexual orientation, disability and socio-economic background.

The consultation process ended in October 2021 and the FCA said in November 2021 that it expects to publish new rules to implement the proposals by early 2022. The new rules would apply to U.K. and overseas issuers with equity shares, or certificates representing equity shares, admitted to the premium or standard segment of the FCA's Official List, but excluding open-ended investment companies, "shell companies" and existing exemptions for small and medium companies.

Other Jurisdictions

The FCA's initiative keeps the U.K. in line with other significant financial markets, such as the U.S., Hong Kong, Japan, Australia and Singapore, each of which has taken similar steps over the past two years.

Investor Policies in Favor of Diversity

In parallel with these initiatives from regulators, high-profile large institutional investors are pledging to exercise their voting rights to encourage listed companies to increase diversity on their boards.

On December 2, 2021, Goldman Sachs Asset Management (GSAM) announced that, beginning March 2022, its proxy voting policies would include an expectation that each company in the S&P 500 and FTSE 100 indexes would have at least one diverse director from an unrepresented ethnic minority group on its board. GSAM also stated that it expected public companies globally to have at least two women on their boards (unless the board has 10 or fewer members or local requirements are higher than this minimum). GSAM has stated that it will enforce these expectations by voting against members of the nominating committees of companies that fail to meet them, and, in the U.S., GSAM will continue to vote against all members of boards that do not include any women.

The global push for diversity continues to gather momentum and that seems unlikely to change, not least because investors believe diversity is good for business. In announcing its new policy, GSAM was clear: "Boardroom diversity is an important source of diverse thinking at the highest level of every company and is an important driver of corporate performance."

Market	Agency/Exchange	Date	Description
United States	The U.S. Securities and Exchange Commission: approved board diversity rule for companies listed on the Nasdaq exchange	Approved: August 6, 2021	Nasdaq-listed companies must (subject to some exceptions): – annually report on board-level diversity statistics using a standard matrix template beginning in 2022:[2] • total number of board members; and • how those board members self-identify regarding gender, race and ethnicity categories and LGBTQ+ status; and – appoint at least one diverse director by August 7, 2023, and at least two by August 6, 2025, of whom one should self-identify as female and one as either an underrepresented minority or LGBTQ+. If the company has not met these standards by those dates, explain why not. See our September 28, 2021, client alert "SEC Approves Nasdaq Board Diversity Listing Standards."

[2] Disclosure is required by the later of (a) August 8, 2022, or (b) the date on which the company files its proxy or information statement for its 2022 annual shareholder meeting.

Market	Agency/Exchange	Date	Description
Hong Kong	The Stock Exchange of Hong Kong Limited (HKEX): has adopted measures to improve board diversity at HKEX-listed companies	Took effect: January 1, 2022	HKEX-listed companies must: - appoint at least one director of the absent gender by December 31, 2024, if they have single-gender boards; - not have single-gender boards from July 1, 2022, if they are IPO applicants; - set and disclose numerical targets and timelines for achieving gender diversity both on their boards and within their wider workforces for financial years commencing on or after January 1, 2022; and - have their boards review the progress of their diversity policy annually for financial years commencing on or after January 1, 2022.
Japan	The Tokyo Stock Exchange: revisions to Japan's Corporate Governance Code	Took effect: June 11, 2021	Japan-listed companies must: - disclose their policies and "voluntary and measurable" goals for ensuring diversity in senior management, such as the promotion of women, foreign nationals and midcareer hires to middle management roles; and - disclose their human resource development policies to ensure diversity and report on the implementation of those policies.
Australia	The Australian Securities Exchange (ASX): Corporate Governance Principles	Published: February 2019	ASX-listed companies must: - set and disclose measurable objectives for achieving gender diversity in the composition of their boards, senior management and workforces generally; and - report annually on the achievement of those objectives. For members of the S&P/ASX 300 Index, the objective should be to have at least 30% of its directors be of each gender.
Singapore	The Singapore government: Council for Board Diversity (CBD)	Established: 2019	The board has a mandate to "promote a sustained increase of women on boards of listed companies." The CBD set a target for the top 100 listed companies of: - 20% women on boards by the end of 2020; - 25% by the end of 2025; and - 30% by the end of 2030. As of June 30, 2021, the CBD reported a level of 18% — below the target but an improvement from 16.2% in December 2019.

ESG Disclosure Requirements Put New Spotlight on Private Capital Managers

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Takeaways

- New EU regulations require detailed disclosures about the ways in which asset managers implement sustainability policies in the businesses they investment in. Similar rules are being considered in the U.K. and U.S.
- The EU requires that some disclosures be made public on asset managers' websites, not just in offering documents circulated to investors on a confidential basis.
- The EU rules have an extraterritorial impact because they apply to non-EU firms raising funds within the EU, and some non-EU firms are opting to comply simply to demonstrate their ESG credentials.
- The public disclosures open up private capital firms to the risk of public criticism, investigation and litigation from a range of stakeholders.

For decades, the private capital industry strived to stay out of public view. Beginning in 2007, IPOs of fund managers prompted some of the industry's leading firms to reveal for the first time details about their investments and inner workings. Other disclosures mandated in the U.S. under the Dodd-Frank Act in the wake of the global financial crisis put additional information about fundraising and fund managers into the public domain. The current wave of ESG-related regulation, which is impacting the entire financial community, is indirectly causing private capital firms — including private equity, venture capital, private debt, real estate and infrastructure fund managers — to increase disclosures about their investments and their operations.

The EU Takes the Lead

For some time, many investors in private funds have required their managers to demonstrate some form of ESG credentials — whether that was adherence to the United Nations Principles for Responsible Investment, or narrower restrictions on investing in particular sectors such as gambling or fossil fuels. The significant growth of so-called "ESG funds" has, unsurprisingly, led to new regulatory initiatives, with the EU leading the pack in implementing requirements largely targeted at preventing "greenwashing" — misleadingly advertising investments as having a positive ESG impact.

The EU's Sustainable Finance Disclosure Regulation (SFDR), which came into force in March 2021, requires entities that fall within its scope to make a number of disclosures to their clients or investors and more publicly on those firms' websites. (See our September 2, 2020, client alert "Private Fund Managers Should Prepare for New ESG-Related Regulatory Obligations.")

The U.K. appears set to follow suit. The U.K. Financial Conduct Authority has begun consultations on new rules regulating the information to be provided in relation to ESG funds.

In the U.S., the Securities and Exchange Commission (SEC) has stated it is considering rules for private capital funds and other investment advisory businesses regarding ESG factors, including ESG claims and disclosures. SEC Chair Gary Gensler has singled out funds marketing themselves as "green" or "sustainable" and has noted there are no standardized meanings for such terms. In addition, the SEC has established a Climate and ESG Task Force within its Enforcement

Division to identify and investigate ESG-related disclosures by corporate issuers as well as disclosure and compliance issues relating to investment advisers' and funds' ESG strategies.

A New Era of Public Scrutiny

What is perhaps most notable about the EU's SFDR is the requirement for entities within its scope to make disclosures on their websites. Private fund managers that operate, or raise money, in Europe are likely to be subject to these rules. Even where a private capital firm is technically outside the scope of the SFDR, investors may demand compliance.

The SFDR requires an in-scope firm to include on its website details of how sustainability risks are integrated into investment decision-making; how remuneration policies are consistent with the integration of sustainability risks; and a statement on the firm's due diligence policies with regard to potential adverse impacts of investment decisions on sustainability factors. It seems likely that, by forcing firms to provide public disclosures of this nature, some private capital firms may have to alter their behavior rather than make adverse disclosures that could be detrimental to their public profiles and, consequently, their ability to raise capital.

For private capital firms, this means a new era of public scrutiny, where an increasingly wide base of stakeholders will seek to hold them to account. Private fund managers will continue to be subject to scrutiny by their investors, aware that bad investment decisions or activities could impact future fundraising prospects and thus the ability to keep their business running. Moreover, if "greenwashing" is found to have occurred, it may result in claims by investors who have suffered losses due to untrue or misleading statements or omissions made by private capital firms.

A number of hedge funds have noted that investors are particularly keen to see detailed evidence of so-called "ethical" practices in the supply chains of potential investments. The M&A community has seen plenty of examples of auction processes where sellers have not been able to complete a disposal, have had to accept a lower price than anticipated or have provided the buyer with indemnity cover or other risk protection, as a consequence of the divested business having significant ESG issues. While these risks commonly mean a problem for the seller, for the right buyer, which may often be a private fund, there is an opportunity to create value by addressing the problems and bringing the business into compliance with global ESG standards.

Disclosures Could Create New Risks

The growth of private capital, coupled with an increased public focus on ESG, raises the prospect of new risks to private fund managers. For example, having to make public disclosures raises the prospect of a much broader universe of potential complainants. If something goes wrong, private fund managers could conceivably face the risk of class actions or litigation brought by experienced nonprofit organizations.

Even without litigation risk, the industry and individual firms may encounter more negative PR as the non-financial media becomes more familiar with private capital activities. Unfavorable PR is likely to be noticed by investors and that, too, could negatively affect fundraising.

And, lest we forget, regulators will also be watching. Should a portfolio company of a private fund be seen to be having a damaging or adverse impact on the environment or society, regulators will be under pressure to investigate whether any blame lies at the door of the private fund manager. Regulators, especially in the U.S., will be watching to see whether investment advisers adhere to claims about ESG investment strategies and whether all aspects of their business are run in a manner consistent with their public stance on ESG issues. Where they find ESG claims are not supported, it is likely that the private fund manager will be asked to provide more information to support those claims, or otherwise drop such labels.

Bracing for the Changes

The private capital industry needs to prepare for these new challenges. Those within the industry are well aware that public perception of private equity and other forms of private capital is not always positive. As a result, many firms have taken steps to demonstrate the contributions their investments make — whether through job creation or other benefits — to their wider communities. Now there will also be a stronger desire to tell a positive ESG story on a firm website. With the press, regulators and a wide universe of stakeholders watching, firms will have to ensure their disclosures can be verified. In a world of 24-hour news and social media, it is not possible to predict all the potential public scrutiny that private capital may face. But it does seem clear that stories about private capital's ESG efforts, or misrepresentations about them, will start to appear, and private capital firms need to be ready.

Increased Demand for Renewable Energy PPAs Expected To Create Seller-Friendly Market

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Takeaways

- The widespread adoption of sustainability goals by major corporations has created significant demand for renewable power.
- That, in turn, is strengthening the hand of producers in negotiations over power purchase agreements.
- Energy producers are seeking to bind buyers for substantially longer terms and are shifting more risks to buyers.

Over the past decade, hundreds of companies have publicly committed to various sustainability goals. Many are seeking to obtain all or most of their power from renewable sources. But bringing new renewable power projects on line takes years. As a result, companies seeking to offset their greenhouse gas emissions (GHG) will face increasing competition for supplies of green power, and producers will have more leverage in negotiating power purchase agreements (PPAs). This shift in negotiation dynamics is already resulting in more seller-friendly terms.

Demand Rises for Green Energy

RE100, a global corporate renewable energy initiative, has over 340 member companies that have pledged to source 100% of their electricity from renewable energy by 2050, and at least 20% of these companies have committed to an earlier deadline of 2030. Additionally, in 2021, more than 180 companies signed on to The Climate Pledge, agreeing to decarbonize (*i.e.*, use energy sources that do not produce GHGs) and reach net zero emissions (*i.e.*, offset GHGs with activities that remove those emissions) by 2040.

In the U.S., approximately 20% of the total energy supply comes from renewable sources, but green energy capacity is not expanding nearly rapidly enough to meet corporate sustainability goals. Because new projects can take up to four to six years to be developed, financed and constructed, companies with near- and mid-term sustainability pledges will face increasing competition for supplies of green power.

Corporate PPAs Promote Sustainability and Provide Steady Revenues for Project Financing

A key component of most companies' sustainability strategies has been the procurement of renewable energy or renewable energy credits (RECs), certificates representing a certain amount of clean power delivered by a producer to the grid. Companies historically bought RECs to meet their mitigation targets for GHGs. But the sale of RECs typically did not yield enough revenue to finance a project. Investors and lenders now generally insist that a producer have a buyer contractually bound to purchase its energy output for many years in the form of a PPA.

Under a typical PPA, a company agrees to buy power at a specified price determined in the agreement for many years, ensuring the long-term, predictable revenue essential for obtaining project financing and investment. Corporate PPAs typically run from 12 to 15 years, but may be up to 20 or 25 years.

In many cases, however, corporate buyers do not actually take delivery of a project's energy output. The power, for example, may be generated too far from the user to be delivered economically. In these situations, the parties can enter a "synthetic PPA," which does not involve physical delivery of the energy to a buyer.

Synthetic PPAs effectively function as hedge arrangements, offering project owners guaranteed income and buyers price predictability and potential savings on the energy generated by the project.

These contracts are frequently structured as fixed-price purchase and sale agreements for RECs with an embedded "contract for differences" for the energy. The project owner sells the energy into a wholesale electricity market and is paid the prevailing market price. At the end of a specified settlement period, usually a month, the owner calculates the "floating price payment" based on the amount sold (or a hypothetical energy profile) and the weighted average of the price received.

If the floating price payment exceeds what the producer would have received at the fixed price in the PPA, the excess is paid to the corporate buyer. If it is less, the corporate buyer pays the difference to the project owner.

The settlement process under the synthetic PPA, together with the transfer of RECs to the buyer, acts as a GHG offset for that portion of the buyer's energy use corresponding to the output of the project used in the settlement process.

Shifting Negotiation Dynamics Are Likely To Result in More Seller-Friendly Terms

Corporations purchased 23.7 gigawatts of green energy in 2020, 18% more than in 2019, and 74% more than in 2018. The total is forecast to grow by at least 30% per year in order for companies to meet their 2030 commitments.

Recently, some producers have been taking advantage of the leverage this demand has given them and have pressed for more favorable terms:

- Synthetic PPAs have typically run from 12 to 15 years. Increasingly, producers are negotiating terms of up to 20 or 25 years.
- Producers are bearing less "basis risk." Synthetic PPAs are imperfect hedges, which create basis risk for the power generator when the floating prices used in the settlement process under the PPA differ from what the producer receives for its energy. This difference can be significant if the floating price is determined at a trading hub instead of the pricing node at which the project sells its energy output, or if the settlement process is based on a hypothetical energy profile instead of actual sales.
- Generally, synthetic PPAs also have not provided producers with relief if actual energy sales differ from the hypothetical profile due to *force majeure* events, such as the January 2021 storm that led to a crisis for Texas' grid. Increasingly, producers are requiring corporate buyers to cover all or some portion of the floating price difference and seeking *force majeure* relief for such production issues.
- Up to now, corporate buyers have generally been successful in negotiating reduced pricing for excess energy to avoid having to pay for power produced beyond their needs and what was expected to be hedged by the synthetic PPA. Increasingly, such pricing terms are being resisted by producers.
- Synthetic PPAs have generally included many terms to mitigate the risk of the producer's nonperformance. For example, (1) a letter of credit to secure a seller's payment obligations, (2) a production guarantee to compensate a buyer if the quantity of power generated by a project is less than expected and (3) construction milestones and preconditions to commercial operation to allow a buyer to terminate the contract if construction issues prevent a project from being completed. Increasingly, producers are not offering credit support to secure their payment obligations, and instead have pushed buyers to rely on project revenues. Likewise, they have been less willing to agree to construction milestones and have provided very limited recourse for failure to meet production guarantees or a target date for commercial operation (*e.g.*, termination without liability after an extended period).

In conclusion, synthetic PPAs are effective ways for companies to advance their sustainability commitments, but they need to prepare to negotiate in a more seller-friendly market.

Expansive Stimulus and Monetary Policy Helped Limit Restructurings, but Debt Maturities Loom

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Takeaways

- After an initial surge in debt restructurings and insolvencies in the early stages of the pandemic, stresses eased and fewer companies sought reorganizations.
- Default rates are low, as governments have offered fiscal and monetary support and capital markets remain healthy.
- Large amounts of speculative-grade debt come due in the next several years, and borrowers' ability to meet or refinance their obligations hinges on factors such as inflation and the strength of the global recovery, even as the pandemic continues.

The COVID-19 pandemic initially triggered a spike in business restructurings and insolvencies around the globe. According to the UCLA-LoPucki Bankruptcy Research Database, 56 large public corporations filed for bankruptcy in the U.S. in 2020 — the most in any year since the 2008 global financial crisis, and a 124% year-over-year increase. However, that was followed by a plummet in insolvency filings for a variety of reasons, including the expansionary fiscal and monetary policies adopted by many countries. Although the health effects of the COVID-19 pandemic persisted into 2021, many of the economic consequences did not. The global corporate default tally through mid-December 2021 was at its lowest level since 2014.

Over the past year, the combination of widely available government support and open capital markets has made refinancing and amend-and-extend transactions the preferred solution for many struggling companies. Borrowers have generally been able to refinance existing loans and bonds at lower cost and with extended maturities. And while 2021 saw heavy restructuring activity, it has tended to be either sector-specific (*e.g.*, real estate, retail, travel) or situation-specific.

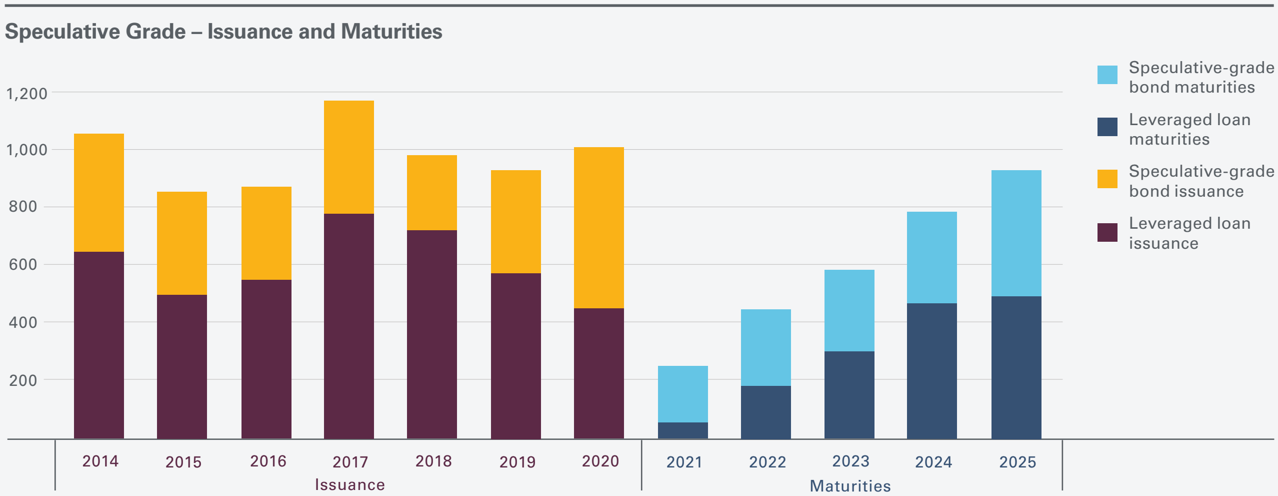
Government Policy Helped Avert More Business Stress

The virus has had a devastating impact on people and businesses across the globe. In October 2021, the World Health Organization reported more than 241 million confirmed cases and over 4.9 million deaths. The U.S. accounts for around one-fifth of all global cases.

Millions of people have also lost their jobs and hundreds of thousands of businesses have closed. Governments implemented lockdowns, quarantines and travel restrictions in an effort to slow transmission rates.

But, in response, governments and central banks around the world enacted robust stimulus policies, increased expenditures and lowered interest rates to avoid a catastrophic economic collapse. In the U.S., the Federal Reserve cut interest rates to near zero and implemented aggressive quantitative easing measures. Congress enacted more than $5 trillion in emergency legislation. Outside the U.S., the International Monetary Fund (IMF) reports that, in 2020, Japan for example adopted fiscal packages worth 307.8 trillion yen (approximately $2.7 trillion), or 54.9% of its 2019 GDP.

In October, the IMF updated its forecasts for the global economic growth to 5.9% in 2021 and 4.9% in 2022. However, economic recovery varies widely among countries, driven by early policy support and access to COVID-19 vaccines. Only 4% of people in low-income countries have been vaccinated, versus 60% in wealthier ones.



Note: Maturities include bonds, loans and revolving credit facilities that are rated 'BB+' and below by S&P Global Ratings.
Sources: S&P Global Ratings Research and LCD, an offering of S&P Global Market Intelligence.

As economies reopen, observers are increasingly concerned about inflation in some countries. For example, at the end of 2020, the Federal Reserve estimated that U.S. inflation would average 1.8% in 2021. By September, the Fed's estimate increased to 4.2%. Economists attribute the increase in prices to a combination of labor shortages, supply chain bottlenecks, rising costs of raw materials and the extraordinary monetary and fiscal policies adopted in response to the pandemic. At least in the U.S., inflation continues to run hot, to the degree that real (inflation-adjusted) yields on corporate bonds have plunged into negative territory for the past several months.

Speculative-Grade Debt Maturities Loom

Scheduled maturities for speculative-grade debt are approximately $427 billion in 2022 and approximately $580 billion in 2023, and that figure rises in later years, reaching a peak of approximately $934 billion in 2025. The chart above shows total speculative-grade issuances and maturities through 2025 (*i.e.*, rated BB and lower).

On the positive side, even in 2025, speculative-grade bond and leverage loan maturities are below recent years' volume of speculative-grade bond and leveraged loan issuances, which has averaged $1 trillion annually for the past four years. In other words, unlike in past cycles, barring sustained inflation or a significant slow-down in economic growth, we do not seem to be facing an unmanageable speculative-grade debt-maturity wall. At the same time, there are record levels of "dry powder" available in private equity markets.

What To Watch in 2022

Many corporations entered the COVID-19 pandemic already highly leveraged, and corporate borrowing has only increased during the pandemic. The coming year presents new challenges as companies adapt to the withdrawal of government support and shift to focus on longer-term recovery and growth.

If, as expected, further government support is limited, companies will turn increasingly to the capital markets and existing lenders and shareholders to meet their liquidity and working capital requirements. Looking forward, observers will monitor whether lasting inflation will trigger increased interest rates and usher in the next wave of restructurings, or whether, as the IMF predicts, inflation rates prove to be transitory and return to pre-pandemic levels without a resulting increase in interest rates.

Recent Delaware Bankruptcy Rulings Address Whether a Plan of Reorganization Can Deny a 'Make-Whole' Payment Without Impairing Lenders' Claims

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Takeaways

- "Make-wholes" — one-off payments required if debt is prepaid or, in certain cases, otherwise accelerated — have generated litigation, with debtors contending they can continue to pay lenders under the debt's original terms without the lenders' consent and without paying the make-whole.
- Lenders often resist attempts by debtors to reinstate debt without payment of the "make-whole," arguing their claims are "impaired" for purposes of the debtor's reorganization plan if they do not receive the payment.
- In one case, a Delaware bankruptcy court recently sided with a debtor, citing Bankruptcy Code sections that allow reinstatement despite acceleration clauses and prohibit penalties for filing bankruptcy.
- In another Delaware bankruptcy case, claims for make-whole premiums survived the debtors' motion to dismiss based on the specific redemption language of the governing debt documents.
- Drafting make-whole provisions carefully to avoid uncertain outcomes is increasingly critical.

A recent bankruptcy ruling may have material implications for the enforceability of make-whole premiums in Chapter 11 cases.

In *In re Mallinckrodt plc*, the U.S. Bankruptcy Court for the District of Delaware held on November 5, 2021, that the debtors did not have to pay a "make-whole" premium in order to reinstate secured first-lien claims as unimpaired under a plan of reorganization.

This ruling is the latest development in the rapidly evolving case law of make-wholes — lump-sum payments called for in some loan agreements that are triggered when debt is prepaid or a borrower goes into bankruptcy (which results in acceleration of the debt claim). The decision may have lasting implications for creditor recoveries, debtors' plans of reorganization and negotiations of debt documents.

Mallinckrodt Files, Then Offers To Pay Noteholders Everything Except the Make-Whole

Mallinckrodt Pharmaceuticals has faced enterprise-threatening litigation, including a dispute with the Centers for Medicare and Medicaid Services and over 3,000 lawsuits related to the production and sale of opioids. To date, the company has spent over $100 million defending these lawsuits. Its cash reserves faced additional pressure in April 2020 when approximately $495 million in unsecured notes came due.

To manage its cash flow, Mallinckrodt, through two affiliates, arranged a private debt exchange that month, issuing more than $495 million in new notes with higher yields and longer maturities, secured by a first lien on substantially all of the company's assets. The new notes paid 10% and matured in 2025. They included a make-whole provision, referred to in the governing indentures as the "Applicable Premium."

The indenture provided that Mallinckrodt pay the noteholders the "Applicable Premium" in the event that the notes were accelerated, which would occur if the company voluntarily filed for bankruptcy prior to April 15, 2022. On October 12, 2020, Mallinckrodt and its affiliates filed a petition for Chapter 11 protection.

On September 29, 2021, the debtors proposed a reorganization plan that would reinstate the first-lien notes but not pay the make-whole. The noteholders would continue to receive payments at the original rate, with the same maturity and security. In short, the debtors intended to pay as though they had never filed for bankruptcy. The debtors maintained that the noteholders could not vote against the plan, because the proposed treatment left them unimpaired by the plan.

Does Nonpayment of a Make-Whole Constitute Impairment?

The Bankruptcy Code sets out conditions that must be met before a reorganization plan may treat a claim as unimpaired. In particular, the Code requires that (a) subject to a few exceptions, the debtor cures any default giving rise to accelerated payment, and (b) the plan does not otherwise alter the legal, equitable or contractual rights of the creditor. Among the defaults that do not need to be cured are those triggered by the debtor filing for bankruptcy.

Mallinckrodt argued that the noteholders could be treated as unimpaired under its reorganization plan because (a) under the Bankruptcy Code, the make-whole did not need to be cured given that it was triggered only by the company's petition for Chapter 11, and (b) the plan did not otherwise alter the legal, equitable or contractual rights of the noteholders, who would have "the same claims, against the same companies, with the same priority position, and the same terms."

An ad hoc group of first-lien noteholders disagreed. They objected to the proposed plan, arguing that they could not be treated as unimpaired without payment of the make-whole. They maintained that the statute only applied to the curing of defaults that have accelerated a debt. Because neither the make-whole provision nor the debtors' failure to pay it accelerated a debt, the cited statute was irrelevant, the noteholders contended.

Additionally, the noteholders argued that their legal and contractual rights were altered by the debtors' plan because, once Mallinckrodt filed for bankruptcy, they obtained an unavoidable contractual right to the make-whole payment. In other words, once the debtors entered Chapter 11, they owed a new charge under the governing contract: the premium, which on the first-lien notes amounted to approximately $94 million.

On November 5, 2021, the Bankruptcy Court overruled the creditor group's objection, holding that payment of interest and principal pursuant to the original indenture — but not of the make-whole — was sufficient to treat the noteholders as unimpaired.

First, the court noted that the Bankruptcy Code permits a debtor to reinstate an obligation even if there is a contractual provision requiring an acceleration of any claim or interest after a default. The court went on to disagree with the noteholders' characterization of the make-whole as a "new charge." Instead, it found that it amounted to an acceleration of a claim, and was precisely the type of provision that the Bankruptcy Code permitted a debtor to de-accelerate.

Moreover, because the Debtors proposed to fully meet the original terms of the notes, the make-whole amounted to a bankruptcy penalty, the court found. But reinstatement allows a debtor to "roll back the clock to the time before the default existed," the court explained. In this case, that meant prior to Mallinckrodt filing for bankruptcy. Because the make-whole was only triggered by the filing, reinstatement meant that Mallinckrodt did not owe the make-whole.

Outcomes Have Varied in Make-Whole Disputes

Mallinckrodt is not the only case to take up the enforceability of make-whole clauses, but outcomes have differed with the circumstances and varying loan agreement terms.

In 2016, the borrowers in *In re Energy Future Holdings Corp.* argued that they could refinance secured debt without triggering a make-whole under an "optional redemption" provision in the governing documents. They contended that payment of a debt after maturity is not a "redemption," and the maturity date had been accelerated upon the debtors' bankruptcy.

The U.S. Court of Appeals for the Third Circuit disagreed, siding with the lenders. The Third Circuit reasoned that a redemption may occur before or after a note's maturity, and it held that the redemption was "voluntary" because the debtors redeemed the notes over the noteholders' objections. Because the refinancing was an "optional redemption," the Third Circuit concluded that the indenture required the debtors to pay the make-whole.

However, in a 2017 case involving similar facts and arguments, *In re MPM Silicones LLC (Momentive)*, the U.S. Court of Appeals for the Second Circuit held that the make-whole was not payable. The court reasoned that payment on a debt that is automatically accelerated due to the debtor's bankruptcy filing is not an "optional redemption," because "redemption" refers to payments made prior to maturity, and this one was made after (the automatic acceleration clause changed the maturity date to the petition date). The Second Circuit went on to explain that even if this payment were a redemption, it was not "optional" because operation of the automatic acceleration clause made it mandatory.

On December 22, 2021, the U.S. Bankruptcy Court for the District of Delaware issued another ruling regarding the enforceability of make-whole provisions. The court, in *In re Hertz Corp.*, granted in part the debtors' motion to dismiss a complaint filed on behalf of holders of two series of senior unsecured notes for recovery of allegedly due make-whole premiums.[3] Under the previously confirmed plan, the debtors would pay all of the principal owed on the series of notes but would not account for any make-whole payments. As in *Mallinckrodt*, the *Hertz* plan denied the payment of make-wholes while treating the claims as unimpaired. However, a key distinction between the *Mallinckrodt* plan and the *Hertz* plan is that the noteholders in *Hertz* would receive payment of the principal in full, in cash on the plan's effective date as opposed to *Mallinckrodt*'s plan, which reinstated the debt. The noteholders in each case challenged such treatment, arguing that their claims could not be treated as unimpaired without payment of the make-whole.

In determining whether to dismiss the noteholders' make-whole claim, the court focused on the specific redemption language in each of the governing debt documents. The relevant provision for one group of notes provided for a make-whole if the debtors redeemed the notes "prior to maturity" (a date accelerated to the petition date upon a filing for bankruptcy), whereas the provision for another set of notes stated that a make-whole would be due if the debtors redeemed the notes "[a]t any time prior to [the specified date]." Moreover, for purposes of the make-whole provisions, the debtors' plan to pay the noteholders in cash, rather than reinstate the debt, constituted a voluntary redemption of the notes.

The court dismissed claims regarding the former notes but not the latter. Regarding the former notes, the court agreed with the debtors' argument that use of the undefined term "maturity" in the make-whole provision must refer to the common meaning of maturity because the indentures used a defined term, "Stated Maturity," to reference the original due date. Accordingly, although the notes were redeemed prior to the original maturity date, they were nevertheless not redeemed "prior to maturity," because the maturity date had been accelerated by the debtors' Chapter 11 petition, the court explained. As for the other group of notes, the court denied the debtors' motion to dismiss because under the express terms of the redemption provision, the noteholders had stated a plausible claim that the make-whole was triggered by a redemption "prior to [the specified date]," a date that was not modified upon the debtors' bankruptcy filing.

A case now pending in the U.S. Court of Appeals for the Fifth Circuit, *In re Ultra Petroleum Corp.*, could provide further guidance as to the enforceability of make-whole premiums in the context of unsecured debt. The *Ultra* debtors proposed a reorganization that purports to leave all unsecured claims unimpaired. Under the plan, noteholders would receive a payment in cash for all allowed claims, from which the debtors excluded any make-whole. Some unsecured creditors contend that their claims were impaired because the debtors did not pay a make-whole triggered by the bankruptcy filing. Oral arguments were heard on October 4, 2021.

Conclusion

The decisions in *Mallinckrodt* and *Hertz* exemplify the importance of careful drafting of make-whole provisions, and companies in bankruptcy or weighing a filing should consider whether and how to reinstate or otherwise treat claims involving these terms to ensure they are properly classified as "unimpaired" under a reorganization plan.

[3] The noteholders' claim for postpetition interest and the court's analysis of the "solvent debtor exception" are beyond the scope of this article but will likely be the focus of a follow-up article after the Fifth Circuit rules in *Ultra*. The court's discussion regarding the payment of postpetition interest (and the distinction between code impairment and plan impairment) so as to render the claims unimpaired is also beyond the scope of this article.

Treatment of Midstream Agreements in Bankruptcy Remains Unsettled, but Limited Consensus May Be Emerging

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Takeaways

– Pipeline companies have opposed efforts by oil and gas producers to reject midstream gathering agreements in bankruptcy, claiming that the exclusive "dedication" provisions in such agreements "run with the land" under state law and preclude rejection.

– Bankruptcy and appellate courts have reached different conclusions about the validity of these dedication clauses under state law.

– But more recent cases suggest an emerging consensus that a debtor can reject a midstream gathering contract even if its dedication clause runs with the land under state law.

Volatile and generally depressed oil and gas prices drove over 250 North American exploration and production (E&P) operators into bankruptcy from 2015 to 2021. Although this wave of energy restructurings has subsided with the recent rise in commodity prices, the legal issues left in its wake remain relevant.

Among these issues, few have attracted greater interest than the ability of an E&P debtor to reject burdensome midstream agreements in bankruptcy. That question, which lies at the intersection of federal bankruptcy and state oil and gas law, has played a pivotal role in numerous E&P restructurings since 2015.

Surprisingly, this issue generated little case law until recently. A spate of decisions, beginning in late 2019, has yielded an emerging consensus that midstream agreements are not wholly immune from rejection in bankruptcy. But a definitive answer remains elusive.

Typical Midstream Agreements Include a 'Dedication' Clause

E&P debtors have used bankruptcy not only to restructure their balance sheets, but also to recalibrate their cost structures. Midstream gathering agreements — long-term contracts to transport oil and gas from the wellhead to central facilities by pipeline — are a popular target. Many producers have sought to reject these agreements as uneconomical, typically over the vigorous opposition of their counterparties.

In most contexts, a debtor seeking to reject an executory contract in bankruptcy need only show that it has a good business reason to do so. But midstream companies have a unique defense. Most gathering agreements contain a "dedication" clause that designates the midstream party as the exclusive provider of gathering, transportation and processing services for hydrocarbons produced from leases and wells in a specified area. The contracts typically characterize the provision as a covenant that "runs with the land."

These clauses raise two pivotal questions:

- Do these dedication clauses actually create enforceable covenants that run with the land under state law?
- If so, does the running covenant preclude rejection or just create an *in rem* interest that survives it?

Do 'Dedication' Clauses in Midstream Agreements 'Run With the Land'?

A threshold question is whether dedication clauses are what they purport to be: real covenants or equitable servitudes that "run with the land."

A running covenant is an agreement among real property owners that is deemed to attach to, and "run" with, the land, binding later owners, even if contractual privity is lost. Such covenants originate in contract but acquire *in rem* character only if they satisfy certain requirements prescribed by state law. These vary from state to state, but at common law there are two fundamental elements: The covenant (1) is an element of a contemporaneous real property conveyance between the covenanting parties (denoted "horizontal privity"); and (2) "touches and concerns" the land, meaning, roughly, that it benefits or burdens it.

This threshold question proved fertile ground for litigation during the initial wave of E&P bankruptcies that began in early 2015, but surprisingly yielded only one reported decision until 2019. In that case, the U.S. Court of Appeals for the Second Circuit held that dedication clauses in debtor Sabine Oil & Gas Corp.'s midstream gathering contracts did not create valid running covenants under Texas law. Sabine and its midstream counterparties lacked horizontal privity of estate, because the purported covenants were not part of a conveyance of real property. Moreover, the dedication clauses conferred merely a personal benefit on the pipeline operators, without benefitting the land.

Recent Decisions Provide Some Guidance, But Leave Ample Grounds for Further Dispute

Since late 2019, at least eight similar disputes have been litigated to judgment. These cases reveal no consensus on whether dedication clauses constitute valid running covenants. Some courts have construed the legal prerequisites for such covenants liberally, holding, for instance, that (1) (whether or not part of a conveyance) contractual easements created to facilitate oil and gas gathering create horizontal privity, and (2) a gathering agreement touches and concerns the land by facilitating the production of hydrocarbons and restricting the E&P debtor's ability to procure alternative gathering services.

Other courts, following *Sabine*, have declined to construe the dedication clauses as running covenants. Several have dismissed the relevance of surface easements as proof of horizontal privity, emphasizing that the surface estate and subsurface mineral estate constitute distinct fee simple estates. Likewise, the same courts have carefully distinguished produced hydrocarbons from unproduced reserves, holding that a gathering agreement concerns only the former, which are personal property under state law.

Recent cases have addressed not just the state law nature of the dedications, but the scope of the rejection power in bankruptcy.

Some of these courts have questioned the premise (assumed, but not discussed, in *Sabine*) that a valid running covenant precludes rejection. They emphasize that the dedication clause is but one provision of a larger contract; that the dedication clause runs with the land does not necessarily mean all of the debtor's obligations do. On this view, the question is not whether the debtor can reject its gathering agreement, but whether the contract encompasses any *in rem* interests that survive rejection. On this basis, a bankruptcy court in the Southern District of Texas recently authorized a debtor to reject midstream agreements despite concluding that its dedication clauses ran with the land under state law and thus would survive rejection.

Two recent decisions of bankruptcy judges in the District of Delaware go further, concluding not only that a gathering contract containing a valid running covenant is susceptible to rejection, but that the running covenant itself can be rejected. These decisions reason that, because running covenants arise by contract and are reducible to claims for money damages, they merit no different treatment in bankruptcy than other contractual obligations.

A Consensus That Running Covenants Might Survive But Not Preclude Rejection?

Given the recovery in oil and gas prices, it may be some time before courts take up these issues again. But those planning for the next cycle of distress in the energy sector can draw several tentative conclusions from recent cases.

On one hand, these cases leave important facets of this issue unresolved — in particular, the validity of purported running covenants in midstream gathering agreements under state law.

On the other hand, the cases suggest an emerging consensus that a valid running covenant in a midstream gathering agreement does not preclude its rejection, but instead creates a real property interest that survives rejection. To be sure, the far-reaching conclusion that a valid running covenant can be reduced to a claim for damages and discharged fits uneasily with longstanding case law distinguishing *in personem* claims and *in rem* interests in bankruptcy. This conclusion therefore may not attract widespread support.

But the more modest proposition that a valid running covenant in a midstream agreement survives, but does not preclude, rejection may represent a point of consensus among courts that diverge on other aspects of this controversy.

Unhappy Lenders Challenge Aggressive Debt Exchanges

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Takeaways

- Loan agreement provisions allowing borrowers to repurchase their loans to take advantage of steep debt discounts and restructure their debt became popular in the wake of the financial crisis. The meaning of some common terms in those clauses is now being tested in courts.
- Court decisions so far have varied, but more are expected soon, potentially providing clarity to both lenders and borrowers.
- The disputes, and the prospect that borrowers might be allowed to offer favorable terms to subsets of existing lenders, may prompt additional changes in standard loan agreements.

Most syndicated term loan B credit facilities allow the borrower or its affiliates to purchase loans from lenders on a non-pro rata basis if those transactions are made through either an "open market purchase" or a "Dutch auction."

Such provisions became popular during the Great Recession, when many syndicated loans traded at a discount to par. Before that, borrowers generally could not take advantage of discounted loan prices because most credit agreements either prohibited them from taking assignment of their loans or treated such purchases as a voluntary prepayment required to be allocated pro rata to all lenders.

If, instead, a borrower is permitted to use the "open market purchase" and "Dutch auction" mechanisms provided in many credit agreements to repurchase or exchange loans with a subset of its lenders, it can gain negotiating leverage with the remaining lenders in a restructuring. Borrowers can induce participation in the exchange by offering more favorable terms in the new debt, possibly subordinating the debt held by the nonparticipating lenders, and sometimes also stripping some covenants from the existing loan documents, reducing protections for lenders that do not participate. Those lenders, who often do not receive the repurchase or exchange offer, or were required to commit substantial capital to participate, may view the partial exchanges as coercive.

Absent provisions authorizing limited debt purchases, prepayments must generally be made on a pro rata basis to all lenders at par or, in some cases, a premium. Also, credit agreements often treat the pro rata sharing of payments as a "sacred right," requiring unanimous lender consent, rather than majority, to modify. Debt buybacks through open market purchases or Dutch auctions are exceptions to the pro rata sharing requirement and restrictions on loan assignments to the borrower.

Recently, the meanings of "open market purchase" and "Dutch auction," as those terms are used in the assignment provisions of credit agreements, have been contested in state and federal courts. In those cases, borrowers used these processes to "repurchase" loans from some lenders on a non-pro rata basis in exchange for new superpriority or other favorable debt.

As these can be powerful tools for distressed borrowers, strengthening their hands in dealing with remaining lenders, the decisions in these cases may significantly impact borrowers considering out-of-court restructurings.

Serta Simmons: Challenged but Permitted to Close

On June 8, 2020, Serta Simmons announced its intent to repurchase hundreds of millions of dollars of term loans held by a majority of its first- and second-lien lenders in exchange for new superpriority loans with priority over the existing first- and second-lien debt. A group of nonparticipating lenders sought a preliminary injunction in state court to block the transaction, arguing, in part, that the proposed transaction impermissibly amended the pro rata sharing clause of the existing loan documents.

The court denied the motion, finding the credit agreement "seem[ed] to permit[] the debt-to-debt exchange on a non-pro rata basis as part of an open market transaction." It concluded that, since the amendments did "not affect [plaintiffs'] so-called 'sacred rights' under the Credit Agreement, plaintiffs' consent [did] not appear to be required," and the transaction could go forward.

A second group of nonparticipating lenders brought suit in federal court, arguing the exchange was not an "open market" transaction because the purchase of existing debt (1) did not retire existing loans; instead it exchanged existing loans for new loans; (2) was not priced at market value; and (3) was arranged privately rather than negotiated in an open market. Ultimately, the court dismissed the case on jurisdictional grounds and did not resolve the issue.

TriMark: Resolved Outside of Court

In September 2020, TriMark issued superpriority loans composed of new money "first out" (Tranche A) loans and "second out" (Tranche B) loans exchanged, through an open market purchase, for a portion zof existing loans held by a majority of its first-lien lenders. Some of the nonparticipating lenders sued the borrower, its private equity sponsors and several participating lenders, alleging, as the second group of nonparticipating lenders did in *Serta Simmons*, the transaction was not an "open market purchase" because it (1) did not retire debt; it instead implemented a debt-for-debt exchange; (2) was not priced at market value, but above the existing loans' trading value; and (3) was negotiated privately, rather than in the "open market" on an arm's length basis. The court denied, in part, the defendants' motion to dismiss, finding the original credit agreement could be reasonably read to require the plaintiff lenders' consent for the amendments. One amendment modified the definition of an "open market purchase" to include transactions "below or above par for cash, securities, or any other consideration with one or more lenders that are not made available for participation to all lenders."

On January 7, 2022, TriMark announced that it reached a consensual resolution of the dispute with the nonparticipating lenders. According to a press release, TriMark will exchange "all outstanding First Lien Term Debt on a dollar-for-dollar basis for Tranche B Loans pursuant to the company's Super Senior Credit Agreement. Tranche A Loans outstanding under the Company's Super Senior Credit Agreement will retain their position …, senior to the Tranche B Loans." TriMark expects to complete the transaction by January 31, 2022, after which the court would dismiss the pending litigation.

Boardriders: Challenge Pending

In August 2020, Boardriders contracted with a majority of its first-lien lenders to exchange their existing loans for new superpriority loans. The minority lenders, who did not receive an offer to participate, sought to unwind the transaction. They alleged, similarly to the other challenges described above, the transaction was not an "open market purchase" because it (1) was a debt-for-debt exchange rather than a debt retirement; (2) was priced not at market value, but above the trading value of the existing first-lien loans; and (3) was not a stand-alone transaction, but part of a broader reorganization diverting value from nonparticipating lenders to those participating. As of press time, the defendants' motion to dismiss was pending.

Murray Energy: Heading Toward an Evidentiary Trial

In 2018, Murray Energy Holdings used a modified Dutch auction to exchange new superpriority debt for existing debt held by a majority of its lenders under a 2015 agreement. In Murray's subsequent Chapter 11 case, the agent for the nonparticipating 2015 lenders sought a declaratory judgment that the 2018 transaction was invalid. Among other reasons, the agent argued the mechanism through which Murray repurchased the participating lenders' debt did not qualify as a "modified Dutch auction."

On November 8, 2021, the court denied cross-motions for summary judgment due to conflicting expert testimony on whether the transaction was in fact a modified Dutch auction "as that term is commonly understood in the finance industry." The court said it was unable to determine without a trial "whether a modified Dutch auction requires a range of offer prices or a minimum discount at which the debt will be repurchased," or "whether: (1) the negotiations leading up to the [2018 auction] fulfilled any requirement of a range or minimum discount; (2) the negotiations leading up to the transaction can fulfill the requirement of bidding; and (3) the par-value bid precludes a finding that the [2018 auction] was a modified Dutch auction."

Conclusion

Following the *Serta Simmons* transaction, lenders began insisting that credit agreements include so-called "anti-Serta" provisions to better protect against priming efforts by borrowers and sponsors. That trend, however, appears to be losing steam. A November 2021 *Xtract Research* survey of credit agreements in the large sponsor market in the second and third quarters of 2021 found that agreements with "anti-Serta" provisions decreased 9% between those quarters.

Assuming that the parties in *Boardriders* and *Murray Energy* do not follow the path of *TriMark* and reach out-of-court settlements, the resolution of those cases should help clarify the meaning of an "open market purchase" or "Dutch auction."

NFTs Give Rise to Innovative New Business Models and Revenue Opportunities

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Takeaways

- Most existing agreements covering the exploitation of intellectual property rights did not contemplate how NFTs should be treated.
- Drafting and negotiating agreements involving NFTs requires an understanding of both the underlying technology and business models, and the novel legal issues they present.
- Parties seeking to exploit the potential of NFTs need to consider the growing popularity of decentralized autonomous organizations (DAOs).
- Those marketing NFTs should be careful not to promote them as investments in ways that could run afoul of securities laws.

The dramatic increase in the use and adoption of non-fungible tokens (NFTs) in 2021 can be seen in the wide range of year-end reviews and lists in which they are featured. Rankings of these blockchain-based assets can be found in industries such as marketing/branding, sports, movies and television, music, art, gaming, fintech and cryptocurrencies. The impact of NFTs in these and other sectors is in its nascent stages, and their use and attendant legal issues will only multiply as companies that gave little thought to NFTs at the start of 2021 enter 2022 armed with business plans and NFT divisions.

The Nature of an NFT

An NFT is essentially a digital certificate stored on a blockchain that reflects certain rights, including ownership, associated with an asset — typically, a digital one. The unusual terminology comes from the fact that each NFT is unique, in contrast to other blockchain tokens, such as cryptocurrencies, that are fungible (*e.g.*, every bitcoin is the same, just like every dollar is the same). NFTs can also be associated with physical goods or experiences, acting as a digital password or key to authenticate the NFT owner.

While there is often just one NFT associated with a work, a creator could also make a limited-edition series of NFTs all tied to one work, such as special access to certain videos or music available only to a set of "superfans" who purchased the NFTs. They might also be used to generate tickets to attend an event or access real-world physical assets.

NFTs have been around for about four years, but it was only in 2021 that creators and rights holders began to capitalize on their potential. Today, most NFTs are bought and sold through third-party marketplaces that also provide the technology to mint new NFTs.

NFTs have a number of powerful features allowing for interesting and important innovations in the digital asset space:

- Since they are stored on a blockchain, NFTs are immutable and allow brand owners and creators to sell ownership of an "original" digital work even though that work can be easily replicated.
- Although designated as a token, NFTs are actually pieces of computer code so that, when created (or "minted"), they can be programmed to execute a variety of functions. Most importantly, they can be designed to allocate, efficiently and automatically, any revenue from the initial or secondary sale of an NFT to an unlimited number of stakeholders.
- Since most NFT transfers are recorded on a blockchain, whose transactions are transparent, holders can establish the provenance of a digital asset, and, in cases where one can identify the minting party, the authenticity of the NFT.

Legal Issues Generated by NFTs

A threshold issue for many companies seeking to mint NFTs is whether they have the rights to do so. Not surprisingly, few contracts written before 2021 that allocate rights in intellectual property or publicity rights address the minting of NFTs. Companies are therefore trying to parse contract language and determine, often on a case-by-case basis, whether they alone have the appropriate rights to mint a specific NFT or need a license or consent from other stakeholders. This entails a determination of how an NFT should be characterized under existing contractual provisions. For example, is an NFT a type of merchandise or something different, and what intellectual property rights are needed to mint an NFT (*e.g.*, a derivative work right, a distribution right, a display right, a performance right)?

There have already been two high-profile disputes over just such questions. One pits director Quentin Tarantino against film company Miramax over the former's right to mint NFTs of script pages from his movie "Pulp Fiction." In another, Jay-Z and Damon Dash, co-founders of Roc-A-Fella Records, are in a dispute over Dash's attempt to mint and sell an NFT of his copyright rights to Jay-Z's debut album, "Reasonable Doubt."

We anticipate more such disputes over NFTs as creators, rights holders, and licensees test the interpretation of existing license agreements and the boundaries of their rights. Going forward, parties to new agreements involving the exploitation of intellectual property rights or name, image or likeness (NIL) rights will want explicitly to address which party or parties have the right to mint NFTs.

The minting of NFTs typically involves a collaboration between a traditional rights holder and a company with the technical know-how to write the computer code (or "smart contract") to mint an NFT onto a blockchain and to administer the storage aspects of digital work associated with the NFT (since the digital work itself is typically not stored on a blockchain). Drafting and negotiating these contracts requires a nuanced understanding of the technology and "tokenomics" underlying NFTs, as well as experience with the legal issues such agreements need to cover. For example, parties should address how to unwind a contractual relationship where the NFTs that were minted pursuant to that relationship nonetheless continue to persist on a blockchain.

Issues To Watch For

As NFTs continue to evolve in 2022, we expect to see a variety of new and expanding business models raising other legal issues that companies will need to consider. For example, in the second half of 2021, we saw the formation of an increasing number of decentralized autonomous organizations (DAOs) for the purpose of being involved in the NFT sector. DAOs extend the decentralization ethos underlying cryptocurrencies and decentralized finance to corporate governance, so decision-making authority is not concentrated in a small group such as a corporate board of directors or executive team. Rather, DAO governance is exercised through membership voting managed and recorded on a blockchain through "smart contracts." The legal status of DAOs and how they are organized will continue to evolve in 2022, and stakeholders engaged in the NFT ecosystem will likely need to decide whether and how to contract with them.

This past year also saw some NFT providers create business models that could raise securities law concerns. For example, some projects attached separate coin offerings to their NFT project that closely mirrored the types of "initial coin offerings" (ICOs) that the U.S. Securities and Exchange Commission found violated securities laws in 2017-18 when ICOs were common. Careful consideration should be given to any such coin offerings. In addition, NFT sales should not be promoted or marketed as investment opportunities in a manner that could raise securities law considerations.

Overall, we expect 2022 to be a growth year for NFTs, with the creator class, brand owners and rights holders continuing to innovate — raising novel legal issues along the way.

Litigation

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Issues on the Horizon at the US Supreme Court: 2022 and Beyond

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Takeaways

- Litigants will ask the Court to rule on an array of matters growing out of the COVID-19 pandemic, beyond challenges to the Biden administration's vaccine policies.
- The preemption of state employment laws by industry-specific federal labor laws is already before the Court, and more cases may follow.
- Decisions about the degree to which the federal Communications Decency Act protects social media platforms from state law claims could clarify an uncertain area of the law.
- If crowdfunding of cases designed to make new law catches on, the Court could face any number of novel issues in the coming years.

The Supreme Court's 2021 term is shaping up to be another blockbuster, with guns, abortion, religion and a host of other headline-grabbing issues on the agenda. Although this term has only just begun, it won't be long before the justices start filling next term's docket. And while it's never easy to predict which cases the Court will decide to hear, some key issues percolating in the lower courts may capture the justices' attention. We discuss several areas of the law that might shape headlines for the Court's 2022 term and beyond.

COVID-19 Litigation

The pandemic has spawned no shortage of lawsuits, with nearly 2,100 COVID-related cases filed since March 2020. Most recently, litigation over the Biden administration's vaccine policies has dominated headlines. The Court held oral argument on January 7, 2022, on stay applications in two cases — one challenging the Occupational Safety and Health Administration's COVID-19 Vaccination and Testing Emergency Temporary Standard (ETS), which requires employees of large employers to be vaccinated or regularly tested; and another challenging the Department of Health and Human Services' (HHS) regulation requiring health care workers to be vaccinated against COVID.

Less than a week later, on January 13, 2022, the Court issued its decisions, staying OSHA's ETS but allowing HHS' mandate to take effect for now. But both sharply divided decisions pertain only to the preliminary injunction stage, and the Court will likely be asked to weigh in again on the merits. In the meantime, lower courts are grappling with other COVID-related questions that also may be destined for the Supreme Court.

One issue to watch is whether and how the Worker Adjustment and Retraining Notification (WARN) Act of 1988 applies to pandemic-induced layoffs. The WARN Act bars employers from terminating more than 50 workers en masse without at least two months' notice, except where the layoffs are caused by natural disasters or unforeseen business circumstances. Plaintiffs have filed dozens of WARN Act cases challenging COVID-related layoffs and their claims hinge on the scope of those two exceptions. Several of those cases are now on appeal and, depending on how lower courts rule, may ultimately head to the Supreme Court.

The Supreme Court also may face questions about the meaning and scope of the Public Readiness and Emergency Preparedness (PREP) Act. The PREP Act immunizes from liability manufacturers, distributors and other "covered person[s]" who implement public health "countermeasures." The sole exception to this immunity is for serious injuries or deaths caused by willful misconduct, and the PREP Act requires those claims to be brought in federal court. Nursing homes across the country are facing state law claims brought by the estates of deceased residents alleging that the facilities were negligent in handling COVID-19.

Several nursing homes have sought to remove those suits from state to federal court. They argue that federal jurisdiction is proper because the PREP Act preempts state tort law (such that the plaintiffs' negligence claims can "arise under" only federal law) and, in any event, insulates them from liability. So far, most courts have been skeptical of removal. The Third Circuit recently rejected jurisdiction and remanded a suit for the state court to decide the scope of PREP Act immunity. With similar cases pending nationwide, however, the Supreme Court may be asked to weigh in.

Finally, the pandemic has given rise to hundreds of insurance coverage disputes, with restaurants, retailers, hotels and even sports teams suing over denied claims. But because these cases ultimately hinge on contract interpretation — questions of state law — most are unlikely to make their way to the Supreme Court.

Federal Preemption of State Employment Law

The Supreme Court is already considering whether to hear several questions about whether federal law preempts state employment regulations, including break rules and sick-leave laws. In November, the Court invited the solicitor general to express the United States' views on a petition Skadden filed on behalf of Alaska Airlines and Virgin America (which Alaska Airlines acquired). Alaska and Virgin are urging the Court to hold that the Airline Deregulation Act (ADA) preempts California's meal-and-rest-break laws with respect to flight attendants.

Enacted to preserve free-market forces in the airline industry, the ADA broadly preempts state laws that have a significant impact on airline prices, routes or services. Completely relieving flight attendants of all duties every few hours, as California law requires, would have just such a forbidden impact by disrupting carefully choreographed flight schedules and casting air traffic nationwide into disarray. The United States (which supported Alaska and Virgin in the Ninth Circuit) likely will file its brief on this issue in the Supreme Court by the end of May 2022.

Other pending cert petitions present similar questions, including whether the ADA preempts Washington's paid-sick-leave law. And in the railroad context, the Ninth Circuit will soon consider whether the federal Railroad Unemployment Insurance Act preempts California's sick-leave rules. Meanwhile, the Court recently denied a petition urging it to consider whether per diem allowances for traveling expenses must be included when calculating overtime pay under the Fair Labor Standards Act.

Social Media Liability

In the internet arena, questions are percolating about the extent of liability under the Communications Decency Act (CDA). Section 230 of the CDA provides that social media companies and other web hosts are not liable for content that third parties post on their platforms. But the statute allows states to enforce laws "consistent with" Section 230. And Congress also has clarified that the section does not limit any law "pertaining to intellectual property." Lower courts are wrestling with the interplay between these provisions, which affect the scope and potential liability of web hosts for the content and use of their sites.

A pending cert petition asks the Supreme Court to consider whether Section 230 shields Facebook from state law claims arising from an alleged sex trafficker's use of the social media platform to contact victims. And the Third Circuit recently held that Section 230 does not bar a newscaster's claim that Facebook's and Reddit's sites used her image without consent, reasoning that the claim pertains to intellectual property. If the Supreme Court decides to weigh in on these or other questions about the section's scope, it could provide valuable guidance to web hosts and their users.

Litigation Crowdfunding

In looking at issues that may reach the Supreme Court, it's useful to consider the pipeline of potential lawsuits. One recent phenomenon that could fuel cases destined for the Court is litigation crowdfunding.

Third-party litigation funding has long sparked controversy, and enterprising plaintiffs are devising new tactics in this arena. In a case pending before the Eastern District of California, a hemp grower alleged it lost $1 billion when California unconstitutionally seized its harvest. To finance its suit, the plaintiff announced an "initial litigation offering" — a campaign to raise money from individual investors. The plan works like this: Investors buy crypto-tokens from the plaintiff, which gets 20% of the proceeds up front. The rest is held in escrow. If the case is dismissed with prejudice, the balance is refunded to investors; if it moves to discovery, the balance goes to the plaintiff. And if the plaintiff wins or the case settles, investors could realize up to 350% returns.

If this model gains traction, it could generate more test cases designed to reach the Supreme Court and shape the law. Small-scale investors may be willing to back lawsuits that professional financiers and other traditional gatekeepers find too dubious, risky or unpalatable. Those investors might also be more motivated by particular causes and personal views on key issues, further fueling the possibility of test cases.

While all eyes are currently on the blockbuster cases before the Court in the 2021 term, the justices will have no shortage of important questions to consider in 2022 and beyond. From COVID-19 issues to preemption and social media platforms, there is ample fodder for next term's headlines.

Despite Last Year's Decline in Filings, Securities Litigation Will Likely Pick Up in 2022 Due to Plaintiffs' Continued Focus on SPAC Transactions and Event-Driven Litigation

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Takeaways

- Despite a decline in securities class action filings in 2021, we saw a spike in SPAC-related lawsuits and continued activity in event-driven suits focused on issues of cybersecurity, the pandemic and cryptocurrency — trends we expect to continue in 2022.
- The Supreme Court ruled last year that defendants can introduce all relevant evidence at the class certification stage showing a lack of price impact, imposing new hurdles for plaintiffs, who must now address arguments that the alleged misstatements are too generic to have impacted the share price.
- As more state courts uphold federal forum provisions that require shareholders to file their 1933 Act claims in federal court, corporate defendants could be well positioned to avoid state court forums by including these terms in their charters.

For the second consecutive year, fewer securities class actions were filed in 2021 than in the prior year. However, we anticipate the pace of securities-related litigation to increase in 2022 as plaintiffs' securities firms continue to focus on cryptocurrency, special purpose acquisition company (SPAC) transactions, foreign issuers and so-called event-driven suits. Private litigation also is likely to get a boost as the Securities and Exchange Commission and Department of Justice pursue more aggressive regulatory and enforcement policies. (See "DOJ Steps Up Corporate Criminal Enforcement, Looks More Broadly at Past Misconduct" and "SEC Expected To Introduce Host of New Rules in 2022, Enhance Enforcement.")

As we predicted early last year, suits involving SPACs rose in 2021, with 23 such cases filed through the third quarter, more than three times the total for all of 2020. This trend is likely to accelerate given the Delaware Court of Chancery's decision in *In re MultiPlan Corp. Stockholders Litigation*, which upheld claims for breach of fiduciary duty against a SPAC's sponsor and its directors and held them subject to the entire fairness standard of review where conflicts of interest and misleading disclosures were alleged. (See "Delaware Courts Simplify Rules for Derivative Actions, Analyze SPAC Fiduciary Duty Review and Clarify Books-and-Records Obligations.") The court also allowed the plaintiffs' aiding-and-abetting claim to proceed against the SPAC's financial advisor. Considering the volume of SPAC transactions expected over the next year and the decision's potential to spur additional filings, more SPAC litigation is inevitable.

In a bullish stock market, we expect plaintiffs to rely on short-seller reports to assert claims, and we predict the continued use of the books-and-records statutes in Delaware and other states to obtain information to lay the groundwork for future securities actions.

On the other hand, as more companies add federal forum provisions to their corporate charters, we anticipate a continued decline in the number of parallel state and federal court 1933 Act filings.

Below we discuss select significant decisions and their potential impact on securities litigation in 2022.

Courts May Consider 'All Probative Evidence' at Class Certification in Evaluating Price Impact

In June 2021, the U.S. Supreme Court issued a decision that will continue to make class certification a fertile battleground in many securities lawsuits.

Arkansas Teacher Retirement System held that courts should consider "all probative evidence" at the class certification stage in assessing whether a defendant has rebutted the presumption of classwide reliance recognized in *Basic Inc. v. Levinson*. The fact that the evidence may also be relevant to materiality later, when the claims are addressed on their merits, does not preclude its use in deciding if a class should be certified, the Court held. This includes evidence of the generic or aspirational nature of the alleged misstatements, which can be considered when evaluating price impact evidence.

In *Arkansas Teacher*, the plaintiffs alleged that the defendant investment bank and its executives made false and misleading statements about its conflict of interest policies. The statements allegedly maintained the bank's stock price at an inflated level until purported conflicts came to light.

In opposing class certification, the defendants argued that the alleged misstatements were too generic in nature to have any meaningful effect on the stock's price, defeating *Basic*'s presumption of classwide reliance. The Second Circuit refused to consider evidence of the generic nature of the statements, saying that would "really [be] a means for smuggling materiality into Rule 23," and affirmed the lower court's class certification order.

The Supreme Court reversed and remanded. Clarifying its decisions in *Amgen v. Connecticut Ret. Plans & Trust Funds* and *Halliburton v. Erica P. John Fund* in 2013 and 2014, respectively, the Court said that, because the inflation maintenance theory asserts that a stock's "back-end price drop equals [its] front-end inflation," the "generic nature of a misrepresentation often will be important evidence of a lack of price impact." For instance, it said, "[W]hen the earlier misrepresentation is generic … and the later corrective disclosure is specific … it is less likely that the specific disclosure actually corrected the generic misrepresentation, which means that there is less reason to infer front-end price inflation — that is, price impact — from the back-end price drop."

However, the Court held that defendants bear not only the burden of production, but also the burden of persuasion by a preponderance of the evidence when seeking to rebut the presumption of reliance at the certification stage.

On remand, the Second Circuit vacated the class certification order and remanded the case to the district court, which then certified the class again. Applying the Supreme Court's new guidance, and weighing the parties' opposing expert evidence, it concluded that the "alleged misstatements were not so generic as to diminish their power to maintain pre-existing price inflation" and, therefore, had "some impact" on the price of the defendant's stock.

So, while the price maintenance theory survives another day and defendants now bear the burden of persuasion, the decision affirms an important right for defendants: For certification purposes, they can present all relevant evidence showing the absence of price impact.

State Courts Continue To Uphold Federal Forum Provisions

Last year's decline in filings can be attributed in part to a continued drop-off in the number of federal merger objection lawsuits filed as class actions, which fell to their lowest level since 2014. They had been a major contributor to overall filings since 2016. As *The D&O Diary author Kevin LaCroix noted*, while plaintiffs brought more merger objection suits in federal court in 2021 than in recent years, more were cast as individual rather than class actions. He suggested that this may be to avoid court scrutiny of "mootness fees" — sums corporate defendants pay to plaintiffs' counsel where the company has made supplemental disclosures that moot the plaintiffs' claims and the case is voluntarily dismissed.

Meanwhile, filings of 1933 Act claims in state courts also declined. This is in part due to the growing number of state courts that have enforced federal forum provisions (FFPs) in corporate charters requiring shareholders to bring their 1933 Act claims in federal court. In practice, these address the U.S. Supreme Court's 2018 decision in *Cyan, Inc. v. Beaver County Employees Retirement Fund*, holding that state courts have jurisdiction to hear class actions under the 1933 Act, and that defendants cannot remove such cases to federal court. Last year, courts in New York and Utah upheld corporate charters containing FFPs, joining California and Delaware.

Because New York and California state courts have been forums for 1933 Act claims in recent years, corporations could be well positioned to avoid these forums by including FFPs in their charters. That said, changing the charter often requires shareholder approval, which may not be appropriate or viable in some cases. Since FFPs have not been universally adopted, we expect state court 1933 Act litigation to continue, albeit at lower levels than in previous years.

However, as a cautionary tale, in a January 7, 2022, decision the Seventh Circuit refused to enforce a company's bylaws containing a forum selection clause that required its shareholders to file their federal derivative claims under Section 14(a) of the Exchange Act in the Delaware Court of Chancery.

Because the forum bylaw would "force plaintiff to raise its claims in a Delaware state court, which is not authorized to exercise jurisdiction over Exchange Act claims" the court concluded it would "foreclose entirely plaintiff's derivative action under Section 14(a)." While acknowledging that Delaware law grants corporations "considerable leeway" in drafting their bylaws, the court concluded it "does not empower corporations to use such techniques to opt out of the [Exchange Act of 1934]."

Judge Frank Easterbrook dissented, opining that there was "no problem" with plaintiff litigating its derivative suit alleging Section 14(a) claims in state court. Section 14(a) "does not say one word about enforcement" and its judicially created private right of action permits investors (not issuers) to sue. Because nothing in the bylaw prevents a plaintiff from filing a direct action in federal court, plaintiff has not been "deprived" of any right to enforce Section 14(a). Regarding the Exchange Act's "supposed exclusivity of jurisdiction," Congress has "told us that derivative suits related to securities matters may begin in state court" and "stay there" since these suits cannot be removed. And Section 27(a) of the act does not change this result because derivative suits arise under state law "even if a federal issue may come to the fore" and that section's right to exclusive federal jurisdiction is waivable.

Ninth Circuit's *Pirani* Decision Arguably Creates Split Regarding Section 11 Actions

Ruling on an issue of first impression, the Ninth Circuit held in September 2021 in *Pirani v. Slack Technologies, Inc.* that shareholders have statutory standing to bring claims under Sections 11 and 12(a)(2) of the 1933 Act arising from a direct listing. In its motion to dismiss, Slack argued that Pirani, who purchased shares during the company's direct listing, lacked standing because he could not prove his shares were traceable to the registration statement.

In a 2-1 decision, the Ninth Circuit affirmed the lower court's denial of Slack's motion to dismiss, holding that both the registered and unregistered shares in the direct listing were sufficiently traceable to the registration statement to satisfy the 1933 Act's standing requirements. The court expressed concern that a contrary reading of Section 11 would leave investors without recourse against misrepresentations made in direct listings, undermining its remedial purpose.

But as Judge Eric D. Miller's dissent observed, other circuit courts and prior Ninth Circuit precedent have interpreted Section 11 narrowly, to apply only to securities issued pursuant to a registration statement and directly traceable to that statement.

Slack has filed a petition for rehearing *en banc* and, if unsuccessful, we expect it will file a petition for *certiorari* to the U.S. Supreme Court to address the apparent split in the circuits.

Event-Driven Lawsuits Focused on Issues of Cybersecurity and COVID-19

Keeping with trends from recent years, plaintiffs have continued to file "event-driven" securities class actions, where the catalyst is the disclosure or occurrence of a significant event that negatively impacts the stock price, often unrelated to the company's financial results. This year saw more pandemic-related suits as well as cases stemming from cybersecurity breaches.

Companies have faced an onslaught of cyberattacks, giving rise to suits alleging material misstatements or omissions with respect to the strength of companies' cybersecurity systems. These suits do not appear to have gained much traction and have tended to end in dismissals or settlements. Courts have found that companies' extensive disclosures about the risks of hacking and data breaches were sufficient warning to investors, and that generic statements about the risks were unlikely to be misleading or indicate knowledge of specific, ongoing breaches.

The pandemic continued to drive new filings, as well, with 11 COVID-19-related securities cases through September 30, 2021. Most of the actions filed in 2020 alleged that companies failed to prepare adequately for the effects of a pandemic or overstated their resilience. By contrast, last year brought suits alleging that companies like home exercise and networking businesses overstated the sustainability of their growth during the pandemic, or that pharmaceutical companies overstated the efficacy of their treatments.

These cases demonstrate that companies should continue to pay particular attention to their disclosures that could be affected by COVID-19, as well as its secondary and tertiary impacts (including supply chain, employment and other issues).

In addition, 2021 brought more securities class actions involving cryptocurrencies, where plaintiffs alleged misrepresentations in initial coin offerings or the sale of unregistered securities by token issuers and asset exchanges.

ESG Litigation

Lastly, we note the emerging trend of shareholders using litigation as a tool to further environmental, social and corporate governance (ESG) goals. Securities and Exchange Commission officials have also made it clear they will make ESG disclosures a priority. We expect more ESG-related suits to follow as issuers pay greater attention to these issues and make more statements about their efforts.

Rulings in 2022 Could Bring Clarity on California and Nasdaq Board Diversity Mandates

Contributing Partner

Virginia Milstead / Los Angeles

Takeaways

- A bench trial challenging California's gender mandate for boards on state constitutional grounds is underway, and a similar challenge to the requirement to appoint directors from other underrepresented communities is scheduled for trial in March.
- Suits have been brought in federal court by a shareholder, as well as an association of shareholders and would-be directors, arguing that mandates violate the federal Equal Protection Clause and anti-discrimination laws.
- The SEC's approval of Nasdaq's board diversity rules is at issue in another federal case.

Over the last several years, investors, state legislatures and self-regulatory organizations have taken steps to increase diversity on public company boards. Many of these have been challenged in court. Companies may gain a clearer understanding of their obligations as a number of those cases are resolved in 2022.

Legislative and Regulatory Actions

In September 2018, California became the first state to mandate gender diversity for public companies, requiring those headquartered in California to have at least one woman on their board by 2019 and, depending on the company's size, two or three women by the end of 2021 (Senate Bill or SB 826). That was followed in September 2020 by a similar measure requiring California-based public companies to have at least one director from an "underrepresented community" — defined as "an individual who self-identifies as Black, African American, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian, or Alaska Native, or who self-identifies as gay, lesbian, bisexual, or transgender" — by the end of 2021 and, depending on size, up to three by the end of 2022 (Assembly Bill or AB 979).

Other states, including Maryland, Illinois and New York, have sought to increase diversity not by mandating that companies add women or diverse directors, but by requiring companies to disclose board demographics.

At the national level, in August 2021 the Securities and Exchange Commission approved a new Nasdaq listing rule requiring companies to (1) disclose board-level diversity statistics using a standardized matrix by August 2022 or their next proxy filing and (2) have one "diverse" director by 2023 and two by 2025, or explain why they do not, with "diverse" defined as (1) a director who self-identifies as female; (2) a director who self-identifies with certain underrepresented racial or ethnic minorities; or (3) LGBTQ+. (See our September 28, 2021, client alert "SEC Approves Nasdaq Board Diversity Listing Standards.")

Legal Challenges

Predictably, there have been a number of legal challenges to these provisions. In 2022, we expect the courts to resolve some of them, giving companies greater clarity about their legal obligations to establish more diverse boards.

State court challenges to California laws. On December 1, 2021, a bench trial started in *Crest v. Padilla*, a suit in Los Angeles County Superior Court alleging that SB 826 violates the equal protection clause of California's constitution. We expect a decision in early 2022. A companion suit challenging AB 979, also captioned *Crest v. Padilla*, is set for trial on March 28, 2022, before a different judge of the same court. Although the losing party is likely to appeal, these will likely be the first decisions to address the constitutional merits of the diversity provisions and may provide some guidance to companies subject to the laws.

Federal court challenges to California laws. Meanwhile, two suits claiming the California laws violate the Equal Protection Clause of the U.S. Constitution and federal anti-discrimination statutes are pending in the Eastern District of California.

In *Meland v. Weber*, an action challenging SB 826, the court initially dismissed the complaint, concluding that the plaintiff, a shareholder of a company subject to the law, lacked standing to sue because SB 826 caused him no injury. In June 2021, the U.S. Court of Appeals for the Ninth Circuit reversed that decision, reasoning that the plaintiff alleged he was coerced to vote for a woman candidate in board elections and therefore engage in sex discrimination. The circuit court held that was a sufficient allegation for the complaint to proceed.

Back in the district court, the plaintiff recently moved for a preliminary injunction to stop enforcement of the law. In opposition, the defendant (California Secretary of State Shirley Weber) maintained the constitutionality of SB 826 and reasserted her challenge to the plaintiff's standing. She pointed out that the plaintiff owned a tiny amount of stock in the company at issue — too little to affect the outcome of any director election — and had voted *against* the woman candidate for the past two years, belying his claim that he was coerced to vote *for* a woman candidate.

The court's ruling on the preliminary injunction, which we expect soon, may signal how the court will ultimately decide in the case. But if the court again finds that the plaintiff lacks standing, it will not necessarily address the merits.

Another action, *Alliance for Fair Board Recruitment v. Weber*, is pending before the same judge as the *Meland* matter. The plaintiff — a Texas-based nonprofit with anonymous members who claim to be aspiring directors or shareholders of companies subject to SB 826 and AB 979 — challenges both laws. The parties there have fully briefed a motion to dismiss, and the court has scheduled a hearing for January 11, 2022. Again, California Secretary of State Weber has defended the constitutionality of the laws and challenged the standing of the organization that brought the suit, so, it is not clear if a ruling will address the merits.

Federal court challenge to Nasdaq rule. Finally, in *Alliance for Fair Board Recruitment v. SEC*, the same Texas-based organization that brought the challenge to SB 826 and AB 979, brought a suit directly in the U.S. Court of Appeals for the Fifth Circuit, arguing that the SEC's approval of Nasdaq's rule violated the Equal Protection Clause of the U.S. Constitution and federal anti-discrimination laws. The petitioner in that matter has filed its opening brief, and we expect further briefing and argument to be complete in the next year.

A decision from the Fifth Circuit is possible in 2022, but the timing is difficult to predict. Nasdaq-listed companies may have to comply at least with the board statistics disclosure requirement before the court rules.

Conclusion

To date, companies have had to consider how to address diversity on their boards without a clear answer as to whether the applicable legal requirements will stay in place or be struck down. As courts make decisions in these areas, companies can look forward to greater clarity on that question.

Climate-Related Securities Suits May Increase With New SEC Standards

Contributing Partner

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Takeaways

- The SEC plans to issue new disclosure requirements regarding climate-related risks and opportunities, and the agency's recent actions suggest we have entered a new era of oversight when it comes to climate-related disclosures by public companies.
- Additional SEC disclosure requirements may increase litigation risk, as investors will scrutinize required disclosures along with other statements regarding climate issues, seeking potentially actionable misstatements or omissions.
- Past cases provide insight into how courts might treat future climate-related shareholder suits.
- If a company experiences adverse effects from climate change and a corresponding drop in stock price, federal securities suits may follow.

A New Era of Climate Disclosure Oversight

In 2010, the Securities and Exchange Commission (SEC) provided public companies with interpretive guidance on existing SEC disclosure requirements as they applied to climate change developments. The guidance did not alter disclosure requirements but suggested that, under the existing framework, companies might be required to disclose some climate-related risks and developments.

In March 2021, the SEC announced that, in response to investor demand it had established a task force within its Division of Enforcement whose mandate is to identify gaps in existing SEC disclosure requirements regarding climate and other ESG matters. The SEC also published a corresponding request for comment. Three-fourths of 550 letters subsequently submitted supported mandatory climate disclosure rules.

Then, in July 2021, SEC Chair Gary Gensler gave a speech suggesting that any new climate-related disclosure regulations are likely to be mandatory, noting that "it's with mandatory disclosures that investors can benefit from that consistency and comparability." Chair Gensler also explained that he asked SEC staff "to consider whether these disclosures should be filed in the Form 10-K [annual report], living alongside other information that investors use to make their investment decisions."

The new focus on ESG matters was evident again when, last September, the SEC released a sample comment letter that its staff may send to public companies regarding climate-related disclosures, or the absence thereof, in annual reports. (See our September 22, 2021, client alert "SEC Staff Issues Detailed Form 10-K Comments Regarding Climate-Related Disclosures.") The topics included the differences between the company's corporate social responsibility reports and its SEC filings, material climate-related litigation risks and indirect consequences of climate-related regulation or business trends. Those consequences could include decreased demand for goods and services that produce significant emissions, increased demand for goods that result in lower emissions and reputational risks resulting from operations or products resulting in material emissions, the letter indicated.

Taken together, the SEC's recent actions suggest we may soon enter a potential new era of oversight when it comes to climate-related disclosures by public companies.

The Risk of More Climate-Related Securities Suits

The anticipated SEC rules also raise the prospect of a new wave of federal securities suits by private investors stemming from climate change disclosures. Such lawsuits could be either event-driven (*e.g.*, a drop in the stock price triggered by an adverse event affecting the company due to climate change) or proactive attempts to bring about corporate change through litigation.

Existing case law provides insight into how courts might treat future climate-related shareholder suits.

In re Volkswagen "Clean Diesel" Marketing, Sales Practices, and Products Liability Litigation (N.D. Cal.). Volkswagen bondholders alleged that the company violated securities laws by failing to disclose its emissions fraud. While Volkswagen had made statements in a bond offering memorandum and in corporate social responsibility (CSR) and sustainability reports that certain of its vehicles were environmentally friendly "clean diesel" vehicles, plaintiffs alleged the company had installed a device in those cars allowing them to evade emissions test procedures.

The court rejected the plaintiffs' claims based on the CSR and sustainability reports because the offering memorandum stated that investors should rely only on the information in that memorandum. However, the court allowed claims based on statements in the offering memorandum to proceed. The court noted that certain statements made by the company could lead a reasonable investor to conclude that Volkswagen "was committed to emissions-reducing technology," which could have been misleading.

Ramirez v. Exxon Mobil Corporation (N.D. Tex.). The court denied in large part a motion to dismiss a securities fraud complaint based on statements made by the company in a report titled "Energy and Carbon — Managing the Risks." While the company stated there that it applied a certain proxy cost of carbon in preparing its financials, the plaintiffs alleged that the defendant used a lower proxy cost internally. The court concluded that the plaintiffs had adequately alleged that the company made a material misstatement.

In re Vale S.A. Securities Litigation (E.D.N.Y.). After one of the defendant's dams in Brazil collapsed, plaintiffs alleged the company had made material misrepresentations in public filings and other statements relating to the safety of its dams, its sustainability practices and its compliance with safety standards. In that case, the court cited a sustainability report the company issued in connection with its general practices, and held the plaintiff adequately alleged material and actionable statements in that report because Vale "put the topic [of sustainability and safety] at issue such that [the Court] cannot say that, as a matter of law, investors would not find [certain] representations material."

See "Despite Last Year's Decline in Filings, Securities Litigation Will Likely Pick Up in 2022 Due to Plaintiffs' Continued Focus on SPAC Transactions and Event-Driven Litigation" and "Environmental Groups Have Sued Large German Companies To Reduce Their Products' CO2 Emissions."

Three Ways To Reduce Litigation Risk

In advance of the expected SEC requirements, companies may wish to consider the following actions to reduce litigation risk.

First, they should bear in mind that the new reporting rules may require more specificity as to the effects of climate change on the business's operations and results, which could make it more difficult for companies to argue in litigation that statements are merely aspirational or inactionable "puffery." When characterizing any climate-related information positively, companies should consider disclosure of any contrary material facts.

Second, general statements regarding a company's commitment to net-zero emissions or other climate goals may be deemed "material" to shareholders — at least at the pleading stage of litigation — even if those statements are relatively unspecific. Companies should ensure any forward-looking statements are identified as such and accompanied by adequate cautionary language.

Third, courts and plaintiffs will likely look at sustainability reports issued by the company, and not just SEC filings, as a source of potential alleged misrepresentations. Therefore, companies need to ensure the accuracy of all their statements about climate matters regardless of the document in which the statement appears, in addition to implementing appropriate disclosure controls and procedures regarding sustainability disclosures. (See our June 29, 2021, client alert "Enhancing Disclosure Controls and Procedures Relating to Voluntary Environmental and Social Disclosures.")

Environmental Groups Have Sued Large German Companies To Reduce Their Products' CO_2 Emissions

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Takeaways

- Environmental groups have sued four large German companies, seeking to alter their products and activities to comply with climate goals far stricter than those set by German law.
- The cases derive in part from a decision last year by Germany's Federal Constitutional Court, which found a major environmental statute unconstitutional in part, saying its near-term emissions were too lax, thereby constraining the options of future generations to combat climate change.
- By asking courts to impose the plaintiffs' detailed environmental prescriptions on businesses, the suits present significant separation-of-powers issues.
- The plaintiffs face serious hurdles proving that the defendants contributed significantly to a harm and are in a position to alter overall emissions by others.

Current Environmental Suits: From BMW to Wintershall

Members of environmental groups brought numerous suits last year aiming to set deadlines for companies to cease activities that indirectly or directly create greenhouse gases. In September 2021, members of the German non-governmental organization (NGO) Deutsche Umwelthilfe (Environmental Action Germany) filed lawsuits against BMW and Mercedes, and in November, Greenpeace brought a suit against Volkswagen. All of the suits are seeking court orders for the automotive makers to discontinue worldwide sales of cars with internal combustion engines by 2030 and, in the meantime, to sell only cars emitting up to certain levels of CO_2. Deutsche Umwelthilfe also sued Wintershall Dea, a gas and oil producer, to bar it from developing any new gas and oil fields after 2026. The NGOs aim to use Germany's courts to impose new obligations on domestic companies related to climate change even though the defendants have complied with German law.

These suits differ from another pending climate change litigation: a Peruvian farmer's suit against German utility RWE seeking damages to cover the cost of building a dam to protect his home from potential flooding from a glacial lake. He contends that RWE should bear 0.47% of his construction costs because this allegedly corresponds to RWE's share of global greenhouse gas emissions since the beginning of industrialization.

Federal Constitutional Court Laid the Ground for Private Climate Suits

A Dutch court decision in 2021 ordering Royal Dutch Shell to reduce CO_2 emissions was one model for the German cases. However, the German suits draw directly from a March 2021 ruling of Germany's Federal Constitutional Court that found parts of the Federal Climate Change Act (the Act) unconstitutional on the ground that its emissions standards did not adequately protect the rights of future generations. The climate-related suits attempt to apply that ruling to private civil suits against corporations.

The court used the CO_2 budget approach followed by the United Nations' Intergovernmental Panel on Climate Change and the German Advisory Council on the Environment, which caps CO_2 contributions over time based on the maximum permissible temperature threshold of the Paris Climate Accords. The court found that the national residual budget of 6.7 gigatons left in 2020 will be nearly completely depleted by 2030 at the rate of emissions permitted under the Act. On that basis, the court voiced serious concerns about the constitutionality of the CO_2 emissions allowed until 2030 because it permitted too much CO_2 to be emitted in this decade, creating an irreversible threat that would restrict the constitutionally protected freedoms of future generations. The court only refrained from a constitutional ruling on the effectiveness of the law's requirements for this time period because of the uncertainties inherent in the calculation of the residual budget, but it expressly reserved the right to demand even more strict reductions from legislators.

The court found that CO_2 reductions after 2030 were insufficiently regulated by the legislation and thus unconstitutional. In response to the ruling, legislators bolstered the Climate Protection Act comprehensively.

Suits May Conflict With Separation of Powers

Deutsche Umwelthilfe and Greenpeace's claims are based on the emissions budget approach applied by the court. The plaintiffs calculated a residual CO_2 budget for German automakers.

However, by calling on the courts to order selected enterprises to restrict their sales or other activities, the suits raise serious issues about the separation of powers. If legislation to fight climate change is found to be insufficient, it is the legislator's responsibility to amend it.

In fact, a ruling by the Federal Constitutional Court in a similar situation cited the separation of powers. In light of the extensive effects of nuclear power on citizens, nuclear energy policy was a fundamental issue that could only be addressed by the legislature, the court said. The same must be true for weighing constitutional rights in the context of the fight against climate change.

Proving Causation and Defendants' Control Over the Nuisance May Pose a Challenge

The environmental suits will likely also have a difficult time satisfying basic civil law principles, and causality, in particular.

The cases against BMW, Mercedes, Volkswagen and Wintershall Dea, like the lawsuit against RWE, are based on the protection under civil law of absolute rights such as life, property, health and privacy. German law requires that the person against whom the claim is asserted must be a "disruptor" (*Störer*). In the current cases, this can only be a person who (a) sufficiently causes the nuisance directly or — in the case of vehicle emissions — indirectly through third parties and (b) is able to prevent such disruptions.

The plaintiffs must prove that, but for the contribution of these companies, the threatened disruption would not exist.

In light of the amount of global emissions, the comparatively infinitesimal contributions of the defendants to total emissions, as well as other factors such as the storage of CO_2, it is questionable whether the plaintiffs can prove causation.

The second aspect, the controllability of the nuisance, is also highly questionable here. For instance, automakers are unable to control emissions from vehicles already sold. That is only within the power of car owners. Moreover, imposing restrictions on the three defendant automakers might merely cause consumers to buy from other manufacturers.

Finally, the plaintiffs' calculations do not consider the effects of disproportionate CO_2 savings in other sectors, because they cannot forecast technical progress in the reduction of CO_2 many years into the future. Additionally, the calculation rests on a fixed allocation of the CO_2 budget to various industries.

Outlook for Potential Litigation

Deutsche Umwelthilfe declared that it selected the defendants because (a) they are among the largest corporations in Germany, (b) they are active on a global scale and (c) they allegedly have not provided any (or sufficient) statements as to how they intend to adjust their activities to adequately protect the climate and individuals' constitutional rights.

The environmental suits filed to date are focused on the transportation sector, which undoubtedly causes CO_2 emissions on a large scale. However, according to the German Federal Ministry for the Environment, transportation's contribution is significantly smaller than that of energy and industry, and the building sector contributes nearly as much as transportation. This suggests that large Germany-based corporations from these other sectors — as well as the banks financing them — may soon find themselves facing similar suits.

See "Climate-Related Securities Suits May Increase With New SEC Standards."

What Is the Future for Opt-Out Class Actions in the UK After *Lloyd v Google*?

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Takeaways

- The U.K. Supreme Court, in its much-anticipated decision in *Lloyd v Google*, held that "opt-out" representative (class) actions cannot proceed unless the plaintiff proves material damage and shows that each class member is seeking the same compensation.
- The unanimous judgment limits the potential for *in terrorem* claims involving significant sums that create settlement pressure.
- Representative actions remain viable, however, where harm is quantifiable on a common basis across the class, *i.e.*, where monetary loss need not be assessed on an individualized basis.
- Antitrust "opt-out" class actions, which are expressly provided for by statute, are not affected by *Lloyd*, and have gained momentum following the Supreme Court's landmark judgment in *Merricks v Mastercard* in late 2020.

The class action landscape in the U.K. is quickly evolving, with the availability of "opt-out" class actions taking center stage. *Lloyd v Google*, the latest landmark judgment from the U.K. Supreme Court (UKSC), serves as a reminder of the hurdles plaintiffs face in bringing opt-out representative actions, the U.K.'s primary counterpart to American class actions. However, the *Lloyd* judgment has left the door open for such actions where damages can be quantified on a common basis across the putative class members.

Background: Data Protection Claims and Representative Actions

In the U.K., increased regulatory enforcement of data protection obligations has not been accompanied by successful "opt-out" representative class actions arising from breaches of the Data Protection Act 1998 (DPA 1998). The courts have not yet been asked to adjudicate representative actions under the Data Protection Act 2018 (DPA 2018, successor to the DPA 1998) or the U.K. General Data Protection Regulation (UK GDPR).

Representative actions under U.K. civil procedure rules (CPR 19.6) may be pursued on an opt-out basis, meaning that the claim is brought on behalf of every individual falling within the class unless they expressly opt out. Framed this way, with classes defined very broadly, the potential damages can be enormous, generating significant pressure on defendants to settle.

In *Lloyd v Google*, Richard Lloyd brought a representative action on behalf of over four million data subjects, seeking damages for an alleged breach of data protection law. Mr. Lloyd claimed that, by placing a "Safari workaround" on iPhones, Google was able to track users' data without their knowledge or consent and create user profiles for targeting advertising. Mr. Lloyd sought a uniform amount of approximately £750 in damages for each class member — over £3 billion in total.

Under CPR 19.6, a representative action cannot be brought unless all class members share the "same interest" in the claim. Given the facts of *Lloyd*, any claim for personal distress or pecuniary loss would have been inherently individual. Therefore, Mr. Lloyd sought damages for loss of control over personal data, contending that each class member had suffered this damage equally, with the quantum based on the lowest common denominator of damage across the class.

Google prevailed in the High Court, but the decision there was overturned in the Court of Appeal. When that decision was appealed, the UKSC was required to decide two principal issues:

- whether damages could be recovered under the DPA 1998 for loss of control of personal data, even if no material damage had been proven; and
- whether each class member had the "same interest" in the claim.

On the first issue, the UKSC decided damages could not be awarded purely for the loss of control of personal data, as explained in our November 2021 *Privacy & Cybersecurity Update*. Below, we discuss the "same interest" issue.

No 'Same Interest' Where Damages Must Be Calculated on an Individual Basis

The UKSC unanimously found that the class members did not have the "same interest" in the claim. The Safari workaround's impact was not uniform because the plaintiffs were profiled to differing extents, based on various aspects of their personal data, depending on their use of Safari. Damages could therefore only be calculated on an individualized basis, and therefore the "same interest" requirement was not met. The argument that each user had suffered a lowest common denominator of damage was rejected, too, on the grounds that this level of damage would be trivial.

The UKSC accepted that representative actions may be appropriate where all class members have suffered equal damage — for instance, where each class member is wrongly charged a fixed fee or suffers an identical reduction in value arising from the same defect in a product. Furthermore, the UKSC confirmed that representative actions may be viable where damages can be ascertained on a top-down basis (*i.e*., without needing to evaluate the losses suffered by individual class members). Alternatively, proceedings could be brought on a bifurcated basis: a representative action seeking a declaration of breach, followed by individual claims for compensation, relying on the declaration.

The Implications of *Lloyd*

- The judgment restricts the availability of "opt-out" class actions, which now appear to be limited to antitrust claims or claims where individualized assessments of loss are not necessary. While the findings in *Lloyd* were expressly confined to the DPA 1998 and are therefore untested against the DPA 2018 and UK GDPR, the decision made clear that it will be difficult to bring representative actions for breaches of any such laws.
- To the extent that class members have suffered universal losses, or their losses need not be calculated on an individualized basis, representative actions may still be brought. Hence, there is some potential for *in terrorem* suits alleging significant sums in damages.
- While *Lloyd* leaves open the possibility of bifurcated proceedings where individualized assessments of harm are necessary — with liability established as a preliminary step and individuals' damages then proven separately — such proceedings face major hurdles, not least because of the economics of litigation funding. Such financing is integral to representative actions, and funders require the prospect of a monetary award in order to obtain a return on their investment. In bifurcated proceedings, the first stage — seeking a declaration of breach — would not generate any monetary award. The second stage may generate such awards, but requires individual claims for relatively small sums. That may be uneconomical and would make it very difficult to forecast at the outset how much could ultimately be sought and awarded. For litigation funders, who must underwrite the litigation costs and potentially pay the defendants' expenses if the suit fails, bifurcated proceedings may be commercially unattractive, perhaps even prohibitively so.
- Claimant law firms and litigation funders may still pursue group litigation claims under CPR 19.11, where class members need only show that their claims give rise to common or related issues of fact or law. However, such claims can only be brought on an "opt-in" basis, where class members must affirmatively choose to participate. Absent a large class opting in (which has been rare), these may not be commercially viable, either.
- Finally, the UKSC's 2021 ruling in *Merricks v Mastercard* provided a strong endorsement for antitrust cases, where collective actions are expressly provided for by statute. In *Merricks*, the UKSC considered the claims suitable for collective proceedings, finding that it was relatively more appropriate to litigate the claim collectively rather than individually. These collective proceedings may be brought by businesses or consumers, on either an opt-out or opt-in basis. (See our January 7, 2021, client alert "*Merricks v Mastercard* — UK Supreme Court Clarifies Low Bar for Class Action Certification.").

Courts Weigh ERISA Fiduciary Duty Pleading Standards and Limit Arbitration Clauses

Takeaways

- The Supreme Court heard arguments in December 2021 in a case that could raise the bar for pleading ERISA fiduciary claims.
- A split developed in the circuits in 2021 on the arbitrability of ERISA claims, with two courts diverging from what had been a consensus view.
- To gain evidence that retirement plan fiduciaries paid excessive fees, plaintiffs in a California case successfully sought discovery from a third-party plan about the fees it paid, raising the prospect that other plan administrators may face subpoenas in cases to which they are not parties.

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Putative class actions brought under the Employee Retirement Income Security Act (ERISA) alleging breaches of fiduciary duties continued to proliferate in the past two years. More than 200 such cases were filed in 2020, an 80% increase from 2019 and double the number in 2018. This trend continued in 2021, with hundreds of new ERISA suits cast as class actions. Plaintiffs are testing new legal theories, and parties are battling over discovery tactics and arbitrability. Meanwhile, a case now before the U.S. Supreme Court is being closely watched.

The Supreme Court Reviews Pleading Standards

The upcoming ruling in the Supreme Court case *Hughes v. Northwestern University* could change the ERISA fiduciary litigation landscape for years to come. The complaint, a putative class action, alleges that fiduciaries of two retirement plans breached their duties in connection with the plans' recordkeeping and investment fees by (1) allowing participants to pay excessive recordkeeping fees to multiple service providers and (2) offering expensive and duplicative investment options when alternative lower-cost options were available.

The suit, originally captioned *Divane v. Northwestern University*, was dismissed in the Northern District of Illinois, and the Seventh Circuit affirmed, holding that there was nothing wrong with paying recordkeeping fees as a component of a fund's expense ratio, and that the plaintiffs failed to identify an alternative entity that would have accepted a lower fee while providing high-quality services. The Seventh Circuit also observed that Northwestern's plans "offered hundreds of options," including low-cost options, "making a claim of imprudence less plausible."

The Supreme Court granted a writ of *certiorari* in July 2021 to address the pleading standards for ERISA breach of fiduciary duty actions. Before the high court, the plaintiffs argued that affirming the dismissal would make it "extremely difficult for ERISA participants to bring a lawsuit for imprudence in incurring excessive fees."

Northwestern countered that the plaintiffs' position "would expose nearly all fiduciaries to the threat of damages litigation" because "[a]llegations that a fiduciary breached its duty because of marginal cost differences in isolated investments are easy to make and costly to litigate." Reversing the dismissal would "thrust the federal courts into the role of rate-setters and investment pickers," the university contended.

Oral arguments were heard on December 6, 2021, and the Court is expected to issue a ruling by June 2022. Affirming the dismissal would indeed make it more difficult for plaintiffs to successfully pursue ERISA claims and would likely curb nuisance suits, at least in the short term.

Circuit Court Rulings Cast New Doubt on Arbitrability of ERISA Claims

Prior to 2021, the prevailing view — most recently articulated by the Ninth Circuit in *Dorman v. Charles Schwab Corp.*, and currently being tested by the Sixth Circuit in *Hawkins v. Cintas Corps.* — was that defendants could compel arbitration of ERISA fiduciary breach claims where plan documents contained arbitration provisions, but not where such clauses were contained only in plaintiffs' individual employment agreements. However, two recent appellate decisions have chipped away at this rule.

In *Cooper v. Ruane Cunniff & Goldfarb Inc.*, a retirement plan's investment adviser moved to compel arbitration of a plan participant's federal claim based on his agreement to arbitrate claims "relating to employment." The Second Circuit held that the arbitration provision did not "encompass the claims for breach of fiduciary duty" and determined that the plaintiff's ERISA claims did not "relate to" his employment because they did not "involve facts particular to an individual plaintiff's own employment."

While the outcome was consistent with the Ninth Circuit rule — the arbitration clause in an employment agreement would not be enforced where ERISA fiduciary breach claims were involved — *Cooper* broke new ground in finding that ERISA fiduciary breach claims were not employment-related.

The Seventh Circuit further undermined ERISA fiduciary breach arbitration in *Smith v. Board of Dir. of Triad Manufacturing, Inc.* There, retirement plan documents contained a provision requiring participants to arbitrate ERISA claims and precluding the award of non-individualized, plan-wide relief. The Seventh Circuit held that, while the clause was part of the plan documentation, it was unenforceable because a prohibition of plan-wide relief was incompatible with ERISA's broad statutory remedies.

Cooper potentially precludes defendants from utilizing individual employment contracts to compel arbitration of plan-wide claims, and *Smith* casts doubt on plan-wide arbitration provisions mandating individualized relief. Both rulings may curb the arbitration of ERISA class actions.

With these two rulings departing from the Ninth Circuit view, and the Sixth Circuit also poised to rule on the issue, the viability of arbitration clauses may soon find its way to the Supreme Court. For now, retirement plan administrators and fiduciaries should be alert to the diverging rulings when evaluating whether and how to draft and enforce arbitration provisions.

ERISA Plaintiffs Allowed Discovery From Unrelated Third Parties

Recently, in *Munro v. University of Southern California,* the U.S. District Court for the Central District of California allowed the plaintiffs in an ERISA fiduciary case to obtain discovery from an unrelated third party concerning the recordkeeping fees it paid.

The plaintiffs alleged that fiduciaries of two University of Southern California retirement plans breached their duties by, among other things, allowing participants to pay excessive recordkeeping fees. To help prove their case, the plaintiffs subpoenaed records from a plan at the California Institute of Technology (Caltech) that the plaintiffs asserted was similar. Caltech objected, noting that the size of the two universities' plans was quite different. It also charged that plaintiffs' counsel was actually gathering information that could be used to initiate an ERISA suit against Caltech.

The plaintiffs' counsel denied those assertions, and the court held that the discovery was relevant and proportional to the needs of the case. In response to "Caltech's suspicions" about the counsel's motives, the court imposed an additional protective order prohibiting counsel from using the discovery "for any purpose other than the litigation of this action."

Following the success of the plaintiffs' strategy, it is likely that other plan administrators will become involuntary fact witnesses in cases against their peers or competitors.

Delaware Courts Simplify Rules for Derivative Actions, Analyze SPAC Fiduciary Duty Review and Clarify Books-and-Records Obligations

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Takeaways

- The Delaware Supreme Court simplified the pleadings-stage test applied to derivative suits where no demand has first been made on the board.
- Disputes about stockholder books-and-records requests focus increasingly on whether companies must provide documents beyond formal board records.
- In two cases, the Court of Chancery found it reasonably conceivable that companies had not followed the test laid out in the Delaware Supreme Court's decision in *MFW* to ensure negotiations over a transaction involving a controlling stockholder are overseen by an independent committee and subject to a minority vote from the first substantive talks.
- The Court of Chancery held that public SPAC stockholders could bring direct claims for breach of fiduciary duty against a SPAC sponsor and directors involving misleading proxy information regarding a merger, and that standard SPAC structuring may lead to an "entire fairness" review.

Delaware's business courts continued to operate largely unaffected by the pandemic in 2021 and issued several notable decisions. Here is what we saw last year and what we are watching for in 2022.

Delaware Supreme Court Simplifies Derivative Litigation

In two decisions in 2021, the Delaware Supreme Court (1) simplified the demand standard for derivative cases and (2) overruled prior case law that allowed for certain claims to confer both direct and derivative standing.

Demand futility. *In United Food and Commercial Workers Union and Participating Food Industry Employers Tri-State Pension Fund v. Zuckerberg (Zuckerberg)*, the Delaware Supreme Court adopted a three-part "universal test" for evaluating whether a stockholder can bring a derivative lawsuit without first making a litigation demand on the board. While taking care not to overrule 40 years of precedent, it blended the tests set forth in the seminal cases *Aronson v. Lewis* and *Rales v. Blasband* and held that a demand will be deemed futile where at least half of the directors of a corporation:

- "received a material personal benefit from the alleged misconduct that is the subject of the litigation demand";
- faced "a substantial likelihood of liability on any of the claims that are the subject of the litigation demand"; or
- are not independent of another director "who received a material personal benefit from the alleged misconduct that is the subject of the litigation demand or who would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand."

While this new test simplifies the questions for litigants and the courts, we expect the Delaware courts will continue to refine its application in 2022.

Transactions with controlling stockholders. In *Brookfield Asset Management, Inc. v. Rosson*, the Delaware Supreme Court overruled *Gentile v. Rossette*, bringing more clarity to a confusing area of the law that had been long criticized.

Under *Gentile*, if a controlling stockholder was alleged to have caused a company to issue shares and overpay for an asset owned by the controller

— thereby transferring both economic value and voting power from minority stockholders to the controller — such a claim could be considered both "direct" and "derivative," allowing stockholders to bring lawsuits challenging the transaction without first making a demand on the board or adequately pleading why demand would be futile.

By overruling *Gentile*, the court removed an exception to the general rule that overpayment claims are "quintessential derivative claims." We will be watching in 2022 to see if plaintiffs attempt to find new and creative ways to avoid the demand futility pleading requirements under *Zuckerberg*.

Court of Chancery Continues To Grapple With Books-and-Records Requests

In several recent cases, including the Delaware Supreme Court's 2020 *AmerisourceBergen Corp. v. Lebanon County Employees' Retirement Fund and Teamsters Local 443 Health Services & Insurance Plan*, the state's courts have made clear they will not tolerate substantive defenses and overly aggressive litigation in response to a stockholder books-and-records demand made for a well-established proper purpose.

Not surprisingly, in 2021 litigants and the courts shifted focus to scope-related issues, such as when stockholders are entitled to records beyond formal board-level materials.

In 2019, in *KT4 Partners LLC v. Palantir Technologies Inc. (Palantir),* the Delaware Supreme Court held that, while the default scope for books-and-records actions should be production of formal board materials, courts can require additional records. These can include electronic communications, if the corporation "conduct[s] formal corporate business largely through informal electronic communications" so that board-level materials do not provide stockholders with the information they are entitled to by statute.

Two cases in 2021 tested the limits of that holding — one where the company was ordered to turn over other types of documents and communications, and one restricting the demand to formal board records.

- In *Employees' Retirement System of Rhode Island v. Facebook, Inc.*, a Facebook stockholder sought books and records related to an investigation by the Federal Trade Commission (FTC) into a data breach and whether the company had overpaid in agreeing to a record-breaking $5 billion settlement with the agency in order to shield its CEO from personal liability. Even though Facebook produced more than 30,000 pages of board-level records in response to the stockholder's demand, the Court of Chancery granted the plaintiff additional records because the materials produced offered "only a basic outline of the Board's process and the resulting negotiations with the FTC leading to the 2019 Settlement." Thus, the court concluded that "if such information exists, it will be in the nonprivileged electronic communications."
- In contrast, in *Jacob v. Bloom Energy Corp.*, the Court of Chancery denied access to materials beyond formal board presentations and minutes where stockholders submitted a demand after a short-seller alleged in a report that the company had misrepresented its financials. The court held that the plaintiffs had failed to meet their burden to show that anything other than formal board materials were necessary and essential for their stated investigatory purpose.

We expect the case law to continue to evolve in 2022 as plaintiffs seek additional avenues to obtain records beyond formal board materials.

A Resurgence of Deal Litigation

After a dip in 2020, 2021 (and January 2022) saw a resurgence of deal litigation touching on several areas of Delaware law, including the interpretation of *Corwin v. KKR Financial Holdings LLC, Kahn v. M&F Worldwide Corp. (MFW)*, and issues of first impression applying Delaware fiduciary duty law to SPAC transactions.

***Corwin*/officer liability under *Revlon*.** In *Firefighters' Pension System of the City of Kansas City, Missouri Trust v. Presidio, Inc.*, the Court of Chancery dismissed claims against directors of Presidio, Inc. and its controlling stockholder arising out of the company's sale, while sustaining breach of fiduciary duty claims related to so-called "*Revlon* duties" against Presidio's chairman/CEO, and aiding-and-abetting claims against the buyer and Presidio's financial advisor.

The court credited allegations that the CEO favored the buyer because it would retain him in his position and allow him to roll over equity. In addition, the court credited allegations that Presidio's financial advisor "tipped" the buyer about a competing offer, and the buyer used that information to prevail in the negotiations.

The court also held that the failure to disclose the "tip" to stockholders precluded dismissal of the viable fiduciary duty and aiding-and-abetting claims under the *Corwin* cleansing doctrine. By contrast, in *Kihm v. Mott*, the Court of Chancery dismissed Revlon duty claims against directors and officers under the *Corwin* doctrine where the plaintiff's primary alleged disclosure deficiencies were the failure to disclose (1) slightly higher projections for the target company and (2) analyses by the target's banker of other strategic alternatives.

***MFW* criteria.** Two recent rulings denying motions to dismiss provide additional guidance for directors, officers and advisers attempting to comply with the criteria set forth by the Delaware Supreme Court's 2014 decision in *MFW* in conflicted controller transactions.

- In *In re Pivotal Software, Inc. Stockholders' Litigation*, the Court of Chancery held that negotiations failed to satisfy the "ab initio" requirement of *MFW*, which requires irrevocable commitment to *MFW*'s procedural conditions, including establishment of an independent committee and minority vote approval, before the first substantive economic negotiations occur in a transaction. While the initial offer in *Pivotal* was conditioned on the satisfaction of the *MFW* requirements, allegations of months of diligence between the two companies prior to that offer "support[ed] a reasonable inference that substantive economic discussions or negotiations between [buyer] and Pivotal occurred before [the first offer]."
- *In The MH Haberkorn 2006 Trust v. Empire Resorts, Inc.*, the Court of Chancery held that negotiations failed to satisfy the requirement to condition negotiations "irrevocably" on compliance with *MFW*. In *Haberkorn*, the *MFW* requirements were enshrined in a letter agreement between buyer and seller. However, the relevant terms of the letter agreement were scheduled to expire in February 2020. The court held that, even though the parties negotiated the deal in 2019, when the *MFW* requirements identified in the letter agreement were indisputably applicable, the buyer's refusal to commit to honoring the *MFW* terms past February 2020 precluded dismissal at the pleadings stage because the expiring conditions did not "mitigate concerns of retribution" by the controlling stockholder in the event its offer was rebuked.

SPAC litigation. In the first Delaware case analyzing the intersection of fiduciary duty principles and SPACs, on January 3, 2022, the Court of Chancery denied a motion to dismiss a complaint *In re MultiPlan Corp. Stockholders Litigation*, allowing claims for breach of fiduciary duty to survive against a SPAC's sponsor and its directors and officers.

The plaintiffs alleged that the sponsor-controller (which was controlled by the CEO of the SPAC), as well as the directors and officers of the SPAC, breached their fiduciary duties to public stockholders by issuing a materially misleading proxy statement in connection with a proposed merger with MultiPlan. That allegedly impaired the public stockholders' ability to make an informed determination of whether to redeem their shares under the SPAC's charter or to own shares in the post-merger entity.

Under "well-worn fiduciary duty principles," the court found that public stockholders could bring such claims directly. It also held that dual class structure of the SPAC — which provided its sponsor and directors with a separate class of "founder" shares — made it reasonably conceivable that the sponsor and directors had "misaligned incentives" because they would profit in a merger even if the transaction were unfair to public stockholders. Thus, the court held that the stringent entire fairness standard of review applied to the plaintiffs' fiduciary duty claims. However, the court expressly stated that it was not addressing a scenario "where the disclosure is adequate and the allegations rest solely on the premise that fiduciaries were necessarily interested given the SPAC's structure."

In 2022, we expect deal litigation to continue to increase as M&A activity remains heavy, and we expect that plaintiffs will continue to aggressively assert claims against officers and use books-and-records actions and increasingly creative arguments to attempt to avoid dispositive motions under *Corwin* and *MFW*. Furthermore, it remains to be seen how the *MultiPlan* decision will be applied to other SPACs, or if it will give rise to additional SPAC litigation, including in situations where plaintiffs cannot allege a material disclosure claim.

See "Despite Last Year's Decline in Filings, Securities Litigation Will Likely Pick Up in 2022 Due to Plaintiffs' Continued Focus on SPAC Transactions and Event-Driven Litigation."

Supreme Court Opens Door for Assignors To Challenge Patent Validity

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Takeaways

- *Minerva Surgical v. Hologic* limits the application of assignor estoppel, which bars inventor-assignors from challenging patents they obtained.
- If a buyer-assignee later expands the scope of its claim, under *Minerva Surgical* that may allow the assignor-seller to challenge the patent's validity.
- In light of *Minerva*, parties that assign or acquire patent rights may need to review their documentation, reconsider blanket assignments covering multiple patents and revise representation language.
- Patent owners faced with a validity challenge from an inventor may consider proceedings before the U.S. Patent and Trademark Office, where assignor estoppel can still be asserted.

Concerns about employee mobility have prompted companies to carefully scrutinize their intellectual property and information security policies. This has been particularly important at startups, where entrepreneur-founders are frequently the chief innovators and often leave to pursue competitive ventures. Typically, businesses have focused their attention on protecting trade secrets and other inchoate forms of IP, while continuing to rely on largely boilerplate documentation for patent assignments.

But a June 2021 Supreme Court decision adds patent rights to the list of concerns associated with incoming and outgoing employees.

How Assignor Estoppel Works

For nearly 100 years, Supreme Court law has recognized a common sense equitable rule governing the sale of patent rights called assignor estoppel. It prevents the seller (assignor) of a patent from later claiming it is invalid. This doctrine is grounded in simple fairness: If you represent that something has value when selling it, you cannot later assert that what you sold is worthless.

The following scenarios, based on actual cases, illustrate circumstances in which assignor estoppel would apply:

- Company A sells a patent to Company B. The named inventor moves from Company A to Company C, where he helps develop a competing product. Company B brings an infringement action against Company C and the inventor, who is then precluded from claiming the patent is invalid.
- An inventor misrepresents or conceals facts when selling her patent, and the buyer relies on the statements or omissions. The inventor then tries to claim the patent is invalid, based on the true facts she misrepresented or concealed. Assignor estoppel would prevent her from contesting validity.

In practice, the circumstances in which assignor estoppel is invoked are rarely this cut and dried, and the result of categorically applying it is not always equitable. In particular, it can be unfair where the seller could not foresee what would become of the applications under a new owner. The assignor's representations may not have been boundless, and the buyer's view of the patent's scope may be more expansive.

The Facts and Rationale of *Minerva Surgical v. Hologic*

Just such a complex scenario came before the Supreme Court in *Minerva Surgical, Inc. v. Hologic, Inc.* Its decision, handed down June 29, 2021, clarified the limits of assignor estoppel.

Through a series of sales, the founder of Minerva Surgical, Inc. assigned all patent rights in a device that treats abnormal uterine bleeding to Hologic, Inc. The instrument includes an applicator with a moisture-permeable head. Years after assigning the rights to Hologic, the Minerva founder developed another device to treat abnormal uterine bleeding, this time using an applicator with a moisture-*im*permeable head.

Aware of Minerva's new device, Hologic procured a continuation patent with claims encompassing all applicator heads, regardless of moisture permeability. Hologic then brought an infringement suit against Minerva, which countered that the continuation patent was invalid because the broadened claims do not match the invention's description, which only addressed moisture permeability. Hologic claimed that Minerva could not raise a patent invalidity defense due to the doctrine of assignor estoppel.

The Supreme Court concluded that, if the new claims are materially broader than the ones that were assigned, Minerva is not estopped from raising an invalidity defense. Assignor estoppel applies only when an assignor's contention that a patent is invalid contradicts implicit or explicit representations made during the patent's assignment.

Implications of *Minerva Surgical*

The decision casts doubt on the viability of assignor estoppel where a blanket assignment of future inventions has been granted, especially when there is a change in law after the sale or a material expansion in the scope of the patent claims.

Narrowing the doctrine's scope significantly affects assignors and assignees alike, as the blanket assignment at issue in *Minerva Surgical* was similar to standard patent assignment forms used by countless companies around the world. The following are key issues to be considered in the wake of the ruling.

- Assignees should be cognizant that adding or modifying claims to make them materially broader than what was originally assigned could result in the patent being vulnerable to invalidity challenges by the assignor. Assignees may be able to mitigate this effect by obtaining explicit representations of validity when the assignment is made, and even requiring subsequent confirmations upon issuance of later applications.
- Assignors and assignees should both be aware that any representations made during the assignment process may affect the availability of assignor estoppel in the event of a later dispute.
- Companies may want to include express provisions in employment agreements preventing inventors from later challenging the validity of an assigned patent or patent application, especially to bar challenges in the U.S. Patent and Trademark Office.
- Assignment agreements should be very explicit and specific as to the representations made, and should be narrowly tailored to each patent. Avoid blanket assignments for several patents.
- Assignor estoppel does not apply in post-grant proceedings in the U.S. Patent and Trademark Office, so such reviews may provide assignees an alternative forum in which to assert invalidity.

The Pandemic Brought Some Welcome Innovations to the Justice Process, but Also Many New Challenges

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Takeaways

- Courts and litigators have become increasingly comfortable with remote proceedings, and they are likely to be used more frequently after the pandemic subsides than they were before.
- Where jurors participate remotely, it can be challenging to keep their attention and maintain communication.
- For the foreseeable future, case and trial backlogs and delays are likely to remain a problem.

The COVID-19 pandemic is hardly the first emergency to test the resilience of the judiciary. Following the September 11 terrorist attacks, federal courts enhanced security and testing for biological weapons, and in response to Hurricane Katrina, Congress passed legislation that allowed federal courts to temporarily host proceedings in adjacent judicial districts.

In many respects, however, the operational disruptions from COVID-19 have been unprecedented — and remain unrelenting. Jury and bench trials and in-person appellate arguments began their comeback in 2021, but each new wave of the virus appears to reset expectations and demand flexibility.

With parallel state and federal court systems, and some rules and procedures set locally, it is difficult to make general observations about the courts' response to the pandemic. Even within the federal system, responses have varied district to district and circuit to circuit. Some circuits that had begun holding in-person arguments again have now reverted to virtual format — others have stuck to traditional, in-person appearances.

Still, here are some observations and reflections gleaned from nearly two years of litigating in the shadow of COVID.

Expect That Many Technology Changes Are Here To Stay

Like many work environments, the practice of civil litigation may never return to the "old normal." Courts and lawyers were forced to break with tradition and innovate in ways that may make litigation more efficient.

For example, it was confirmed that some aspects of litigation do not have to be conducted in person.

- Telephonic court conferences and remote depositions might not become the norm when the pandemic risk subsides, but they will certainly be far more commonplace than they had been before. In a recent Thomson Reuters poll, 49% of the state judges and court professionals surveyed felt that virtual hearings made access to the justice system easier. For more complex cases, with witnesses and counsel in many locations, litigants may want to avail themselves of these tools even when the health risks recede.
- Recent juror interviews from cases we tried in person in 2021 revealed that jurors were not bothered by watching witnesses appear on video. In some instances, they even preferred viewing witnesses on a big screen to observing them from across a large courtroom. This ran counter to pre-pandemic accepted wisdom.

The federal judiciary's investments in response to the pandemic may lay the foundation for permanent changes. The federal courts expanded public and media remote access to proceedings, obtained equipment and licenses necessary to support remote communication platforms and strengthened their IT infrastructure.

The more courts innovate, the more momentum will build to use technology at all levels of the justice system.

In many respects, these changes are overdue and — especially in the context of complex multidistrict or cross-border disputes — could reduce some litigation costs. Companies with large litigation portfolios should view remote technology not as a temporary response to a public health crisis, but as a lasting change in how they access the courts.

Trials With Jurors Participating From Home Are Challenging

Not every innovation was an unqualified success. Our experience trying cases with jurors participating remotely from home showed that there was a significant risk of distractions. With two-way video links, for example, jurors were seen participating in voir dire while driving, playing a video game on a second monitor, and receiving a delivery during the proceedings.

For lawyers, the most challenging part of a virtual jury trial might be the inability to connect with jurors. Since our job is to respond to jurors, who are not allowed to talk to us during trial, that means making eye contact, reading body language, and observing actions like note-taking. These critical parts of our practice are almost impossible in a virtual courtroom.

Despite these difficulties, post-pandemic, we expect some courts to remain receptive to trying cases with jurors participating remotely.

What To Watch For

Changing court protocols. With the most recent variant of the virus, some courts are imposing stricter masking requirements and other precautions. As pandemic conditions evolve in different regions of the country, we expect more changes in these protective measures. Companies with geographically dispersed litigation portfolios will need to track court requirements on an ongoing basis.

Anticipate further delays in civil trials. Time to trial in civil cases may be another casualty of the latest pandemic surge. Some courts have begun to postpone jury selection and delay trials. These developments will likely compound trial backlogs, especially if criminal trials receive priority as public health restrictions ease. Companies planning and budgeting for complex civil litigation should consider the possibility of an even longer timeline to reach a jury or bench trial. Alternative dispute resolution mechanisms like mediation or expedited arbitration may become an attractive option for some time-sensitive conflicts.

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SEC Expected To Introduce Host of New Rules in 2022, Enhance Enforcement

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Takeaways

- In 2022, the SEC is likely to mandate ESG disclosures, and it intends to revise rules governing executive preplanned stock sales and corporate share buybacks.
- SPACs will face more regulation and also be targeted with enforcement actions.
- The commission is expected to continue asserting its jurisdiction over cryptocurrency activity that it deems to be securities-related.
- Undisclosed executive perks will continue resulting in enforcement actions.

The Securities and Exchange Commission (SEC) had an active 2021 as new leadership sought to reshape the commission's priorities. Chair Gary Gensler, who took over in April, and Enforcement Director Gurbir Grewal, who joined in July, have espoused an ambitious agenda for both rulemaking and enforcement.

Most leadership positions have been filled, with a higher proportion from academia and the public sector than has been typical in recent administrations. For example, Division of Corporation Finance Director Renee Jones and Division of Investment Management Director William Birdthistle were law professors. Enforcement Director Grewal came from the New Jersey Attorney General's Office. And the new general counsel, Dan Berkovitz, served as a commissioner of the Commodity Futures Trading Commission since 2018.

Republican Commissioner Elad Roisman announced his intention to resign at the end of January 2022.

Priorities for 2022

Based on statements by Chair Gensler, other commissioners and staff, and according to regulatory agendas issued by the agency, the SEC will likely concentrate primarily on the following issues.

Regulatory

ESG disclosures. The SEC is increasingly focused on disclosures related to environmental, social and governance (ESG) issues, including climate change, board diversity, human capital management and cybersecurity risk governance. Climate change will be a particular priority, as evidenced recently by the staff's detailed, stand-alone comment letters on climate-related disclosures in SEC filings. The commission is expected to propose mandatory ESG-related disclosure rules in early 2022, but even without specific requirements, any ESG-related material impacts should be disclosed under existing SEC rules.

Rule 10b5-1 sales/share repurchases. In response to increasing scrutiny of insider trading practices by executives and issuers, the SEC issued proposed amendments affecting Rule 10b5-1 plans, which allow executives to establish predetermined trading plans. The changes would include mandatory cooling-off periods, director and officer certifications, limits on multiple/overlapping plans, enhanced "good faith" requirements and new disclosure and reporting obligations. Legislation that may require further amendments to Rule 10b5-1 passed in the House and is pending in the Senate.

The commission also issued proposed amendments to modernize share repurchase rules, including a requirement that repurchases be disclosed by the end of the first business day after they are executed.

SPACs. The SEC plans to increase disclosure requirements for special purpose acquisition companies (SPACs), which have been the subject of recent staff guidance and statements, as well as recommendations by the SEC's Investor Advisory Committee. Areas to be covered likely include fees, projections, dilution and potential conflicts of interest between sponsors and investors, marketing practices and gatekeeper obligations.

Foreign issuers. On December 2, 2021, the SEC adopted final amendments implementing the disclosure and submission requirements of the Holding Foreign Companies Accountable Act (HFCAA). The legislation directs the SEC to delist registrants if, for three consecutive years, the Public Company Accounting Oversight Board (PCAOB) is unable to inspect the auditor of the registrant's financial statements. On December 16, 2021, the PCAOB made its first HFCAA determinations regarding accounting firms in mainland China and Hong Kong.

The HFCAA also requires a foreign registrant to provide disclosures if it files an annual report incorporating an audit report from an auditor that was not subject to PCAOB inspection. The final amendments went into effect January 10, 2022. The earliest year any trading prohibitions would apply is 2024.

Clawbacks. The SEC also reopened for comment long-shelved proposed rules that would require companies to implement policies allowing them to recoup executive compensation if the company is forced to restate financials. (See "SEC Revives Proposal for Executive Comp Clawback Rules.")

Enforcement

SPACs. SPACs are likely to be a focal point for enforcement, as evidenced by the relatively speedy actions brought against Stable Road and its target Momentus and the Nikola and Akazoo SPACs, and other widely reported ongoing investigations. The actions so far have a wide sweep: The SEC has brought charges against SPACs, a SPAC sponsor, merger targets and senior executives at various of these entities. The proposed disclosure obligations may provide the basis for further enforcement actions.

Cryptocurrency/decentralized finance. Cryptocurrency and other digital assets will be an area of ongoing scrutiny as the SEC attempts to grasp the fast-growing industry. The SEC brought multiple actions during the last fiscal year charging issuers of various digital assets with selling unregistered securities and a cryptocurrency trading platform with operating unregistered digital asset exchanges.

Cybersecurity. Enforcement in 2021 suggested that actions growing out of cybersecurity breaches may no longer be reserved for extreme cases. Recent examples involved fairly familiar types of disclosure violations, such as equivocal statements that a breach may have occurred when one was known to have occurred, or allegations that a company unreasonably delayed revealing a cyber incident.

Executive perks. The recent trend of enforcement actions stemming from a failure to properly disclose executive perks shows no signs of slowing, with the most recent action being settled in November 2021. With the Enforcement Division using risk-based analytics to uncover potential violations, continued focus on perks is likely. The precise alleged violations appear to be unique to each case. They involved personal use of corporate aircraft, automobiles and credit cards, as well as car, club and concierge services, housing and travel costs, and related-party transactions.

While commission activity in 2021 was quick to pivot to the priorities of new leadership, 2022 may prove to be even more instructive. The commission has staked out an ambitious rulemaking agenda through a set of varied and significant rule proposals issued in December 2021. And, on the enforcement front, Director Grewal has signaled a more hawkish approach in determining penalties and has suggested in speeches and a recent action that the SEC would require that defendants admit to misconduct as a condition of settlement.

SEC Revives Proposal for Executive Comp Clawback Rules

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Takeaways

- The SEC has reopened comments on a 2015 proposal to require companies to implement policies to recoup executive compensation if they have been forced to restate financials.
- Questions the agency posed in reviving the clawback proposal suggest that, if the rules are finalized in 2022, they may be broader than those proposed in 2015.
- The new rules could require companies to disclose not just how much they have clawed back but how they calculated that amount.

The Securities and Exchange Commission (SEC) recently signaled a renewed interest in implementing the incentive-based compensation recovery (clawback) provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) by reopening the comment period on proposed regulations it issued more than six years ago, but never adopted.

The action, which SEC Chairman Gary Gensler referred to as an "opportunity to strengthen … the accountability of corporate executives to their investors," indicates that the regulations, if finalized in 2022, may be more expansive than those proposed in 2015, potentially requiring companies to adopt new executive compensation clawback policies or revisit existing ones (even if those policies were intended to satisfy the 2015 proposed rules).

2015 Proposal

In July 2015, the SEC issued long-awaited proposed rules to implement the clawback provisions of the Dodd-Frank Act. The proposed Rule 10D-1 would have required stock exchanges to adopt listing standards mandating public companies to develop and implement clawback policies and make disclosures about them.

All listed companies would have been required to have a policy providing for recovery of incentive-based compensation awarded to any current or former executive officer in the three-year period preceding the year in which the company is required to prepare an accounting restatement resulting from material noncompliance with financial reporting requirements. The restatement need not stem from misconduct by an individual executive officer, or from matters under that individual's responsibility, for the individual to be subject to a clawback.

The proposed rule applied to all listed entities, including foreign private issuers and controlled, emerging growth and smaller reporting companies, but certain registered investment companies were excluded.

A company could be subject to delisting if it failed to adopt a clawback policy complying with the listing standard, disclose the policy in accordance with SEC rules or comply with its recovery provisions.

The 2015 proposed rules were never adopted, and no further action was taken by the SEC until it reopened the comment period in October 2021.

Potential Expansion of Rules

In addition to requesting further comments from the public on the 2015 proposed rules, the SEC's October 14, 2021, reopening release sought comment on additional questions, which shed light on what companies can expect when the agency finalizes the rules, which it plans to do in 2022.

- **Range of restatements triggering a clawback.** The SEC asked whether the types of accounting restatements to which the clawback rules would apply should be expanded to include all restatements made to correct an error in previously issued financial statements, rather than only to restatements that correct errors that are *material* to previously issued financial statements.

  In particular, the SEC asked whether its clawback rules should apply to restatements required to correct errors that were not material to previously issued financial statements, but would result in a material misstatement if (1) the errors were left uncorrected in the current report or (2) the error correction was recognized in the current period. The SEC noted in the release that the definition in the 2015 proposed rules would not have picked up these types of restatements and that, as a result, companies might be tempted to take such exclusions into account when making materiality determinations.

- **Three-year period.** The three-year lookback period in the 2015 proposed rules would have run from the earlier of the date (1) the company concludes, or "reasonably should have concluded," that a restatement was required, or (2) of a court order or similar action requiring a restatement.

  The SEC asked whether the standard of "reasonably should have concluded" should be removed or replaced with a different one. In the release, the agency noted concerns that the standard added uncertainty to the determination of the appropriate three-year lookback period.

- **Disclosure of recoverable amount.** The 2015 proposed rules required the issuer to disclose the amount subject to clawback, but not how it determined the amount. The SEC requested comment on whether companies should be required to detail how they calculated the recoverable amount, since a number of methods could be used to make this determination, particularly regarding the impact of an accounting restatement on stock prices or total shareholder return.

Timing of New Rules

The SEC's timeline for finalizing the clawback regulations remains unclear. Even if the agency adopts final regulations in the very near future, the stock exchanges will need to implement them in new listing standards, which would then require approval by the SEC. Thus the effectiveness of the listing standards might potentially occur as late as the first anniversary of the date the SEC finalizes the regulations.

Regardless, companies may want to use this opportunity to review their existing clawback policy (or adopt a new policy, as necessary) and should continue to monitor developments with respect to the finalization of the clawback rules.

Companies Face New Pressure From Shareholders and Regulators To Disclose Political Policies and Contributions

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Takeaways

- Activist shareholders are increasing the pressure on companies to disclose their political spending and their lobbying and trade association activity.
- In 2021, a record 40% of shareholders' proposals regarding corporate political activities were adopted, a year after a prior record was set at 20%.
- The SEC is considering new ESG reporting requirements that could require more disclosures.

Political activities of corporations are increasingly subject to scrutiny on environmental, social and governance (ESG) grounds. Demands that corporations and their political action committees (PACs) justify their contributions based on candidates' voting records on ESG issues came to the fore with the North Carolina gender bathroom bill in 2016. This evolved to a more general focus on LGBTQ+ and other ESG issues, such as diversity and climate change, and culminated with the events at the U.S. Capitol on January 6, 2021. That resulted in many companies reevaluating their political-giving programs. Some temporarily paused all political giving, while others suspended contributions to the 147 members of Congress who voted against certifying the 2020 presidential election results.

Many companies that suspended some or all corporate and PAC contributions in the wake of January 6 have been emerging from their self-imposed bans and are actively contributing again. An increase also has occurred in the number and intensity of activist shareholder requests regarding disclosure of political spending, lobbying and trade association activity. Apart from political giving, corporations also are being asked to weigh in on state voting law changes across the country.

Shareholder Political Proposals Gaining Support

Meanwhile, during the 2021 proxy season, shareholder proposals requesting disclosure of corporate political spending passed at the highest rate ever recorded. Although some shareholders have been pushing for increased disclosure of corporate political spending for almost two decades, their proposals rarely secured majority support until recently. (See "Activism Landscape Continues To Evolve.")

In 2020, a record 20% of these political shareholder proposals were adopted, a number eclipsed in 2021 with a new high of 40%, according to *Bloomberg Law*. In addition to requesting disclosure of the contributions themselves, many of these proposals call for the disclosure of company policies for making contributions, as well as the titles of the individuals involved in the decision-making.

In making these requests, the proponents often point to the aftermath of January 6, as well as the intense polarization of the 2020 election, hoping to boost support for their measures given the public scrutiny of companies' actions in response to these events. In some ways, the effect has been similar to the Supreme Court's *Citizens United* decision in 2010, which also led to a significant increase in shareholder support for political disclosure proposals, given that the Court struck down the ban on corporate independent expenditures, permitting unlimited corporate independent political spending. But campaigners in 2021 started from a much higher baseline of support.

The impact of the political disclosure movement goes beyond companies that have faced shareholder proposals. According to a recent study by the Center for Political Accountability, 370 S&P 500 companies now disclose some or all of their political spending, or ban at least one type of it, up from 332 companies in 2020.

The 2021 proxy season also saw an expansion in the scope of the proposals. Increasingly, proposals ask not for mere disclosure but also for substantive restrictions on the company, such as prohibiting it from contributing to candidates who voted for certain anti-ESG bills or asking the company to provide metrics on how it weighs ESG issues when making contributions or working with trade associations.

Companies that lost a proxy vote this year or are concerned about possibly losing a vote in the future are reevaluating their political activity practices and disclosures. There is a trend toward increased board oversight of political activity and memorializing guidelines for corporate political spending. Companies vary in their approaches to disclosure, balancing the transparency sought by some shareholders with the administrative burden of compiling reports and the need to conduct government affairs initiatives.

The SEC May Mandate Disclosures

During 2021, the Securities and Exchange Commission (SEC) considered updating reporting requirements and enhancing its standards requiring publicly traded corporations to report on ESG matters. (See our April 30, 2021, client alert "SEC Primed To Act on ESG Disclosure.") Gary Gensler, the new SEC chair, publicly indicated that the SEC planned to propose mandatory climate risk disclosure rules by the end of the year.

Currently, disclosure of ESG matters to shareholders is required only if they are considered material, and there is no guidance regarding whether political spending is considered a material ESG factor. However, on March 15, 2021, then-Acting SEC Chair Allison Herren Lee called on the public for input in crafting new disclosure requirements pertaining to ESG factors, calling them "inextricably linked" to corporate political spending. Moreover, Chair Gensler stated during his confirmation hearing on March 2, 2021, that he would consider implementing a shareholder political spending disclosure rule.

Most recently, on November 3, 2021, the SEC announced changes to its no-action letter policy regarding the exclusion of shareholder proposals, which make it harder for companies to quash proposals on ESG issues. In particular, the SEC said it will give less credence to corporate arguments that shareholder proposals focused on social policy issues should be excluded because they interfere with a company's "ordinary business" operations. The move highlights the SEC's continued focus on ESG reporting. (See our November 5, 2021, client alert "SEC Staff Issues New Shareholder Proposal Guidance, Rescinding 2017-2019 Guidance.")

DOJ Steps Up Corporate Criminal Enforcement, Looks More Broadly at Past Misconduct

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Takeaways

- The DOJ will take a more proactive approach to FCPA investigations.
- Companies seeking cooperation credit must disclose information about all culpable individuals, not just those "substantially involved" in misconduct.
- Corporate resolutions will take into account all prior misconduct, not just misconduct similar to that in the current case.
- Monitors will be required where deemed necessary to ensure corporate compliance with obligations imposed by resolution; they are not reserved for exceptional circumstances.

As was widely expected, the Department of Justice's (DOJ's) enforcement approach shifted when the Biden administration took over, with senior officials adopting a somewhat less corporate-friendly tone in their policy pronouncements and public statements concerning corporate crime. It remains to be seen whether this tougher approach will result in more investigations and charges against individuals and entities, or more significant penalties. But the message from the department is clear: Companies should actively review their compliance programs to ensure adequate monitoring and remediation of misconduct. Those that have entered into nonprosecution or deferred prosecution agreements with the department in the past should ensure they are compliant with the obligations imposed.

Foreign Corrupt Practices Act Enforcement

The new administration has not revised the department's Foreign Corrupt Practices Act (FCPA) enforcement policies, and 2021 was relatively quiet with respect to enforcement in this area. The DOJ brought 14 FCPA actions during 2021, compared to 30 in 2020. This decline could be a result of the diminishing investigation numbers over the past few years and, if so, might continue into 2022; but, based on statements from DOJ officials, we may instead see an uptick in cases over the next year.

In June 2021, then-Acting Assistant Attorney General Nicholas McQuaid, currently the principal deputy assistant attorney general for the Criminal Division, promised an entirely new approach to FCPA enforcement. In particular, he noted that the department is now more focused on proactive and innovative data mining, the use of law enforcement sources and close partnerships with foreign governments, as means to build cases.

His statements suggested that, to the extent the department previously sought to incentivize cooperation and voluntary self-disclosure in identifying misconduct, it will now rely more heavily on using proactive — and in many cases covert — investigative tools. He also predicted that FCPA enforcement results in 2021 would be on par with past years' size, scope and significance, suggesting that, while the figures so far have lagged, these new investigative techniques could bear fruit in the coming year.

Other signs indicate the FCPA will be an area of enforcement focus. The White House has identified corruption as a "core" national security interest and developed a new five-pillar strategy to combat it. That includes new investigative tools, such as the recently expanded foreign bank subpoena power pursuant to the National Defense Authorization Act, which should allow the DOJ and its enforcement partners to obtain additional information about overseas bank accounts. The department has also formed a new anticorruption task force to focus on Central America, seeking to mentor prosecutors in the region so they can build and charge their own cases, with the task force handling cases with jurisdictional links to the U.S.

Corporate Enforcement More Broadly

On October 28, 2021, Deputy Attorney General Lisa Monaco announced what promises to be the first of a number of changes to the DOJ's policies concerning its response to corporate crime, simultaneously with the issuance of a memorandum memorializing those changes. Consistent with the approach of prior administrations, her remarks made clear that the department's first priority in corporate criminal cases is to prosecute individuals who engage in and profit from corporate misconduct. She noted that, while high-profile cases against corporate executives are difficult, the department will not shy away from meritorious charges, and plans to "surge resources" to its prosecutors. These resources will include embedding a squad of Federal Bureau of Investigation agents within the department's Criminal Fraud Section — a proven model for success in complex high-profile cases.

In addition, as anticipated, Deputy Attorney General Monaco announced several key policy changes set out in the October 28 memorandum, not only reversing some of the more corporate-friendly pronouncements of the Trump Justice Department, but also taking a tougher stance with respect to certain issues than the Obama DOJ.

Evidence of individual wrongdoing. Newly enacted DOJ policy now requires companies that seek cooperation credit to disclose all nonprivileged information about individual wrongdoing. Policies imposed during the prior administration allowed disclosure to be limited to individuals whom companies viewed as "substantially involved" in the misconduct.

The recent change shifts to the DOJ — and away from the corporate entity seeking cooperation credit — the responsibility for determining the relative culpability and importance of the individuals involved in the misconduct. This may not result in more charges, or more charges of minor participants, but, at a minimum, it changes the tone of the DOJ's approach to corporate cooperation.

Past misconduct. Another notable shift in DOJ policy pertains to the significance of historical misconduct in determining an appropriate resolution of a corporate criminal investigation. At least since 2008, the department has directed its prosecutors to consider a company's history of conduct *similar to the conduct under investigation* in deciding whether to bring criminal charges. Going forward, however, prosecutors are required to consider not only similar misconduct, but the entire domestic or foreign criminal, civil and regulatory record of a company when shaping a resolution. (See also the discussion of recidivism below.)

Monitors. Finally, as discussed in the October 28 memorandum and in Monaco's accompanying remarks, the DOJ has indicated it may be more willing to press for corporate monitors than the prior administration. The DOJ's 2018 guidance required prosecutors to consider a number of factors in determining whether a corporate monitor should be imposed, but noted that many corporate criminal resolutions will not require a monitor and directed that the scope of any monitorship be appropriately tailored to the specific needs and concerns at issue.

The prior guidance concerning principles governing whether a monitor should be required as part of a corporate resolution has been rescinded and superseded — specifically to the extent it suggests that monitorships are disfavored or reserved for exceptional circumstances. While that change may not result in more frequent use of monitors, it makes clear that a monitor may appropriately be imposed whenever the DOJ feels that one is needed to ensure a company complies with its post-resolution obligations.

Recidivism and deferred and non-pros-ecution agreements. Deputy Attorney General Monaco made clear that the department is actively considering how to deal with corporate recidivists, raising the question whether they should be eligible for nonprosecution agreements (NPAs) or deferred prosecution agreements (DPAs), and how to ensure that companies subject to such agreements comply with their obligations.

The recent resolution of the DOJ's investigation of NatWest Markets Plc gives some insight into the effects of the department's new policies. On December 21, 2021, Deputy Attorney General Monaco announced that NatWest would plead guilty to one count of wire fraud and one count of securities fraud and pay $35 million in criminal fines, restitution and forfeiture. The plea resolved an investigation of alleged spoofing by NatWest traders — placing orders with the intent to cancel them as a means of manipulating prices — from January 2008 through May 2014, and again in 2018, involving the secondary market for U.S. Treasury instruments and the market for U.S. Treasury futures.

The plea agreement detailed NatWest's criminal history, as well as prior civil and regulatory actions, and the DOJ's public statements about the resolution made clear that it considered the bank's status as a "repeat offender," both related and unrelated to the conduct at issue.

The DOJ also took the position that NatWest's 2018 conduct breached a prior

NPA between the bank and government, entered into to resolve a securities fraud scheme in 2017, and that the breach called for serious consequences, despite the fact that NatWest reported the spoofing giving rise to the breach. The DOJ further noted that NatWest's 2018 conduct occurred while it was on probation following its 2015 guilty plea and 2017 sentencing for conspiring to manipulate the foreign currency exchange market. In light of these facts, despite the substantial improvements NatWest already had made to its compliance program, the government required NatWest to agree to the imposition of an independent compliance monitor.

While the DOJ has not yet issued new policies concerning corporate recidivists, this precedent indicates that the department may well insist on guilty pleas, as opposed to NPAs or DPAs, in such cases.

Will FDA and DOJ Reassert Their Enforcement Muscle With Life Sciences in 2022?

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Takeaways

- Despite predictions that the Biden administration would devote increased enforcement resources to the life sciences industry broadly, so far, the FDA and DOJ have focused their efforts on COVID-related conduct.
- Although both the FDA and DOJ experienced lengthy delays in appointment and confirmation of top officials, the DOJ has recently announced new policies regarding corporate prosecutions, which could have significant consequences for life sciences companies.
- The question remains: Will 2022 see an uptick in enforcement and policy changes or will the focus continue to be on COVID-related misconduct?

FDA Inspections Are Sharply Down and Enforcement Has Shifted to COVID Products

Fiscal year 2021 saw a dramatic drop in U.S. Food and Drug Administration (FDA) inspection activity. The agency conducted 60% fewer domestic inspections and 94% fewer international inspections during 2021 than it did on average in the four years prior to the pandemic.

Perhaps unsurprisingly given the reduction in inspections, the overall level of enforcement activity also dropped in FY2021, even compared to FY2020, which itself was significantly down due to COVID-19. The FDA issued 56% fewer warning letters and brought 60% fewer injunctions in FY2021 than the year before, and product recalls dropped by approximately 27%.

Although at first blush the number of warning letters issued to drug, biologic and medical device companies during FY2021 appeared similar to pre-pandemic levels, the nature of the letters has shifted. In FY2021, many were issued in connection with fraudulent medical products marketed with unsubstantiated claims regarding the treatment, prevention or cure of COVID. The number of warning letters that would normally be issued to such companies as the result of significant inspectional findings is down significantly, as a direct consequence of fewer facility inspections.

Long before COVID, warning letters issued by the FDA's Center for Devices and Radiological Health (CDRH) had fallen off sharply, and were down 90% between 2015 and 2019. CDRH leaders had signaled this trend would change in 2020, but the exigencies of COVID and the concomitant reduction in inspections clearly challenged those plans. 2021 did not see a return to historic levels of CDRH warning letter activity, but did see the FDA issue six current good manufacturing practices (cGMP) warning letters based solely on remote record reviews conducted in lieu of inspections. However, all six were issued to foreign over-the-counter (OTC) drug manufacturers.

While the FDA may issue similar letters outside the OTC drug sector based on remote reviews if its inspection capabilities — and particularly its international capabilities — continue to be hampered by COVID, notably it has not yet done so more than 18 months into the pandemic.

Although the FDA began to resume domestic inspections in the second half of 2021, it announced in early January 2022 that it had again paused non-mission-critical inspections through at least mid-January due to the Omicron variant. As such, it remains to be seen whether inspections return to pre-pandemic levels in 2022, and whether that leads to more enforcement against prescription drug, biologic and medical device manufacturers.

DOJ Enforcement Activity Is Also Down, but Newly Declared Priorities Could Change That

DOJ enforcement focus in 2021 was likewise trained on COVID, with the department taking action against companies allegedly touting fraudulent and ineffective vaccines, COVID treatments and faulty personal protective equipment. It also targeted fraud associated with use of funds available under the Coronavirus Aid, Relief and Economic Security (CARES) Act.

In traditional areas of DOJ life sciences enforcement — violations of the Anti-Kickback Statute (AKS); Food, Drug and Cosmetic Act; and False Claims Act — in 2021, the DOJ announced only 11 settlements of greater than $1 million involving drug, biologic or medical device manufacturers, and an additional two settlements of that magnitude involving alleged AKS violations by electronic health record system manufacturers. In contrast, by the end of September 2019, the DOJ had announced 18 such settlements with life sciences manufacturers.

There was one sign that enforcement may intensify in the future. In late October 2021, Deputy Attorney General Lisa Monaco announced several significant changes to DOJ corporate enforcement priorities that could have a substantial impact on the life sciences industry. These include:

- A focus on individual accountability and reversion to the Obama-era expectation that, to earn cooperation credit, companies will have to produce all nonprivileged information about the involvement of all individuals implicated in wrongdoing. To meet this expectation, companies may be required to reconsider how they conduct internal investigations.
- An intent to consider a company's total history of criminal, civil and regulatory misconduct in assessing corporate prosecution factors, rather than focusing only on previous misconduct of a similar nature. This could have implications not only for companies that have faced prior DOJ matters in unrelated areas (such as antitrust or environmental matters), but also those with a history of regulatory noncompliance, such as FDA warning letters or repeat FDA Form 483 inspection observations.
- An intent to closely scrutinize companies that commit wrongdoing while bound by nonprosecution agreements or deferred prosecution agreements, which have been used to resolve a number of life sciences cases because of the potential for exclusion from federal health care programs that can result from a conviction.

See "DOJ Steps Up Corporate Criminal Enforcement, Looks More Broadly at Past Misconduct."

Expect Policy Changes and Possibly Increased Enforcement as Key Officials Are Confirmed

Nearly a year after being elected, President Biden nominated Robert Califf to serve as FDA commissioner, the role he held during the last year of the Obama administration. Under Janet Woodcock, a long-serving FDA official who was acting commissioner since President Biden took office, the agency has largely focused on COVID and has not announced major policy or enforcement initiatives. If confirmed, FDA-regulated companies can expect Dr. Califf to direct the agency's resources to align with his policy priorities, such as further emphasis on real-world evidence, a focus during his prior tenure.

While top leadership was in place at DOJ headquarters in Washington, D.C., as of early January 2022, only approximately one-third of the 94 federal districts had confirmed U.S. attorneys in place. We expect DOJ enforcement activity to increase as additional new U.S. attorneys are confirmed, assume their roles and launch enforcement initiatives reflecting their priorities.

Congress Sets Sights on Financial Services, Climate Change and Big Tech

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Takeaways

- Large financial institutions, SPACs and consumer finance are top concerns of key congressional committees.
- Democrats are pressing energy and social media companies about their alleged roles in spreading climate change disinformation, while Republicans want details on U.S. climate envoy John Kerry's activities at the U.N. COP26 conference.
- Lawmakers' focus on Big Tech has shifted from its market power to its effects on users, particularly children. Members of both parties want to monitor the companies for their social impacts.
- Sen. Elizabeth Warren continues scrutinizing the private equity industry.

As expected, since Democrats assumed control of both the House and Senate in January 2021, congressional oversight committees have intensified their focus on the private sector. Whether a bipartisan consensus, single party or individual lawmaker drives oversight of a particular industry, companies should take note. A single lawmaker's pet project could mushroom into a sector-wide investigation engulfing an unwary company.

Despite highly publicized divisions among Democrats on key policy initiatives of the Biden administration, Democratic lawmakers in both chambers have shared an interest in oversight of the financial and technology industries and in addressing climate change.

Financial Industry

Three of the most powerful and active players on Capitol Hill have focused heavily on Wall Street:

- Sen. Sherrod Brown (D-Ohio), chair of the Senate Banking, Housing and Urban Affairs Committee (Senate Banking Committee);
- Rep. Maxine Waters (D-Calif.), chair of the House Financial Services Committee; and
- Sen. Elizabeth Warren (D-Mass.), member of the Senate Banking Committee, chair of its Subcommittee on Economic Policy, member of the Senate Finance Committee and chair of its Subcommittee on Fiscal Responsibility and Economic Growth.

Top agenda items in this area have included the use of special purpose acquisition companies (SPACs) to take companies public; oversight of the largest financial institutions; and general consumer protection issues, such as race-based disparities in lending and the improved financial performance of banks during the pandemic's economic upheaval.

Congress's focus on the financial sector has been buttressed by President Biden's appointment of key progressives to high-profile regulatory positions in his administration, including Gary Gensler as chairman of the Securities and Exchange Commission and Rohit Chopra as director of the Consumer Financial Protection Bureau — an agency the Trump administration effectively dismantled over the previous four years.

Climate Change

Democrats have made climate change a top oversight priority. In September 2021, Rep. Carolyn Maloney (D-N.Y.), chairwoman of the House Oversight and Reform Committee, and Rep. Ro Khanna (D-Calif.), chairman of the House Oversight and Reform Subcommittee on the Environment, sent letters to leading fossil fuel executives requesting documents and communications related to their organizations' roles in "supporting disinformation and misleading the public to prevent action on the climate crisis."

Following the requests, the committee held a hearing with seven CEOs, where Rep. Maloney announced she would issue subpoenas to the companies, that had failed to provide requested documents and communications. During a hearing recess, Rep. Khanna hinted to reporters that the committee might hold additional hearings on the topic and question other witnesses, including social media executives whose platforms may have spread climate disinformation.

Notably, Reps. James Comer (R-Ky.) and Ralph Norman (R-S.C.), two key Republicans on the House Oversight and Reform Committee, are seeking a hearing with John Kerry, the special presidential climate envoy, to examine his participation in the recent United Nations Climate Change Conference (COP26) and the impact of the Biden administration's climate policies on the economy. As minority party members, they cannot set congressional hearings, but their request may provide a glimpse into their climate priorities should Republicans take back the House in 2022.

Big Tech

As in previous years, Big Tech has been subjected to bipartisan oversight. In the 117th Congress, however, lawmakers seem to have shifted their focus from antitrust topics to the industries' role in social issues.

In March 2021, 23 Democrats issued a letter to a technology company demanding answers related to its advertising practices and alleged promotion of disinformation. The House Energy and Commerce Committee held a related hearing titled "Disinformation Nation: Social Media's Role in Promoting Extremism and Misinformation," which included testimony from three tech CEOs. The Senate Homeland Security and Governmental Affairs Committee also issued a letter to three social media companies regarding their policies for monitoring and removing extremist content.

In stark contrast, Republican efforts have focused largely on limiting Big Tech's ability to police and censor content based on a user's viewpoints and affiliations.

Despite partisan rancor over many issues, Democratic and Republican lawmakers have shown bipartisan interest in understanding and regulating the industry's impact on children and teenagers. In April 2021, Rep. Raja Krishnamoorthi (D-Ill.) requested information from a tech company and expressed concerns about its content quality, advertisement practices and effects on children. The House Oversight and Reform Committee also issued letter requests to two tech companies regarding their alleged role in facilitating human trafficking content and their impact on the mental health of teen girls.

Meanwhile, the Senate Commerce, Science and Transportation Committee held a hearing with a tech company executive regarding its alleged harmful effects on youth. Several Republican lawmakers issued letters to tech CEOs requesting information regarding internal research or studies conducted by the companies so as to better understand their products' impact on children's mental health. Despite overlap in this issue, the Republican lawmakers issued a press release along with the letters titled "Democrats Refuse To Help Expose Big Tech's Harms to Children."

Although no bipartisan consensus has emerged on these issues, Democratic and Republican lawmakers seem to agree that the industry should be subject to some type of additional oversight. Therefore, regardless of the results of the November 2022 midterm elections, Big Tech will likely be in the congressional spotlight for the foreseeable future.

Private Equity

Sen. Warren has long criticized private equity (PE) firms and shows no signs of relenting. In addition to reintroducing a 2019 bill aimed at PE, Sen. Warren has issued several oversight letters.

In November, Sen. Warren sent a letter to the PE firm that owns a major pet retailer regarding its treatment of workers and animals. She has targeted buyout firms over their retail investments following the liquidation of several private equity-backed department stores and chains. In March 2021, after issuing two letter requests to a nursing home network, Sen. Warren announced plans to launch an investigation into for-profit care facilities and those owned by PE firms. Recently, she and two other senators sent letters to two PE executives in support of workers on strike at a coal mine the investment firms control.

As chair of the Senate Banking Subcommittee on Economic Policy, Sen. Warren led a hearing titled "Protecting Companies and Communities From Private Equity Abuse," and the committee held a hearing on PE landlords in October.

Although some news outlets have described the attendance at these hearings as "sparse" and predict that lawmakers will largely remain uninterested in pursuing the industry, the House Ways and Means Subcommittee on Oversight also held a hearing regarding private equity's extensive investment in the U.S. health care system. In addition, in June 2021, oversight subcommittee chair Rep. Bill Pascrell (D-N.J.) wrote the Government Accounting Office, requesting it study the effects of PE across the health care sector.

Conclusions

Congressional oversight of the private sector has been active in 2021, and high-profile hearings at the end of the year signaled that 2022 will bring more of the same, particularly as the midterm elections approach. We can expect Democrats to move ahead aggressively with their agenda as they fight to keep their majority. Meanwhile, Republicans will likely focus their attention on oversight of the executive branch.

Companies should therefore continue monitoring relevant press and evaluate their policies, procedures and related compliance efforts to determine whether modifications should be made.

Federal and New York City Workplace Vaccination and Testing Mandates: A Primer

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Takeaways

- Conflicting rulings and a patchwork of injunctions have made it difficult for employers to know how or whether to comply with federal vaccination mandates.
- The Supreme Court stayed OSHA's vaccinate-or-test order, the broadest of three federal COVID-19 mandates, but it allowed another covering health care workers to go into effect for now. A third mandate for federal contractors is enjoined pending a circuit court appeal.
- The mandates for health care workers and federal contractors, including federally funded educational institutions, like New York City's mandate, do not allow for a testing option; employees must be vaccinated unless they fall within limited exceptions.
- A TRO against New York City's order was denied in a suit filed after the mandate took effect, and it may be less vulnerable to challenge because of the broad powers state and local governments have to protect citizens.

At President Biden's urging, in late 2021, different arms of the federal government issued three high-visibility vaccine mandates to private employers, applying to federal contractors, many health care workers, and midsized and large employers. Those were followed by a sweeping order in New York City requiring businesses there to verify that their on-site employees have been vaccinated.

On January 13, 2022, in *National Federation of Independent Business v. Dept. of Labor*, the U.S. Supreme Court stayed the broadest of the three federal orders, an emergency temporary standard (ETS) issued by the Occupational Safety and Health Administration (OSHA), holding that the ETS exceeded the agency's statutory authority. However, in a second case decided the same day, *Biden v. Missouri*, the Court allowed the Department of Health and Human Services' vaccination mandate for health care workers to take effect. That requirement applies to workers at Medicare- and Medicaid-certified hospitals, nursing homes and other facilities.

The third federal mandate, covering federal contractors and subcontractors, including educational institutions receiving federal funding, was not before the court, but it has been enjoined while a circuit court appeal is pending.

All three federal mandates required employees to be fully vaccinated by January 4, 2022, or, in some cases, as an alternative, that employers have testing programs in place. The federal government said it would not enforce the mandates while the litigation was pending, but there is now nothing to bar enforcement of the rules for health care workers.

It is important to note that the health care worker and government contractor mandates are stricter than OSHA's: They and the New York order do not permit employees to choose testing in lieu of vaccinations, except in limited cases.

Note, too, that the Court has refused to hear several challenges in recent months to vaccine mandates by state and local governments, which traditionally have broader powers to ensure public welfare.

In the wake of the Supreme Court's decision, here is a guide to the scope and requirements of the federal actions and their legal status at the time this article is published. (For a more detailed explanation of the mandates' terms, see our January 3, 2022, client alert "Status of Recent Federal and NYC Workplace Vaccination and Testing Mandates.")

The New York City mandate, first announced on December 6, 2021, by Mayor Bill De Blasio, took effect December 27, 2021, without any court challenges, according to the city's law department. It applies to all private employers in the city, regardless of size, requiring them to verify that their on-site employees are vaccinated.

An Overview: Which Mandates Apply to Which Employers

The three federal mandates and the New York City order differ in their requirements and legal foundations, and employers may need to comply with more than one:

- **Federal contractors and subcontractors, including educational institutions receiving federal funding (enjoined while appeal is pending):** Executive Order 14042, issued September 9, 2021, by the White House, and later guidance issued by the Safer Federal Workforce Task Force.
- **Midsized and large employers (enjoined by the Supreme Court while appeal is pending):** Emergency Temporary Standard (ETS), issued November 4, 2021, by OSHA
- **Health care workers at Medicare- and Medicaid-certified facilities (allowed to go into effect by the Supreme Court):** Omnibus COVID-19 Health Care Staff Vaccination plan, issued November 4, 2021, by the Department of Health and Human Services Centers for Medicare and Medicaid Services (CMS).
- **New York City private employers:** Order of the Commissioner of Health and Mental Hygiene, issued December 13, 2021, and New York City guidance, issued December 15, 2021.

Details and Status of Federal and New York City Mandates

Federal Contractors (Executive Order)

- **Who is covered:** almost all employees who (1) work in facilities that perform services under a covered government contract, (2) perform administrative and back-office work supporting a contract, or (3) work at a location where employees performing such services also work. Also applies to educational institutions receiving federal funding. No minimum number of employees.
- **Employee mandates and deadline:** receive all vaccinations by January 4, 2022. No option to be tested in lieu of vaccination.
- **Exceptions:** exemptions for disability (including medical conditions) and sincerely held religious beliefs.
- **Status of legal challenges:** The Eleventh U.S. Circuit Court of Appeals refused to stay a national injunction issued by a district court in Georgia against the executive order, so the injunction remains in effect in all 50 states. The government has appealed. Final briefs are due January 24, 2022. No date for oral arguments has been set. Separately, a Kentucky district court enjoined the mandate in Kentucky, Tennessee and Ohio. There is no final adjudication on the merits and no appeal to date.

Midsized and Large Employers (OSHA)

- **Who is covered:** by far the widest-reaching mandate: private sector employers with 100 or more employees total at all locations, estimated to encompass 83 million workers. Explicitly excludes federal contractors covered by Executive Order 14042 and health care facilities covered by the CMS mandate. Employers must provide paid time off for vaccinations and recovery from any side effects.
- **Employee mandates and deadline:** receive all vaccinations by January 4, 2022, or wear masks on the job and be tested weekly.
- **Exceptions:** does not apply to employees who work outside or remotely at home; exemptions for disability (including medical conditions) and sincerely held religious beliefs.
- **Status of legal challenges:** In National Federation, the Supreme Court granted a stay of the ETS while the litigation is pending, holding that the ETS exceeded OSHA's statutory authority.

Health Care Workers at Medicare- and Medicaid-Certified Facilities (CMS)

- **Who is covered:** Medicare- and Medicaid-certified providers and suppliers, including hospitals, hospices and home health agencies, ambulatory surgical centers and outpatient rehabilitation facilities. No minimum number of employees. In practice, most health care facilities are Medicare/Medicaid-certified because that is a requirement for reimbursement under those programs.
- **Employee mandates and deadline:** receive all vaccinations by January 4, 2022. No option to be tested in lieu of vaccination.
- **Exceptions:** exemptions for disability (including medical conditions) and sincerely held religious beliefs.
- **Status of legal challenges:** In *Biden v. Missouri*, on January 13, 2022, the U.S. Supreme Court stayed injunctions issued by district courts in

Louisiana and Missouri against the CMS rules while those cases are on appeal, saying the Secretary of Health and Humans Services acted within his authority in issuing the rules.

New York City Employees

- **Who is covered:** all private employers in New York City, no matter their size — estimated to be 184,000 businesses.
- **Employee mandates and deadline:** receive at least one vaccination by December 27, 2021. Those who have received just one Pfizer or Moderna vaccination must submit proof of a second dose within 45 days. Employees who do not comply will not be permitted in the workplace.
- **Exceptions:** reasonable accommodation required for "disability, pregnancy, childbirth, lactation, religious beliefs or observances, or status as a victim of domestic violence, stalking, or sex offenses."
- **Status of legal challenges:** the only challenge, filed in the Eastern District of New York after the mandate took effect, alleges that the rules violated a business's federal due process rights; a temporary restraining order was denied. Mayor Eric Adams, who assumed office January 1, 2022, left the mandate in place.

More Aggressive Consumer Financial Services Enforcement Expected

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Takeaways

- Redlining enforcement will be a significant priority for the CFPB, DOJ and other agencies.
- Loan servicers should expect increased scrutiny to prevent unnecessary defaults.
- Credit bureau reporting will be an area of focus.

As expected, 2021 brought an uptick in fair lending enforcement in the U.S., particularly by the Consumer Financial Protection Bureau (CFPB). As President Joe Biden's nominees for key agency positions settle into their roles and move to implement their policy agendas, more enforcement actions are likely in 2022. Actions alleging redlining and other types of mortgage lending discrimination will remain a significant priority. In addition, we expect increased enforcement in areas that have received less attention recently, including loan servicing, credit reporting, student loans and small business lending.

Key Appointees Foreshadow Significant Enforcement Activity

Several important administration officials are expected to play roles in expanding scrutiny of lending compliance:

- Rohit Chopra, the former member of the Federal Trade Commission, who was confirmed in September 2021 as director of the CFPB;
- Marcia Fudge, secretary of Housing and Urban Development; and
- Attorney General Merrick Garland.

One of Director Chopra's first moves after confirmation was to appoint Eric Halperin as assistant director for the Office of Enforcement. An Obama Justice Department veteran, Mr. Halperin is expected to intensify the CFPB's enforcement of the fair lending laws.

An important position overseeing lending practices remains vacant. President Biden's nominee for comptroller of the currency (OCC), Saule Omarova, withdrew after criticism from banking groups and moderate Democrats.

Areas of Focus

This year, we expect enforcement to increase and expand into new areas:

- **Redlining.** Federal and state agencies have announced their intention to direct even greater attention to potential redlining issues. At an October 2021 press conference, the CFPB, Department of Justice (DOJ) and OCC announced a redlining settlement with a bank and the formation within the DOJ of a new Combatting Redlining Initiative as one part of an ongoing, government-wide effort. We expect that bank and non-bank lenders alike will face increasing scrutiny.
- **Loan servicing.** Federal agencies are expected to increase their focus on loan servicers, and in particular their adherence to consumer protections implemented to mitigate the effects of COVID-19. These agencies are likely to scrutinize whether servicers are being proactive, working with borrowers and responding to their inquiries, evaluating income fairly and seeking to prevent avoidable foreclosures and the other adverse actions.
- **Credit reporting.** A recent CFPB report concluded that credit bureau disputes are more common among Black and Hispanic borrowers. We expect federal agencies, based on this report, to approach credit bureau reporting not only from the perspective

of unfair, deceptive or abusive acts or practices (UDAAP), but also through the lens of fair and equitable treatment: how lenders furnish information to credit bureaus, how lenders and credit bureaus respond to borrowers when they dispute entries and what impact these practices may have based on race, ethnicity or other bases.

- **Student lending and expansion of credit.** Federal agencies have initiated enforcement actions against student lenders in the past, and we expect a more sustained review of student lending and servicing practices in the next several years. Director Chopra has cited student lending as a critical area of focus, and the CFPB has already taken one enforcement action, charging an institution with misrepresenting its product as an "income sharing" arrangement rather than a loan. The Bureau's action suggests that it and other federal agencies will seek to expand the scope of acts and practices subject to federal consumer protection laws.
- **Small business lending.** The CFPB recently issued a proposed rule requiring financial institutions to collect and report data on small businesses' credit applications, with an emphasis on businesses owned by women and minorities. We expect the availability of this data will lead to increased scrutiny of small business lending.
- **Machine learning / artificial intelligence.** Director Chopra has made clear his concerns about the increasingly important role of so called "Big Data" in loan underwriting. In testimony before the House Committee on Financial Services, Director Chopra asserted that "automation and algorithms" lead to "less transparency into how credit decisions are made," and that "these practices can unwittingly reinforce biases and discrimination, undermining racial equity." We expect enforcement actions from the CFPB aligned with the Director's perspectives.

New Rules, Enforcement Actions Make Financial Institutions' Planning for Cyberattacks Even More Imperative

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Takeaways

- Implementing strong cybersecurity practices helps companies prepare for future regulatory requirements.
- Incident-response plans must enable financial institutions to give timely and accurate notifications to regulators and consumers following a cyber incident.
- Companies should use risk assessments to develop robust cybersecurity programs and test the strength of those programs against known threats.
- Boards must take a leadership role in managing cybersecurity risks.

Growing Threat, Expanding Regulation

A new cybersecurity regulation and recent enforcement activity by federal bank regulators signal heightened regulatory scrutiny for financial institutions in 2022.

In November 2021, the Federal Reserve, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency (OCC) approved a rule that directs banking organizations to report certain cybersecurity incidents to their primary regulator within 36 hours of discovering it, a tighter timeline than current industry standards.

The stricter regulation comes as cyberattacks on financial institutions have grown more frequent and sophisticated. In the first half of 2021, the financial industry experienced a more than 13-fold year-on-year increase in ransomware attacks. Even if attackers are not successful in extracting ransom, these incidents exact a significant toll on financial institutions. The average cost of recovering from a ransomware attack, including those where ransom is paid, stands at $2 million.

Financial institutions should anticipate higher regulatory standards and more cyber-related enforcement actions in 2022. Regulators continue to regard cyberattacks as a major threat to the safety and soundness of individual firms and the broader financial system, and they are using their enforcement powers increasingly to focus the industry and impose discipline to prevent damage.

Institutions can glimpse into the future regulatory environment through recent activity by the New York State Department of Financial Services (NY DFS), the Securities and Exchange Commission (SEC) and the OCC, which have collectively brought over a dozen enforcement actions related to cyber events and assessed over $635 million in fines in the past two years. This activity confirms that enforcement in this space is no longer reserved for outlier cases and serves as a reminder for financial institutions to focus on the following areas in the year ahead.

Establish Processes To Ensure Timely Notifications and Accurate Communications

Given that successful attacks will occur despite preventive controls, key regulators have instructed companies to review, update and test incident-response and business-continuity plans so that they can both quickly recover from a cybersecurity attack and prevent one from impacting the entire network. Response plans should also anticipate attacks against recovery systems and take steps to protect those systems.

Importantly, incident response plans must allow financial institutions to comply with the new notification rule that takes effect in April 2022. These plans should allow companies to quickly:

- identify and escalate cyber events;
- evaluate the impact of such events;
- contact the primary regulator; and
- for bank service providers, notify banking customers when necessary.

Financial institutions must be able to complete these steps even if a cyberattack renders primary IT systems inoperable.

The 36-hour reporting window under the new federal notification rule is even shorter than NY DFS' 72-hour deadline, and a recent NY DFS action against Residential Mortgage Services, Inc. shows that regulators may penalize organizations that fail to investigate cyber incidents promptly. Financial institutions' incident-response plans must incorporate a process to ensure that incidents are investigated and regulators are notified quickly.

Notifications to Customers Must Be Accurate

Though the new federal notification rule does not require financial institutions to report cyber events to consumers, any misleading or inaccurate communications about cyber events may create liability under other laws. For example, in a recent SEC enforcement action involving compromised email accounts at a group of financial advisory firms, the SEC alleged that the notification to affected customers from outside counsel referred to a "recent" cyber incident and stated that the companies had "learned that an unauthorized individual gained access to" the client's personal identifying information two months prior to the notification, when, in fact, the companies had discovered the breach at least six months earlier.

Routinely Use Third-Party Risk Assessments To Test Cybersecurity Programs

Risk assessments are a fundamental building block of cybersecurity programs. Increasingly, regulators are instructing financial institutions to regularly test the strength of their cybersecurity programs against the particular threats identified during risk evaluations. NY DFS requires periodic penetration testing if an organization does not continuously monitor its systems for vulnerabilities. The OCC likewise recommends that financial institutions use a penetration program that includes periodic internal and external testing of the institution's ability to detect and respond to attacks.

Institutions that conduct these audits should ensure the testing is completed by independent personnel and that the institution addresses any vulnerabilities that are exposed in a timely manner. Indeed, failing to address vulnerabilities identified during testing was one factor cited by NY DFS in a 2020 enforcement action against a title insurance company where hundreds of millions of confidential customer records were disclosed.

Deploy Strong Access Controls

NY DFS requires multifactor authentication for any individual accessing a company's internal network from an external network, unless the company's chief information security officer approves in writing the use of an equivalent or more secure access control. This requirement also applies to third-party applications that access the company's internal network.

Though the OCC does not require one particular technology, it advises companies to have appropriate identity and access management controls that can include using multifactor authentication, limiting user permissions to those necessary for jobs and regularly reviewing the appropriateness of assigned access.

Boards Must Proactively Manage Cyber Risks

Boards should oversee the creation of strong cybersecurity programs, which includes making sure incident-response plans adhere to all relevant laws. Directors must also be involved in decision-making after a cyber event occurs and should hold management accountable for addressing known risks. A McKinsey survey of financial services companies in 2020 suggests best practices. Nearly 95% of the surveyed firms reported that one of their board committees discussed cybersecurity and technology risks four times or more per year. Almost half the companies involved the board in cybersecurity exercises, and nine in 10 provided regular updates on cybersecurity to the full board.

Failing to ensure proper polices are in place to protect the company or issuing misleading statements about the company's preparedness may give rise to personal liability for directors, as reflected in several recent securities class actions. (See our February 3, 2021, client alert "A Practical Guide to the Role of Directors in Fighting Ransomware.")

Companies With Strong Cybersecurity Programs Will Be Better Positioned as New Regulations Are Adopted

As cybersecurity attacks intensify, new cyber-related regulations will continue to be implemented, and not just at the federal level. For example, in 2018, California voters approved the groundbreaking California Consumer Privacy Act (CCPA), which allows consumers to sue companies after certain types of data breaches. Just two years later, voters significantly amended and expanded the CCPA by approving the California Privacy Rights Act (CPRA). The CPRA created a new agency that will issue regulations, including those that require certain businesses to perform annual cybersecurity audits and to submit regular risk assessments.

Financial institutions with strong cybersecurity practices will be better able to adapt to these regulations, and others, as they will already have the foundation required for compliance.

Central Banks Consider Digital Currency Pros and Cons in US and Europe

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Takeaways

- The Bank for International Settlements and seven central banks are studying how to launch CBDCs and have flagged key issues that will need to be addressed, including interoperability and confidentiality.
- In the U.S., Federal Reserve leaders have questioned the need for a CBDC, given the sophistication of existing payment systems. Offering retail accounts at the Fed would also fundamentally alter the structure of the U.S. banking industry.
- The Bank of England and the U.K. Treasury have formed a taskforce and plan to consult on the merits of a CBDC.
- In Europe, with more decentralized banking and payment systems, the European Central Bank has shown greater enthusiasm for implementing a CBDC, saying it could drive innovation.

The advent of distributed ledger technology and other innovations has resulted in the widespread adoption and use of privately issued digital currencies such as bitcoin and ether, which allow for rapid payments with minimal transaction costs. This phenomenon has prompted central banks around the world to assess their roles in the digital asset economy — in particular, by examining the pros and cons of offering a central bank digital currency (CBDC) to the public.

CBDCs would be liabilities of the central bank that issued them, and could be either wholesale (*i.e.*, accessed only by financial institutions, similar to existing central bank settlement accounts) or retail (*i.e.*, the digital equivalent of cash, to be used as a digital payment instrument by the general public).

China has already initiated its version of a general purpose CBDC. But, while there is real exuberance and interest in this possibility elsewhere, central banks in most major economies are proceeding cautiously.

International Exploration of CBDCs

One of the most serious international efforts to explore the utility of a CBDC system is being led by the Bank for International Settlements (BIS) and central banks from seven jurisdictions (Bank of Canada, Bank of England, Bank of Japan, European Central Bank (ECB), the Federal Reserve System, Sveriges Riksbank and Swiss National Bank). This effort has already identified important challenges that must be addressed in designing an effective CBDC arrangement, including the need to:

- establish interoperability between a CBDC and other key payment systems and arrangements within a jurisdiction to facilitate the easy flow of funds necessary to achieve accessibility, resilience and diversity in payments;
- protect the privacy or confidentiality of consumer payment data;
- allow sufficient transition time for the existing financial system to adjust; and
- maintain flexibility in design to accommodate evolving user needs over time.

Individual countries could also face unique in-jurisdiction legal and structural challenges.

United States

In the U.S., there is a fundamental question of whether a general-purpose CBDC is needed, given the variety of private electronic payment options available within the existing payment system, including online bill payments through banks and payment methods such as PayPal, Zelle and Venmo. They already offer speed and accessibility and are low cost.

Key Federal Reserve governors have signaled their skepticism. Chair Jerome Powell has observed that the U.S. already has a "safe, effective, dynamic, and efficient … domestic payments system [capable of serving] the needs of households and businesses." Fed Gov. Christopher Waller has said that it remains unclear whether "CBDC would solve any existing problem that is not being addressed more promptly and efficiently by other initiatives."

Moreover, a retail CBDC for which the Fed provided accounts directly to the general public would require legislative changes and alter the central bank's role vis-à-vis private commercial banks and the U.S. economy in profound ways. Under existing law, the Fed provides accounts to private commercial banks, which then offer bank accounts to the general public. That structure, in which private commercial banks are intermediaries between the Fed and the public, dates back to the negotiations that brought the Fed into existence in 1913. Providing accounts directly to the public would upend that negotiated balance and could disintermediate private banks by encouraging deposits to flow from them to the Fed.

These factors weigh heavily against an account-based, retail CBDC in the U.S., whatever benefits it might offer in speed, availability, accessibility and cost, especially considering that competition and other initiatives such as FedNow (the Fed's instant payment system due to launch in 2023) are intended to address these very issues. It is therefore highly unlikely that we will see a retail CBDC in the U.S. in the next few years.

Nonetheless, we expect the Fed to continue to participate in the discussions about CBDCs in the U.S. and inter-na-tionally so it can maintain leadership and influence in setting standards for their design and related policy questions.

United Kingdom

There has also been substantial interest in the structural and conceptual issues in a central bank adopting a CBDC in the U.K. and Europe, with central banks themselves and other market participants debating the benefits, challenges and legal and regulatory requirements.

In November 2021, the Bank of England and U.K. Treasury announced plans for a joint consultation on the subject during 2022. They envision a CBDC being introduced in the U.K. by the end of the decade if there is support from market participants. The two bodies have formed a taskforce to oversee the consultation and any future consideration of such a proposal.

However, several issues in terms of design, control, access, legal framework and regulation remain before any such initiative can be implemented. Like the Fed in the U.S., the Bank of England does not provide accounts directly to the general public. Adopting a "retail" CBDC that requires this therefore would result in a seismic change to the U.K. banking system.

The U.K. Treasury has already stated that it envisions any CBDC as a parallel offering to existing cash and bank deposits, not a replacement. The outcome of the consultation will determine whether the U.K. moves toward a "development" phase.

Euro Zone

In contrast to regulators in the U.S., the ECB has been fairly public in its support for the development of a CBDC in the medium to long term.

In a report published in October 2020, the ECB advocated the introduction of a digital euro, which it argued is needed to underpin innovation, deliver strategic autonomy and guarantee security of European payment systems. Fabio Panetta, a member of the executive board of the ECB, argued in a blog post in November 2021 that the ECB needs to actively consider the role of a CBDC given the move to digital payments over cash. He drew the analogy of the postage stamp falling by the wayside in the age of the internet.

That transition to digital payments is driving much of the thinking on the development of CBDCs in Europe and the U.K. Mr. Panetta also argued that central institutional involvement in money, whether through a CBDC or otherwise, will remain a cornerstone underpinning confidence in the value of money and the financial system, and that development work and debate is needed now to address the structural and regulatory challenges of a CBDC.

The ECB project focuses on a "retail" CBDC in particular, which would mark a significant shift in the current payment ecosystem if adopted. To the extent the ECB has addressed wholesale systems, it has concentrated on technical upgrades to existing systems rather than the introduction of a CBDC.

We anticipate that central banks in the U.K. and Europe will continue exploring CBDC models, with increased focus in the next few years. Much of this work will be preparatory and technical rather than moving swiftly to adoption. But central banks in the region appear much more open to introducing CBDCs later this decade than their counterparts around the world.

Biden's Broad Mandate Has Altered the Antitrust Landscape, Making Merger Clearance Process Less Predictable

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Takeaways

- Under the Biden administration's "whole-of-government" approach to promoting competition, a range of agencies outside the DOJ and FTC have been asked to use their authority to reform markets.
- Wide-ranging procedural changes at the FTC have expanded its review powers and complicated merger clearances.
- The long-standing view that most vertical mergers pose no threat to competition is being abandoned.
- Bipartisan support in Congress for more controls on Big Tech could result in amendments to antitrust statutes in 2022.

The Biden administration has demonstrated a clear pro-enforcement approach to antitrust, implementing numerous directives and changes, driven in part by concerns about the power of Big Tech, and by progressives who want antitrust enforcement to further their social goals.

These efforts have brought more uncertainty in the short term as the antitrust agencies and the business community adjust. Whether 2022 brings more dramatic, rather than incremental, changes will depend on whether Congress revises the antitrust laws and if the agencies successfully challenge deals and conduct in court.

Key Players

The main faces of antitrust enforcement in the Biden administration are vocal progressives, and in 2022 we expect to see them push for changes in policy, practice and the law:

- Timothy Wu, special assistant to the president for technology and competition policy, coined the term "net neutrality" and advocates reigning in dominant telecom firms and online platforms.
- Lina Khan, before her appointment as chair of the Federal Trade Commission, was best known for a 2017 law review article advocating a new antitrust framework to address market power in the digital age and using antitrust law to protect social interests, such as to prevent layoffs or stagnation of wages.
- Jonathan Kanter, assistant attorney general overseeing the Department of Justice (DOJ) Antitrust Division, comes from private practice, where he was a vocal critic of Big Tech and pursued, on behalf of clients, Google and other tech firms for antitrust violations.

The Administration's 'Whole-of-Government' Approach to Antitrust

In a July 2021 executive order, President Joe Biden articulated the administration's broad antitrust policy. That order instructed the antitrust agencies to increase enforcement to prevent a rise in consumer prices and competitive harm in labor markets, and preserve nascent competition. Additionally, in what the order calls a "whole-of-government competition policy," it charged more than a dozen other agencies to protect competition using their authority under a range of statutes.

This approach allows the administration to challenge conduct it deems anticompetitive or unfair without having to resort to suits under the antitrust statutes. For example, in a town hall meeting in December 2021, Mr. Wu criticized distribution practices that allegedly favor large alcohol suppliers over small ones and called on the U.S. Department of the Treasury's Alcohol and Tobacco Tax and Trade Bureau to address them through rulemaking or regulation.

Former FTC Commissioner Rohit Chopra, now director of the Consumer Financial Protection Bureau, has advocated that his new agency's mandate be expanded to cover antitrust and "abuses of dominance," which traditionally would require a DOJ investigation and lawsuit alleging violations of the Sherman Act, such as monopolization or illegal agreements that foreclose competition.

The order instructs agencies to take additional steps, some directed toward specific outcomes, to promote competition and prevent "unfairness" by competitors in the marketplace. We expect agencies to use their separate statutory authorities under this whole-of-government approach to advance the administration's antitrust goals in priority sectors such as financial services, health care, transportation, agriculture and telecommunications.

Changes in Policy and Process Further the Administration's Goals

Mr. Kanter's time as assistant attorney general has been too brief to provide clear insights into the Antitrust Division's new enforcement priorities. But Ms. Khan's first six months as chair of the FTC make the commission's new direction plain. A string of moves either on a 3-2 party line commission vote or through process changes by the FTC's director of the Bureau of Competition, have undone decades-old policies and practices and replaced them with aggressive approaches that add uncertainty to the deal process and bring additional administrative burdens.

Vertical mergers: The commission abandoned the Vertical Merger Guidelines, which for years had embraced the principle that most vertical tie-ups are pro-competitive and should not be challenged. The Khan commission advocates scrutiny of vertical mergers, considering, in particular, potential harms in the context of "modern firms," as well as harms to labor markets. In December 2021, for example, the FTC sued to block Nvidia's takeover of chipmaker Arm, asserting that the vertical merger would allow the combined entity to unfairly undermine competitors.

Prior approvals: The commission adopted a policy to include in merger consent orders a provision requiring firms to obtain approval before consummating future deals.

Individual commissioners can seek compulsory process: The commission adopted a resolution to authorize compulsory process — a demand for documents or testimony enforceable in federal court — at the request of a single commissioner.

Second requests: The Bureau of Competition director modified second-request requirements, making the process lengthier, and giving the FTC's more time and leverage to challenge mergers.

Other process changes include the suspension of the Hart-Scott-Rodino Act early termination option, which allows deals to close before the end of the statutory waiting period with the FTC's consent, and the adoption of a practice of sending letters to merging parties warning them that the FTC will continue to investigate and reserves the right to challenge the deal after it closes.

See "Deal Uncertainty Increases as Merger Control Authorities Gain Discretionary Powers of Review."

Antitrust Legislation May Pass in the Upcoming Congressional Session

Many Republicans are critical of the Khan FTC's aggressive approach, calling out the Democrats for unilaterally making significant substantive changes by amending procedures. Nevertheless, the potential for antitrust legislation to pass this session is real, because Democrats in Congress enjoy Republican support to rein in the power of Big Tech.

Numerous bills have been introduced in the House and the Senate, but the most likely to advance is the Platform Competition and Opportunity Act, with the House version introduced in June 2021 and the Senate version in November 2021. The measure would prevent technology platforms valued at more than $600 million from acquiring existing or nascent competitors worth more than $50 million. The prohibition would also apply to acquirers with more than 50,000 monthly users, or that are considered to be critical trading partners, defined as owning or controlling an online platform or having the ability to prevent a business user from accessing its own customers or tools it needs to serve its customers.

Conclusion

The FTC under Chair Khan is expected to implement further policy changes, and the Kanter Antitrust Division will begin similar efforts. We also expect both agencies to attempt to test the limits of antitrust enforcement through new cases. That will stretch already-thin agency resources and require the FTC and DOJ to prevail in court. Whether the administration will succeed in pushing its progressive antitrust agenda may depend primarily on the staffs' capacity to handle the increased workloads, and on whether Congress amends the laws to make it easier for them to prevail.

Deal Uncertainty Increases as Merger Control Authorities Gain Discretionary Powers of Review

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Takeaways

- More than 50 countries now have the discretion to conduct competition reviews of mergers below mandatory notification thresholds, and the European Commission, EU member states, the U.K. and others are using this authority more frequently.
- As a consequence, companies whose merger might not have been subject to a competition review in the past need to provide for the possibility that their deal will draw the attention of regulators with discretionary review powers.
- Risks need to be allocated between the parties, and adjustments may need to be made to long-stop dates and the parties' obligations to help secure regulatory clearances.
- Understanding the areas of particular concern to individual merger control authorities is now key to a smooth closing. Transactions in innovative industries such as pharma and tech where large players acquire emerging targets with little or no revenue are most likely to see reviews.

The Perceived Enforcement Gap

In many countries, concerns exist that traditional turnover (revenue) thresholds for merger reviews do not capture some acquisitions by incumbents of nascent competitors that could play a significant competitive role in the market in the future — so-called "killer acquisitions." For example, the Australian, German and U.K. regulators issued a joint statement in 2021 noting the challenges they face when investigating mergers in dynamic and fast-paced markets, particularly in the tech sector. In many cases, the target may have a promising technology but little or no revenue, so the deals do not meet traditional notification thresholds.

Below-Threshold Reviews Become More Common in the EU

Since early 2021, the European Commission (EC) has invited national regulators to refer certain transactions to it that do not meet either national or EU thresholds for investigation, in particular "killer acquisitions." The EC is doing so under a provision in the EU Merger Regulation allowing national regulators to refer transactions that are not purely national in scope and that may give rise to serious competition issues.

Enabling the referral of transactions that do not meet national thresholds is creating uncertainty and can result in investigations of deals that have already closed.

A recent example is Illumina's completed acquisition of GRAIL, which did not meet the EU's or any member states' notification thresholds. The merger of the two cancer screening businesses was announced in September 2020, and in March 2021 several national regulators requested that the EC review the transaction. The EC accepted the referral in April 2021, and subsequently launched an in-depth investigation.

Illumina is currently challenging the EC's jurisdiction before the EU courts. But the extended investigation threatened to extend beyond the deal's long-stop date, so they chose to close the transaction in August 2021 while the EC review was still underway. As a result, the EC has launched a gun-jumping investigation that could result in a substantial fine, and it ordered Illumina to hold GRAIL separate for the duration of its investigation.

Stretching Jurisdiction in the UK

In the U.K., the Competition and Markets Authority (CMA) is increasingly construing the criteria for review broadly, taking jurisdiction over deals where targets appear to have limited (if any) revenues or direct activity in the U.K. In some cases, other global regulators have already approved them. Exacerbating the situation, Brexit has created the possibility of parallel reviews in the EU and U.K.

For example, the CMA recently ordered Facebook (since renamed Meta) to unwind its completed acquisition of the GIF-sharing social media company Giphy. Although Giphy did not generate any revenue in the U.K. in its last financial year, the CMA asserted jurisdiction after finding that the company's small presence in the country overlapped with Facebook's activities.

The CMA's action in this deal is not an outlier. In recent years, it has intervened in non-U.K.-centric deals in dynamic global markets on a number of occasions.

In addition, the CMA fined Facebook £50 million for failing to comply with an order requiring it to hold the Giphy business separate from its own. The regulator routinely imposes hold-separate orders, especially when reviewing completed acquisitions. Meta has appealed the order.

Other Jurisdictions Also Scrutinize High-Value/Low-Turnover Deals

Germany and Austria both adopted alternative transaction-value thresholds in 2017, requiring the notification of acquisitions by large companies of targets with significant activities in those countries, even if the targets generate no revenue there. For Germany, the new review powers extend to deals with a global value over €400 million and, for Austria, those with a global value over €200 million.

Facebook was also recently fined €9.6 million for failing to notify Austrian regulators of its acquisition of Giphy, for which Facebook reportedly paid $315 million. Austria is now conducting an in-depth investigation into the deal.

More jurisdictions are considering this approach, including South Korea, which introduced an alternative transaction-value threshold at the end of 2021, capturing deals with a global value of at least KRW 600 billion.

Separately, over 50 competition regulators around the world have the discretion to review deals that do not meet notification thresholds. More will likely follow. Italy, for example, recently proposed introducing such a power. These regulators frequently monitor the financial press and can request information from merging parties to determine if a deal raises significant enough competition issues to open an investigation, even if it has already closed.

Discretion Creates Uncertainty for Deals

There is some good news on the competition regulation front. Regulators have been trying to ease the burden of merger control for deals that clearly do not raise competition concerns. For example, a growing number of regulators are introducing or expanding simplified procedures, with shorter timescales and/or shorter notification forms for less problematic mergers.

But the trend toward alternative notification thresholds and more regulatory discretion to review deals that do not meet well-defined thresholds has led to uncertainty, delays and increased costs for dealmakers, and it can result in standstill or hold-separate orders. Regulators also can, and on occasion do, order retrospective divestments to address competition concerns, or even order a completed deal be unwound.

How Should Dealmakers Navigate This New Landscape?

Conducting an early analysis of potential competition issues, alongside the usual assessment of required filings, can identify jurisdictions where regulators may seek to investigate a transaction that falls below the notification thresholds. Proactive, voluntary approaches to those authorities can help determine whether they are likely to review a deal, thereby reducing the period of uncertainty.

For transactions in the digital and pharmaceutical sectors, which will likely be of particular interest to regulators, parties may want to consider including appropriate conditions precedent in deal documents to address the risk of an investigation. Building in extra time or flexibility into timetables may be necessary, particularly if the deal may be reviewed in jurisdictions where investigations move slowly.

For jurisdictions that do not have a statutory bar on closing before the review is complete (for example, the U.K.), the buyer may choose to go forward and close the transaction, taking on the risk of any future intervention by regulators.

See "Biden's Broad Mandate Has Altered the Antitrust Landscape, Making Merger Clearance Process Less Predictable."

CFIUS Goes Global: New FDI Review Processes Proliferate, Old Ones Expand

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Takeaways

- Since 2018, the U.S. and several other countries have revised or installed national security-related screening of foreign direct investments.
- Many jurisdictions now require filings for investments in the defense and security sectors, critical infrastructure, advanced technologies and sensitive personal data, or where state-backed investors are involved.
- While the CFIUS review process in the U.S. often remains the stiffest hurdle, the growing number of jurisdictions with similar regimes means that investors and parties to mergers must plan carefully for the review process.
- With the encouragement of the U.S. and EU, many reviewing authorities now frequently share information.

In 2021, more than a dozen countries enacted or significantly changed foreign direct investment (FDI) review processes. Some countries with relatively mature screening regimes, including Australia, Canada, China, France, Germany, Japan, New Zealand and Spain, strengthened or expanded them. Others, such as the Czech Republic, Denmark, the Netherlands, Saudi Arabia and Slovakia, implemented review schemes for the first time.

More reforms will follow in 2022, led by the U.K.'s National Security and Investment Act (NSIA), which took full effect on January 4, 2022. Other countries are expected to introduce significant legislation (*e.g.*, Ireland and Norway) or publish new FDI technical guidance (*e.g.*, France).

Several factors explain the expansion of these reviews:

- **A common "threat."** Many governments traditionally receptive to FDI have expressed concerns about the intentions of state-backed investors from nonmarket economies. For example, the European Commission's (EC's) first annual report on FDI screening, released in November 2021, noted a "clear change in investor profiles and investment patterns, *i.e.*, increasingly non-OECD investors, occasionally with government backing or direction, whose motivation for a particular investment might not always be exclusively commercial."
- **EU regulatory developments.** The Foreign Direct Investment Screening Regulation, which became fully operational in 2020, has dramatically expanded FDI review and related information sharing across the EU.
- **Emerging technologies.** More governments now recognize the significant role emerging technologies play in national security and defense. With recent supply chain disruptions in the semiconductor and other industries, technological sovereignty is seen as a particularly important issue.
- **U.S. government encouragement.** Since the passage of the Foreign Investment Risk Review Modernization Act (FIRRMA) in 2018, the U.S. Treasury has engaged with dozens of countries on FDI screening. The act directed Treasury to "facilitate the harmonization of action" on FDI by conferring favored status on countries with reliable screening mechanisms. This directive could have a farther reaching impact than FIRRMA's other changes to the existing review process under the Committee on Foreign Investment in the United States (CFIUS).

- **The continuing COVID-19 pandemic.** Several countries have established or strengthened FDI review as an emergency measure to avoid pandemic-related opportunism, renewing and extending these measures as the crisis continues.

See "Institutional Investors, Activists and Legal Reforms Begin Altering Japanese Corporate Governance."

Keys to Successfully Navigating FDI Reviews

While the CFIUS review process remains the most challenging and the one most likely to result in obstacles for a deal, the expansion of FDI requirements in other countries highlights the importance of developing a sound cross-border strategy for navigating this issue.

- **Early on, assess the necessity of FDI reviews for investments in sensitive industries.** In broad strokes, virtually all the major FDI review mechanisms focus on the defense and security sector, critical infrastructure, raw materials and inputs (energy products, minerals, food security), advanced technologies, mass media and sensitive personal data. Cross-border investments in these categories are the most likely to trigger FDI reviews.
- **Recognize that investor-related due diligence is essential.** A number of FDI regimes require filings for transactions involving state-backed investors, sometimes even for passive investments. Private equity and other investment partnerships therefore must be prepared to disclose information about their limited partners and partnership agreements during FDI reviews.
- **Understand and submit mandatory filings.** Most FDI regimes now require mandatory and suspensory filings for at least some transactions, usually with certain exemptions or waivers. We foresee more penalties imposed for noncompliance, led by the U.S.
- **Expect increased coordination between review authorities.** Parties should assume that information provided to one FDI regulator will be sent to others.
  - **European Union.** EU regulations create a notification mechanism to facilitate information-sharing between member states and the EC, and the EC reviewed over 400 such cases between October 2020 and November 2021. An FDI filing in one EU country may result in questions from others. FDI regulations also encourage member states and the EC to cooperate with non-EU countries.
  - **United Kingdom.** The NSIA allows the U.K. government to disclose information obtained in an FDI review to foreign authorities for various purposes, including to protect national security.
  - **United States.** Expect more formal cooperation between CFIUS and other FDI authorities, because FIRRMA provisions make sharing information with counterparts easier.
- **Allow more time for FDI reviews.** With more jurisdictions requiring filings, parties need to plan for lengthier reviews. Even jurisdictions with time limits and mechanisms to expedite reviews may fail to meet their deadlines due to increased FDI workloads. Implementation of the EU's FDI cooperation mechanism has already caused delays and longer review periods in some member states.
- **Anticipate the need for mitigation in sensitive cases.** FDI regulators now more commonly condition approval of sensitive transactions on mitigation measures addressing security concerns, which can materially impact governance and operations of the acquired business. Regulators are also increasingly monitoring existing mitigation commitments.
- **Engagement with FDI regulators is critical.** With so many new, revised and expanded FDI review mechanisms, parties must be prepared to engage early and proactively with regulators regarding jurisdiction, control and co-investments (particularly involving investment funds), mandatory filing requirements, filing thresholds and timing. In some cases, informal outreach in advance of filing to gauge its need or likelihood of success can yield invaluable information.

FDI Approvals Have Grown More Complicated but Can Be Navigated Successfully

Even with enhanced screening and more aggressive jurisdiction assertions, most FDI filings are approved. In 2020, approximately 80% of cases subject to full U.S. filings or formal EU member state notifications were cleared without conditions, according to data published by government regulators. Another 10% received approval with conditions or "mitigation," while the remaining 10% were withdrawn or (in a handful of cases) formally prohibited.

These figures conform to our experience that robust FDI-related analysis in the due diligence phase can help identify and weed out transactions that will face problems during a review in the U.S. or elsewhere, and compliance and engagement with regulators can maximize prospects for success.

Security Concerns Prompt Multiple Supply Chain Initiatives

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Takeaways

- As a national and economic security initiative, the Biden administration is developing policies to protect several critical supply chains.
- The Commerce Department is expected to take further measures to regulate imports of information and communications technology and services from countries deemed to be adversaries.
- A broad prohibition on imports from China's Xinjiang region due to forced labor concerns will complicate the importing of some products, including solar panels.
- Previously granted tariff exclusions for some Chinese goods are likely to be extended, but there is pressure to expand the process for seeking exceptions.

One prominent U.S. media outlet dubbed 2021 the "Year of Supply Chains," for good reason. Shortages of semiconductors and other products and components caused by the pandemic, combined with trade-related national security concerns, resulted in a number of regulatory initiatives in 2021 that will lead to new restrictions — and potentially new business opportunities — this year.

A renewed process for granting exclusions to China-related Section 301 tariffs, which is also in the works, should help alleviate some supply problems.

Companies should monitor these developments carefully as they unfold.

Critical Supply Chain Reviews

President Biden opened his administration by proclaiming that "resilient, diverse and secure supply chains" will ensure U.S. economic prosperity and national security, and he directed several cabinet agencies to review and report on recommended regulations to strengthen them.

- **Developments in 2021.** In June 2021, the administration published reports identifying vulnerabilities and making policy recommendations to ensure long-term availability of several critical product categories: semiconductor manufacturing and advanced packaging, electric vehicle and other high-capacity batteries, critical minerals and other strategic materials, and pharmaceuticals and active pharmaceutical ingredients. Similar reports are to be finalized in early 2022 for other broader economic sectors: defense, public health and biological preparedness, information and communications technology, energy, transportation and agricultural commodities and food products.
- **What to expect in 2022.** Multiple departments have solicited industry and public input on appropriate government initiatives to strengthen supply chains: Defense, Transportation, Energy, Agriculture, Commerce and Health and Human Services. They have been charged with devising policy recommendations, both "positive" (*e.g.*, workforce development, financing opportunities, stockpile creation) and "negative" (*e.g.*, addressing surveillance and cyberrisks). Agencies should begin work on regulatory or legislative proposals later in 2022.

Information and Communications Supply Chain Restrictions

In response to a May 2019 executive order, the Commerce Department imposed restrictions, in the interest of U.S. national security, on the importation of information and communications technology and services (ICTS).

- **Developments in 2021.** Shortly before President Trump left office, Commerce published regulations providing the agency with authority to prohibit a broad range of transactions related to ICTS goods and services involving designated "foreign adversaries" (currently defined to include China and Hong Kong, Cuba, Iran, North Korea, Russia and Venezuela) if Commerce finds that the transaction threatens national security. The department may take prospective or retroactive actions to prohibit such transactions, and has wide discretion to determine the restrictions.

The Biden administration maintained these ICTS regulations, but it is unclear what, if anything, Commerce has done to implement or enforce them since the new president took office. The department has done little to clarify its intentions, leaving unanswered a number of fundamental definitional and jurisdictional questions, such as the threshold for determining when a transaction is sufficiently connected to a foreign adversary to trigger coverage, or whether Commerce will issue guidance clarifying its enforcement priorities and expectations.

In November 2021, Commerce proposed expanding these regulations to cover ICTS transactions involving "apps," or connected software applications. Proposed criteria for imposing restrictions include potential surveillance capabilities and the scope and sensitivity of data collected.

- **What to expect in 2022.** The Biden administration is expected to amend and clarify the existing ICTS regulations this year to devise a more workable framework, though no specifics have been offered. Some industry participants have pressed for a mechanism to seek clearance or licenses from Commerce for ICTS transactions, which would serve as a safe harbor against retroactive reviews. Others have suggested that Commerce establish a "blacklist" of foreign companies considered off-limits for ICTS dealings, with a presumption that other ICTS transactions are not prohibited. Regardless of the approach adopted, businesses should be prepared for more aggressive implementation by Commerce once the regulations are clarified or revised.

Xinjiang Supply Chain Restrictions

The importation of some products has also been complicated by restrictions imposed in response to U.S. government findings that goods made in the Xinjiang Uyghur Autonomous Region (Xinjiang) of China have been produced by forced labor.

- **Developments in 2021.** The U.S. government continued to impose sanctions against Chinese government entities and businesses in response to their actions in Xinjiang. U.S. Customs and Border Protection has issued withhold release orders blocking the entry of products from China because of forced labor, including 10 directed specifically at activity in Xinjiang.
- **What to expect in 2022.** On December 16, 2021, the U.S. Congress passed legislation that effectively prohibits imports of goods made either wholly or in part in Xinjiang, relying on a strong presumption that forced labor is used in all products coming from the region. President Biden signed the legislation on December 23, 2021, and the import ban will go into effect 180 days later. In particular, this legislation will affect the U.S. solar industry, as Xinjiang is a major center for polysilicon manufacturing. (See our December 17, 2021, client alert "Legislation Targeting Imports From Xinjiang Region Moves to President Biden's Desk.")

Section 301 Tariffs: Exclusions on the Way?

At the same time new import restrictions are being imposed and contemplated, businesses are lobbying for relief from Section 301 tariffs imposed on products from China beginning in 2018.

- **Developments in 2021.** The Biden administration has maintained these tariffs, which apply to the majority of goods shipped to the U.S. from China, and it has been slow to restart the Section 301 tariff exclusion process established by the Trump administration, by which companies could argue the charges should not be imposed on their products. In October 2021, the U.S. trade representative (USTR) invited public comment on whether to reinstate tariff exclusions that have expired. (See our October 12, 2021, client alert "USTR Relaunches Exclusion Process for China Section 301 Tariffs.") A large bipartisan group of lawmakers is reportedly advocating changes to make it easier to seek exclusions, citing (among other things) the harm to U.S. supply chains caused by the tariffs.
- **What to expect in 2022.** USTR likely will reinstate most of the tariff exclusions for which it sought public comment and move forward with another, and potentially expanded, procedure for obtaining exclusions in 2022. Broader relief from Section 301 tariffs, however, remains unlikely. The United States and China successfully concluded a "Phase 1" trade deal in 2019, but prospects for a more far-reaching "Phase 2" deal — which might eliminate or substantially reduce the tariffs — appear remote, at least in the near term. In addition to continuing geopolitical tensions between the two countries, China likely has fallen short of its Phase 1 commitments to purchase an additional $200 billion in U.S. goods and services by the end of 2021.

Supply Chain Initiatives To Present Challenges and Opportunities in 2022

In 2022, we expect the U.S. government to devote substantial attention to addressing the supply chain challenges outlined above. U.S. firms affected by these initiatives should monitor developments carefully, consider providing input where appropriate, and prepare to comply with new restrictions and capitalize on new opportunities.

China Faces Existing and Expanded US Restrictions on Trade, Investment and Technology

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Takeaways

- Chinese investments requiring CFIUS review have declined as the U.S. scrutinizes those transactions aggressively, and rules governing interactions with "Chinese military-industrial complex companies" have been revamped.
- Import restrictions on products made in the Xinjiang region have been deployed by the U.S. government.
- Despite several high-profile case dismissals and a trial loss, the DOJ's China Initiative, aimed at thwarting economic espionage and trade secret theft, continues.
- Multinational companies that have dealings in China or with its citizens will need to comply with two new Chinese data protection laws.

National Security Regulation

China remains one of the U.S. government's top priorities for national security regulation. The Biden administration has retained or even augmented key aspects of the Trump administration's national security approach to China, while making modest adjustments to some of the more controversial or legally vulnerable regulations:

- The Committee on Foreign Investment in the United States (CFIUS) maintained an aggressive approach to reviewing transactions involving investors from China or third-country investors with significant connections to China. This has resulted in a notable drop in Chinese investments requiring a CFIUS review, from an average of 57 cases per year in the 2016-18 time period to 28 in 2019 and 22 in 2020. We anticipate that the data will reveal a comparable drop in China-related CFIUS cases in 2021.
- The U.S. government has deployed sanctions and new legislation to pressure U.S. companies to avoid products from the Xinjiang region of China, in response to U.S. government concerns about the use of forced labor for products from Xinjiang. On December 23, 2021, President Biden signed into law the Uyghur Forced Labor Prevention Act, which Congress had passed with broad bipartisan support. The act effectively prohibits imports of goods made wholly or in part in Xinjiang, relying on a strong presumption that forced labor is used for all products coming from the region.
- In a modification of Trump administration policy, in June 2021 President Biden revoked an executive order that would have restricted the use of eight popular Chinese apps in the U.S. In its place, the Commerce Department was instructed to monitor and take appropriate action against any "connected software applications" — defined as software "used on an end-point computing device … [with] the ability to collect, process, or transmit data via the internet" — that may pose risks to U.S. national security. We expect Commerce to issue further guidance on this issue in 2022, and we anticipate a rigorous regulatory and enforcement regime.
- In June 2021, the Biden administration revamped the sanctions framework for "Communist Chinese Military Companies" (now called "Chinese Military-Industrial Complex Companies" or CMICs) by clarifying listing criteria, revoking some of the more controversial sanctions on particular companies and shifting primary responsibility for administering the list from the Department of Defense

to the Treasury Department's Office of Foreign Assets Control (OFAC). In December, OFAC added additional companies to the CMIC list.

We anticipate a similar approach in 2022, with the administration continuing a relatively aggressive but more nuanced approach to national security regulation.

Securities Regulation

On December 2, 2021, the Securities and Exchange Commission (SEC) adopted final amendments implementing the disclosure and submission requirements of the Holding Foreign Companies Accountable Act (HFCAA). The legislation directs the SEC to delist registrants if, for three consecutive years, the Public Company Accounting Oversight Board (PCAOB) is unable to inspect the auditor of the registrant's financial statements.

On December 16, 2021, the PCAOB sent the SEC a report with its determinations that it was unable to inspect or investigate completely PCAOB-registered public accounting firms headquartered in China and Hong Kong because of positions taken by government authorities in those jurisdictions. Access to the audit work papers of firms headquartered in China and Hong Kong likely will continue to be a significant issue in 2022.

DOJ China Initiative

Originally announced in November 2018 as a Department of Justice (DOJ) effort to counter Chinese trade secret theft and economic espionage, the China Initiative faced significant criticism last year. After the DOJ dropped several cases, and a judge acquitted University of Tennessee professor Anming Hu on wire fraud and false statement charges based on allegations that he hid his affiliation with a Chinese university while receiving funding from the U.S. National Aeronautics and Space Administration, some observers questioned whether prosecutors had overreached. Critics also raised concerns that the China Initiative could contribute to negative stereotypes of Asians and Asian Americans.

The DOJ has not disavowed the China Initiative, however, and on December 21, 2021, a federal jury in Massachusetts convicted Harvard professor Charles Lieber of false statements and tax offenses stemming from the concealment of his affiliation with the Wuhan University of Technology and his participation in China's Thousand Talents Program.

Although the DOJ may be more cautious in bringing false statement-type cases given its losses in other cases last year, we expect continued focus on the Chinese government's perceived involvement in intellectual property misappropriation, economic espionage and cyberattacks.

New Chinese Legislation

In addition to American laws and regulations applying to Chinese companies and trade, two new Chinese laws came into force in late 2021 that are likely to have an impact on many multinational companies operating in, or with operations touching, the country: the Data Security Law (DSL) and the Personal Information Protection Law (PIPL).

The DSL applies to all data activities in China, as well as extraterritorially if they are deemed to impair the country's national security and public interest. It sets up a framework to classify data collected and stored in China based on its potential impact on Chinese national security and regulates its storage and transfer depending on the type of data. Specifically, the DSL clarifies and expands data localization and transfer requirements for certain categories of data and certain types of data handlers, and it expands the scope of regulation to cover both the initial collectors and downstream intermediaries.

The PIPL generally applies to all types of data activities involving the personal information of subjects in China, as well as activities outside the country aimed at providing products or services to individuals in China or analyzing their behavior. The PIPL imposes the following key obligations on data handlers:

- obtain consents;
- localize and delete data when certain conditions are met;
- ensure that any foreign recipient of the data has protection measures in place that are no less stringent than those imposed by the PIPL in cross-border data transfers; and
- conduct regular self-audits to assess information security risks and implement corresponding policies and safeguards.

Given these laws' broad coverage and expansive compliance obligations, companies doing business in China should reassess their information technology systems and seek advice before exporting data overseas.

Build Back Better Act Would Change Monetization Playbook for Tax-Free Spin-Offs

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Takeaways

- Tax law changes in the Build Back Better Act (BBBA) would limit the amount of value a company could extract in a spin-off by using a debt-for-debt exchange.
- Companies may be able to achieve most of the tax-free monetization currently available using alternative approaches, such as effecting a reverse spin-off, transferring high-basis assets to the Spinco or using a debt-for-equity exchange.
- Under the BBBA amendment, dividends to shareholders and stock buybacks do not appear to count toward the proposed cap on other forms of monetization.

If enacted in its present form, the Build Back Better Act (BBBA) would amend the U.S. tax code's rules for tax-free spin-off and split-off transactions (spin-offs), imposing significant restrictions on a parent company's ability to reallocate debt to the spin-off company without incurring a tax liability. Navigating these restrictions, or mitigating their impact, will require careful planning and transaction structuring, particularly in spin-offs involving highly appreciated assets.

Background on Spin-Offs and Traditional Methods of Debt Reallocation

A spin-off generally involves the separation of a historic business line of a parent company (Parent) into an independent, separately traded entity. Typically, they are structured as "divisive" reorganizations in which the Parent contributes the spin-off business to a newly formed subsidiary (Spinco) and then distributes the Spinco's stock to the Parent's shareholders. If the spin-off satisfies certain requirements, the transaction is not taxable to the Parent, Spinco or shareholders who receive Spinco stock.

Current spin-off rules sanction a variety of tax-free methods of extracting value from the spin-off business. For example, the Parent may receive cash proceeds or reallocate some of its existing debt to the Spinco as a way of partially "monetizing" the Parent's interest in the spin-off business and establishing appropriate capital structures for the two companies going forward.

The Spinco's assumption of debt or other liabilities from the Parent is generally tax-free to the extent the liabilities assumed do not exceed the tax basis of the assets that the Parent transfers. Similarly, the Parent's receipt of cash or other property (referred to as "boot") from the Spinco is generally tax-free to the extent (1) the value of the boot does not exceed the tax basis of the transferred assets less the amount of liabilities assumed, and (2) the Parent "purges" the boot through payments to its shareholders (*e.g.*, as dividends or stock repurchases) or to its creditors (*e.g.*, via repayment of outstanding Parent debt).

The current law provides flexibility to reallocate additional debt to the Spinco — in excess of the tax basis of the transferred assets — through a "debt-for-debt exchange," by which the Parent receives newly issued Spinco debt "securities" (a term of art that refers to certain longer-term debt instruments) and uses them to retire outstanding Parent debt. That is usually achieved through an intermediary such as an investment bank that buys the relevant Parent debt in the secondary market and exchanges it for the newly issued Spinco debt, which is usually sold promptly to investors. This is one of the most well-trod and generally efficient paths to "monetize above basis" in a spin-off.

Proposed BBBA Amendments to Spin-Off Rules

The BBBA would amend the spin-off rules in an effort to create parity among these different methods of debt reallocation by subjecting debt-for-debt exchanges to the same overall tax basis limitation that currently applies only to liability assumptions and boot payments (the BBBA spin-off amendment). If enacted, the changes would apply a single, aggregate tax basis limitation to (1) the amount of liabilities assumed by the Spinco, (2) the amount of cash (and the value of non-cash boot) paid by the Spinco and transferred to the Parent's creditors, and (3) the principal amount of debt securities (and the value of certain debt-like "nonqualified preferred stock") issued by the Spinco and transferred to the Parent's creditors.

As a result, the Parent would generally be taxed on any built-in gain in the spin-off business to the extent the aggregate amount of these items exceeds the Parent's tax basis in the assets that it transfers to the Spinco.

If enacted, the proposed tax basis limitation will force many companies undertaking spin-offs to engage in complex transaction structuring to avoid paying higher taxes when the amount of debt that the Parent wishes to reallocate to the Spinco exceeds the tax basis of the spin-off business.

Revisiting the Monetization Playbook

While the BBBA spin-off amendment, if enacted, would introduce new structuring challenges for companies and their advisers, several key techniques may address the proposed tax basis limitation and achieve tax-efficient monetization in a spin-off. Each technique should be evaluated in the early planning stages of the transaction to determine which best suits the Parent's particular facts and business objectives.

Efficiently maximizing available monetizable tax basis in multitiered structures. The proposed tax basis limitation increases the importance of maximizing the available tax basis to support monetization. In most spin-offs by large public companies, the "external" spin-off of the Spinco is preceded by a series of internal restructuring transactions to package and separate the spin-off business. Depending on the Parent group's tax attributes and legal entity structure, proper planning may allow the Parent to use the tax basis at lower-tier subsidiary entities to support tax-free leveraged distributions of cash to the Parent, monetizing value without exceeding the tax basis limitation.

Sales of "low-taxed" assets by subsidiaries. With careful structuring, the Parent may sell some spin-off business assets into the Spinco structure in a manner that permits tax-efficient cash extraction from the Spinco. For example, if a subsidiary of the Parent holds recently acquired spin-off business assets that have little built-in gain, the subsidiary may be able to sell those assets to the Spinco at minimal tax cost, as long as the sale is respected as a separate exchange and not integrated with the Parent's contribution of the rest of the spin-off business to the Spinco. Non-U.S. subsidiaries of the Parent can also sell assets to the Spinco at reduced effective U.S. tax rates.

"Reverse" spin-offs. Another option is to reverse the "direction" of a spin-off, which can allow for largely unrestricted, tax-free extraction of value from the "unwanted" business. Instead of spinning that business off, the Parent transfers the core business it wants to retain to a newly formed subsidiary (New Parent) and distributes the New Parent's stock to the Parent's shareholders, and the "old" Parent keeps the unwanted business, which can be leveraged in advance of the distribution to provide cash proceeds for the New Parent.

A reverse spin-off allows the unwanted business to be allocated an amount of debt, either historic or newly incurred, in excess of the Parent's tax basis in that business, because the Parent is not the company being spun off. The Parent may also transfer cash to the New Parent before the reverse spin-off without any tax basis limitations or "purging" requirements. This structure can be used in preparatory internal spin-offs to similar effect.

Debt-for-equity exchanges. Although debt-for-debt exchanges are subject to the proposed tax basis limitation, the BBBA spin-off amendment does not change the treatment of debt-for-equity exchanges in which the Parent uses Spinco common stock (or "qualified" preferred stock) as the medium of exchange to retire Parent debt in connection with a spin-off. Like debt-for-debt exchanges, debt-for-*equity* exchanges are often structured as intermediated exchanges. They can be used to effectuate an initial public offering by the Spinco before the spin-off or to dispose of a retained equity stake in the Spinco after the spin-off.

The spin-off rules require the Parent to distribute "control" of the Spinco (generally, an amount of Spinco stock representing at least 80% of the Spinco's voting power and at least 80% of each of its nonvoting classes of stock) to the Parent's shareholders. This normally means that the Parent can dispose of up to 20% of the Spinco stock in a debt-for-equity exchange, assuming that the Spinco has just one class of voting stock. If a dual-class voting structure is palatable as a business matter, the Parent may be able to monetize an even larger portion of the Spinco's equity value (up to 49.9%) by capitalizing it with "high-vote" and "low-vote" classes of stock, distributing the high-vote shares (representing at least 80% of Spinco's voting power and more than 50% of its equity value) to the Parent's shareholders and using the low-vote shares to retire Parent debt.

Cash payments to the Parent's shareholders. By its terms, the proposed tax basis limitation only takes into account boot that is "purged" through payments to the Parent's creditors; the statutory cap does not apply to boot that is paid to the Parent's shareholders in the form of dividends or stock repurchases. For companies that file consolidated U.S. tax returns, regulations effectively cap the latter at the Parent's pre-spin-off tax basis in the stock of the Spinco, but those rules apply separately from the BBBA spin-off amendment's statutory debt reallocation limitations.

In other words, the amendment appears to allow a monetization of up to two times the Parent's tax basis in the spin-off business. Although it is unclear if this is the intent, the BBBA spin-off amendment appears to permit the Parent to (1) extract cash proceeds from the Spinco up to its tax basis in the Spinco stock and use that amount to fund dividends or stock repurchases, and (2) receive Spinco debt securities in a principal amount up to the tax basis of the spin-off business and use them to retire the Parent debt. After the spin-off, the Parent would presumably be free to use its other cash resources (*e.g.*, amounts that it would otherwise have used to pay dividends or repurchase stock) for further deleveraging.

For more details, see our December 17, 2021, client alert "Build Back Better Act Would Change Monetization Playbook for Tax-Free Spin-Offs."

Multinationals Should Consider Adding 'Competent Authority Processes' to Their Tax Strategies

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Takeaways

- Transfer pricing uncertainty has increased with U.S. tax reforms and an OECD proposal establishing a new approach to determining the jurisdiction where income is recognized.
- The "competent authority processes" created by standard tax treaties offer cost-effective ways to resolve tax disputes and plan for the future.
- One procedure (MAP) allows taxpayers to initiate negotiations among multiple jurisdictions to resolve transfer pricing and double taxation problems.
- Through another one (APA), companies can obtain advance approval of transfer pricing policies — authorizations that can extend for years.

As the global tax landscape evolves, multinational enterprises (MNEs) in many jurisdictions increasingly find themselves subject to double taxation or conflicting transfer pricing rules. Fortunately, long-standing tax treaties provide administrative procedures to resolve disputes and obtain guidance for the future — processes that have been underutilized and even overlooked but are important options for taxpayers now, as the accepted rules and interpretations change.

A host of new cross-border intercompany issues have been raised by recent tax reforms in the United States, including the 2017 Tax Cuts and Jobs Act (the largest overhaul of U.S. tax law regarding overseas corporate income in over 30 years) and the spate of 2021 proposals. Meanwhile, the Organization for Economic Cooperation and Development (OECD) has won broad international support for reforms aimed at addressing taxation of the digital economy and nexus issues — *i.e.*, where income should be recognized when the taxpayer has little or no physical presence in jurisdictions from which it derives revenue. These reforms would require MNEs to revisit their transfer pricing systems. (See our June 16, 2021, client alert "Is Tax Competition Dead?")

As a consequence of these developments and financial anomalies resulting from the COVID-19 pandemic, MNEs face more controversies involving international taxes and transfer pricing issues and find it more difficult to plan. That makes it increasingly important to consider the "competent authority" mutual agreement process (MAP) and advance pricing agreements (APAs) as alternate ways to head off and resolve disputes.

Overview of the Competent Authority Process

The term "competent authority" derives from widely adopted model tax treaties, which typically establish the MAP and APA processes.

MAP allows companies to seek relief from double taxation and taxation inconsistent with treaty terms by initiating negotiations among the governments that are parties to a treaty. Each country has its own set of internal procedures for implementing the process.

Taxpayers are not directly involved in negotiations between the tax authorities. Instead, they launch the proceeding through their home jurisdiction's competent authority, providing the necessary factual and legal information. U.S.-based parents with international subsidiaries submit a request to the Internal Revenue Service and each subsidiary applies to the relevant foreign tax authority.

In addition to addressing transfer pricing disputes, the MAP process can be used to resolve double taxation arising from other treaty issues, such as foreign tax credits, permanent establishment and withholding tax.

While MAPs come after an assessment, an APA looks forward, establishing a formal agreement between a taxpayer and one or more tax authorities to determine the transfer pricing methodology for future intercompany transactions. Like MAP, the APA process begins with a request by the taxpayers to the relevant competent authorities and can be multilateral. APA approvals typically run five years or more, with possible renewal and rollbacks (authorizations for past years when returns have already been filed).

Benefits Include Efficient Resolution With Multiple Jurisdictions

Competent authority processes offer many benefits compared to traditional methods of resolving international tax disputes, such as domestic tax administrative remedies and litigation.

First, the competent authority process is effective and efficient. Because MAP is bilateral or multilateral, involving the taxing authorities of the relevant jurisdictions, taxpayers can simultaneously resolve transfer pricing adjustments in multiple countries on consistent terms. In contrast, dispute resolution channels in a single jurisdiction usually do not provide relief from double taxation because actions undertaken in one country may not be available in another, or different outcomes may be reached.

In addition, companies have a high success rate with the MAP process, making it a better alternative to litigation. For instance, in 2020, of the 209 transfer pricing MAP cases resolved by the IRS, 105 concluded in an agreement that fully eliminated double taxation, 14 resulted in the IRS granting unilateral relief from double taxation and 25 were withdrawn by the taxpayer, according to OECD data.

Taxpayers also have the option to manage their transfer pricing arrangements proactively through bilateral or multilateral APAs, which provide up-front certainty about methodology and avert the risk of double taxation.

Second, the competent authority processes tend to be amicable, less costly and less time-intensive compared to administrative remedies or litigation. The cost of submitting the request and providing the necessary information, though considerable, is usually a fraction of the expense of depositions, experts and so on in litigation.

Third, where appropriate, competent authorities can consider the OECD guidelines when interpreting applicable domestic law. Depending on the facts at issue, that may provide common ground where domestic laws or rule interpretations conflict.

Fourth, the competent authority process is flexible. Taxpayers can usually submit a MAP request after an unsuccessful examination or alternative dispute resolution. Moreover, companies may request that the terms of a MAP resolution be extended to subsequent tax years when a return was filed but not yet audited.

Finally, the outcomes are not judicial rulings, so the parties are not bound by the competent authorities' proposed determinations, and those do not constitute precedent for future disputes. Thus, if a proposed MAP settlement is unsatisfactory to the taxpayer, it can pursue litigation. And, if an advantageous APA preapproval cannot be obtained, the taxpayer can simply wait for an assessment and deal with the issue at that point.

Considerations To Weigh

The decision to pursue a MAP or APA involves many factors, including the materiality and complexity of the issues and the sophistication and experience of the relevant tax authorities. Similarly, business considerations may make the competent authority process less attractive. For example, some MNEs may hesitate to disclose details about their business and transactions to certain authorities.

On balance, however, the competent authority process serves as an effective remedy for relief from double taxation, and MNEs should consider these avenues as alternatives to domestic channels of tax dispute resolution.

Tax Law Struggles To Keep Pace With the Proliferation of Cryptocurrency

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Takeaways

- The technical architecture of various cryptocurrencies makes it difficult to bring them within existing tax rules, even those designed to deal more generally with the digital marketplace.
- The U.S., U.K. and Australia have started to offer guidance on topics such as the timing of income recognition and capital gains treatment.
- Because it is debatable where some crypto transactions occur for tax purposes, determining which jurisdiction has primary taxing authority is often unclear.
- Moves by regulators and tax authorities to tighten cryptocurrency regulation and require more reporting from exchanges and other financial institutions could cause some crypto activity to migrate to different jurisdictions, further complicating these tax issues.

As of December 2021, more than 15,500 cryptocurrencies and 445 digital asset exchanges existed (according to CoinMarketCap), and the global market cap of cryptocurrencies reached $2 trillion, rivaling the estimated $3 trillion in alternative assets under management globally.

As digital assets proliferate, so do questions about their taxation. Many rules designed over the last century to deal with financial and commercial assets — from derivatives to intellectual property — are ill-suited to the digital assets now being created, traded, lent and hypothecated.

A lack of international consistency compounds this problem. Even if one jurisdiction works out rules for, say, the timing of taxable events, those may not dovetail with other countries' approaches, and existing tax treaties are little help.

National tax authorities are forced to choose between supporting new legislation, which risks quick obsolescence, or stretching existing legislation — generally with administrative guidance under existing law — to cover cryptocurrencies. Neither approach is ideal.

We analyze some key tax questions below, along with a view on where authorities are likely to focus future efforts.

Are Cryptocurrencies Legal Tender for Tax Purposes?

Tax authorities are putting significant effort into disabusing taxpayers of the notion that income earned through cryptocurrencies is not taxable because it is just "exchanging cash."

Cryptocurrency has certain features of legal tender. The European Central Bank, for example, lists three defining characteristics: It can be used (1) as a medium of exchange to avoid barter, (2) as a unit of account to simplify the measurement of value and costs, and (3) to store value for future saving and retrieval. Some cryptocurrencies may check all three of these boxes.

Yet tax authorities increasingly hold the view that cryptocurrencies are not legal tender, but rather a distinct property asset. In the U.S., the Internal Revenue Service (IRS) characterizes cryptocurrency as property that is not currency. The IRS's characterization is apparently intended to apply even to stablecoins, for which this treatment may be more questionable (particularly, for example, for stablecoins pegged to and backed by the U.S. dollar).

When Does a Taxable Realization Event Occur?

Two primary taxable events are when cryptocurrency is:

- "mined" or otherwise initially created or distributed, including via an "airdrop" (a free, often promotional distribution) or "fork" (a change in a cryptocurrency's blockchain protocol, potentially converting it to two new chains); and
- sold, exchanged or otherwise disposed of.

Mining

Mining is essentially the creation of a digital asset through application of computing power. Mining has attracted some detailed attention from tax policymakers.

In informal guidance, the IRS has stated that, when a taxpayer mines cryptocurrency, its fair market value on the date of receipt is included in the taxpayer's gross income. If the mining occurs as part of an individual taxpayer's trade or business (and is not undertaken by the taxpayer as an employee), the income (less allowable deductions) is also subject to self-employment tax.

In the U.K., HM Revenue and Customs (HMRC) states that it treats each situation on a case-by-case basis. For example, using a home computer while it has spare capacity to mine tokens would not normally amount to a trade. However, purchasing a bank of computers dedicated to mining tokens for an expected net profit (taking into account the cost of equipment and electricity) would probably constitute trading activity. If the mining activity does not amount to a trade, the pound sterling value (at the time of receipt) of any crypto assets awarded for successful mining will generally be taxable as miscellaneous income.

In Australia, if mining is carried out as a business activity, any cryptocurrency generated is treated as trading stock income, and changes in trading stock's value are included in income. If the mining is not a business activity, the mined cryptocurrencies are taxed under capital gains rules on disposal. The Australian Tax Office has stated that the treatment of new cryptocurrency received through a fork will depend on whether it is held as an investment or in a business.

Disposal

Disposal of cryptocurrencies, or assets exchanged for crypto, is also getting attention from tax authorities.

According to the IRS, a U.S. taxpayer's receipt of cryptocurrency will generally result in gross income on the date received, assuming it is gross income under general tax principles. Thus, the IRS's view is that receiving cryptocurrency in return for other property, or vice versa, may trigger recognition of a gain or loss — either a capital gain or ordinary income, depending on the circumstances. In the U.S., when a taxpayer invests in cryptocurrency, it is generally treated as a capital asset, so gain or loss can be either short- or long-term. However, if it is not a capital asset in a particular taxpayer's hands — for example, inventory and other property held mainly for sale to customers in a trade or business — the sale or exchange can result in ordinary income. In addition, at least certain digital assets could be subject to "mark to market" taxation for taxpayers trading or dealing in those assets and otherwise subject to Internal Revenue Code §475.

The U.K. distinguishes between investing and trading, particularly when it involves the value of losses from commercial activity. To date, HMRC has been reluctant to confer the title of "trading" on digital assets activity, for fear of allowing individuals who generate significant losses to offset other income. In guidance, HMRC has therefore focused on the capital gains treatment of profits from the sale of digital assets.

In common with other authorities, the U.K. acknowledges that calculating the basis can be difficult, particularly for crypto assets created rather than acquired.

Do Tax Exemptions for Foreign Investments in Pooled Investments Apply When Funds Invest in Digital Assets?

Both the U.S. and U.K. offer tax exemptions for foreigners investing through asset managers based in those countries.

In the U.S., a safe harbor applies to nonresidents trading stocks, securities or commodities through U.S.-based agents. Digital assets have raised several questions here. One example: Is a foreign miner using U.S.-based servers, custodians, software or personnel a "dealer," not a trader, and thus outside the scope of the exemption? Second, for traders, are the digital assets "stocks," "securities" or "commodities" within the meaning of the statute? It may be difficult to cast typical cryptocurrencies like bitcoin or ether as "stocks" or "securities," but they may be "commodities." Status as a "commodity" for this purpose depends on whether the cryptocurrency, or derivatives on that cryptocurrency, are traded on an "organized commodity exchange." It seems the IRS is still considering this point.

The U.K. has a similar regime, called the "investment manager exemption." The asset management industry tried unsuccessfully to convince HMRC three years ago that existing legislation sufficiently covered many of the more commonly traded digital assets. A process is now underway to define "digital assets" for the purposes of offshore funds trading through a U.K. investment manager.

Where Are the Assets, and Where Is the Taxable Commercial Activity?

Tax authorities face serious obstacles claiming jurisdiction over digital asset activity. Is the source of income determined by the location of personnel or hardware, or where relevant software is produced or updated? This is particularly difficult in a world of the distributed ledger. But the answer could be critical to establishing the existence of branches or permanent establishments under tax treaties, and, consequently, which country has a primary right to tax.

The issue also arises with digital asset exchanges, some of which claim to have no location. Such exchanges and their participants must consider where the fees from their activities are earned, and manage the potential risk that parties with which they interact may develop a taxable branch or permanent establishment relationship.

Additional Trends To Watch

A number of other potential developments could present challenging tax issues and affect the market for digital assets.

- **Shying away from the U.S.** As the Securities and Exchange Commission increases digital asset scrutiny, some exchanges and other market participants are looking to sever links with the U.S., including by removing U.S.-connected clients or counterparties from their platforms. New trading structures will be required to allow U.S. capital to be deployed in such trading while still respecting U.S. regulatory scoping rules.
- **Information reporting.** Digital transactions can be inherently hard to track, including identifying the true parties to the transaction. Third-party information reporting may be difficult or prohibitively burdensome for some cryptocurrency issuers or exchanges to administer. But both the U.S. and the Organisation for Economic Co-operation and Development (OECD) are addressing this issue.
  - **Broad enforcement actions.** A California district court in 2021 authorized IRS summonses to a cryptocurrency exchange to obtain a list of users involved in $20,000 or more of cryptocurrency transactions from 2016-21. Other exchanges have received similarly broad requests for transaction information. The IRS used that information to send mass-mailed letters to taxpayers with crypto transactions who the IRS believed potentially did not report certain income.
  - **Statutory information reporting.** The U.S. Treasury announced in this year's Green Book a proposed financial accounting regime aimed at cryptocurrency exchanges and wallets, large parts of which were included in the recently enacted infrastructure bill. These provisions will apply to tax returns and statements due after December 31, 2023.
  - **IRS regulatory efforts.** The IRS' "priority guidance plan" includes proposed regulations on broker reporting for cryptocurrency assets, and we understand that the IRS has been working on those proposed regulations while watching legislative developments. Our assumption is that, to the extent they were drafted prior to passage of the infrastructure bill, those proposed regulations will be converted to guidance under the bill's new statutory provisions on broker reporting. Bloomberg reported January 7 that the Treasury Department plans to issue guidance by the end of the month, in advance of the regulations, indicating which types of firms will be "brokers" subject to reporting obligations.
  - **OECD action.** In a similar vein, the OECD, whose Common Reporting Standards set requirements for financial institutions and provide for the sharing of that information across jurisdictions, is expected to issue specific guidelines for cryptocurrencies soon.
- **Cryptocurrencies can require the coordinated operation of multiple computer systems**. Questions will arise about the jurisdictions in which these collaborations are deemed to operate, creating potential compliance headaches for tax directors.

Conclusion

Without a doubt, tax authorities are getting more focused on digital assets. Compliance will increase, as will the complexity of the rules. The earlier era of less restricted commercial activity, uncovered by specific rules, is fading, at least in certain jurisdictions. Corporate participants in the digital asset market need to manage tax risk by building their internal support teams to comply with tax and reporting matters and closely tracking new legal developments. Participants should also be prepared to be flexible on where they establish their relevant structures globally, as the distributed nature of the digital asset market will encourage innovative thinking from a jurisdictional perspective, not least from the regulators and tax authorities.