2024 Insights

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Global M&A Activity Endures Headwinds in 2023 and Displays Resilience Going Into 2024

Contributing Partner

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Key Points

- While interest rates, uncertainty and other factors negatively impacted deal activity in 2023, we saw a steady flow of carve-outs, spin-offs and joint ventures that offered creative ways to achieve strategic goals.
- Financial sponsors remained active, though at reduced levels, using larger equity contributions, seller rollovers and alternative forms of financing to navigate tighter and more costly financing markets.
- Persistent valuation gaps and heightened regulatory scrutiny meant longer negotiations over economic terms and risk-sharing provisions, and more earnouts and contingent payment constructs.
- Activism remained a significant factor, with many campaigns pressing for M&A transactions as a means to enhance shareholder value.

At the end of 2022, we had noted that volatile global financial markets and recession fears had led to a decrease in deal activity from 2021's record levels, but that the overall rate of M&A activity in 2022 was still healthy by historical standards. In 2023, with steadily rising interest rates, persistent inflation, geopolitical uncertainty and heightened regulatory scrutiny in many jurisdictions, global M&A activity slowed down further:

- The $1.95 trillion of global M&A volume through the third quarter of 2023 represented a 27% year-over-year dollar volume decline (with the number of deals down by 7%) and the lowest three-quarter total since 2013.[1]
- The decline in U.S. M&A activity was less severe, with volumes in the first three quarters down 24% year-over-year (and the number of deals down by 4%), with a modest uptick in activity at the beginning of the fourth quarter, led by deals in the oil industry.

Despite the headwinds in the market, M&A remained a vital part of companies' growth strategies and strategic initiatives throughout 2023, and the year presented opportunities for — and rewarded — thoughtful and creative dealmakers.

1 All data is from Bloomberg, Refinitiv and/or FactSet. All activist activity data is for campaigns conducted globally by activists at companies with market capitalizations greater than $500 million at the time of the campaign announcement.

Steady Flow of Carve-Outs, Spin-Offs and Joint Venture Transactions

Throughout the year, we saw a steady flow of carve-outs, spin-offs and joint venture transactions. With companies continuing to focus on monetizing non-core assets and business lines in an effort to deleverage and deliver shareholder value in challenging market conditions, these structures were popular ways to unlock value. We also saw companies engage in creative and complex structuring, such as carve-outs where the seller retained a stake through long-term joint venture or partnership arrangements, as a way to bridge gaps in valuation and cope with tighter financing markets while progressing toward their deleveraging goals.

With valuation gaps between buyers and sellers persisting well into 2023, public companies looking to dispose of non-core business units often turned to spin-offs as an attractive way to unlock value while avoiding the risk of selling "low" and missing out on the value accretion that may be available to their shareholders in the future. In some cases, we have seen corporate sellers pursue a "dual track" carve-out/spin-off process, having a spin-off as a backup option in case a carve-out sale process did not achieve the desired result. We expect to continue to see more of these types of transactions in 2024.

Financial Sponsors Show Resilience, With More Equitized Deals and Alternative Financing Sources

Higher interest rates and tighter financing markets made dealmaking more challenging for financial sponsors in 2023, which was reflected in an approximately 35% year-over-year dollar volume decrease in private equity M&A through the third quarter of 2023.

However, financial sponsors showed resilience and creativity. We saw sponsors provide more upfront equity financing, with the plan to later increase leverage when debt market conditions improve. Sponsors also teamed up with other sponsors, or, in some cases, strategic buyers, more often in consortium arrangements to muster the necessary equity.

Rollovers were frequently used to bridge funding gaps, while serving also to incentivize management shareholders and founders. We also saw buyers using various forms of seller financing to close such gaps, effectively deferring receipt of the full purchase price.

> In some cases, we have seen corporate sellers pursue a "dual track" carve-out/spin-off process, having a spin-off as a backup option in case a carve-out sale process did not achieve the desired result.

While the leveraged loan market remained tepid, private credit funds continued to be active and take a larger share of the acquisition finance market. These funds showed their ability to finance big ticket M&A deals while providing more flexible financing solutions to financial sponsors.

Even if interest rates stabilize and eventually start declining in 2024, as the market appears to anticipate, we expect to see the creative use of financing structures continue to play a role in financial sponsor deals.

Persistent Valuation Gaps and Heightened Regulatory Scrutiny Are Reflected in Contractual Provisions

Entering into 2023, many dealmakers had anticipated that the valuation gap between buyers and sellers would narrow substantially as parties adjusted to current market dynamics. However, this adjustment process is not complete, and meaningful gaps in value expectations continue to be common.

In the case of private targets, we saw buyers and sellers utilize earnouts and other contingent payment mechanisms to bridge valuation gaps. For public targets, we saw contingent value rights (CVRs) used to work around different views of valuation, primarily in the health care sector. And many deals simply did not move forward because of parties' inability to reach an agreed valuation.

We expect this to continue in 2024 but possibly to a lesser degree, as pressures intensify on sellers to obtain liquidity, and on buyers to realize growth and innovation through acquisitions — especially to keep up with global trends of technology and energy transformation.

Dealmakers continued to feel the pressure of heightened merger scrutiny in 2023, as regulators in the U.S. and around the world took more expansive approaches to merger control and foreign direct investment. (See "As US Antitrust Agencies Double Down on Merger Enforcement Approach, New Deal Strategies Emerge" and "EU and UK Merger Regulators Look Beyond Horizontal and Vertical, With Digital 'Ecosystems' a New Focus.")

This, in turn, has led to greater focus during deal talks on regulatory risk-sharing and related contractual provisions (*e.g.*, "drop-dead" dates, reverse termination fees and efforts covenants). Those have been negotiated more heavily and earlier in deal processes, especially for large-cap companies with leading positions in their respective markets and cross-border deals involving sensitive industries. In some cases, deals have fallen apart over these deal terms. Both strategics and financial sponsors have felt the pressure from antitrust officials, and we expect this trend to continue in 2024.

Activism Remains an Important Factor

Shareholder activism remains a major factor in the M&A market. In 2023, activist shareholders sought to take advantage of depressed stock prices and business underperformance to accumulate significant positions and launch campaigns. Through the third quarter of the year, 159 new campaigns were initiated globally, which was approximately 8% above the four-year average.

Despite the overall slowdown in M&A activity, the portion of activist campaigns with an M&A-related thesis remained in line with historical averages. However, a larger portion of the campaigns were focused on breakup transactions or divestitures of specific lines of business, or aimed to scuttle or sweeten previously announced transactions.

We expect activists to continue to have a meaningful impact on the M&A market in 2024, both as a result of the ongoing volatility in the market and as some of the headwinds start to subside and give rise to more transaction opportunities.

Cautious Optimism Heading Into 2024

If the factors that deterred dealmakers in 2023 — higher interest rates, inflation, recession fears — recede in 2024, the pressure on companies to look for growth opportunities and keep up with the speed of innovation (not to mention the need for financial sponsors to deploy capital) could result in a rebound in deal activity in 2024. In the meantime, the market will continue to provide attractive opportunities for thoughtful, resilient and creative deal structuring and execution.

Gray Zone: When a UK-Incorporated Company Is Protected by Neither the UK Takeover Code nor US Law

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Key Points

- U.K.-incorporated companies may assume that they are protected by the Takeover Code's rules on bids and other changes of control, but that is not always true if they are listed in the U.S.
- Whether or not the Takeover Code applies can change with the composition of a company's board or other factors. When it does not apply, a company will generally not be protected by U.S. rules governing takeover bids in the same way the company would have been protected by the Code.
- It is vital for U.K.-incorporated companies that are listed in the U.S. as foreign private issuers to monitor their Takeover Code status. They may want to revise their organizational documents to incorporate some of the Takeover Code's protections there.

The U.K. City Code on Takeovers and Mergers (Takeover Code) is designed to ensure that shareholders in public companies are treated fairly and equally when there is an acquisition or consolidation of control, and to provide an orderly framework within which takeovers are conducted.

The Takeover Code provides protections for both (i) companies, against coercive or creeping acquisitions of control (*e.g.*, by forcing a mandatory tender offer upon reaching a 30% shareholding) and prolonged siege in a bid scenario, and (ii) shareholders, where there is a potential change of control, by ensuring that they have sufficient time and information to consider the merits of a bid and that its terms are equivalent for all shareholders.

However, in some circumstances where a U.K.-incorporated company has its primary or only listing in the U.S. as a foreign private issuer (FPI), the Takeover Code's protections may not apply, and federal and state laws in the U.S. also may not protect the company or shareholders in the event of a hostile or speculative bid.

Moreover, the Takeover Code may apply to such a company at some points but not others, depending on events at the company, including changes in the composition of its board.

U.K. FPIs, their boards and their shareholders therefore can find themselves in a gray zone where it is uncertain what legal framework applies to a bid. This creates the potential for prolonged siege, a risk that the company will not be prepared and a possibility that a hostile bidder may have a strategic advantage.

To prevent this type of situation from arising, U.K. FPIs should closely monitor the applicability of the Takeover Code on an ongoing basis and consider amending their organizational documents to implement any desirable bid protections there.

Jurisdiction and Applicability of the Takeover Code

Public companies incorporated in the U.K., the Channel Islands or the Isle of Man (each, a Code Jurisdiction) that maintain a U.S. listing as an FPI under

U.S. securities laws (U.K. FPIs) are likely to first consider and disclose Takeover Code applicability upon listing. However, in some cases, the Takeover Code will not apply, leaving the U.K. FPI without its protections and without the defenses available to U.S.-incorporated companies.

> U.K. FPIs should closely monitor the applicability of the Takeover Code on an ongoing basis and consider amending their organizational documents to implement any desirable bid protections there.

The Takeover Code applies to any public company that has its registered office in a Code Jurisdiction if it meets one of two tests:

- **Listing Test:** Any of its securities are admitted to trading on a U.K.-regulated market or a U.K. multilateral trading facility or stock exchange in the Channel Islands or the Isle of Man.
- **Residency Test:** Where, although a company does not satisfy the Listing Test, the Takeover Panel (Panel) considers it to have its "place of central management and control" in a Code Jurisdiction.

When assessing the Residency Test, the Panel will look primarily at where the company's directors are resident. The Residency Test will not be satisfied if a majority of the directors are resident outside the Code Jurisdictions.

U.K. FPIs should therefore monitor and reassess their status under the Residency Test as their board composition changes from time to time.

Bid Scenarios

The frameworks within which hostile bids play out, and a target's defensive options, differ greatly for U.K. and U.S. companies.

In the U.K., if an approach is hostile, the Takeover Code's strict leak regime, its 28-day "put up or shut up" deadline for a firm bid and the "certain funds" requirement mandating unconditional financing may help to protect a target company from speculative bids and prolonged siege.

In addition, the Takeover Code's concepts of persons "acting in concert" and "interests in securities," together with its mandatory bid rules (triggered primarily at 30% ownership), can prevent parties from accumulating a controlling stake or consolidating control in a company by obliging those parties to make a cash offer for all remaining shares at the highest price paid in the preceding 12-month period. Furthermore, target companies are protected from "dawn raids" (*i.e.*, a sudden purchase of a large stake) by hostile bidders by delaying their ability to acquire controlling positions.

On the other hand, U.K.-incorporated companies are subject to legal restrictions on new share issues that reduce their defensive options compared to U.S. companies. And, if a board has reason to think a bona fide offer is imminent and the Takeover Code applies, it also restricts a board's ability to issue new shares or enter into an acquisition or disposal of assets outside of the ordinary course unless shareholder approval or the consent of the bidder is obtained.

By contrast, U.S. securities laws are generally disclosure-focused and do not provide a detailed framework for the bid process or the parties' conduct, although when a bidder acquires 5% or more of a company's shares, it must disclose that to the Securities and Exchange Commission (SEC). Other federal shareholder protections apply in the event of a tender offer.

Instead of relying on U.S. federal securities laws when faced with a hostile bid, most companies listed and incorporated in the U.S. rely on protections allowed under the laws of their state of incorporation (most commonly Delaware). These typically include the ability to implement shareholder rights plans (poison pills) and staggered boards. There is an extensive body of case law permitting these strategies.

Adoption of Takeover Code-Like Provisions

U.K. FPIs that could fall into the gray zone — without the benefits of either Takeover Code protections or the defenses available to U.S.-incorporated companies — should consider incorporating some or all of the Takeover Code's protections and restrictions through contractual or constitutional measures. This will require board and/or shareholder support and may provide only limited protection against a third-party bidder that is not already a shareholder in the company, since that bidder will not necessarily be bound by any contractual or constitutional protections.

Options include:

- **Full protection:** Including in the articles of association, or in the implementation agreement in the case of a recommended bid, a requirement that any bid be conducted as if the company were subject to the Takeover Code.
- **Partial protection:** Including in the articles of association mandatory bid rules equivalent to Rule 9 of the Takeover Code and the General Principles of the Takeover Code.
- **Limited protection:** Including mandatory bid rules in the articles of association equivalent to Rule 9 of the Takeover Code only.

Taking such measures will help ensure that the company and shareholders are protected in the event of a hostile or speculative bid. Doing so will also protect against the possibility that the company could find itself in legal limbo, with no clear set of governing rules for dealing with a bid. Ultimately, the best protection will be for the company to understand its Takeover Code status, know how it may change in certain circumstances and be prepared for all eventualities.

Europe Increasingly Turns to Special Committees in Transactions Involving a Controlling Shareholder

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Key Points

- Although more than a third of major European public companies have controlling shareholders — either holding a majority stake or exercising *de facto* control — many European jurisdictions have not developed specific procedures governing transactions with such shareholders, where conflicts often arise.
- Mandatory tender offer and squeeze-out rules in Europe provide one safeguard for minority shareholders, but in many European countries the law does not allow a board to delegate decision-making about a deal to an independent special committee.
- Such independent special committees have been established routinely in the U.K. and by some companies in continental Europe, although some of those committees have been limited to an advisory role.

A takeover offer from a controlling shareholder presents a challenge to boards of directors who are tasked with protecting minority shareholders, particularly where some of the directors on the board may have relationships or conflicts associated with the controlling shareholder.

In the U.S., decades of litigation involving controlling stockholder transactions have led to the routine implementation of certain minority protections that help mitigate judicial scrutiny, including the use of an independent board committee to negotiate the transaction, as well as conditioning the transaction on a majority of the minority vote. Sometimes both protections are used.

In addition, regulation under U.S. federal securities laws requires companies that are engaged in public M&A transactions to describe in detail the history of negotiations between the parties involved in those transactions. Such detail enables minority shareholders, regulators and other stakeholders to evaluate the behavior of all parties involved in the run up to the announcement of the transaction.

Moreover, in take-private transactions with controlling shareholders, U.S. federal securities laws require target companies, together with such shareholders, to make additional disclosures that go beyond those required in similar transactions not involving controlling shareholders, including on the purposes of the transaction, the fairness of the transaction and of materials from outside parties related to the transaction.

Due to the large number of European companies with controlling or significant shareholders, corporate law and regulation in many European jurisdictions impose strict rules regarding director independence — including codes of best practice.

In addition, European companies now often establish committees of independent directors to facilitate the review of conflict transactions. However, special committees in Europe generally operate differently, and may have less authority, than their counterparts in the U.S.; minority shareholders are not usually provided with the same level of information about the special committee's decision-making process as they are in the U.S.

Practice in the United States

Procedural Protections

In Delaware, where most large U.S. companies are incorporated, courts have held that, as a general rule, transactions involving controlling shareholders and the company they control are subject to a rigorous "entire fairness" standard of review, which requires the directors to

prove that the process by which the board conducted the transaction, as well as the ultimate price paid or received, was fair.

Two important exceptions to that general rule have developed. First, Delaware courts have held that the burden will shift to the plaintiff to prove that the transaction did not satisfy the entire fairness test where a board of directors implements one of two procedural protection mechanisms:

i. a well-functioning special committee, comprised of independent and disinterested directors, with bargaining power (*i.e.*, the ability to say "no" to a proposed transaction), or

ii. a non-coercive majority vote by the fully informed minority shareholders.

Second, where the board implements both of these mechanisms before any economic negotiations commence, and the deal is conditioned on using both of these mechanisms on a non-waivable basis, the board's decision will be entitled to deference under the business judgment rule and will not be subjected to review under the stricter entire fairness standard, despite the inherent conflict between the minority and controlling shareholders. When the business judgment rule applies, the court presumes the board has complied with its fiduciary duties and will not second-guess the board's decisions, unless the decision is clearly irrational or constitutes waste.

Special Committee Criteria

To qualify as a well-functioning special committee under Delaware law, the committee must:

- Consist of disinterested directors independent of each of the company, the potential bidder (including a controlling stockholder) and anyone acting in concert with the bidder. Independence factors include financial interests, board or management positions, personal relationships and influence from interested parties.
- Have a clear and broad mandate allowing it to evaluate, negotiate, consider alternatives and, importantly, even reject a transaction. The committee must also be empowered to retain independent legal, financial and other advisors of its choice.

Mandatory Disclosure Obligations

The Delaware courts have held that, to ensure that the minority shareholders are fully informed, all material facts that are relevant to the shareholder vote on the proposed transaction must be disclosed.

In addition, U.S. federal securities laws impose disclosure obligations on both the controlling shareholder and the public company. The information they must provide includes:

- A history of the negotiations and material contacts between the parties engaged in the transaction during the past two years.
- A discussion of the purpose of the transaction, including alternatives considered; reasons for the structuring and timing of the transaction; and a description of the impact on the company and certain other stakeholders.
- A statement about the substantive and procedural fairness of the transaction.
- All reports, opinions and appraisals from outside parties that are materially related to the transaction, including those provided to the board or the special committee in draft form.

As a result, minority shareholders, regulators, courts and other stakeholders are able to evaluate the decision-making process of the special committee in detail. And the knowledge that the negotiations will be described in full detail encourages arm's-length negotiations between all parties involved in the transaction.

Practice in Europe

Procedural Protections

While most U.S. public companies are widely held, many continental European companies have a controlling or major shareholder, with the U.K. falling somewhere between the U.S. and continental Europe. In response, many continental European jurisdictions and the U.K. have developed robust director independence requirements that focus on independence both from the public company and its significant shareholders.

> Special committees in Europe generally operate differently, and may have less authority, than their counterparts in the U.S.

Historically, continental European directors with a conflict would simply refrain from participating in discussions related to the transaction. But growing public scrutiny concerning corporate governance and conflicts of interest — including by U.S. shareholders investing in continental Europe — has compelled independent directors to take a more active role on conflict transactions and more clearly exclude the conflicted directors from decision-making, including by forming committees of independent directors who meet separately from the full board.

This reflects long-standing practice in the U.K., now driven by the requirements of the Takeover Code that shareholders receive a recommendation from the board of a target company regarding an offer

for its shares and that directors with a conflict should be excluded from making the recommendation. Special committees have recently been formed for several deals involving Dutch-incorporated companies, for instance.

However, the law in some jurisdictions in continental Europe — including France and Germany — makes the use of special committees difficult. For example, under French law, a board is not able to delegate decision-making to a committee, as committees have no such power and can only advise the full board. And in some jurisdictions, all board members retain full accountability for all board decisions.

European jurisdictions, including the U.K., have established additional mechanisms for protecting minority shareholders. For example, under the U.K. Takeover Code and the EU Takeover Directive, which has been implemented in the EU member states with slight variations between such states, shareholders who acquire an interest of 25% to 33.33% or more (or in some jurisdictions such as the U.K., but not all, increase their stake when they already hold between 30% and 50%) are generally required to make a mandatory offer for the balance of the shares, subject to the terms and restrictions of the relevant law.

Further, in the U.K., the shares of the bidder and parties acting in concert with it are not counted in the shareholder vote to approve a takeover of a company effected by means of a court-approved scheme of arrangement (rather than a contractual tender offer). In other words, support of a majority of the minority shareholders is required. Similarly, shares held by a bidder and its concert parties would not count toward the threshold for a compulsory squeeze-out of minority shareholders following a tender offer for a U.K. company.

While continental European jurisdictions typically do not require the approval of the majority of the minority in conflict transactions, most require a bidder to control 90% to 95% of shares before it can conduct a squeeze-out, compared to 50% in Delaware. That incentivizes the bidder to persuade the great majority of minority investors to tender in order for the bidder to obtain 100% control (although having such a high threshold sometimes results in holdout shareholders demanding more consideration).

Regulation is catching up with advocacy and investor pressure. For example, Italy has implemented legislation mandating that special committees issue opinions for certain conflict transactions, although such opinions are advisory in nature.

Mandatory Disclosure Obligations

Disclosure in continental European M&A transactions is generally governed by home country laws implementing the EU Prospectus Regulation, and the U.K. has implemented similar legislation. In most jurisdictions, the competent regulator will review and approve a disclosure document before it is issued to shareholders.

However, the disclosure rules are less extensive than in the U.S. For example, they do not require detailed descriptions of the history of negotiations and the purpose of the transaction. Further, in some jurisdictions, disclosure rules do not differentiate between transactions with controlling shareholders and other transactions and, in any event, do not require publication of the history of advice, opinions and reports delivered to the board or the special committee.

As a result, while minority shareholders and interested parties have detailed descriptions of the transaction terms and the final recommendation of the board and/or the special committee, the law does not require the parties to describe the process by which the final terms and recommendations were reached, which can have substantial effects on how the negotiations and transaction processes are run.

In Sum

To address conflicts inherent in transactions involving controlling shareholders, case law and regulation in the U.S. have prioritized board implementation of procedural safeguards for minority or unaffiliated stockholders, including special committees and majority-of-the-minority approvals, and robust public disclosure.

European jurisdictions, responding to such conflicts and heightened investor scrutiny, have seen an increase in the implementation of special committees and, to a lesser degree, majority-of-the-minority approval thresholds; however, each jurisdiction in continental Europe and the U.K. has put a unique spin on how these protections are implemented.

While disclosure rules for public M&A transactions in the U.S. and Europe have converged over the last 20 years, those rules remain substantially more detailed in the U.S., particularly when it comes to controlling shareholder transactions. They require greater disclosure obligations from special committees of U.S. companies while at the same time encouraging arm's-length dealing at all stages of the transaction.

Market Opportunities for Cross-Border M&A in China Persist Despite Regulatory Changes and Trade Tensions

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Key Points

- Chinese cross-border M&A activity began to rebound in 2023.
- Some deal activity, both inbound and outbound, was driven by businesses restructuring or realigning their priorities.
- Government trade and investment restrictions imposed by both the U.S. and China could curb dealmaking, but actions from both sides have been measured.

After a multiyear low in 2022, China's cross-border M&A activity experienced a slow recovery in 2023. Although outbound M&A deal value and volume remained lackluster in the first half of 2023, the market overall rebounded in the second half.

Market sentiment generally remained cautious amid the complex economic backdrop and slowing economic growth in China, but parties were on the lookout for opportunities that fit their strategy and risk profile. Deal activity was concentrated in key sectors including industrials; advanced manufacturing and mobility; financial services; and technology, media and telecommunications.

Transactions such as Chinese internet company NetEase's acquisition of the Canadian game developer SkyBox Labs and Hong Kong-based investment firm BPEA EQT's acquisition of Florida-based IMG Academy underscored the resilience of the cross-border M&A market.

Significant inbound deals included:

- The $739 million strategic investment that electric carmaker NIO Inc. secured from an Abu Dhabi government-affiliated entity focused on advanced and smart mobility.
- Saudi Aramco's expansion of its position in China's energy sector with its acquisition of a 10% equity interest in Rongsheng Petrochemical for $3.4 billion.

In 2023, a significant portion of M&A activity was generated by multinational businesses reevaluating their long-term strategies and restructuring aspects of their business to meet market challenges.

- U.S.-based manufacturer Jabil Inc. agreed to sell its mobile electronics manufacturing business in China to BYD Electronics for $2.2 billion.
- Chinese automaker Geely and Renault Group formed a global joint venture, establishing manufacturing plants and research and development centers throughout Europe, Latin America and China.

These transactions reflect the role that the Chinese auto industry has come to play in cross-border M&A, especially as electric vehicles (EVs) gain market share, as well as in complementary sectors like renewable energy and battery technologies. Fueled by the U.S. Inflation Reduction Act's clean energy tax incentives, Chinese companies with advanced EV-related technology have been making long-term investments in the West. Examples include CATL's joint venture with Ford to build a battery plant in Michigan and Gotion's announced plan to build battery factories in Illinois and Michigan.

Geopolitical Tensions and US Restrictions Shape Dealmaking

Looking ahead, regulatory changes and uncertainty in the U.S., China and other jurisdictions will continue to shape China's cross-border M&A landscape in 2024.

In 2023, geopolitical competition between China and the U.S. continued to evolve, with both sides trading assertive yet calibrated measures and countermeasures. Following the Biden administration's 2022 executive order outlining additional national security factors that should be considered by the Committee on Foreign Investment in the United States (CFIUS) when reviewing inbound investments, the administration issued another executive order in 2023 establishing a new outbound foreign direct investment review program, known as "reverse CFIUS," that could affect M&A and private equity activity in China. (See "'Small Yard and High Fence': US National Security Restrictions Will Further Impact US-China Trade and Investment Activity in 2024.")

> Regulatory changes and uncertainty in the U.S., China and other jurisdictions will continue to shape China's cross-border M&A landscape in 2024.

On the trade front, the U.S. expanded on its 2022 export control rules on advanced chips and semiconductors destined for China. The new rules announced in 2023 further restrict exports to China of advanced chips used for artificial intelligence (AI) applications, raising the hurdle for chip manufacturers seeking to work with Chinese partners.

This continuum of tightening regulatory actions creates added layers of scrutiny and will force companies to reevaluate their M&A strategies with respect to China.

Regulatory Changes on the Chinese Side

China adopted a mixed approach in response to U.S. actions, countering the chips and semiconductor export restrictions with its own export controls on critical rare minerals for chipmaking and battery manufacturing.

At the same time, Chinese regulators are expected to stimulate private sector economic activity through further policy relaxation, including the progressive shortening of the Special Administrative Measures for Foreign Investment Access (the so-called "Negative List"), which is intended to facilitate the participation of foreign investors in high-tech sectors.

China also recently announced it will remove all restrictions on foreign investment in the manufacturing sector. While market players seeking M&A opportunities to and from China must take into consideration the vigorous economic and political contest between China and the U.S., both countries are working to maintain pathways for transactions and the flow of private capital.

On two other fronts, the Chinese government is expected to loosen regulations.

- The Chinese competition agency will likely revise its merger control filing thresholds, effectively removing the filing requirement for smaller acquisitions.
- China's cybersecurity regulators have proposed easing restrictions on personal data transfers from China, an initiative that would benefit foreign businesses operating within China's regulatory purview. (See our November 7, 2023, client alert "China Intends To Ease Controls Over Cross-Border Data Transfers.")

Areas of Potential Opportunity

Despite the growing regulatory and geopolitical headwinds, seasoned market participants are expected to adapt and seek new avenues for market engagement. Possible scenarios may include:

- Rising U.S.-China tensions may encourage joint ventures and acquisition transactions with companies that operate in less sensitive sectors or in friendlier jurisdictions.
- Private equity sponsors will continue to seek diverse fundraising sources and M&A opportunities to deploy capital while actively managing geopolitical risks. That could include splitting their Chinese and U.S. operations, as several prominent private equity firms have done.
- Realignment of business operations by Chinese multinationals in overseas jurisdictions will likely continue. Cash-rich Chinese companies may seek overseas acquisitions and other investment opportunities, while adverse regulatory changes in some jurisdictions may prompt business divestments.
- A significant portion of outbound M&A from China will continue to occur in Belt and Road Initiative destinations as a result of favorable government policies for private and public enterprises to participate in the global infrastructure investment initiative (also known as One Belt, One Road) and enhance their overseas operations. An example is a Chinese state-owned enterprise's acquisition of a Peruvian power distribution and energy service business for $2.9 billion in April 2023.

How Companies Are Adapting to Volatile Capital Markets and Planning Ahead

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Key Points

- Market uncertainty led some companies to delay or reconsider IPO plans in 2023, but strategic planning and advance preparation can better position companies to execute on opportunities in 2024.
- Despite the rise in interest rates, companies were able to remain agile in response to market opportunities by proactively analyzing their balance sheets and capital structures to successfully execute a significant number of debt transactions.
- Companies also continued to look to creative financing strategies, including alternative public equity transactions as well as private capital.

2023 Market Backdrop

U.S. and European capital markets in 2023 proved remarkably resilient in the face of challenges that read like a top 10 list of major market disrupters:

- A rapid rise to higher-for-longer interest rates.
- Inflation.
- Failures of well-established banking institutions.
- Tightening credit and loan standards.
- The U.S. debt ceiling crisis.
- The continuing war in Ukraine.
- The outbreak of hostilities in Israel and the Gaza Strip.
- The (repeated) possibility of a U.S. government shutdown.
- Continued recession concerns.
- Overall economic and geopolitical uncertainty heading into a U.S. presidential election in 2024.

Benchmark interest rates reached new highs this year, with the Federal Reserve's federal funds rate at its highest level in more than 20 years, the Bank of England's rate hitting a 15-year high and the European Central Bank raising its rate to the most elevated it has been since the launch of the euro in 1999. As a result, both stocks and bonds experienced significant volatility in valuations in 2023, and new issues overall were negatively impacted.

Strength, patience, creativity and nimbleness allowed many companies to successfully navigate the challenges and execute transactions in periods when the markets were open only briefly. The IPO window inched open at points, the debt market appeared to accept the new normal of higher interest rates, and issuers and financing sources continued to explore creative alternatives to traditional capital markets transactions.

Heading into 2024, both issuers and investors should focus on positioning themselves to leverage market opportunities as they arise. Advance preparation, exploring financing alternatives and remaining agile in execution can position companies to adapt to changing capital market norms, act opportunistically and achieve their financing objectives.

(For an update on capital markets in Asia, see "Chinese Issuers See Progress on US Audit Issue and HKEX Reforms, but US Policies Could Impact Tech Companies.")

Anticipating Positive Signs in the IPO Market

The IPO market is often seen as a barometer for economic health and corporate growth. Initially, there were signs that 2023 could mark the end of the "IPO drought," the longest stretch of low issuances in more than 30 years. Shares of Mobileye and Porsche, which went public in late 2022, continued to trade above their IPO prices. Arm, Hidroelectrica,

Instacart, Klaviyo, Oddity Tech, Schott Pharma and Birkenstock all went forward with highly anticipated IPOs in the second half of 2023.

> Strength, patience, creativity and nimbleness allowed many companies to successfully navigate the challenges and execute transactions in periods when the markets were open only briefly.

The large IPOs in 2023 featured profitable companies with cornerstone investors (either financial or strategic), as well as non-deal roadshows, traditional shareholder lock-ups and conservative valuations — hallmarks of IPOs that are well received by the market. However, while many of the 2023 IPOs were met with strong demand and price increases in early trading, most have since traded below their debut prices due to rising interest rates and other challenges, including geopolitical turmoil.

Of the 157 U.S. IPOs in 2023 as of December 1, only approximately 38% were trading above their IPO prices, while in Europe, approximately 65% of the 102 European IPOs stayed above their IPO prices.[1] For companies in the U.S. and Europe that had their IPOs in 2021 and 2022, only 21% and 30%, respectively, for the U.S. and 19% and 42%, respectively, for Europe were trading above their IPO prices.

1 IPO data includes traditional IPOs, SPACs, best efforts offerings and all other IPOs, regardless of deal size. The data in this article is from Bloomberg.

Market uncertainty led some companies that were contemplating going public in 2023 to delay or reconsider their plans. The U.S. IPO count through December 1, 2023 (157), even when annualized for a full calendar year, was low compared to median counts from the last 10 years (272). Europe saw a similar decline in IPOs, with the year-to-date count (102), even when scaled to a full calendar year, being low compared to median counts from the last 10 years (211). However, many companies are still preparing for near-term IPOs, anticipating greater market stability and a more receptive market in 2024.

Companies considering an IPO or other exit in 2024 or beyond can take advantage of the current slowdown in IPO activity to continue preparing for a transaction and be ready to move quickly when market opportunities present themselves. Strategic planning should include:

- Working with advisers to enhance the company's readiness for the public markets.
- Focusing on financial health.
- Refining the company's message for value creation.
- Analyzing exit strategies and alternatives.

European issuers and investors should also seek to work more closely with one another on narrowing the valuation gap, which has been stalling the IPO market. This is similar to the approach being seen in the U.S., where shareholders have been more willing to accept lower IPO valuations when compared to a previous funding round valuation.

Finding Selective Opportunities in the Debt Market

The challenges in the capital markets in 2023 also impacted the bond market. Higher interest rates meant higher bond coupons for issuers and, as a result, fewer bond issuances, with increased volatility leading to more uncertainty for both issuers and investors.

However, toward the end of the year, the debt markets began to stabilize, taking into account the higher-for-longer interest rate environment. Many issuers recognized that bonds, despite the increased cost, could offer a more appealing alternative than selling equity at a lower price than they desired.

Investment-grade companies, as well as high-yield issuers — some with inaugural bond offerings — were able to execute transactions successfully. Since September 1, 2023, U.S. issuers have closed over 520 investment-grade and 50+ high-yield bond offerings. In that same time, European issuers have closed more than 480 investment-grade and 40+ high-yield bond offerings.

In 2024, the debt markets will continue to feel the impact of higher interest rates, inflation and economic policy. Companies can best prepare themselves by:

- Analyzing their balance sheets for both near-term and future financing and refinancing needs.
- Reviewing and rationalizing their capital structure.
- Being prepared to move quickly to access selective opportunities.

Exploring Alternatives to Traditional Financings

With uncertainty and volatility in the traditional capital markets, companies on both sides of the Atlantic continued to explore creative strategies to achieve their financing goals and capital structure objectives. Alternatives included:

- Direct listings.
- Registered directs.
- Rights offerings.
- Private investments in public equity (PIPEs).
- Direct lending or other private credit.
- Exchange offers and other liability management techniques.

Some employed a combination of these structures.

Direct listings. 2023 saw the return of a small number of direct listings in the U.S. Surf Air Mobility was the first direct listing in over a year, and it had been more than two years since any significant direct listing activity.

A direct listing allows investors in a company to begin trading their shares on an exchange without the company issuing shares or a large shareholder selling shares, as in a traditional IPO. With a direct listing, a company can go public without the expense of an IPO underwriting and without the share dilution.

However, direct listings do not typically raise additional capital and historically have had lower rates of return for investors than traditional IPOs. As a result, direct listings generally have not been widely used. They are often undertaken by companies without an alternative avenue to raise capital, or by very well-known and well-capitalized companies willing to forgo the IPO roadshow and debut.

Private investments. Given the volatility in the capital markets, many companies elected to sidestep the public markets altogether, relying on private investments from one or a few sophisticated investors. Depending on the company's and the investor's objectives, a private investment can be structured in any number of ways: as regular equity; a convertible or derivative security; a mezzanine or other debt-like instrument; or any combination of these.

The private investment can be an attractive way to raise capital, due to both speed of execution and increased flexibility in structuring the investment and pricing. In addition, companies can use the structure to achieve other objectives, combining a private investment alongside a strategic partner or in some other collaborative transaction. So far in 2023, U.S. companies have raised nearly $50 billion in direct loans across over 100 transactions.

An issuer contemplating a private investment or other financing alternative should carefully consider the alignment of the transaction and the investor with its strategy. For example, companies should think about future obligations, such as registration rights, as well as any additional rights that the investor may request, such as guaranteed rates of return, governance or approval rights and priority in the capital structure.

The type of investor is also important: Are they a long-term strategic partner for the company or may they trade out of the instrument in the near term?

For the company, it also is imperative to ensure that the terms of any investment do not unduly restrict the company from taking other necessary actions in the future when the public markets strengthen, including other financing and refinancing transactions.

Looking Ahead to Opportunities in 2024

Issuers and investors can best prepare for 2024 by positioning themselves to be nimble and leverage market opportunities as they arise. Companies considering transactions should work with their advisers to plan ahead, explore creative and alternative financing strategies, remain well informed about market terms and trends, and be agile in execution.

Chinese Issuers See Progress on US Audit Issue and HKEX Reforms, but US Policies Could Impact Tech Companies

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Key Points

- While progress has been made in resolving the long-standing issue of PCAOB's access to inspect audits of China-based issuers, regulatory initiatives in the U.S. introduce new complexities.
- Chinese authorities recently introduced a new regulatory framework for overseas listings of China-based issuers.
- HKEX has taken a number of initiatives to modernize the Hong Kong market, improve alignment with global standards, provide additional channels for capital-raising and improve liquidity.

The past year presented a complex landscape for China-based companies seeking to access global capital markets. Against a backdrop of challenging macroeconomic conditions and escalating geopolitical tensions, regulatory authorities in the U.S., mainland China and Hong Kong introduced initiatives for China-based issuers that provide opportunities for those able to navigate the regulatory process successfully.

US Regulatory Developments

Concerns over auditor inspections abate. The Holding Foreign Companies Accountable Act (HFCAA), together with the Consolidated Appropriations Act of 2023, requires the U.S. Securities and Exchange Commission (SEC) to prohibit China-based issuers' securities from being traded on a U.S. securities exchange or in the over-the-counter trading market in the U.S. if the Public Company Accounting Oversight Board (PCAOB) is unable to inspect or investigate the issuers' China-based auditors for two consecutive years.

In December 2022, the PCAOB issued a report that removed mainland China and Hong Kong from the list of jurisdictions that are not subject to complete inspection. As a result, many China-based issuers that were designated by the SEC, pursuant to the HFCAA, as "commission-identified issuers" in 2022 because their auditors were located in mainland China or Hong Kong were no longer identified as such in 2023. The PCAOB's inspection of the work of auditors in mainland China and Hong Kong is ongoing.

SEC initiatives focus on China-related disclosures. Following a July 2021 statement from SEC Chairman Gary Gensler requesting more prominent disclosures from Chinese companies, the SEC issued a sample comment letter to those companies. The letter requires certain disclosures in the companies' registration statements and periodic or current reports, emphasizing critical areas including risks relating to the use of variable interest entity (VIE) structures, risks associated with doing business in China, permissions and approvals from Chinese authorities and disclosures about the HFCAA.

In July 2023, the SEC issued another sample comment letter for China-specific disclosures focusing on three areas:

- Commission-identified issuers under the HFCAA.
- Risk of intervention or control by the Chinese government.
- Impact of the U.S. Uyghur Forced Labor Prevention Act.

Both comment letters underscore the SEC's consistent focus on more prominent and robust disclosure regarding China-related issues. Most China-based issuers are receiving, or are expected to receive, those SEC comments during their IPO process or on periodic reports.

Outbound technology investment review is forthcoming. The Biden administration issued an executive order on August 9, 2023, directing U.S. agencies to establish regulations that will prohibit, or require notification of, certain types of outbound investments by U.S. persons in entities in China (including Hong Kong and Macau) involved in three specific categories of advanced technologies and products: semiconductors and microelectronics, quantum information technologies and artificial intelligence.

The final rules are likely to become effective in 2024, and the scope of the review program will be narrowly targeted, at least at the outset, with the greatest impact most likely on U.S. private equity and venture capital investments in China. Some activities are expressly exempted from the review, such as investments in public companies, bank lending and underwriting activities.

> Regulatory authorities in the U.S., mainland China and Hong Kong introduced initiatives for China-based issuers that provide opportunities for those able to navigate the regulatory process successfully.

Certain biotech segments are also reportedly under consideration for potential restrictions for investments in China, and autonomous driving technologies appear to be facing varying levels of regulatory scrutiny. In October 2023, the U.S. Department of Commerce unveiled new regulations that further tighten a sweeping set of export controls on advanced chips and chipmaking equipment first introduced in October 2022.

U.S.-China political tension grows. In July 2023, the U.S. House Select Committee on the Chinese Communist Party sent letters to four U.S. venture capital firms expressing "serious concern" about investments in Chinese tech startups. Some observers interpreted these letters as a means of exerting pressure on the executive branch, given the limited results from legislative efforts to control outbound investments in certain Chinese industries. President Joe Biden's executive order of August 9, 2023, appears to align with the intentions of this House committee.

Impact of New Chinese Filing Requirement on Offshore Listings

In February 2023, the China Securities Regulatory Commission (CSRC) issued new regulations mandating that companies based in China (even if they are incorporated offshore) that offer or list their securities in an overseas market must file with the CSRC within three business days of their listing application overseas. This requirement extends to IPOs and follow-on offerings in the U.S., Hong Kong and other overseas capital markets.

To date, more than 100 companies have filed with the CSRC. The review process experienced some initial delays but has accelerated since August 2023. The CSRC has cleared over 50 filings encompassing a diverse range of U.S. and Hong Kong IPO applicants, companies with and without offshore holding structures and, notably, companies that use a VIE structure — suggesting tacit recognition by Chinese regulators of this structure.

New Initiatives in Hong Kong

Hong Kong's SPAC market matures, sees its first de-SPAC transaction. At the beginning of 2022, The Stock Exchange of Hong Kong Limited (HKEX) introduced a regime permitting the listing of special purpose acquisition companies (SPACs). The market welcomed the initiative, with five SPAC listings on HKEX so far and a number of additional SPAC listing applications filed but not yet completed.

Under HKEX's rules, a SPAC must announce an acquisition or business combination (a de-SPAC transaction) within 24 months of listing and complete a de-SPAC transaction within 36 months of listing. Hong Kong's first de-SPAC transaction was announced in August 2023 by Aquila Acquisition Corporation, the first SPAC listed.

Aquila said it would combine with online steel market operator ZG Group. While that transaction has not yet closed, this "proof of concept" has prompted other companies to actively consider de-SPAC transactions as an option.

There are a number of complexities in structuring de-SPAC transactions under the Hong Kong rules, including the requirement for a simultaneous investment from institutional investors in the form of a "private investment in public equity" (PIPE) placement.

HKEX treats de-SPAC transactions as new listing applications and, as a result, the time and process required for a target to go public via a de-SPAC transaction are comparable to that for a traditional IPO. However, with challenging market conditions, the availability of this alternative channel for companies seeking fundraising and listing opportunities in Hong Kong is a welcome development.

IPO settlement time improves. After several years of planning, Hong Kong's "Faster Interface for New Issuance"

(FINI) plan finally came into effect in November 2023. FINI is a new digital platform for IPO settlement, which has significantly shortened the time between pricing of an IPO and closing and commencement of trading, from five business days to two. Companies undertaking an IPO in Hong Kong will now see their IPO funds received and their shares listed and trading on HKEX on the second business day after pricing. Market participants, including underwriters and investors, will benefit from reduced market risk exposure because of the shorter settlement period.

The new system has also digitized extensive aspects of the IPO application, subscription and settlement process, with numerous documents now being accepted on the exchange's online system.

Treasury shares are permitted. In its latest initiative to improve capital management options and address liquidity issues, HKEX announced plans to permit listed companies to hold their own shares as treasury shares. Historically, HKEX has not permitted treasury shares, but with Hong Kong's increasing success at attracting "homecoming" listings of Greater China companies with dual listings in the U.S., where treasury shares are common, there has been pressure for Hong Kong to align with global market practice in this area.

Permitting treasury shares helps Hong Kong continue to remain an attractive listing destination for the region's leading new companies. HKEX plans to introduce rules governing the resale of treasury shares, which will enable companies to retain repurchased shares in treasury and to resell them into the market. Doing so will make it easier to sell shares in small quantities at market prices (as opposed to sales of large blocks of new shares, which generally take place at a discount).

Resales of treasury shares will be subject to the same rules as those applicable to issuances of new shares. HKEX is attempting to discourage companies from transacting in treasury shares with the aim of manipulating their share price or making a trading profit. As such, certain limitations will be applied to treasury share transactions, including a 30-day moratorium on resales after any repurchase and on repurchases after any resale, as well as a one-month blackout period on treasury share resales prior to any results announcement.

(See also "How Companies Are Adapting to Volatile Capital Markets and Planning Ahead.")

A Decades-Old Question Answered: Term Loans Are Not Securities

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Key Points

- Terms in a typical syndicated term loan B have converged to an increasing extent with those of high-yield bonds in recent decades, leading some to argue that such loans should be considered securities.
- A recent Second Circuit case rejected that argument, holding that syndicated term loans are not securities; a contrary ruling would have caused enormous disruption in the trillion-dollar syndicated loan market.
- The syndicated loan market offers borrowers and lenders greater flexibility, and avoids the registration, ongoing disclosure costs and burdens imposed by securities laws as well as the trading and information-sharing restrictions of that regime.

A recent appellate ruling, *Kirschner v. JPMorgan Chase Bank, N.A.*, rejected the contention that syndicated term loans should be treated as securities, affirming the long-held view by market participants that these loans are not (and should not be) subject to the complex registration, disclosure and trading rules under securities laws.

The decision is a relief to those operating in the syndicated loan market. An adverse ruling would have caused upheaval in an enormous and essential area of financing. While *Kirschner* is not the first case to look at whether loans constitute securities, the ruling is the latest and most definitive with respect to term loan Bs as they exist today and sends a clear message to those thinking of litigating the issue in the future.

The Millennium Laboratories Case

Historically, term loan Bs (TLBs) and high-yield bonds (a type of debt security) have been considered two distinct classes of debt with separate and identifiable characteristics. However, over the last few decades, the TLB market has evolved significantly and taken on many of the terms and characteristics of high-yield bonds. Those include:

- Key covenants and baskets.
- Covenant-lite structures and other borrower-friendly terms.
- An increasing overlap of the lender/investor base.

These similarities have raised the question of whether a TLB should also be considered a security, subject to the requirements of federal and state securities laws. On August 24, 2023, the U.S. Court of Appeals for the Second Circuit rejected that contention in *Kirschner*, which involved a term loan B that was similar to most TLBs in the market today. The appellate court held that the loan was not a security.

The Kirschner case arose out of a $1.75 billion term loan B made to Millennium Laboratories LLC in 2014. Millennium defaulted on the loan and filed for bankruptcy the following year. Marc Kirschner, the litigation trustee in the bankruptcy, sued the banks that arranged and syndicated the loan, alleging that they violated various state and federal securities laws by not disclosing that Millennium was under investigation by the Department of Justice (DOJ) prior to the issuance of the loan.

In 2020, the U.S. District Court for the Southern District of New York dismissed the claims against the banks, concluding that the Millennium loan was not a security and was therefore not subject to securities laws. The Second Circuit upheld the district court, finding that Kirschner failed to plausibly suggest that

the Millennium loans were securities by applying the four-pronged "family resemblance" test established in 1990 by the U.S. Supreme Court in *Reves v. Ernst & Young*.

One important factor in the Second Circuit's ruling may have been the decision made by the Securities and Exchange Commission (SEC) to not respond with an *amicus* brief on the matter after the Second Circuit solicited its views.

Why It Matters

If the Second Circuit had ruled in favor of Kirschner, there likely would have been extraordinary disruption across the entire leveraged loan market, which in turn could have had far-reaching effects on the broader U.S. economy. The syndicated term loan B market is estimated to be around $1.5 trillion, according to *LevFin Insights*, a publication that provides news and analysis on the global leveraged finance markets.

Impacts on Lenders: Syndication and Trading

Requiring TLBs to comply with securities laws would have caused a seismic shift in loan origination and trading practices, which now are fairly flexible because participating lenders are assumed to be sophisticated parties that are responsible for their own decisions to purchase and trade loans. By contrast, federal securities laws are designed to protect investors at large, including retail investors, who may not have access to the information necessary to make informed decisions about investments.

Securities must be registered with the SEC (or qualify for an exemption), and securities underwriters are subject to a higher level of liability to investors for material misstatements and omissions in disclosures made to investors. Thus, to arrange a TLB compliant under securities laws, underwriting banks would need to conduct extensive due diligence and require cumbersome disclosures from the borrower, and then prepare detailed offering documentation. These added steps would result in significant delays and add costs to the loan origination process.

Unlike bond investors, who rely on the disclosures mandated by securities laws, as they have no direct relationship with the issuer, TLB lenders conduct their own diligence on a borrower's business and have a direct contractual relationship with the borrower. Moreover, often TLB lenders receive non-public information from a borrower (for instance, financial projections), which may be a key factor in their decision to make the loan but the sharing of which is not allowed under securities laws.

> If the Second Circuit had ruled in favor of Kirschner, there likely would have been extraordinary disruption across the entire leveraged loan market, which in turn could have had far-reaching effects on the broader U.S. economy.

Treating TLBs as securities would also severely limit secondary trading of TLBs and make the market less liquid, as trading would likely need to be conducted through registered broker-dealers. Trades would also be subject to transfer restrictions imposed by securities laws, including on trading securities based on material non-public information (MNPI) and additional reporting requirements and rules governing settlement.

Finally, certain lenders would no longer be able to participate, as they could be restricted from investing in securities.

The recharacterization of TLBs as securities would effectively paralyze and result in an immediate freeze of the entire loan market, since existing TLBs would not be in compliance with securities registration requirements.

Impacts on Borrowers

Borrowers, too, would suffer if TLBs were treated as securities.

- **Higher costs and slower execution.** Borrowers would bear the additional costs of registering a security, producing detailed, ongoing disclosures and satisfying extensive due diligence requirements. The additional costs and burdens borne by underwriting banks and other lenders would also likely be passed on to borrowers in the form of higher pricing or additional fees. With the extra steps, it would take more time for borrowers to access capital, which could be critical in time-sensitive situations, or where there is a "hot" market window.

- **Required disclosures and restrictions on providing MNPI.** Some borrowers may not want to publicly reveal information that would be required in securities filings, which are much more extensive than those provided for TLBs. In today's TLB market, borrowers may share MNPI, such as financial projections or information about a pending acquisition or litigation, with private lenders (which are a subset of lenders choosing to receive MNPI). Indeed, such MNPI may provide the reason for a lender to offer financing. Public lenders (*i.e.*, those lenders who cannot receive MNPI) agree not to receive such MNPI and knowingly participate in the financing based on publicly available information. The public/private lender distinction is not applicable in a securities offering, and securities laws would prevent the borrower from sharing MNPI selectively with a subset of lenders.
- **Reduced flexibility.** Given the smaller group of lenders in a typical TLB and standard lender voting provisions in credit agreements, borrowers can modify many provisions in loan documents and obtain waivers of them with consent from only those lenders holding 50.1% of the loan. By contrast, bonds are generally held more widely, and consequently changes to the terms of the indentures governing bonds can be more time-consuming and costly to obtain.
- **Inability to control the lender syndicate.** A TLB borrower typically has a consent right with respect to assignments of the loan by lenders and has the ability to exclude certain parties, such as competitors, from the lender group. If TLBs were securities, however, the borrower could not assert this type of control, as bondholders have the ability to freely assign without needing any consent from the borrower.

In Sum

While the syndicated loan market may continue to evolve and changing structures may result in a different application of the *Reves* factors in the future, the Second Circuit's ruling in *Kirschner* should reassure the syndicated loan market and ensure that TLBs, in their current form, can continue to be an available financing option to a large class of borrowers, some of which may not be able to access the bond markets.

At the same time, lenders and borrowers alike should continue to remain vigilant in following current market practices that protect against the risk of a loan being treated as a security.

Adapting to a Dynamic Commercial Real Estate Landscape

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Key Points

- Increased vacancies and higher interest rates and financing costs will likely create opportunities for distressed buyers with dry powder to obtain properties and real estate debt at a discount.
- Office-to-residential conversions present an opportunity to unlock the value of underutilized office space and address housing shortages.
- Refinancing debt on acceptable terms remains difficult and will continue to strain the commercial real estate market.

The commercial real estate (CRE) market is in a transformative period as remote work has reduced occupancy levels at the same time that financing costs have risen rapidly. The changes have created opportunities for investors willing to take on stressed and distressed properties or related debt, and for those willing to tackle the challenges of converting office space to residential use.

In this environment, lenders have altered their approach, lending more cautiously and demanding more protections. Borrowers who foresee potential problems with their properties should act proactively.

The Hybrid Work Revolution

The impact of the COVID-19 pandemic on CRE has been widely discussed. Hybrid work — now an enduring feature of the post-pandemic corporate workplace and not just a temporary adaptation — has led to reevaluations of office square footage and configuration needs, and pushed up vacancy rates, particularly in urban centers.

Hybrid work has also given workers greater flexibility in where they choose to live and work, resulting in the diffusion of demand for office space away from traditional metropolitan areas and into peripheral regions that may provide more affordable space and flexible lease terms. While demand and rental rates for newly constructed high-end office space in certain urban centers like New York City remains high, the market for older buildings lags.

These residual effects of the pandemic, coupled with steadily rising interest rates, financing costs and inflation, have led to a volume of stressed and distressed CRE assets. Many CRE owners, struggling with reduced cash flows, find themselves anticipating difficulties in meeting debt and liquidity obligations. The result will be an influx of non-performing loans into the debt market, with stakeholders looking to offload some CRE holdings.

This environment will offer strategic and well-capitalized buyers the ability to acquire and recapitalize CRE assets at reduced prices, and to purchase discounted debt in order to either reposition the asset or negotiate favorable terms with the borrower. In such a market, we expect opportunistic acquisitions and innovative redevelopments.

These residual effects of the pandemic, coupled with steadily rising interest rates, financing costs and inflation, have led to a volume of stressed and distressed CRE assets.

Practice point: In a stressed or distressed sale of CRE, time is of the essence. Distressed acquisitions are typically made in a buyer's market, and buyers often require the ability to move on accelerated timetables. There may not be time to conduct in-depth due diligence. But for those with capital, strategic vision and CRE expertise, 2024 will offer a favorable

landscape to leverage those attributes and turn challenges into opportunities for substantial rewards.

Opportunities To Repurpose Office Space

The hybrid work revolution presents opportunities to contribute to urban revitalization and combat the national housing shortage by converting underutilized office space into residential units. However, office-to-residential conversions come with significant challenges, including:

- Comprehensive infrastructure adaptations (*e.g.*, additional plumbing).
- Legal barriers to conversions, including restrictive zoning regulations and building codes.

Some U.S. cities, including New York, are actively amending housing regulations to make conversions economically viable. The New York plan includes:

- Expansion of the number of buildings eligible to be reconfigured as residential space.
- Conversions into a wider range of housing types.

While conversions offer a compelling opportunity, including the possibility of creating affordable housing, conversions are not a panacea. The extent to which conversions will contribute to overall affordable housing stock will depend on both public and private efforts.

Given the importance of tax revenue generated by CRE in funding local government services in cities like New York, there is reason to believe that public officials and CRE owners will partner to make necessary reforms and spur redevelopment. However, conversions likely cannot occur quickly enough to stave off significant losses in value to office buildings in the face of increased borrowing costs.

Practice point: Developers considering a conversion should examine strategies for addressing existing tenants, including tenant buyouts and relocations. They should also be aware of financing challenges. Lenders typically exhibit caution in the financing of conversions, given the complexity and risks involved. For example, some lenders are requiring provisions that provide for lender damages if plans and specifications are reconfigured as a result of enforcement actions or a governmental determination of non-compliance with building, zoning or multiple dwelling laws.

Lenders may also expand recourse events to include losses resulting from the relocation and/or buyout of existing office tenants needed to consummate a conversion. Finally, developers should be aware that conversions are not suitable for all buildings and be prepared for alternatives.

Financing Challenges

With all the pressures facing the CRE market, financings have become increasingly expensive and burdensome. In addition, the universe of CRE lenders continues to constrict as traditional lenders become increasingly selective with their capital allocations and small and midsize banks pull back from CRE lending.

In response to the increased risk and interest rate uncertainty, we are seeing lenders adjust their lending strategies to reflect a more conservative outlook. They are running health checks on properties in their existing portfolios. New loan terms often involve higher interest rates and stricter underwriting standards, including more stringent loan-to-value ratios, revised valuation criteria, more rigorous scrutiny of borrowers' and guarantors' creditworthiness, and a focus on properties with strong pre-leasing activity and high-credit tenants.

Going forward, we expect to see lenders increasingly require sponsors to guarantee payment of all operating expenses to ensure the sponsors' vested interest in the continued operations of the properties, as well as expansion of the scope of traditional recourse obligations in certain contexts (*e.g.*, to cover losses to lenders for failure to achieve property conversions by particular dates). These shifts are causing challenges for developers and investors, who now find it more difficult to secure financing for their projects.

A Borrower's Playbook

CRE borrowers need to adjust to the fact that we are in a lender's market, with respect to office and retail assets in particular. Borrowers with debt coming due in the next 24 months should be proactive and strategic.

In preparing for looming debt maturities, borrowers should consider:

- **Early monitoring and assessment.** Proactive planning (*i.e.*, at least 12 months before debt is due) is crucial. Strategic plans should be framed based on timelines, amounts due and any penalties, as well as an understanding of one's overall financial position.
- **Communication.** In a stressed or distressed situation, establishing a clear line of communication with the lender early on can pay benefits. Restructuring debt can be a time-intensive process. Taking preemptive steps may be beneficial, particularly where the lender does not want, or does not have the capability, to own and operate a property. Borrowers with good track records may be able to negotiate loan extensions or other modifications to provide interim relief. Borrowers with larger loan portfolios and/or company- and asset-level debt may also wish to explore holistic opportunities to right-size their overall capital structures.
- **Reserves.** While financings are still occurring, capital accessibility is coming at a premium. If possible, borrowers should work to build up financial cushions and emergency reserves. Available liquidity will expand a company's ability to weather recessionary pressures and preserve options for debt restructurings and distressed acquisitions.

Climate Change and Its Undeniable Impact on Insurance: How To Respond?

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Key Points

- The increase in severe weather events predicted by most climate scientists is likely set to significantly impact the insurance industry by affecting the ability of underwriters to measure, predict and apportion risks.
- Insurers must better analyze and understand how their models will fare in light of unforeseen climate events.
- Adapting pricing strategies, using innovative technologies and collaborating with industry stakeholders may be the way forward.

Models that have historically been used by insurers to hedge risk were not designed to predict uncertain events such as natural disasters that may be exacerbated by climate change. This now leaves insurers overexposed to climate risk. Insurers could respond to the gap in climate-related insurance coverage by underwriting and offering policies to consumers who would suffer without such safeguards. But determining how to seize that opportunity is not easy.

The European Insurance and Occupational Pensions Authority (EIOPA) suggests that insurers are taking steps to mitigate the effects of climate change by implementing dedicated adaptation measures in insurance products and offering premium-related incentives. However, EIOPA also reports that the EU insurance market generally appears to be at an early stage in its journey to increase resilience to global warming.

Insurers could simply increase premiums to build larger reserves that are arguably necessary to cover possible volatility in future payouts. However, given the frequency and increasingly serious nature of environmentally destructive events, this would lead to continually increasing premiums — an unfeasible solution.

Insurers are thus confronted with two issues:

- If they price their premiums at a low level to attract consumers, they may fail to take climate risk into account, leading to under-pricing and losses.
- If insurers opt for high premiums to take into account the large payouts for severe weather events, businesses and consumers who cannot afford the premiums will go uninsured.

These themes are discussed thoroughly in a November 2023 report issued by the International Association of Insurance Supervisors (IAIS), "A Call to Action: The Role of Insurance Supervisors in Addressing Natural Catastrophe Protection Gaps."

Opportunities To Develop New Insurance Models

Insurers have a chance to address such issues.

Understanding their current exposure to risks associated with climate change is the first step. The U.K. Prudential Regulation Authority (PRA) is set to run a dynamic general insurance stress test in 2025, which will:

- Assess the insurance industry's solvency and liquidity resilience to a specific adverse scenario. The stress test will involve simulating a sequential set of adverse events over a short period of time.
- Evaluate the effectiveness of insurers' risk management and management actions following an adverse scenario.
- Inform the PRA's supervisory response following a market-wide scenario.

Insurers should use the findings from this test to inform their approach to the

market and see how protected they are against climate-related losses.

In the U.S., the National Association of Insurance Commissioners (NAIC) has established a Climate and Resiliency Task Force to serve as the coordinating NAIC body for discussion and engagement on climate-related risk and resiliency issues, including dialogue among state insurance regulators, the insurance industry and other stakeholders.

On a more individual level, insurers should themselves adopt climate-specific stress testing to inform their pricing and make portfolio adjustments. By utilizing predictive analytics such as geospatial tools, insurers can make a more detailed assessment of where (geographically) wider protection may be needed, thereby helping to bridge the protection gap.

For example, if insurers are able to more accurately map out where the risk of tsunamis is higher due to tectonic plate patterns, they will be able to apportion risk in a more nuanced way and thereby offer their customers policies that are more tailored to the risks those customers face.

> Insurers should themselves adopt climate-specific stress testing to inform their pricing and make portfolio adjustments.

Insurers can also aid their clients by developing enhanced and innovative insurance products. A leading consulting firm has suggested that the insurance industry currently does not capture the full spectrum of potential losses that are a result of severe weather events. With the use of artificial intelligence, firms can parametrically (*i.e.*, by using statistical estimation techniques) price their policies to take such overlooked losses into account. Doing so would help mitigate the effect on generic, unspecialized protection.

Insurance companies can also encourage their policyholders to take initiative. For example, by urging their clients to install anti-flood doors or early warning systems, insurers can help their customers mitigate risk. They can then charge such companies lower premiums, thereby offering better coverage while maintaining a steady supply of insurance products.

Government Collaboration

A unique opportunity also exists for insurance companies to diversify the role they play in the economy. They can collaborate with governments to create agreements on how to apportion risks between public and private institutions. Further, insurers can work with government authorities to put measures in place for financial assistance in the case of an unexpected mass payout caused by an unforeseen crisis, similar to the Flood Re scheme in the U.K. Under this joint initiative, the U.K. government works with private insurers to provide reinsurance for areas with particularly high flood risks.

Such collaborative arrangements are not uncommon — in the U.S., the National Flood Insurance Program performs a similar coordination function.

Insurers can also cooperate with third parties to devise risk-transfer solutions that offer wider and more significant protection for consumers across the market. For example, the World Bank acted as an intermediary between a South American state-owned hydroelectric power company, a hedge fund, an insurer and a reinsurer. Under this public-private partnership, the power company was offered protection against droughts, and its consumers were safeguarded against extreme fluctuations in commodity prices.

A Path Forward

The insurance industry can no longer rely on past data in underwriting and pricing policies, and it is evident that no company can shy away from the impact that risks associated with climate change will have on its business practices. How insurers respond remains an open question.

Exits, Ring-Fencing and Other Risk Management Strategies for Multinationals Operating in Geopolitically Volatile Areas

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Key Points

- The past two years have highlighted the vulnerability of some multinationals' operations and even loss of control in the event of geopolitical disruption.
- Drawing on the lessons of 2022 and 2023, businesses should formulate contingency plans to ring-fence units in vulnerable jurisdictions and plan for potential exits.
- Those plans should encompass everything from modified supply chains to IP rights and IT support, cash management and protections for local management.

With mounting geopolitical tensions, multinationals face a very real and immediate risk of being deprived of profits, control or even ownership of some wholly or partially owned local businesses. As a result, business leaders are expected to formulate contingency plans for foreseeable geopolitical and trade threats, including new conflicts, economic sanctions, hostile action by national authorities toward foreign investors and public pressure compelling a withdrawal.

Such contingency plans should set forth the path to a full exit or, at a minimum, to ring-fencing the local business. Applying the "in country for country" approach can help mitigate the exposure risks of the global business, its people and its key assets operating in (or exiting from) volatile areas.

Many multinational companies struggled to extricate their businesses from Russia following the invasion of Ukraine, and several other regions could potentially present similar challenges.

While the issues are often business- and jurisdiction-specific, a number of challenges are foreseeable and need to be factored in to business strategies.

> Contingency plans for foreseeable geopolitical and trade threats should set forth the path to a full exit or, at a minimum, to ring-fencing the local business.

The overall objective of the preemptive actions below is to get the local business to operate in an isolated manner and treat it as an unaffiliated entity. Doing so should:

- Facilitate an exit if that proves necessary.
- Protect the global group in case its shareholders' rights regarding the local business can no longer be enforced and/or the interests of the local management are no longer aligned with those of the global group.

With that objective in mind, business leaders should consider some or all of the following actions.

Formulate a ring-fencing and exit strategy. Companies should take all internal preparatory actions to implement this strategy, even if no decision to exit has been made.

- **Devise (and keep under regular review) a separation plan** for the local business so it can operate on its own, with minimum support from the global platform.
- **Collect (and continue to update) information for potential third-party buyers**, because accessing due diligence information may become challenging, or even impossible, when a conflict arises and local management is subject to new restrictions and/or pressure from national authorities.
- **Identify all third-party consents necessary to sell the local business** and, to the extent practicable, develop a plan to obtain those consents (or waivers) in advance, or quickly.
- **Prepare for a worst-case scenario** where the global group finds itself subject to conflicting laws. A sale of the local business may not be permitted by authorities in the relevant jurisdiction, while operations as part of an international group could become difficult or impossible due to sanctions and counter-sanctions. Even when businesses are prepared to give up their equity stake, abandoning shareholders' rights may not be permitted in the local jurisdiction and/or would expose local management to increased liability. Identifying structures for giving up the investment (*e.g.*, transfer to local management, with or without a call-back option; transfer to local charity groups or employees) is time-consuming and needs to be considered in advance.
- **Revamp supply chain strategies** to enhance supply chain resilience by:
  - Diversifying suppliers of the local business and substituting, as much as possible, local suppliers for suppliers outside that jurisdiction (especially those that are likely to become prohibited from operating there).
  - Reducing the local business's role as a supplier to the rest of the group, to protect the global business's continuity.

Review on an ongoing basis accumulated cash and cash needs at the local level and consider regular distributions to the parent entity through dividends, under intragroup financing and cash-pooling arrangements, or via alternative value-extraction structures. Once a geopolitical crisis arises, expect the local jurisdiction to impose or increase capital controls, including restrictions on cash transfers outside its borders.

Proactive cash management, including regular offsets of outstanding intragroup payables and receivables, could reduce the amount of potentially "trapped cash" and the group's post-exit exposure. In particular, multinationals should reconsider any "two-step distribution" practices where cash is first transferred to parent entities in the form of loans and subsequently offset against dividends once they can be formally declared. The risk is that, if distributions become prohibited, the offset might not be possible and the local business may be forced to recover payables under outstanding loans to parent entities.

Examine intragroup arrangements involving the local business and implement any necessary amendments to ensure:

- The ability to terminate those arrangements on short notice, ideally with automatic termination upon change of control.
- The termination or replacement, if practicable, of parent guarantees and similar support provided by group entities.
- Arm's length terms that will not jeopardize continuity of the business upon termination by the parent.
- Clarity of ownership, registration and use of intellectual property (IP) rights.

Separate or limit dependence of local IT systems on the global platform. The aim is to (i) facilitate a subsequent divestiture without the need for transitional service arrangements and (ii) minimize the risks that a bad actor might gain access to the global platform through unauthorized entry to the local IT platform. It is critical that multinationals identify and establish arrangements with alternative IT providers locally or develop local IT infrastructure in-house. In addition, to the extent permitted by local law, global groups should consider maintaining offshore backups of local businesses' key contracts, data sources and other important information that may become inaccessible due to local restrictions.

Review IP rights owned, licensed or used by the local business and implement a strategy involving:

- Documenting the use of material IP rights by the local business.
- Replacing (or decreasing), if possible, use of global brands with local brands in an effort to operate the local business on a stand-alone basis and limit the exposure of the global group's IP rights.
- Testing the ability to withdraw trade secrets on short notice (to prevent access or disclosure by third parties following an exit by the parent).
- Planning a minimal use of key group trademark rights post-exit (*e.g.*, a limited license to use key group brands in a safer neighboring jurisdiction, with a plan for the group to distribute or otherwise commercialize limited products in the local jurisdiction under those brands). Minimal use is frequently required to avoid abandonment of trademark rights, which would allow any third party to use or register them. This protection is often assessed against the risk of local authorities suspending treaty exemptions on royalty payments or even prohibiting such payments, resulting in a *de facto* nationalization of licensed IP rights.
- Considering ramifications of unauthorized use of IP rights, either temporarily during rebranding or an unauthorized long-term use, which is likely to require (i) registration of IP rights in neighboring and other relevant jurisdictions to help prevent unauthorized

export of goods or services, and (ii) communications with third parties (*e.g.*, key customers or suppliers) explaining the post-exit use of IP rights.

Consider revising the shareholding structure of the local business to curtail the possibility of abusive claims from the local business, its creditors or local authorities against direct or indirect parent entities within the global group. The risk could be particularly high if the local business becomes insolvent, which could be caused or accelerated by actions taken by authorities in the local jurisdiction. Transferring key assets from the parent entity to affiliates in jurisdictions with robust bankruptcy laws may be a means to reduce temptation for opportunistic or abusive actions.

Alternatively, a parent entity's protection may be optimized if it is incorporated in a jurisdiction that has bilateral investment treaties with the jurisdiction of the local business because that could allow the parent to seek compensation for unfair treatment. Of course, in practice, a realistic remedy may be unavailable until the geopolitical crisis is resolved and awards can be enforced.

As far as practicable, conduct due diligence on all arrangements with local management, including existing protections for them in case of potential investigations. Doing so can help ensure the global group provides the managers with access to independent advisers and reimbursement of fees as they are incurred. Consideration should be given to which members of the management team could operate from abroad and whether a sufficient number of trusted local managers could run the business on the ground if foreign employees are forced to leave.

Once a "local headquarters" team is identified, develop plans to ensure that the team continues to be compensated in the event of restrictions on payments, perhaps with payments to accounts in a more stable jurisdiction.

It may be necessary to clarify which decisions can be made locally — with the team operating the business in an autonomous manner — and which decisions exceed the local management's authority and require the board's or shareholders' approval. Clearly identifying matters that are reserved for the board or shareholders would also reduce the danger of local authorities exerting pressure on local management to take significant actions.

Evaluate in advance the tax, accounting, financial reporting and operational implications for the parent group of any divestiture or restructuring of the local business. In particular, multinationals should consider treatment of any unpaid taxes at the local level (and their potential acceleration) and any taxes arising from restructuring or exits, together with potential funding solutions.

In Sum

The appropriate actions to implement will depend on the business, industry and jurisdiction, but the preemptive measures are ones business leaders can take to formulate solid and tested plans for managing their companies' exposure.

ESG

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The Supreme Court's Affirmative Action Opinion Continues To Spawn Challenges to DEI Programs

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Key Points

- In the wake of the Supreme Court's decision in *Students for Fair Admissions*, challenges to DEI initiatives have focused on programs that facially appear to provide a zero-sum advantage based on protected characteristics, including race or gender, or that are open only to applicants with certain protected characteristics.
- DEI initiatives undoubtedly will continue to face similar and potentially expanded challenges in 2024 as litigants opposed to such initiatives continue their efforts to extend the reach of *SFFA*.
- Programs that focus on eliminating bias, cultivating a broad view of diversity and promoting equal opportunity among employees generally remain lawful.

Following the U.S. Supreme Court's June 29, 2023, decision in *Students for Fair Admissions, Inc. v. President and Fellows of Harvard College* and *Students for Fair Admissions, Inc. v. University of North Carolina* (together, *SFFA*) prohibiting the consideration of race in university admissions, legal challenges to diversity, equity and inclusion (DEI) programs and initiatives of various forms have continued, including in contexts outside higher education.[1]

New Challenges to Admission Policies in Higher Education

Several recent suits against higher education institutions are noteworthy, as they may allow courts to weigh in on the application and impact of *SFFA*.

Suits against military academies. Although *SFFA* applies to both private and public institutions of higher education, the Supreme Court expressly noted that its holding did not apply to the U.S. military academies, which were not parties to the litigation and might present "potentially distinct interests" that could warrant the consideration of race in admissions.

Students for Fair Admissions filed suits in September and October 2023 against the U.S. Military Academy and the U.S. Naval Academy, respectively, seeking to close that exception. The plaintiff alleges that both academies' use of racial classifications in their admissions programs is unconstitutional.

> Several recent suits against higher education institutions may allow courts to weigh in on the application and impact of *SFFA*.

According to the complaints, the compelling interests proffered by the academies are reduced to two propositions:

- That racial preferences enhance the military's internal functioning.
- That racial preferences enhance the military's functional capacity by fostering internal confidence within the ranks and by bolstering its external legitimacy. This, in turn, increases societal trust and recruitment efforts.

SFFA disputes that these interests are sufficiently compelling.

Suit against NYU. America First Legal, a national nonprofit, filed a putative class action lawsuit in October 2023 against New York University on behalf of prospective *New York University Law Review* applicants. It alleges that the *Law Review*'s consideration of race and

1 Lara Flath and Amy Van Gelder represented the University of North Carolina at Chapel Hill in the *SFFA* litigation.

sex in its member and editor selection process violates Title VI of the Civil Rights Act and Title IX of the Education Amendments. The suit alleges that the *Law Review* sets aside positions for women, non-Asian racial minorities and LGBTQ+ students at the expense of white and Asian men.

These suits eventually may provide an additional opportunity for the Supreme Court to weigh in on the limits and/or breadth of its reasoning in *SFFA*.

Recent Court Rulings on Challenges to DEI Initiatives

Since our update on this topic in September 2023, several federal courts have ruled on suits brought by public interest litigation groups relating to corporate DEI policies and programs.

- A September 27, 2023, ruling in the U.S. District Court for the Northern District of Georgia denied a request to enjoin a private company from operating its small business grant program open only to Black women. The court held that applying 42 U.S.C. Section 1981 likely would be an unconstitutional restriction on the defendants' expressive conduct under the First Amendment. Three days later, however, the U.S. Court of Appeals for the Eleventh Circuit reversed the district court and granted an injunction pending appeal, stating that the defendants were not engaging in constitutionally protected expression and holding that the plaintiff was substantially likely to succeed on the merits.
- On October 18, 2023, the U.S. Court of Appeals for the Fifth Circuit denied an equal protection and administrative law challenge to the approval by the Securities and Exchange Commission (SEC) of a Nasdaq rule that requires Nasdaq-listed companies to disclose statistics about the demographics of their board members and to include at least one woman and one underrepresented minority or LGBTQ+ member (or explain why they do not). The Fifth Circuit did not reach the underlying merits of the initiative and dismissed the suit on the grounds that, because Nasdaq is not a state actor, the constitutional challenges failed. The Fifth Circuit further held that the SEC had not exceeded its authority under the Securities Exchange Act or the Administrative Procedure Act. The plaintiff has petitioned for *en banc* review of this decision.

Continued Challenges to DEI Programs, Including Those Open to Diverse Applicants Generally

Shortly after *SFFA*, the American Alliance for Equal Rights (AAER), on behalf of prospective law student applicants, filed lawsuits against two prominent law firms, Perkins Coie and Morrison Foerster. Those complaints alleged that the firms' diversity fellowships violated Section 1981 because they were open exclusively to racial minorities, members of the LGBTQ+ community and, for one of the fellowships, students with disabilities. After both law firms expanded the application criteria for their fellowships, AAER voluntarily dismissed both suits.

AAER continued to send letters to additional law firms with similar diversity fellowships, inquiring about applicant criteria and threatening litigation after these dismissals. On October 30, 2023, AAER filed another suit against one such firm, Winston & Strawn, in which it alleged that the firm limits the applicant pool for its fellowship to candidates who are "diverse," "disadvantaged" or "historically underrepresented." Even though the applicant criteria is not exclusive to certain groups, the complaint alleges that this language is shorthand for "not a straight white male."

On December 7, 2023, AAER dismissed this suit as well and has indicated that it has no current plans to sue additional law firms.

Corporations may not be so fortunate. Indeed, America First Legal recently filed a charge of discrimination with the Equal Employment Opportunity Commission (EEOC) asserting that NASCAR discriminates against white men through its "Drive for Diversity" program. This program previously specified that it was intended for women and ethnic minorities but was updated on September 1, 2023, to seek applicants of "diverse backgrounds and experiences."

Despite the language change, America First Legal alleged in its November 2, 2023, complaint that NASCAR continues to carry out unlawful hiring practices "under the cloak of a 'diverse backgrounds and experiences' rebranding."

These recent developments may signal a coming wave of challenges to programs based not only on their facial description but how they are applied in practice.

Heightened Scrutiny of DEI Initiatives To Undoubtedly Continue

Individuals and nonprofits seeking to challenge race-conscious policies are energized because they see *SFFA* as a decisive, favorable change in doctrine, and they seek to apply its reasoning to contexts beyond higher education.

As we discussed in our September 2023 article on this topic, DEI initiatives and programs that are not open to all applicants or those that apply an explicit race- or gender-based focus will likely face continued and heightened scrutiny. We also expect to see ongoing scrutiny of perceived hiring quotas and set-asides, particularly those that may appear to be incentivized by bonuses for management or company leadership.

DEI programs — especially those that are focused on eliminating bias, cultivating a broad view of diversity and promoting equal opportunity among employees — remain lawful. But companies should closely examine their public statements regarding these programs and consider whether they are closely connected to specific business goals, are non-exclusionary and avoid providing an advantage due to race in a zero-sum outcome.

Non-EU Companies Face Challenges Preparing for Europe's Corporate Sustainability Reporting Directive

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Key Points

- Detailed rules governing some of the upcoming requirements for sustainability disclosures will help companies prepare to comply, but many requirements have still not been specified.
- The rules for non-EU companies will not be available until 2026, giving those companies less time than they had assumed to begin preparing to collect and share the required information.
- Non-EU companies that want to begin making ESG disclosures ahead of the EC deadlines could find themselves having to comply with inconsistent requirements, because it is not clear which alternative disclosure regimes the EC will deem equivalent to its rules.

The European Union's Corporate Sustainability Reporting Directive (CSRD), under which reporting will start in 2025, covers companies operating in the EU, including multinational groups with European operations.

The European Commission (EC) expects that approximately 49,000 entities will be required to report under the CSRD, versus the 11,000 under the existing Non-Financial Reporting Directive (NFRD). Thus, many non-EU companies find themselves with a need to analyze their obligations to comply with the new reporting regime in the coming years.

However, a delay in the publication of detailed CSRD reporting requirements means that non-EU companies will not have as much time to prepare for compliance as previously expected.

Applicability to Non-EU Companies

Broadly, the CSRD will apply to non-EU companies:

- that have securities listed on an EU-regulated market (excluding EU multilateral trading facilities), or
- that exceed one or both of two revenue thresholds (Turnover Test):
  - annual net turnover in the EU at the consolidated or individual level exceeding €150 million for each of the last two consecutive financial years, and/or
  - a qualifying EU subsidiary or branch that generated annual net turnover in excess of €40 million in the preceding financial year.

Non-EU companies caught by the first test must report starting in 2025, 2026 or 2027, depending on their size. Non-EU companies that satisfy the Turnover Test must report starting in 2029. For additional information, see our October 9, 2023, client alert "Q&A: The EU Corporate Sustainability Reporting Directive – To Whom Does It Apply and What Should EU and Non-EU Companies Consider?"

The European Sustainability Reporting Standards and 'Double Materiality'

On July 31, 2023, the EC formally adopted the first set of detailed reporting requirements under the CSRD, known as the European Sustainability Reporting Standards (ESRS). The ESRS consists of two general standards ("General Requirements" and "General Disclosures") and 10 "topical standards" — environmental, social and governance (ESG) matters where the company's impact must be assessed and, if material, disclosed. These range from climate change to pollution, water and marine resources, biodiversity, workers in the value chain, and consumers and end users.

Whether a company is obliged to report its impact under the 10 topical standards depends on whether the issue or standard is "material" for its business model and activity. In assessing materiality, a company must consider both:

i. value creation for the company; and

ii. the wider impact the company has on the economy, environment, nature and communities.

Together, (i) and (ii) are referred to as the "double materiality" standard, because a company must consider both. Satisfying either test amounts to a standard being "material." If, following a thorough assessment, a company determines information to be material, disclosure is mandatory.

> Whether a company is obliged to report its impact under the 10 topical standards depends on whether the issue or standard is "material" for its business model and activity.

Of particular note is the topical standard on climate change (ESRS E1), which is subject to a comply-or-explain requirement: If a company concludes that climate change is not a material topic and it therefore does not report on that topic, it must provide a detailed explanation of its conclusion. This requirement applies only to determinations regarding climate change.

Supplemental ESRS for Non-EU Companies

In addition to the details in the first ESRS, the CSRD authorizes the EC to develop supplemental ESRS for non-EU companies that satisfy the Turnover Test. Those standards will provide the details necessary for non-EU companies to determine the kinds of information they will need to gather in order to meet their reporting requirements starting in 2028.

But the target date for publication of these supplemental ESRS has been postponed from June 30, 2024, until June 30, 2026. Similarly, the EC expects to publish sector-specific ESRS around that time. This delay means that non-EU companies will have substantially less time than previously indicated to establish compliance processes and gather the necessary information for disclosure.

The shortened time to prepare is significant given the changes that were ultimately made to the draft sector-agnostic ESRS. For instance, in the final ESRS, the EC opted to allow flexibility for companies not to disclose certain information that is not material to them for a greater number of topical standards than originally proposed. The EC also made more data points (such as reporting a biodiversity transition plan) voluntary rather than mandatory.

As was the case with sector-agnostic standards, it is possible that the EC will adopt final standards for non-EU companies and sector-specific standards that deviate significantly from the draft submissions. Non-EU companies preparing for their eventual disclosures should build some flexibility into their reporting systems in case the EC's final requirements differ from current expectations.

The CSRD requires information on entire value chains, and there may be friction between the competing or misaligned deadlines of various companies that fall within the scope at different moments. To the extent possible, companies should prepare to cooperate on information-sharing with business partners and key counterparties at an earlier or later time than expected.

Early Disclosure: What Are the Risks?

Some non-EU companies that have been tracking the development of the CSRD and other European ESG-related legislation may be considering making disclosures ahead of EC deadlines, either as part of their preparatory steps for mandatory disclosure or to burnish their ESG credentials. However, there are some risks to consider in being ahead of the requirements.

In order to ease the compliance burden for multinational groups, the CSRD gives the EC the ability to recognize other reporting standards as equivalent to the ESRS. However, as of yet, no equivalency decisions have been made, and none are expected until mid-2024. As a result, companies risk reporting without certainty regarding which reporting standards will be declared as equivalent for CSRD purposes.

The International Sustainability Standards Board (ISSB) is developing its own set of global rules for sustainability disclosures. Although the European Financial Reporting Advisory Group (EFRAG), which was responsible for drafting the ESRS, has indicated that it continues to work alongside the ISSB to optimize compatibility of the ESRS and ISSB standards, the extent of overlap is not yet fully determined. In addition, companies could face requirements to comply with disclosure mandates in non-EU jurisdictions that diverge from both CSRD and ISSB standards.

Companies deciding to disclose ahead of time run the risk of collating data or establishing systems that do not ultimately enable the company to comply with CSRD without further changes. The lack of certainty also means that non-EU companies that disclose earlier than is necessary could expose themselves to potential liability if their disclosures are not consistent with the final CSRD requirements.

Timeline for CSRD Reporting

Reports Due	For Full Financial Years Ending in	Companies Subject to Requirements
2025	2024	Any EU-incorporated company already subject to the NFRD.
2026	2025	Large companies[1] incorporated in the EU and EU-incorporated parents of large groups (including non-EU subsidiaries), including captive insurance and reinsurance undertakings, as well as small and non-complex institutions that meet the large company requirements.
2027	2026	Small and medium-sized entities listed on an EU-regulated market.
2029	2028	Companies whose ultimate parent company is outside the EU but which have a significant presence in the EU; report must encompass the whole global group, including non-EU companies.

1 Large companies are defined as those with a net turnover of more than €50 million, balance sheet total assets greater than €25 million and/or more than 250 employees.

Antitrust

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As US Antitrust Agencies Double Down on Merger Enforcement Approach, New Deal Strategies Emerge

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Editor's note: ***The merger guidelines were finalized after this article was published. For an update on this topic, see our December 21, 2023, client alert "DOJ and FTC Release Final 2023 Merger Guidelines Formalizing Aggressive Merger Enforcement Playbook."***

Key Points

- New draft merger guidelines reflect the aggressive approach that has defined merger enforcement in the Biden administration, including novel theories of harm.
- Proposed changes to HSR notification will make merger filings more burdensome while providing agencies with more information to assess mergers against the new guidelines.
- Though the agencies have lost most recent merger challenges, suggesting that courts may be reluctant to accept the principles articulated in the new merger guidelines, the agencies still hope to deter deals they view as problematic.
- Merging parties must be prepared to defend strategic deals through litigation and should proactively consider remedies to remove concerns and maximize the odds of litigation success.

Throughout 2023, the Department of Justice (DOJ) and Federal Trade Commission (FTC) have continued to pursue an aggressive merger enforcement agenda, including releasing new draft merger guidelines and proposed changes to Hart-Scott-Rodino Act (HSR) notification requirements that threaten to make dealmaking more burdensome.

However, the courts have been an important counterweight to the agencies' efforts to block deals, and parties undertaking strategic transactions can adapt to the new regulatory environment with deal strategies that include the willingness to litigate or alter transactions in ways that address alleged competition concerns.

Updated Merger Guidelines Seek To Formalize Agencies' Existing Approach

The FTC and DOJ jointly released draft merger guidelines in July 2023 setting forth 13 "frameworks" under which the agencies will assess the competitive impact of mergers. The guidelines formalize the aggressive enforcement approach the agencies have been following in the Biden administration and read as a menu of ways a transaction might harm competition.

The document consolidates and sometimes blends horizontal, vertical and other theories of harm into an amalgamation that targets not only mergers between competitors and parties in the same supply chain, but also those involving adjacent relationships, parties with "dominant" positions and any other kind of merger that the agencies believe is harmful. (See "EU and UK Merger Regulators Look Beyond Horizontal and Vertical, With Digital 'Ecosystems' a New Focus.")

Rather than establishing a flexible framework of economic analysis for assessing competitive effects, the guidelines have a heavy focus on **presumptions of harm**. In particular:

- For **horizontal transactions**, a combined market share of 30% is deemed sufficient to presume competitive harm, even if one party's share is minimal.
- For **vertical mergers**, the guidelines presume foreclosure harm if one party holds 50% market share in an upstream or downstream market.

- Also subject to heightened scrutiny are **transactions that could "entrench" an existing dominant position or "extend" dominance into another market.** The guidelines assume that a 30% market share is sufficient to establish dominance.

In addition, the guidelines' approach to defining product markets potentially allows for the exclusion of "significant substitutes," meaning the agencies may focus on "narrow group[s] of products" to find positions where market shares exceed the new, lower thresholds.

The guidelines also adopt principles for assessing competitive harm in **mergers involving actual or perceived potential competitors, multisided technology platforms and transactions that could impact the supply of labor**. Notably, the guidelines seek to prohibit deals that facilitate a "trend toward consolidation" and acquisitions that are part of a series of transactions deemed anticompetitive as a whole, even if an individual transaction does not violate the law.

Critically, the guidelines are not legally binding, but in the hope that courts will follow them, the agencies cite a wealth of case law in footnotes. However, these cases skew heavily toward pre-1980s precedent. While presented as both an update for the "modern economy" and a statement of existing law, the guidelines do not mention many relevant cases from the last several decades where judges grappled with exactly this challenge of applying the competition laws to modern market dynamics.

> Rather than establishing a flexible framework of economic analysis for assessing competitive effects, the guidelines have a heavy focus on presumptions of harm.

In court, the agencies have suffered repeated defeats in the last several years, involving cases where they relied on the kinds of theories they promote in the guidelines, including vertical theories (*Microsoft/Activision*, *UnitedHealth/Change Healthcare*), potential competition theories (*Meta/Within*) and circumstances where they pressed very narrow product or geographic market definitions (*Booz Allen/EverWatch, U.S. Sugar/Imperial Sugar*).

These losses demonstrate that courts are a key check on the agencies and potential roadblock to the guidelines turning into legal precedent.

The agencies have claimed success despite these losses, pointing out that many transactions have been abandoned in the face of regulatory scrutiny. Indeed, in a recent letter responding to questions from Rep. Tom Tiffany, R-Wis., about merger enforcement, FTC Chair Lina Khan pointed to 19 mergers that were abandoned during FTC investigations and remarked that "deterrence is a real mark of success."

Nevertheless, the fact that courts have not endorsed the agencies' aggressive new theories suggests that strategic transactions will continue to sign and close.

Overhaul of HSR Filing Requirements Seeks More Information on Transactions

Consistent with the goal of merger deterrence, less than a month before releasing the draft merger guidelines, the agencies proposed changes to HSR form and filing requirements that would not only give the agencies more tools to develop the theories of harm in the guidelines but also increase the burden of HSR filings.

At an international summit of competition enforcers in November 2023, FTC Commissioner Rebeca Slaughter opined that the HSR changes are "going to have a much more material effect" than the nonbinding draft guidelines "on how we can actually … execute our responsibilities to review transactions."

If adopted, the proposed changes would dramatically increase upfront disclosures in HSR notifications, requiring parties to produce a cross-section of strategic business documents beyond just transaction-related ones, including, among other things:

- Drafts of transaction-related documents rather than only the final versions of the documents currently required.
- Narrative descriptions of the products, markets and competitive dynamics of the relevant industries.
- Representations about planned products that may be potentially competitive with those of the other merging party.
- Data on employee types.
- More information on prior transactions.

These changes would arm the agencies with information early in the review process (*i.e.*, before the issuance of a second request) that would allow them to scrutinize a transaction under each of the new merger guidelines.

Further, the systematic collection of documents and data will provide the agencies with greater ability to police long-term M&A strategies and identify patterns or trends across individual transactions. Those include industry "roll-ups" (where companies acquire and combine businesses to gain scale and efficiencies), strategies to leverage a strong position in one market as a means to enter others and concentration of bargaining power in labor markets.

With these changes, it will be more critical than ever for merging parties to fully understand what their internal documents say before signing and develop a strategy to engage with regulators on potential issues under the new guidelines.

Litigation Readiness and the Role of Remedies

Although the agencies are scrutinizing more transactions with novel theories of harm, their recent court setbacks show that difficult deals can still close if the parties are ready and able to fight in court and have a timetable in the merger agreement that allows for the possibility of litigation.

To maximize the chance of success, parties must build enough time into merger agreements to allow for extended reviews and potential litigation, particularly if parallel reviews in other jurisdictions could allow a U.S. agency to delay filing a complaint for tactical reasons. Parties should also develop a credible litigation strategy early in the merger investigation and be ready to consider remedies or changes to the transaction that could remove concerns and/or improve litigation odds.

The agencies have taken a highly skeptical view of remedies in merger cases, preferring to sue to block transactions rather than accepting divestitures or behavioral commitments they deem inadequate. However, the agencies risk losing in court when parties proactively make changes to a transaction that alters the competitive impact of a deal and forces the agencies to "litigate the fix" in court. That was demonstrated by *UnitedHealth/Change Healthcare* in 2022, where the court evaluated the parties' proposed divestiture and denied the DOJ's request for an injunction.

In the second half of 2023, the agencies agreed to settle some cases with remedies. However, in court papers for the only merger case where the DOJ has accepted a remedy since Jonathan Kanter became assistant attorney general (*Assa Abloy/Spectrum Brands*), the agency indicated its reluctance, saying that it did "not contend the remedy would fully eliminate the risks to competition," but that there were "risks associated with this litigation" that contributed to the decision to settle.

The FTC has also been skeptical of, but slightly less hostile to, formal remedies. Indeed, in August and September 2023, it reached settlements after the commencement of litigation to resolve both horizontal (*ICE/Black Knight*) and non-horizontal (*Amgen/Horizon Therapeutics*) concerns.

These examples do not mean that the agencies are now openly embracing remedies, but they reinforce the importance to merging parties of:

- being prepared to defend their merger "all the way" in court and
- developing strategies to offer or implement remedies — either within the regulatory process or outside of it — that can change the enforcement calculus for the agencies or improve the merging parties' odds in court.

In Sum

The draft merger guidelines and proposed HSR changes are expected to be finalized in 2024. The U.S. agencies will continue to push the envelope of merger enforcement, advocating an expansive view of the antitrust laws by the courts.

UPDATE: The merger guidelines were finalized on December 18, 2023.

In addition, the U.S. agencies' recent courtroom losses show that the courts remain a check on the agencies, and merging parties can navigate risks by framing deal strategies that include a plan to litigate and, when appropriate, offer changes to the transaction to eliminate competition concerns or make litigation riskier for the agencies.

EU and UK Merger Regulators Look Beyond Horizontal and Vertical, With Digital 'Ecosystems' a New Focus

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Key Points

- EU competition regulators are increasingly considering "ecosystems" of products and services in their analysis of the competitive impact of mergers — a framework that often does not fit with the historical focus on horizontal and vertical relationships.
- The merging parties' rationales and internal documents have taken on a greater importance in both EU and U.K. merger reviews.
- EU and U.K. regulators are resorting more frequently to "stop the clock" mechanisms, thereby extending the time they have to investigate transactions.
- Agencies are continuing to apply traditional frameworks of assessment in most non-horizontal mergers, and large, complex deals are still getting cleared where the parties employ the right strategy.

The regulatory review of mergers in dynamic and innovative markets has become more complex and fragmented across key jurisdictions. On the back of perceived underenforcement, several competition authorities in Europe have seen their ability to review deals in innovative markets increase with the introduction of flexible jurisdictional rules and new notification thresholds.

Regulators also continue to refine their substantive assessment of mergers in dynamic markets, shifting their focus to new concerns, a trend that is particularly visible in digital markets. Authorities are increasingly investigating digital ecosystems competition, platform-based competition, access and interoperability issues, user data concerns and interplay between competition and data protection.

Authorities in Europe continue to adapt their framework of analysis for large, complex deals in digital markets that do not fit squarely in their traditional approach to horizontal, vertical or conglomerate effects. They are considering complex interconnecting theories of harm, anticipating multiple repercussions of a transaction across numerous markets.

The European Commission (EC) is particularly attentive to transactions that involve a combination of horizontal and non-horizontal effects that can reinforce each other. A good example of this approach is the review of Google's 2021 acquisition of Fitbit, where the EC examined multiple effects across several business segments and apps.

In addition, regulators are increasingly concerned about restrictions of potential competition, examining the long-term effects of a merger on products or services that have not yet been developed. As part of their assessment, regulators query the merging parties' growth strategies, including:

- Innovations.
- Investments and product development.
- How these impact the parties' ability and economic incentive to enter or expand in the relevant market.

The trend of testing novel theories of harm is also apparent in the U.S., where the Department of Justice (DOJ) and the Federal Trade Commission (FTC) have been focusing on the elimination of potential competition from nascent competitors and looking beyond traditional horizontal and vertical theories of harm.

In their July 2023 draft revised merger guidelines, the agencies take the position that mergers that could entrench or extend a dominant position are problematic, even if the deal parties do not compete or vertically intersect with one another. The agencies also provide guidelines specifically dealing with mergers involving platform competition. (See "As US Antitrust Agencies Double Down on Merger Enforcement Approach, New Deal Strategies Emerge.")

EC's New Focus on 'Ecosystem' Mergers

The EC has stepped up its focus on mergers that involve "ecosystem" markets where, according to the EC, a company operates in several linked markets. As a result, not only the acquisition of a direct competitor but also the addition of a linked service to a company's ecosystem of services raises concerns.

The EC's decision in September 2023 to block the proposed merger between the hotel reservation platform Booking.com and the flight booking platform Etraveli is the regulator's first prohibition resulting from concerns arising from a service ecosystem.

The EC concluded that the transaction would have channeled Etraveli customers to Booking.com, allowing the latter to expand its travel services ecosystem business and strengthen its position on the market for online travel agencies. It considered the proposed remedies offered by Booking.com (including to show flight customers a choice screen on the flight check-out page with multiple hotel offers from competing hotel online travel agents) to be insufficient to address the concerns.

With its decision, the EC departed from its merger guidelines and adapted its framework of analysis to the novel nature of these online businesses. In sharp contrast, the U.K. Competition and Markets Authority (CMA) cleared the transaction a year earlier without conditions, concluding that customers do not necessarily purchase different travel services from the same provider.

The EC has stepped up its focus on mergers that involve "ecosystem" markets where, according to the EC, a company operates in several linked markets.

Ecosystem theories have also been considered in other cases. The EC examined Meta's ecosystem in the context of its acquisition of cloud-based customer relationship management services provider Kustomer. The agency considered whether the deal would enable Meta to steer more customers into its ecosystem, but this fed onto a traditional non-horizontal foreclosure theory of harm: that Meta would have the ability, as well as an economic incentive, to engage in foreclosure strategies toward Kustomer's close rivals and new entrants.

In the U.K., when the CMA initially prohibited Microsoft's acquisition of Activision, it considered the effect on Microsoft's ecosystem. The CMA eventually cleared the transaction with conditions after it was restructured. In contrast, the FTC in the U.S. filed an administrative complaint, and later a federal lawsuit, challenging the proposed acquisition alleging vertical theories of harm. (The U.S. District Court for the Northern District of California eventually allowed the merger to proceed).

There is no clear definition of what an "ecosystem" is, but authorities appear attentive to strong links among different markets with one central hub, even where there are no clear horizontal or vertical business relations.

This new theory of harm is not confined to the digital space, and the EC indicated the possibility of new guidelines for how it will handle ecosystem mergers in the future.

Increased Focus on Deal Rationale and Internal Documents

European competition authorities have also been placing ever-greater focus on deal valuation, large and unexplained deal premiums and deal rationale — *i.e.*, the parties' future intentions and the impending implications of the deal for the market. In addition, regulators continue to use the parties' internal documents and third-party evidence and market tests.

The EC regularly asks for copies of documents produced for other regulators, including internal documents provided to the FTC and DOJ in the context of "second requests" for information.

Similarly, in the U.K., the CMA's revised merger assessment guidelines emphasize the importance of internal documents to reveal the parties' intent, particularly when other data or sources of evidence are scarce and market developments are uncertain.

European competition authorities have also been placing ever-greater focus on deal valuation, large and unexplained deal premiums and deal rationale.

The CMA increasingly relies on this type of evidence, and its decision to block Meta's acquisition of Giphy in 2022 was almost entirely based on the internal documents of the merging parties, third-party evidence and the CMA's discussions with market participants.

Both the EC and the CMA do not hesitate to use their formal information-gathering powers, with threats of penalties for failure to comply.

Longer In-Depth Merger Reviews

The duration of "stop the clock" periods in in-depth merger investigations has been increasing in large, complex cases. The EC and the CMA can suspend the statutory deadlines of in-depth investigations if the merging parties fail to respond to requests for information on time.

Although stop-the-clock suspensions have long been part of the transaction review process, they have become more common in recent years, contributing to longer review proceedings.

The Way Forward

In the vast majority of non-horizontal mergers, agencies continue to apply traditional frameworks of assessment, examining the ability, incentive and potential effects of foreclosure. Large, complex deals still get cleared where the parties have the right strategy.

However:

- Merging parties should identify early on in their negotiations which authorities are most likely to have an interest in the deal.
- They should also consider right from the start how regulators will perceive their deal rationale.
- Lastly, parties should plan realistic deal timetables to factor in early engagement with authorities and burdensome, resource-heavy document production processes.

Senior professional support lawyer **Caroline M. Janssens** contributed to this article.

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AI in 2024: Monitoring New Regulation and Staying in Compliance With Existing Laws

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Key Points

The rapid adoption of artificial intelligence (AI) technology across the economy has raised a number of novel legal issues. In this article, we discuss five key issues to track in 2024, including:

- AI regulation, including the EU's AI Act, is taking shape and may begin to affect nearly all industries.
- Expect more litigation over alleged copyright infringement in the training and use of AI systems.
- AI technology will increasingly generate cybersecurity challenges and privacy risks that companies utilizing AI systems must manage.
- The use of AI in employment decisions will be circumscribed by employment-related laws.
- As companies integrate AI into products and processes, robust internal governance policies will be needed to manage risks related to the use of proprietary and confidential information, as well as of customer and employee personal information for AI input, for example.

To stay in compliance with existing rules across jurisdictions and prepare for new ones in the making, companies will need to monitor regulatory developments and consider whether to submit comments or otherwise be involved in legislative or regulatory rulemaking on issues affecting their interests.

1. Upcoming AI Legislation

Governments across the world have only just begun to draft and pass laws tailored to AI technology. Heading into 2024, we expect both sector-specific and broader, omnibus AI regulations to impact nearly all industries as the use of AI expands.

European Union

The EU set rules for the use of AI, namely the EU Artificial Intelligence Act (EU AI Act) and the Artificial Intelligence Liability Directive (AILD).

EU AI Act. On December 8, 2023, EU policymakers reached a deal on the EU AI Act following three days of marathon negotiations. The EU AI Act still needs to go through final steps before it becomes law, but the political accord means that its key parameters have been set. The provisional agreement provides that the EU AI Act will apply two years after its entry into force, with some exceptions for specific provisions. The draft law needs the approval of the Council of the European Union and the European Parliament, which comprises representatives from the 27 countries in the EU.

The legislation, which would apply to providers placing AI systems in the EU market, would take a "risk-based" approach, classifying and regulating systems based on their risk levels. For example, new provisions were introduced to account for general purpose AI systems, to require specific transparency obligations for foundational models before being placed on the market, and to impose a stricter regime for high-impact foundational models.

The draft law also deems risks associated with certain use cases unacceptable, banning, for example, the scraping of faces from the internet or security footage to create facial recognition databases; emotion recognition in the workplace and educational institutions; cognitive behavioral manipulation; social scoring; biometric categorization to infer

sensitive data, such as sexual orientation or religious beliefs; and certain cases of predictive policing for individuals. However, the draft law also gives broad exemptions for "open-source models."

The draft law specifies that the scope of the law shall not affect member states' competences in national security (or any entity entrusted with tasks in this area) or apply to AI systems used solely for the purpose of research and innovation.

> The legislation, which would apply to providers placing AI systems in the EU market, would take a "risk-based" approach, classifying and regulating systems based on their risk levels.

AILD. In parallel, the EU is amending its product liability regime, updating the existing Product Liability Directive and adopting the new AILD to harmonize civil liability for AI among EU member states.

The amendments would address strict and fault-based liability regimes to provide recourse to EU citizens for defective or harmful AI products. Importantly, the AILD would establish a rebuttable presumption of a causal link between the fault of the provider of AI systems and the output of those systems.

These regimes will not only affect companies looking to launch and use AI models in the EU but may also help shape future legislation by EU member states and other jurisdictions.

United Kingdom

In contrast, the U.K. has taken an incremental, sector-led approach to AI regulation, as reflected in its March 2023 white paper. The U.K. government has undertaken consultations and invited feedback from the AI industry to guide its regulation of AI practices. In the coming year, it is expected to share high-level guidance and an initial regulatory road map with its sector-specific regulators.

These regulators will then provide tailored recommendations for the financial, health care, competition and employment sectors. At that point, the U.K. government will assess whether specific AI regulation, or an AI regulator, is required, which will inform the business practices of companies placing AI systems in the U.K. in 2024.

United States

The U.S. has yet to adopt a comprehensive AI law. However, in October 2023, the Biden administration issued a sweeping executive order (AI Executive Order) that directed various U.S. government departments and agencies to evaluate the safety and security of AI technology and other associated risks, and implement processes and procedures regarding the adoption and use of AI. Federal and state agencies as well as lawmakers have also shown significant interest in regulating AI technology.

AI Executive Order. The executive order set deadlines for agencies and regulators, and proposed to impose obligations on companies to test and report on AI systems. It followed a suite of AI policies that the White House announced earlier in 2023. (For more on the executive order, see our November 3, 2023, client alert "Biden Administration Passes Sweeping Executive Order on Artificial Intelligence.") Heading into the new year, we expect accelerated efforts to enact AI regulation, particularly in light of the AI Executive Order, both at the federal and state levels.

CPPA's proposed regulations on automated decision-making. The California Privacy Protection Agency (CPPA) recently issued an initial draft of regulations governing the use of automated decision-making technology (ADMT) under the California Consumer Privacy Act (CCPA). The draft regulations broadly define any system, software or process that handles the personal information of California residents and uses computation as a whole or part of a system to make or execute a decision or facilitate human decision-making."

The draft regulations propose granting consumers (including employees and business-to-business contacts) the right to receive pre-use notice regarding the use of ADMT and to opt out of certain automated decision-making activities. The CPPA is expected to begin the formal rulemaking process in 2024.

Copyright Office and Patent and Trademark Office. The two agencies have issued enforcement actions and guidance on various AI-related matters, taking the position that a sufficient degree of human input is needed to qualify for protections under copyright and patent law. Subsequent litigation has affirmed these positions. (See our August 28, 2023, client alert "District Court Affirms Human Authorship Requirement for the Copyrightability of Autonomously Generated AI Works.") We expect guidance from the two agencies to evolve as applicants seek to register new works and inventions that incorporate AI in 2024.

SEC's proposed AI rules. In July 2023, the Securities and Exchange Commission (SEC) proposed broad new rules to address conflicts of interest that the SEC believes are posed by the use of AI and other types of analytical technologies by broker-dealers and investment advisers. We expect the final rules to be released in 2024. (See our August 10, 2023, client alert "SEC Proposes New Conflicts of Interest Rule for Use of AI by Broker-Dealers and Investment Advisers.")

Other Jurisdictions

Beyond the EU and U.S., more than 37 countries — including China, India and Japan — have proposed AI-related legal frameworks.

- In August 2023, the International Association of Privacy Professionals published a list of AI legislation introduced around the world.

- In October 2023, the United Nations unveiled an AI advisory board aimed at creating global agreements on how to govern AI systems. The board plans to release final recommendations by mid-2024, which may influence worldwide regulatory efforts.
- On November 1, 2023, representatives from the EU, U.S., U.K., China and 25 other countries signed the Bletchley Declaration, largely echoing the statements of numerous national and international organizations in recognizing the importance of trustworthy AI and the potential dangers of general-purpose AI models. The declaration suggests international cooperation and an inclusive global dialogue that recognizes varying approaches based on national circumstances.

2. Current and Future Litigation

Copyright Infringement

Generative AI models, including ChatGPT and Google Bard, are generally trained on vast amounts of content and data. These may include copyrighted works extracted from publicly available websites. A number of content creators and owners have filed suits claiming that use of this content infringes the rights, including copyrights, of third parties.

Data compilers and model trainers have argued that their activities constitute "fair use" under copyright law. These cases are just beginning to work their way through the courts.

Cases to watch include:

- *Thomson Reuters v. ROSS Intelligence*: Legal publisher alleges infringement of copyrights in Westlaw material used to train an AI-based competitor.
- *Getty Images v. Stability AI*: Image licensor alleges infringement of copyrights in over 12 million photos and their captions used to build and promote the text-to-image generative AI systems Stable Diffusion and DreamStudio.
- *Authors Guild v. OpenAI Inc.*: Novelists in putative class action accuse OpenAI of using their works without permission to train the AI models powering ChatGPT.
- *Tremblay/Silverman v. OpenAI Inc.*: Two plaintiff groups allege that OpenAI infringed their copyrighted novels to train the AI models powering ChatGPT.
- *Doe v. GitHub Inc.*: Software developers allege that the AI-based coding tools OpenAI Codex and GitHub Copilot infringed rights and violated licensing terms relating to public code developers published on GitHub.

3. Cybersecurity and Privacy Risks

Cybersecurity

AI technology has the capability to expand the arsenal of bad actors to carry out sophisticated cyberattacks (*e.g.*, large language models can be used to write malicious code, engineer advanced phishing attacks or more effectively spread malware and ransomware). In addition, AI systems may themselves be vulnerable to data integrity attacks (*e.g.*, through "model poisoning," an attack conducted by introducing malicious information into training data).

In response to those risks, the AI Executive Order in the U.S. calls for testing and reporting rules for companies developing certain AI tools. Companies must therefore ensure their cybersecurity polices adequately identify, measure and manage these risks.

Privacy

Companies that build or use AI models built on training sets that include personal information — whether purchased from third parties or extracted from publicly available websites — or that otherwise collect personal information, including through inputs by users (such as through note-taking and summarization technologies built into web conferencing software), may implicate privacy laws in various jurisdictions.

Applicability of comprehensive privacy laws. Comprehensive privacy laws, such as the EU's General Data Protection Regulation (GDPR), the CCPA and other U.S. state privacy laws, impose purpose limitation, data minimization, transparency, accountability and integrity principles that may be at odds with the use and development of such AI models. Therefore, companies will need to carefully consider whether they are providing individuals whose personal information is used for or by AI models with the requisite notices and are obtaining the necessary consent prior to such use. Companies will also need to be prepared to respond to requests by these individuals to exercise their rights — some of which, such as the right to delete, are complicated by the mechanisms of AI — under the privacy laws.

Lawsuits under biometric privacy laws. AI companies have faced suits under the Illinois' Biometric Information Privacy Act, which prohibits private companies from collecting biometric data unless they follow stringent requirements. For example, recent lawsuits in state courts allege Clearview AI scraped billions of pictures from social media platforms to create a faceprint database that was then sold to police departments and other private organizations.

FTC's asserted authority over AI. The Federal Trade Commission (FTC) has enforced the FTC Act's prohibitions on unfair and deceptive acts or practices against AI companies (including requiring in some cases that AI models trained on data in violation of privacy commitments be deleted, a remedy termed "algorithmic disgorgement"). The FTC has also indicated that it will continue to enforce the FTC Act to protect against misuses of personal information in connection with AI models. (See "FTC Enforcement

Trends in Consumer Protection Under the Biden Administration.")

In addition, the FTC recently approved, in a 3-0 vote, a resolution authorizing its ability to issue civil investigative demands (CIDs), which are a form of compulsory process similar to a subpoena, in non-public investigations involving products and services that use or claim to use AI.

4. Labor and Employment Issues

Many companies are already harnessing AI to improve efficiency in employment processes by, for example, preparing job descriptions, screening and evaluating job candidates, and analyzing data to predict the future success of job applicants. AI may also be used to analyze employee productivity, measure performance and identify candidates for promotion.

Hiring and Promotion

An employer's use of AI in hiring and promotion must comply with laws that prohibit discrimination based on race, color, religion, sex, national origin, disability or age, including Title VII of the Civil Rights Act of 1964, the Americans With Disabilities Act and the Age Discrimination in Employment Act in the U.S.

In 2022 and 2023, the U.S. Equal Employment Opportunity Commission (EEOC) issued guidance with examples of ways that AI tools may violate anti-discrimination laws and best practices to employ when integrating AI into HR policies and practices.

In addition, state and local legislators are focused on AI use in hiring and promotion. For example, New York City Local Law 144 requires employers using automated employment decision tools (AEDTs) to screen candidates for hiring or promotion to make public the date and summary of the results of an annual independent bias audit of any such AEDTs.

Illinois also enacted the Artificial Intelligence Video Interview Act in 2022, which imposes certain requirements on employers that use AI to analyze video interviews. California, New Jersey, New York, Vermont and Washington, D.C., have also proposed legislation to regulate AI use in hiring and promotion.

In addition, employers and employment agencies must provide a notice of the use of AEDTs to employees and candidates for employment who reside in New York City.

Termination

When laying off employees, employers must also be mindful of compliance not only with anti-discrimination laws but also the U.S. Worker Adjustment and Retraining Notification Act and equivalent state and local laws. Furthermore, pending legislation may impact employers; for example, the U.S. Algorithmic Accountability Act of 2022 would direct the FTC to require organizations to conduct impact assessments for bias when using AI systems to make critical decisions, such as whom to lay off. (See our June 2023 article "AI and the Workplace: Employment Considerations.")

5. AI Governance Practices

As AI becomes integrated more broadly into products and business practices, and as regulations affecting AI use take shape, companies should implement — and regularly update — clear and robust internal governance policies in order to minimize risk and liability.

Specifically, heading into 2024, companies should consider:

- **Terms of use.** Ensure public-facing terms of use sufficiently reflect internal policies regarding AI. For example, companies that make valuable intellectual property (IP) available on their websites should draft terms that make it clear whether use of that IP in connection with third-party AI products is prohibited.
- **Employee policies.** Outline the scope of permitted use of AI in the workplace in internal policies, and design protections for the use of confidential information or IP as inputs in AI tools, as well as processes governing the use of AI-generated content in products and services.
- **Vendor agreements.** Develop and implement policies and processes to address any AI-specific risks arising from their vendor agreements and ensure that negotiated agreements have sufficient protections regarding the use of confidential, proprietary or personally identifiable information, IP infringement risks and IP ownership.
- **Updating processes to reflect AI risks.** Integrate AI-related risks into compliance and governance processes, including through assessments of the impact of AI-related development or procurement, and through training and tabletop exercises to sensitize employees, management and boards to key AI issues likely to affect the organization.

Private Sector Space Projects Take Off, Leaving Legal Unknowns in Their Contrails

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Key Points

- Private enterprise is now driving the long state-dominated space sector.
- As geopolitical tensions mount, and growth in the wider tech M&A market slows, commercial activity in outer space — including M&A — remains resilient because of the sector's strategic significance.
- Many vital legal questions have yet to be answered, including jurisdictional issues regarding liability, intellectual property, dispute resolution and taxation.
- Competition will not be limited to business; new legal frameworks sponsored by different nations will also vie for dominance.

The recent surge in private space activity persisted throughout 2023, and economic and political conditions make it likely to intensify in 2024. Competing powers in outer space are no longer a handful of nations: Commercial entities, encouraged by states, have entered the arena in search of opportunity.

This pluralization has been enabled by, and has itself driven, rapid technological advances and decreased operational costs, making ventures in space more likely to be profitable. Over its lifetime, the cost of NASA's Space Shuttle program is estimated to have averaged $60,000 per kilogram, whereas the SpaceX rocket that NASA contracted to launch Psyche in October 2023 is capable of costs under $3,000 per kilogram, according to a 2022 research paper in the *Oxford Review of Economic Policy* and SpaceX.

Broad Trends

The use of commercial services to fulfill government initiatives is not the only development. Increasingly, businesses are launching space-related operations and services independently of any national space architecture or public partnership agreement. Trends we expect in 2024 include:

Satellite services. For many space companies, satellite services remain a mainstream source of revenue. Demand for the telecommunications and data-related services is expected to accelerate, with manufacturers, operators and processors all standing to benefit. Euroconsult, a consulting firm focused on the space and satellite industry, expects revenue for satellite services to reach $1.2 trillion by 2031. Meanwhile, the profitability of satellite businesses made them the top targets for acquisitions in the space sector last year. As launches increase, however, so do concerns relating to situational hazards, strategic competition and political tensions. As a result, the market's legal environment is growing more complex, and innovative and sometimes contentious regulatory initiatives can be expected.

Consolidation. Global M&A activity in the space tech sector accelerated in the past year, even as numbers for comparable deals in the wider market fell sharply, according to Seraphim, an investor in the space sector. The ability to pool research while disposing of redundant infrastructure makes space tech firms particularly suited for consolidation. Eutelsat's merger with OneWeb is a recent example.

Notably, many of the intra-industry acquisitions this year have been undertaken by younger firms, indicating that fresh entrants are capable of running viable businesses. In other words, startup status is not making investors cautious per se, as they can see scale-up and maturity developing quickly, and this may distinguish the private space industry from other disruptive tech sectors where startups have a low survival rate.

> Competing powers in outer space are no longer a handful of nations: Commercial entities, encouraged by states, have entered the arena in search of opportunity.

Investment. Seraphim reported that M&A activity in the sector in 2023 significantly outpaced deals in the general venture-backed startup market. There was a sizeable jump in investment from the private equity industry in the third quarter of 2023; global activity rose by nearly 40% from the preceding quarter. KKR, Advent and others invested this year, with Advent completing a $6.4 billion acquisition of Maxar. Seed investing also picked up toward the end of 2023, particularly for later-stage funding rounds, with the U.K. in particular displaying strong growth.

Resilience. The safest, and possibly most promising, projects in the eyes of investors have become those relating to national security. As nations establish their presence in space and expand their security capabilities, demand for ultra-high quality commercial space services is likely to grow.

Innovation. Innovative applications for space technology are being continuously developed by pioneering firms. In the pharmaceutical industry, for instance, there is keen interest in producing and testing drugs in unique space environments, and Merck & Co. and Eli Lilly have started doing so. Situational awareness, climate and software technology firms also have strong business and investment prospects.

Legal and Jurisdictional Questions

Despite the advancing state of commercial activity and private enterprise, a number of critical legal and jurisdictional issues remain unresolved. Under international law, accountability for private actors in space lies with the nation hosting the launch. Complications around disputes, liability and property rights are particularly pressing.

Liability. Complications arise as the number of multiparty operations increases. For instance, entities providing the payload, vehicle and launch site may all originate from different states. The growing number of "rideshare" agreements necessitates an equitable resolution to the issue of liability. Current contractual arrangements for such activities tend to approach risks on a no-fault basis. This is unusual for procurement contracts and necessitates a complex cross-waiver and indemnification framework most nations and companies find counterintuitive.

Intellectual property. The international character of space law puts it at odds with territorial legal regimes, such as those concerning intellectual property (IP) rights. As more products and technologies are developed in space, legal issues that need addressing in the absence of settled law include: the need to identify a territorial nexus; how to determine the applicable domestic regime; and how to avoid forum shopping.

Tax. Given uncertain property rights under international space law, there is the possibility of double or triple taxation.

Dispute resolution. The lack of a standardized dispute resolution regime, comparable to the way in which maritime disputes are handled, is another matter to be addressed. The highly technical and sensitive nature of such disputes may benefit from a standard agreement to submit them to international arbitration, which would allow combined hearings for commercial and state parties.

Insurance. Insurance is hard to come by and many missions fly uninsured, relying on some launch nations' generosity in capping liability and, in effect, providing risk subsidy.

International cooperation and competition. Law firms are starting to form teams for the building wave of cross-border legal innovation, challenges and disputes, and the need to construct a sustainable legal architecture for Earth's investment in space. That will likely be based on a foundation of venerable international treaties from the 1960s. The U.S. has led the way with the multinational Artemis lunar exploration program, which pioneers a new approach to international cooperation between government and commercial entities through a blend of public and private partnerships.

However, other countries — particularly, China and India — are developing their own legal approaches, on the grounds that a state that builds a robust national space regime for its launch actors (for example, regarding liability, insurance and rights off-Earth) can influence the legal infrastructure of space as a whole.

Both India and China are active policymakers and legislators, with the latter finalizing a draft bill that promotes a high level of state control over space-related activities. In India, the question of IP law developed in space is answered with complete state ownership. Meanwhile, China's involvement in the construction of launch facilities in Djibouti, which is not a signatory to the major space treaties, presents a way to advance interpretations and practices it may not otherwise be free to.

While much of existing space law was built through consensus, fractures among nations at international fora are becoming apparent as the industry develops. Issues to watch include legal divergences that may escalate the militarization of space through indirect means (*e.g.*, GPS-blocking) and the risk of uncompensated satellite strikes from deliberately created debris.

Transferability: IRS Guidance Energizes Participation in a New Tax Credit Monetization Strategy

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Key Points

- Changes enacted as part of the Inflation Reduction Act allow companies to purchase federal energy tax credits from third parties for cash.
- The success of these provisions, which are designed to streamline monetization of the credits and expand the market of potential participants in energy projects, will depend on the development of a robust transfer market.
- While certain technical aspects of the credit transfer process are still being worked through, the market has seen an increasing number of tax credit transfer deals since preliminary IRS guidance (88 FR 40496) was issued in June 2023.
- Companies participating in the credit transfer market are able to obtain tax savings while supporting the development of renewable technologies at a time when public investors and other stakeholders are increasingly focused on companies' greenhouse gas mitigation and other environmental efforts.

The Inflation Reduction Act (IRA) of 2022 reflected a push by Congress and the Biden administration to address climate change by broadening the applicability of tax credits traditionally available for renewable energy to new technologies (such as clean hydrogen and dynamic glass), increasing the value of credits available for other technologies (such as carbon capture), and incentivizing manufacturing of advanced technologies and mining of elements critical to those technologies.

The IRA also added provisions to the Internal Revenue Code that, for the first time, made certain federal tax credits associated with energy projects freely transferable to third parties for cash. (For more on this topic, see our June 21, 2023, client alert "Newly Proposed Regulations Provide Much-Needed Guidance on Federal Energy Tax Credit Monetization Provisions.")

The ability to purchase these tax credits at a discount to full utilization value provides a new investment opportunity for corporations in various industries that may not have previously considered investing in renewable energy projects. At the same time, the ability to transfer the credits expands the market of potential investors that project developers can look to in order to finance their energy projects.

Tax Credits as a Means of Financing Renewable Energy Projects

Going back more than four decades to the introduction of tax credits for solar projects, the construction of most renewables projects in the United States has been subsidized by federal tax credits. Particularly for technology in nascent stages (such as wind and solar power in the 1970s and 1980s, and carbon capture today), the federal government's decision to provide a subsidy in the form of tax credits has contributed significantly to the development of technologies that, absent those credits, might not have made economic sense to pursue.

Prior to the passage of the IRA, outside investment in these projects was limited to a subset of frequent market players (mostly large financial institutions) that developed strong familiarity with wind and solar technology and the economics of these projects over the course of numerous investments.

> The ability to purchase these tax credits at a discount to full utilization value provides a new investment opportunity for corporations in various industries that may not have previously considered investing in renewable energy projects.

While these investments provided a significant boon to the renewables industry, in order to claim the tax credit, investors were required to bear equity-type risk associated with the projects. That necessarily limited the participants to institutional investors with the time, resources and risk appetite to invest directly in the projects.

Expanding the Investor Base Through Transferability

Congress was aware of these market limitations and sought to address them through the transferability provisions in the IRA, which permit the one-time sale of all or a portion of certain energy tax credits for any taxable year to a third party. The hope was that, with transferability, developers of renewable energy projects would be able to reach a broader range of potential financing sources, including companies with little to no prior experience in this space.

This is possible because, unlike under pre-IRA law, a buyer of the tax credits associated with an energy project need not take any equity risk on the development or operation of the project itself. Instead, the tax credit can be purchased like any other asset, with contractual indemnities in place to protect the buyer against project-level risks that could result in the reduction, disallowance or recapture of the tax credit.

Recapture, or a clawback of the tax credit, is one of these risks and can occur in a number of scenarios, including if the project is destroyed in a casualty event or otherwise permanently taken offline. The transferability rules impose this recapture penalty on the credit buyer rather than the project owner (who will often have control over the circumstances causing recapture). In response, credit buyers typically request an indemnity from the project owner to cover this risk, as well as any other reduction or disallowance of the credit.

While the nature of the asset presents some added complexity in terms of execution of the sale (for example, credit transfers must be registered through an IRS portal that has not yet been made available to the public) and the ongoing relationship between the seller and the credit buyer, this does not appear to be a major deterrent for new market entrants.[1]

1 One side effect of the fact that recapture is imposed on the credit buyer is that the project owner, who may be contractually responsible for indemnifying the credit buyer against recapture, will generally want the ability to control aspects of the credit buyer's tax audit related to this issue. This is a common feature of tax equity transactions but may be a sticking point for new market participants unaccustomed to having another party involved in their federal income tax audits.

Early Successes

The ability to transfer energy tax credits is already factoring into many of the energy projects currently under development. This is particularly the case for projects with terms negotiated following the release of the initial IRS guidance on transferability in June 2023.

Participation by potential credit buyers that are not familiar with the energy industry or do not have direct connections with project developers is being facilitated by a number of third parties, including the large financial institutions that have traditionally participated in tax credit transactions (many of which may have potential credit buyers as clients), as well as credit brokers and other advisory firms.

Credit buyers have a critical role to play in the continued expansion of financing sources for renewable and other energy projects, making them an essential component of the IRA's success.

With New Technology and New Hires, the IRS Aims To Audit More Effectively While Improving Taxpayer Services

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Key Points

- Using billions of dollars in new funding, the IRS is prioritizing improvements to taxpayer services, but it will take years to develop and implement its compliance and enforcement initiatives.
- Increased audit activity will target complex partnerships, large corporations and high-net-worth individuals, driven by 3,700 new employees and special task forces, and deep machine learning.
- Renewed IRS focus on programs like the compliance assurance process may provide some taxpayers opportunities to manage risk and efficiently resolve tax issues.
- The IRS is utilizing data analytics and AI in large partnership audits to better select returns and prioritize issues.

New Funding, New Focus

With some $80 billion in initial funding from the Inflation Reduction Act (IRA), the Internal Revenue Service (IRS) began ramping up taxpayer services, issue resolution planning, compliance and enforcement initiatives, and new employee hiring in 2023. Efforts on all fronts have been carefully orchestrated and publicized as part of the IRS' commitment to greater transparency and stakeholder engagement.

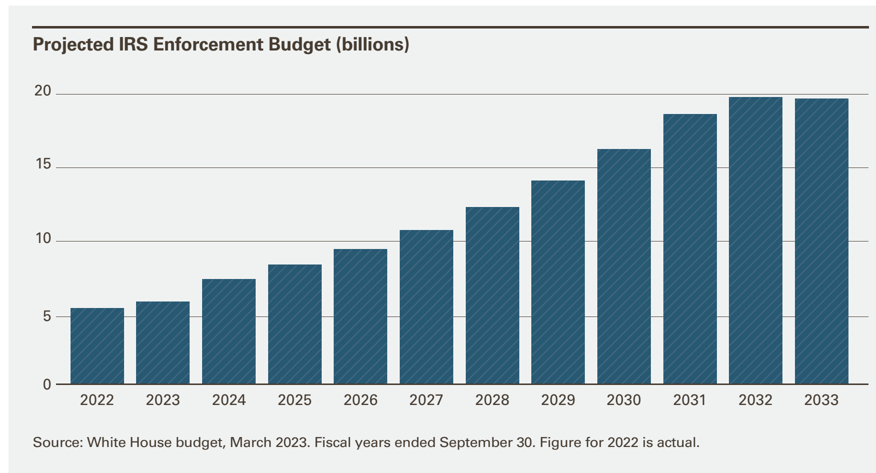
The IRS has launched several transformative service initiatives for individual taxpayers and small businesses. For example, it recently introduced the first phase of the "business tax account," which permits eligible taxpayers to control the timing of their installment payments and will eventually allow sole proprietor taxpayers to conduct IRS affairs online. For the 2023 filing season, taxpayers have also been able to respond to IRS notices online rather than by mail. These and other service initiatives could meaningfully improve compliance over time.

Of particular note to taxpayers subject to enforcement scrutiny, the IRS has solicited public feedback on opportunities to promote tax certainty and facilitate issue resolution. If the IRS follows through, changes could have a significant positive impact on both the IRS and affected taxpayers. Key to this effort will be resurrecting the compliance assurance process (CAP) and industry issue resolution (IIR) initiatives, and enhancing the advance pricing and mutual agreement (APMA) program. Each of these alternatives is designed to facilitate open communication, cooperation, and proactive resolution of issues between taxpayers and the IRS.

Drawing on the new IRA funding, the White House has budgeted to increase the IRS' annual enforcement budget almost fourfold over the next decade, to $19.5 billion, and the agency has announced numerous multiyear endeavors in several key areas to increase collections.

In September 2023, the IRS revealed plans to:

- Audit the returns of 75 partnerships with average assets greater than $10 billion, selected using artificial intelligence (AI).
- Send compliance letters to around 500 partnerships with over $10 million in assets and ongoing balance sheet discrepancies.



Source: White House budget, March 2023. Fiscal years ended September 30. Figure for 2022 is actual.

In carrying out these plans, recent guidance suggests the IRS is likely to scrutinize complex issues involving:

- Distributions in excess of partners' tax bases.
- Disguised sales.
- Special allocations.
- Limited partners' self-employment tax exemptions.

Such scrutiny would follow more than a decade of a challenging environment for partnership tax enforcement[1] due to inadequate funding, insufficient information from partnership returns and an incomplete picture of the most complex partnership structures.

The IRS has also announced various initiatives targeting large corporations and high-income earners. These include the issuance of "compliance alerts" to roughly 150 U.S. subsidiaries of large foreign corporations with "losses or exceedingly low margins" in an effort to "reiterate their U.S. tax obligations and incentivize self-correction."

IRS Commissioner Danny Werfel explained that these compliance alerts are similar to the "soft letters" from past compliance campaigns, and they could lead to transfer pricing audits if there is "strong pushback or no response" from recipients.

Looking ahead, recent and potential legal changes relating to other areas such as green energy investment credits and the implementation of Pillar Two transfer tax regime raise unanswered questions and are likely to attract additional IRS attention beyond the agency's recently stated initiatives.

The IRS expects to execute its current enforcement initiatives by:

- Hiring more than 3,700 new employees.
- Relying on data analytics.
- Creating a new pass-through entities group.
- Expanding its existing large corporate compliance (LCC) program and global high-wealth unit.

Using New Technology To Address Old Problems

Facing challenges in auditing web-like complex partnership structures, the IRS has invested in data analytics to enhance case and issue selection for partnership examinations. The recently established IRS Office of Research, Applied Analytics and Statistics (RAAS) performs compliance studies and develops tools and techniques to better understand such structures.

The IRS may also leverage the capabilities of its Criminal Investigation division, which has developed robust analytical tools to scrutinize information returned from John Doe summonses and address issues such as money laundering through the use of non-fungible tokens (NFTs). Externally, the IRS can look to private industry for assistance with bulk data processing capabilities. One official recently acknowledged that RAAS spends over $70 million annually on independent contractors for data analytics work.

Feedback Loop

Increased examination of new industries and taxpayers often leads to guidance targeted at substantive issues arising from those audits. Indeed, one goal of compliance campaigns is to learn about issues. While new guidance could improve compliance, any guidance applied retroactively or viewed as a change in law would likely be met with scrutiny, and potentially challenges, by taxpayers.

Facing challenges in auditing web-like complex partnership structures, the IRS has invested in data analytics to enhance case and issue selection for partnership examinations.

1 In a July 2023 report, the Government Accountability Office found that the IRS audited 54 of 20,052 large partnerships in tax year 2019 (0.3% audit rate), representing a decline from 2007 (~1.4%). The report also found that "[m]ore than 80 percent of the audits resulted in no change to the return on average from tax years 2010 to 2018, double the rate of large corporate audits. For those that did change, the average adjustment was negative $264,000."

For this reason, the recent trend of challenging the validity of tax regulations and other guidance may continue as the IRS expands its knowledge of new industries and issues, and promulgates related guidance.

Implications for Complex Entities and High-Net-Worth Individuals

As complex entities and high-net-worth individuals face increased audit scrutiny and evolving law, taxpayers might consider anticipatory strategies to prepare. In addition to formal programs such as CAP, taxpayers could conduct "mock audits" to evaluate record-keeping and substantiation.

Particularly for taxpayers that have never dealt with an IRS examination, understanding and addressing weaknesses in documentation now can streamline and facilitate the resolution of a future audit. Similarly, IRS compliance letters and alerts can provide insight into specific issues that the agency considers priorities.

The IRS' latest initiatives will have far-reaching consequences for both taxpayers and the agency itself. Implementation will take years, but taxpayers can take steps now to prepare for increased and evolving enforcement efforts that are already underway.

Election Issues on the Horizon: 2024 National Party Conventions, Transition Efforts and Inaugural Activities

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Key Points

- With the 2024 election season underway, corporations may be presented with opportunities to support the presidential nominating conventions as well as transition efforts and inaugural activities for incoming federal, state and local administrations.
- As with all interactions with political organizations and government officials, these activities are regulated by a complex set of interrelated laws, regulations and policies.
- It is critical to understand the rules of the road and properly examine specific opportunities to ensure compliance with campaign finance, pay-to-play and various government ethics requirements in order to avoid legal repercussions and appearance-of-impropriety risks.

National Party Conventions

The presidential nominating conventions are less than a year away, and expectations are high in both host cities — Milwaukee, where Republicans will gather July 15-18, 2024, and Chicago, which welcomes Democrats August 19-22, 2024 — for a return to pre-COVID levels of attendance.

Conventions are expensive to pull off, and corporations have increasingly become an important source of support, especially after the 2014 elimination of public funding.

The conventions are primarily financed by both the convention committees themselves, which are accounts of the Republican and Democratic national committees, and separate host committees, which are nonprofit organizations established to encourage commerce in the convention city and project a favorable image of the city to attendees.

Convention Committees

Federal law treats convention committees in the same manner as other accounts of the national parties in terms of prohibited sources of support. Accordingly, contributions to them by corporations, foreign nationals, federal contractors and nationally chartered organizations are forbidden.

These sources are also not allowed to pay for expenses such as travel and accommodations for convention speakers and delegates. There are, however, certain limited interactions that corporations may have with the convention committees, including providing:

- Goods and services to the committees in exchange for promotional consideration.
- Certain items of de minimis value, such as samples, pens, tote bags or other items to be distributed to convention attendees.

Individuals and political action committees (PACs) are permitted to contribute to convention committees, within limits. However, companies subject to strict liability pay-to-play laws should be mindful that their contributions may be governed by those laws if solicited by or linked to state or local candidates or officeholders.

Host Committees

The host committees (Development Now for Chicago and MKE 2024 Host Committee), on the other hand, may accept unlimited monetary or in-kind contributions from corporations to provide logistical support for the conventions.

> Conventions are expensive to pull off, and corporations have increasingly become an important source of support, especially after the 2014 elimination of public funding.

To the extent a corporation provides in-kind contributions to a host committee, it is important to ensure that the resources furnished will be used exclusively for purposes that are appropriate and permissible for the host committee, such as logistical support and defraying the host committee's administrative expenses. Examples of this type of support include:

- Security and construction services.
- Welcome booths for convention attendees.
- Providing accommodations for host committee members.

It is a best practice to memorialize any agreement in a memorandum of understanding with the host committee.

Private Events During the Conventions

In addition to supporting the convention and host committees, companies often look to host or support parties and other private events during the conventions. If the event — even if organized by a third party — is coordinated with, or held for the purpose of benefiting, a candidate's campaign, party committee or political committee, payments toward the event may constitute an in-kind contribution.

Such a contribution may be impermissible or subject to limits under campaign finance law and could also trigger an automatic ban on government contracts if the relevant jurisdiction maintains a strict liability pay-to-play law.

Even in the absence of this concern, given the likely attendance of public officials at these events, companies should also vet potential implications under federal, state and local gift laws.

Transition Efforts

Changes of administration at the federal, state and local levels can present opportunities for individuals and companies to contribute to and get involved in the efforts of transition teams.

Contributions to Transition Committees

Transition efforts are usually run out of separately designated nonprofit organizations that are typically allowed to accept unlimited contributions from individuals and corporations. However, some jurisdictions impose bans and limits on these contributions, such as the $5,000 limit under federal law on contributions to a presidential transition committee.

Moreover, there are instances in which transition teams are operated from campaign committees, parties or PACs, in which case contributions would trigger all applicable campaign finance limits and prohibitions in the relevant jurisdiction.

For financial institutions subject to a federal pay-to-play rule (such as Municipal Securities Rulemaking Board Rule G-37 for broker-dealers that underwrite municipal securities and municipal advisors, and Securities and Exchange Commission Rule 206(4)-5 for investment advisers), soliciting or making contributions to transition efforts for a successful state or local candidate is covered under those rules and thus could trigger an automatic ban on business or compensation.

Certain state and local pay-to-play laws also apply to support for transition efforts. As a result, companies that do business with state or local government entities should carefully evaluate the legal implications of any such support.

Corporate Executives Serving on Transition Teams

A corporate executive serving on a transition team (such as for a governor-elect) could raise several legal considerations.

Conflict of interest. Depending on the jurisdiction, a transition team member may be treated as a public official and, as a matter of law or policy, become subject to some or all of that jurisdiction's conflict of interest laws.

Campaign finance and pay-to-play. Use of corporate resources, volunteering during working hours or the executive personally paying for expenses related to their volunteer activity may result in an in-kind contribution to the committee with the ramifications described above.

Procurement ethics. Conflict of interest provisions in many jurisdictions prohibit a company from obtaining an unfair advantage by assisting in the preparation of the terms or specifications of a request for proposal (RFP) and then bidding on that RFP. This conflicts issue may arise if the volunteer helps or advises the transition on RFPs or the bidding process.

Lobbying. If a corporate executive's transition activities include communications with covered officials, and the communications are for the purpose of influencing covered decisions on behalf of their employer, there may be registration and/or reporting implications under applicable lobbying laws.

Inaugural Committees

Following the elections, successful candidates will also begin to prepare and fundraise for inaugural events in celebration of taking office. Support for the inaugural committees running these events can raise issues similar to those described above when contributing to transition efforts.

In particular, while inaugural committees tend to be set up as distinct nonprofit organizations that are not subject to limits, there are jurisdictions that impose dollar limits on contributions to inaugural committees. Additionally, as with some transition teams, inaugural committees are sometimes funded by a campaign committee, political party or PAC, triggering campaign finance restrictions.

Finally, regardless of how they are formed, soliciting or making contributions in support of inaugural activities for successful state or local candidates is covered under the federal, as well as some state and local, pay-to-play rules.

'Small Yard and High Fence': US National Security Restrictions Will Further Impact US-China Trade and Investment Activity in 2024

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Key Points

- The Treasury Department is expected to initiate restrictions in 2024 on U.S. investments in Chinese companies pursuing key technologies deemed to have national security implications.
- The Commerce Department's export controls on advanced semiconductors and computers, and related manufacturing equipment and technologies, are likely to be expanded in the new year.
- Commerce has new funding to step up enforcement of its information and communications technology and services (ICTS) supply chain restrictions.
- There are proposals in Congress to extend the responsibilities of CFIUS to include the review of Chinese investments in agricultural businesses and farmland.

The economic relationship between China and the U.S. remains one of the most significant in the world, and U.S. and Chinese government leaders have repeatedly signaled their intent to maintain stable trade and commercial relations.

Simultaneously, both governments have enacted laws and regulations in the interest of national security that restrict trade and investment between the two countries. U.S. National Security Advisor Jake Sullivan has used the phrase "a small yard and high fence" to describe the Biden administration's intent to allow most trade and economic relations with China to continue, outside a core area of heavily restricted products, technologies and business activities.

In 2024, we anticipate continued additions to the "fence" in the form of targeted changes to three areas of U.S. national security regulation — investment review, export controls and supply chain restrictions — and the potential expansion of both the "fence" and the "yard" in legislative initiatives in the U.S. Congress relating to China. We highlight likely developments in each area below.

Investment Review

Inbound foreign direct investment (FDI) from China to the U.S. decreased significantly in 2022 and 2023, largely as a result of a more aggressive approach to reviewing investments from China by the Committee on Foreign Investment in the United States (CFIUS). Additional U.S. legal and regulatory developments in 2024 will likely result in further meaningful changes to FDI transactions in both directions.

Outbound Investment Restrictions in Key Technologies

In 2024, we expect that the U.S. Treasury Department will issue regulations imposing new restrictions on U.S. investments in companies based in China. In rulemaking materials issued in August 2023, Treasury signaled its intent to take a targeted approach to these restrictions, with reporting or (in more narrow circumstances) prohibitions, where the Chinese companies targeted for investment are developing sensitive products in artificial intelligence, quantum computing, or semiconductors and microelectronics.

Although some have referred to these restrictions as "reverse CFIUS," we expect that the new restrictions will more closely resemble a version of targeted economic sanctions — with prohibitions and reporting obligations to be imposed on U.S. companies and U.S. persons working overseas based on the nature of the investment target — rather than a CFIUS-like case-by-case U.S. government

review of specific investment transactions. (For more on this topic, see our August 10, 2023, client alert "US Moves To Narrowly Limit Investment in China.")

> In 2024, we expect that the U.S. Treasury Department will issue regulations imposing new restrictions on U.S. investments in companies based in China.

Many issues must be resolved before Treasury can finalize outbound investment regulations, such as how the restrictions will apply to continuing investments in assets or joint ventures that predate the restrictions, limited partner liability and the scope of potential exceptions for trading in public securities. The bipartisan leadership of the House of Representatives' Select Committee on the Chinese Communist Party has urged Treasury to broaden some aspects of its proposed approach.

We also expect further developments on outbound investments from the European Union and the U.K. in 2024, as both have signaled an intent to impose similar restrictions.

Potential Restrictions on Investments in US Farmland

In 2023, the U.S. Congress proposed several bills that would increase restrictions on non-U.S. investments in U.S. agricultural companies and agricultural land. In particular, the Promoting Agriculture Safeguards and Security Act (PASS Act) — which the Senate added to its version of the annual National Defense Authorization Act (NDAA) — would expand CFIUS' scope to review transactions involving U.S. agriculture. It would effectively require the committee to prohibit certain investments in U.S. agricultural businesses or land by persons from China, Iran, North Korea and Russia.

The PASS Act (which could become law if it is included in the version of the NDAA enacted by the full Congress) and similar measures under consideration in Congress follow initiatives by numerous U.S. states to enact or expand CFIUS-like restrictions on foreign investment in U.S. agriculture.

Export Controls

In 2024, the U.S. will almost certainly continue to refine and potentially expand restrictions on exports of advanced semiconductors and computers, and related manufacturing equipment and technologies to China.

The U.S. Commerce Department released an initial package of export controls covering these items in October 2022 and expanded the controls in October 2023; Commerce officials have indicated that they expect to review and update these controls on an annual basis. (See our October 25, 2023, client alert "BIS Updates October 2022 Semiconductor Export Control Rules.")

We also anticipate efforts by the U.S. government to seek further coordination on these controls with international partners and allies, similar to the outreach Commerce conducted with counterparts in the Netherlands and Japan on semiconductor controls over the last two years.

Commerce has also made clear that it will consider imposing controls for the first time on the provision of cloud computing services (also known as "infrastructure as a service," or "IaaS") to China-based companies. Commerce has historically taken the position that merely providing these cloud computing services, without more, does not amount to an "export" subject to export controls. But in October 2023, it indicated that it was "concerned regarding the potential for China to use IaaS solutions to undermine the effectiveness" of the semiconductor export controls.

Commerce stated that it "continues to evaluate how it may approach this through a regulatory response." The agency will most likely focus any new cloud computing controls on IaaS that provides access to advanced computers and semiconductors.

Supply Chain Restrictions

Finally, we anticipate that the Biden administration will take steps in 2024 to add "teeth" to the information and communications technology and services (ICTS) supply chain restrictions initially set forth in a 2019 executive order.

The executive order provides the Commerce Department with expansive authorities to protect the ICTS supply chain by reviewing and prohibiting the use within the United States of telecommunications equipment, technology or services from China and other named "foreign adversary" countries upon a finding of an undue or unacceptable risk to U.S. national security.

To date, Commerce has done little publicly to enforce the ICTS restrictions, but the agency received significant additional resources in 2022 and 2023 to expand its implementation of the ICTS restrictions. We therefore expect additional guidance and related activity from Commerce in the new year.

Enforcement and Litigation

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Expert Allegations Could Become More Frequent in Securities Fraud Complaints and Possibly Erode Pleading Standards

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Key Points

- A divided Ninth Circuit panel held that a shareholder plaintiff could rely on an expert's after-the-fact analysis of public information to allege that a company's public statements were false or misleading and thereby state a claim for securities fraud.
- It is too soon to tell whether the majority decision will have any effect on the standards for pleading securities fraud, but other plaintiffs may follow suit, eventually making the appearance of expert allegations common in securities fraud complaints.
- The Ninth Circuit has rejected similar expert allegations in other cases this year and last, so the latest decision should not be read to grant broad approval of the use of experts in pleading securities fraud.

A 2023 case decided by a U.S. Court of Appeals for the Ninth Circuit panel could signal a new era of after-the-fact expert analyses in securities fraud complaints as a means to bolster otherwise insufficient allegations of false statements.

In the August 2023 opinion, *E. Ohman J: Or Fonder AB v. NVIDIA Corp.*, the Ninth Circuit panel held that the plaintiffs satisfied the heightened standards for pleading securities fraud by relying on a retained expert who provided an after-the-fact review of allegedly misleading statements.

Specifically, the panel concluded that the shareholder plaintiffs had adequately pleaded that graphics processing unit (GPU) producer NVIDIA Corporation and its CEO made misleading statements in quarterly reports and investor conference calls by understating the extent to which NVIDIA's revenue growth arose from demand for its GPUs from cryptocurrency miners — a "notoriously volatile" market.

The plaintiffs' expert, Prysm Group, analyzed demand for computing power from cryptocurrency miners in general and extrapolated its findings to NVIDIA using assumptions about its market share. The court determined that the plaintiffs' complaint included enough information about the expert and its methodology and assumptions to credit the allegations and the conclusion that NVIDIA had made misstatements.

The court observed that, according to the complaint, a stock analyst reached similar conclusions, and some former employees alleged that NVIDIA had strong demand from cryptocurrency miners, which the court concluded corroborated the expert's conclusion.

However, the third judge on the panel dissented, remarking: "We have never allowed an outside expert to serve as the primary source of falsity allegations where the expert has no personal knowledge of the facts on which their opinion is based," such as specific internal information or witness statements.

"The majority's approach significantly erodes the heightened pleading requirements for alleging securities fraud," the judge stated.

Potential Consequences of the Ruling

It is too soon to tell whether the majority decision will have the effect of eroding the well-established and stringent standards for pleading securities fraud. However, it may invite more plaintiffs

to attempt to rely on outside experts to supply allegations of false statements when firm-specific information is lacking.

Ultimately, to show that a statement is false, a securities fraud complaint must plead "specific contemporaneous statement or conditions" from reliable and corroborating sources that directly contradict the statements at issue, according to the Ninth Circuit's 2001 decision in *Ronconi v. Larkin*.

> The ruling may invite more plaintiffs to attempt to rely on outside experts to supply allegations of false statements when firm-specific information is lacking.

In the past, after-the-fact analyses of public information were not deemed specific or reliable enough to meet this standard, as they contained "questionable assumptions and unexplained reasoning." The Ninth Circuit reached this conclusion in 2022 in *In re Nektar Therapeutics Securities Litigation* and in 2023 in *Hershewe v. JOYY Inc*.

Indeed, *NVIDIA* likely represents the outer limits of when a plaintiff may substitute after-the-fact analyses for contemporaneous, company-specific facts. Even in *NVIDIA*, as the dissent pointed out, the plaintiffs did not connect the dots between what the expert allegedly inferred about NVIDIA's revenues from public market data and what the company's own internal documents showed about its cryptocurrency mining-related revenues.

The plaintiffs' complaint also alleged that former employees claimed to know about internal documents reflecting the extent to which cryptocurrency miners purchased the relevant GPU product. But the plaintiffs did not include in their complaint any allegations from these former employees about what the documents said.

Expert allegations even less specific and reliable than those in *NVIDIA* are unlikely to survive a challenge. Still, we may see more after-the-fact expert analyses in securities fraud complaints going forward, as a means to bolster otherwise insufficient allegations of false statements.

After all, nearly 20 years ago, Ninth Circuit decisions such as *Nursing Home Pension Fund, Local 144 v. Oracle Corp.* (2004) and *In re Daou Systems, Inc., Securities Litigation* (2005) recognized circumstances under which a plaintiff could rely on unnamed former employees to support allegations of securities fraud.

Since then, it seems that plaintiffs almost always include such allegations if they can (as the plaintiffs in *NVIDIA* did). While most do not pass muster, the Ninth Circuit has developed an extensive body of case law addressing the standards for adequately pleading former employee allegations.

If plaintiffs begin to make regular use of expert allegations, courts may also gradually refine when such experts can and cannot supply the requisite inference of falsity.

DOJ Leverages the Private Sector To Achieve Enforcement Goals

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Key Points

- In the latest round of additions to the DOJ's programs to incentivize voluntary self-disclosure of wrongdoing by corporations, the DOJ has rolled out new policies that outline concrete incentives for self-disclosure and created a safe harbor for disclosure of wrongdoing unearthed during an acquisition.
- The M&A safe harbor may encourage companies with strong compliance programs to consider acquisitions of companies with weak programs or in risky jurisdictions.
- These new policies provide more clarity on the DOJ's position, reflecting a U.S. government focus on encouraging companies to design and implement strong, thorough corporate compliance programs, particularly where corporate crime intersects with national security.

Recent additions to self-disclosure policies signal the Department of Justice's (DOJ's) view that, in an increasingly global economy with an expanding number of actors, private companies have a key role to play in the detection and prevention of corporate crime.

The DOJ has prioritized white collar offenses involving national security, including sanctions evasion, export control violations, bribery and corruption, and money laundering. Over the past several months, every DOJ component with prosecutorial authority has announced new or updated policies encouraging voluntary self-disclosures by corporations.

A new safe harbor for wrongdoing unearthed during M&A activity further guides companies toward self-disclosure.

Voluntary Self-Disclosure

The DOJ encouraged companies to timely self-disclose wrongdoing in a September 2022 speech and memorandum from Deputy Attorney General (DAG) Lisa Monaco (Monaco Memo), which were subsequently formalized through policy announcements from the DOJ's Criminal Division and the U.S. Attorneys' Offices in early 2023.

Pursuant to these policies, companies that identify and voluntarily self-disclose misconduct will improve the terms of any resolution for the conduct that they disclose. Improvement can range from reduced fines to declination of prosecution.

A new safe harbor for wrongdoing unearthed during M&A activity further guides companies toward self-disclosure.

To qualify for favorable treatment, a voluntary self-disclosure must meet a number of criteria. The company must have:

- Had no preexisting obligation to disclose.
- Made the disclosure "within a reasonably prompt time" after becoming aware of the misconduct.
- Made the disclosure prior to an "imminent threat" of disclosure or government investigation, and prior to the misconduct being publicly disclosed or otherwise known to the government.
- Disclosed "all relevant, non-privileged facts" concerning the misconduct that are known to the company at the time.

Whether a disclosure is "reasonably prompt" will depend on the specific facts and circumstances of the case, but generally disclosures should occur shortly after

misconduct is identified. The burden will be on the company to demonstrate that the disclosure was timely.

"All relevant facts" includes information about individuals. According to the Monaco Memo, "to be eligible for any cooperation credit, corporations must disclose to the [DOJ] all relevant, non-privileged facts about individual misconduct."

Where a company "fully" meets the requirements (voluntary, timely and complete disclosure), the DOJ may choose not to impose a criminal penalty. Instead, it may issue a declination or seek another type of resolution, such as a deferred prosecution agreement or nonprosecution agreement.

In any event, where the voluntary self-disclosure requirements are met, criminal penalties should be no greater than 50% of the low end of the U.S. Sentencing Guidelines fine range.

M&A Safe Harbor Policy

In remarks delivered on October 4, 2023, at the Society of Corporate Compliance and Ethics' 22nd Annual Compliance & Ethics Institute, DAG Monaco laid out a new safe harbor policy for merger-related discoveries intended "to incentivize the acquiring company to timely disclose misconduct uncovered during the M&A process."

Under the new policy, there is a presumption of declination of prosecution where an acquiring company (1) promptly and voluntarily discloses criminal misconduct within a designated safe harbor period (generally six months from deal closing); (2) cooperates with the DOJ's investigation; and (3) engages in appropriate remediation, restitution and disgorgement.

Specifically:

- The safe harbor policy will be instituted department-wide, with each division of the DOJ tailoring application of the policy to its area.
- To qualify, companies must report misconduct discovered at the acquired company within six months of the deal closing, regardless of whether the misconduct was discovered before or after acquisition.
- Companies will have one year from the date of closing to fully remediate the conduct at issue.
- The DOJ will apply a "reasonableness analysis" to these baseline time frames, allowing for extended deadlines for both self-disclosure and remediation on a case-by-case basis.
- Companies that discover misconduct related to national security or involving "ongoing or imminent harm" cannot wait until the deadline to self-report.
- Acquiring companies will not be penalized for aggravating factors present at the acquired company; such factors "will not impact in any way" the acquiring company's ability to receive a declination.
- If aggravating factors do not exist at the acquired company, it will also be eligible for the benefits of voluntary self-disclosure, including a possible declination.
- Misconduct that is self-disclosed under the policy will not be factored into any recidivist analysis of the acquiring company that the DOJ conducts at the time of disclosure or in the future.
- The policy is applicable only to misconduct discovered as part of "bona fide, arms-length M&A transactions" and will not apply to conduct that is already public, known to the DOJ or otherwise required to be disclosed by the company. The policy does not affect civil merger enforcement.

The DOJ believes that the safe harbor will protect companies with strong compliance programs that want to acquire companies with weak programs or a history of misconduct. The DOJ also wants compliance professionals to be involved in due diligence to identify, report and remediate issues at target companies early on.

This policy also ties into the DOJ's focus on national security issues, as DAG Monaco alluded to in the pronouncement, noting that "companies are on the front line in responding to geopolitical risks." (See "Exits, Ring-Fencing and Other Risk Management Strategies for Multinationals Operating in Geopolitically Volatile Areas.") This policy may overcome reluctance for companies with a U.S. presence to acquire assets operating in riskier jurisdictions, given that the acquiring company can cleanse itself of successor liability for the pre-acquisition conduct of the target provided that any issues are identified, disclosed and remediated quickly.

Takeaways

Companies can take steps now to best position themselves in light of these new DOJ policies by:

- Implementing policies and procedures that strongly encourage internal reporting of employee misconduct.
- Promptly reviewing all reports of misconduct and quickly determining whether to self-disclose.
- Investigating misconduct and, if a self-disclosure is made, establishing a robust framework for sharing the results of their internal investigation with the DOJ and other authorities, as appropriate.

In the M&A context, companies that wish to avoid successor liability should incorporate compliance personnel in M&A deals, conduct effective due diligence, and timely disclose and remediate any misconduct that they identify.

According to DAG Monaco, these recent policy changes mark a "new era" of corporate enforcement, in which "corporate executives need to redouble time and attention to compliance programs, compensation programs, and diligence on acquisitions."

FTC Enforcement Trends in Consumer Protection Under the Biden Administration

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Key Points

- After the Supreme Court limited the FTC's authority to collect monetary penalties under the FTC Act, the agency has increasingly relied on trade regulations as enforcement tools.
- The agency has been very active on various fronts to protect consumers, enforcing standards for everything from advertising to data privacy, social media influencers and consumer fees.
- About 90% of its consumer protection actions have involved financial services, web services and telecoms, health care or the retail sector.

The Federal Trade Commission (FTC or the Commission) has continued aggressive regulation in the consumer protection space under the Biden administration. This persistent approach has occurred even in the face of recent obstacles — most notably the U.S. Supreme Court's 2021 decision prohibiting monetary penalties under Section 13(b) of the FTC Act.

Through October 2023, the Commission has remained focused on financial services, web services and telecommunications, health care and retail industries, with approximately 90% of its consumer protection actions in these areas. Within those categories, however, there are clues to shifting priorities expected for the remainder of the Biden administration's current term.

Impact of Supreme Court's Decision in *AMG Capital Management*

The Supreme Court's decision in *AMG Capital Management, LLC v. FTC* has significantly affected FTC enforcement. In that case, the Court held that the FTC can no longer obtain equitable monetary relief, such as restitution or disgorgement, in federal courts under Section 13(b) of the FTC Act — a provision the Commission had frequently employed to seek monetary and injunctive relief.

The FTC has remained focused on financial services, web services and telecommunications, health care and retail industries, with approximately 90% of its consumer protection actions in these areas.

While awaiting a congressional fix, the FTC is employing tools like trade regulations allowing for civil penalties, including the Telemarketing Sales Rule (TSR), the Restore Online Shoppers' Confidence Act (ROSCA), the Children's Online Privacy Protection Rule (COPPA) and the Made in USA Labeling Rule.

The FTC also has proposed new rules or amendments that will expand its ability to seek penalties, shedding light on potential areas of focus by the Commission in 2024. In addition, the FTC appears to be expanding its notice practices under the FTC Act, alerting companies that it has found certain practices unfair or deceptive, which could allow it to seek monetary penalties if those companies continue those activities.

Biden-Era FTC Consumer Protection Actions and Priorities

Web services and telecoms: Under the Biden administration, the FTC has initiated or resolved 34 enforcement matters

regarding web services and telecoms, the most of any sector discussed in this article. This includes illegal telemarketing, data security practices, online subscriptions or purchases, deceptive practices regarding user reviews and COPPA violations. Settlements have ranged from $100,000 to $660 million.

Looking ahead, FTC rulemaking and other activity appear to target the following:

- **Robocalls:** The FTC has multiple initiatives targeting robocallers and illegal telemarketing under the TSR. It appears to be expanding its efforts to include voice-over-internet protocol (VoIP) providers, which allow foreign robocalls to enter the United States, as well as "lead generators" that obtain and sell purported consent from consumers to telemarketers.
- **Negative option features:** Online retailers' subscription services and "negative option" features also have become a priority, with enforcement increasing against "dark patterns" that trick customers into difficult-to-cancel recurring charges. The FTC also proposes amending the Negative Option Rule to expand coverage to all forms of negative option marketing and increase consumer protections.
- **COPPA:** The FTC has been very active against and extracted large settlements for COPPA violations involving children's data. Because the rule allows for immediate recovery of monetary penalties, rigorous enforcement of COPPA is likely to continue.

Financial services: The FTC has initiated or resolved approximately 24 financial services enforcement actions since the start of the Biden administration, addressing debt collection, debt relief and credit repair, hidden loan application fees, payday loan overcharges and deceptive marketing of investment-related services. Settlements have ranged from $500,000 to more than $114 million. Further priorities will likely include the following:

- **Cryptocurrency:** Under both the FTC Act and the Gramm-Leach-Bliley Act, the FTC has stepped into the cryptocurrency area, recently settling allegations that an exchange convinced consumers to move assets onto it through false claims about its security.
- **Student loan debt relief:** The FTC has homed in on student loan debt relief scams, working with the Department of Education to obtain settlements from alleged scammers. With student loan repayments resuming, we expect student loan debt fraud to continue as an enforcement priority.

Health care: The FTC has brought or settled approximately 27 health care enforcement matters during the Biden administration, including claims regarding deceptive marketing and health data privacy. While most settlements were below $10 million, one company accused of selling sham health care insurance and charging junk fees for unwanted products settled for over $100 million.

The FTC also has signaled interest in other new health care areas:

- **Health breach notification:** The FTC recently brought its first action under the Health Breach Notification Rule (HBNR), which requires vendors to notify consumers of a breach involving unsecured information. The Commission is proposing amendments to clarify that the rule applies to health apps and to expand breach notification requirements.
- **Cannabidiol (CBD) products:** In 2021, the FTC resolved its first CBD-related enforcement actions, settling with six companies concerning statements about CBD product health benefits.
- **OARFPA:** The FTC brought its first actions under the Opioid Addiction Recovery Fraud Prevention Act, which prohibits deceptive practices related to opioid and other substance abuse treatments. In one case, the conduct concerned deceptive marketing by a smoking cessation products company, signaling enforcement beyond opioid treatments.

Retail: The Commission filed or resolved around 26 retail enforcement matters, involving issues of labeling or marketing of products, deceptive or fraudulent endorsements, consumers' right to repair and data privacy practices. Settlements ranged from $15,000 to $24 million, with the two largest settlements coming where retailers allegedly helped unqualified buyers obtain financing to purchase retailer products. Further FTC priorities include:

- **Made in USA Labeling:** Promulgated in 2021, the Made in USA Labeling Rule has already led to seven enforcement actions, for deceptive or misleading claims, under the Biden administration.
- **Protecting consumer data:** In 2023, the FTC brought multiple actions against companies for failing to properly protect consumer data. The FTC has also proposed a rule to address harmful commercial surveillance and data security practices.

Additional priorities: The FTC also has announced priorities that likely will apply across all industries:

- **Artificial intelligence:** FTC Chair Lina Khan testified before Congress that "AI misuse can violate consumers' privacy, automate discrimination and bias, and turbocharge imposter schemes and other types of scams." She added that the FTC "is poised to move aggressively against businesses that engage in deceptive or unfair acts involving AI." President Joe Biden also recently urged the FTC to use its available powers to protect consumers from the risks of AI in an executive order.

(See our November 3, 2023, client alert "Biden Administration Passes Sweeping Executive Order on Artificial Intelligence." See also "AI in 2024: Monitoring New Regulation and Staying in Compliance With Existing Laws.")

- **Junk fees:** Combating junk or hidden fees has been a focus of President Biden's consumer protection platform. The FTC has proposed a rule for these fees across all industries, which we expect to be vigorously enforced once finalized.
- **Consumer reviews and endorsements:** The FTC updated its Guides Concerning the Use of Endorsements and Testimonials in Advertising in July 2023 and proposed a trade rule to address the use of reviews and endorsements. The FTC has also published guidance for social media influencers on how to stay compliant when promoting products.

In Sum

Throughout the Biden administration, the FTC has shown it can execute on its consumer protection goals, even in the face of significant obstacles. The FTC is continuing to explore various enforcement mechanisms, examining ways new and old rules may be utilized for this purpose.

Fourth Circuit Holds That Bankruptcy Courts Are Not Limited by the 'Case and Controversy' Requirement of Article III

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Key Points

- A recent Fourth Circuit decision analyzed the differences in the source of authority for bankruptcy courts, whose power derives from Article I of the U.S. Constitution, and other federal courts, whose power derives from Article III.
- Most commonly, those differences are cited as limiting bankruptcy courts' power, but the Fourth Circuit held in *Kiviti v. Bhatt* that bankruptcy courts are not bound by the justiciability requirement of Article III absent a statutory limitation.
- The decision implicitly highlights the potentially exceptional reach of bankruptcy power, and that bankruptcy courts have some authority that Article III courts lack.

From time to time, the U.S. Supreme Court has distinguished the bankruptcy courts' power — deriving from Congress' authority under Article I of the U.S. Constitution to enact uniform bankruptcy laws — from the judicial power under Article III of the Constitution. Most often, the Court has recognized constitutional limitations on the power of bankruptcy courts.

A recent decision from the U.S. Court of Appeals for the Fourth Circuit, however, distinguished the source of the bankruptcy courts' powers and held that Congress, exercising its Article I authority, has granted bankruptcy courts some powers that Article III courts do not have.

In one limitation on bankruptcy courts, the Supreme Court held in the 2011 case *Stern v. Marshall* that they lack power to enter a final judgment on claims traditionally determined at law when the Constitution was enacted. The Court has also emphasized that the Bankruptcy Code limits bankruptcy courts' authority where the Code specifically conflicts with traditional equity powers exercised by courts.

For example, in 2017 the Court held in *Czyzewski v. Jevic Holding Corp*. that a bankruptcy court may not approve distributions under a structured dismissal of a Chapter 11 case that do not follow the Bankruptcy Code's priority rules unless the affected creditors consent.

On the other hand, the Court has also recognized that the bankruptcy power granted by the Constitution through Congress can exceed that exercised by Article III courts if congressional authority is clearly enough established. For instance, in *Allen v. Cooper* (2020), the Court held that a bankruptcy court may subject a nonconsenting state to bankruptcy proceedings, abrogating state sovereign immunity, and said that such power reflects "bankruptcy exceptionalism," which is "unique" to Article I's grants of authority.

The Fourth Circuit's September 14, 2023, decision in *Kiviti v. Bhatt* further explores the implications of the distinction between bankruptcy and Article III courts.[1]

Background

Adiel and Roee Kiviti hired Naveen Bhatt to renovate their home. He represented that he was a licensed contractor, but in fact he was not. When the renovations did not go well, the Kivitis sued him for the full amount they paid, $58,770. Bhatt filed for bankruptcy.

1 On November 15, 2023, the Bankruptcy Appellate Panel for the Tenth Circuit issued an opinion, *Pettine v. Direct Biologics, LLC (In re Pettine)*, disagreeing with the Fourth Circuit's decision and analysis in *Kiviti v. Bhatt*. It found that the jurisdiction of bankruptcy courts cannot extend beyond that of district courts, from which bankruptcy courts derive their jurisdiction, and that Article III's limitations on the district courts do in fact apply to bankruptcy courts.

The case had an unusual procedural history. In Bhatt's bankruptcy case, the Kivitis brought an adversary proceeding against him with two counts:

- Count 1 sought a money judgment for the $58,770.
- Count 2 sought a declaratory judgment that the debt was nondischargeable under Section 523(a)(2)(A) of the Bankruptcy Code as having been obtained by "false pretenses, a false representation, or actual fraud."

On summary judgment, the bankruptcy court dismissed Count 2 with prejudice but allowed Count 1 to go forward, so the bankruptcy court's order dismissing Count 2 was not a final order that could be appealed as of right.

Because Bhatt's debt, if established, would be heavily discounted if it could be discharged in bankruptcy — indeed, probably to less than the cost of litigation — neither party wanted to continue litigating Count 1 before exhausting appeals on Count 2. They therefore agreed to voluntarily dismiss Count 1 without prejudice to allow the Kivitis to appeal their loss on Count 2 to the district court.

The Fourth Circuit Decision

On appeal, the district court affirmed the dismissal of Count 2. However, when the case reached the Fourth Circuit, it found that the district court lacked jurisdiction to consider the appeal because the bankruptcy court's order was not final.

Relying on well-established precedent, the circuit court held that the parties could not artificially make an order final — and thus appealable as of right — by colluding to dismiss Count 1. The parties would have to proceed with Count 2 or have it dismissed, too, for lack of prosecution.

The circuit court also addressed the Kivitis' argument that, with the dismissal of Count 2, Count 1 was constitutionally moot. This was because, even if the bankruptcy court granted judgment in their favor, they could not enforce the judgment outside of the bankruptcy claim and distribution process, which was proceeding on a different track, not in the adversary proceeding. Thus, they contended, Count 1, which was not a proof of claim, could not give them "any effectual relief."

> Relying on well-established precedent, the circuit court held that the parties could not artificially make an order final — and thus appealable as of right — by colluding to dismiss Count 1.

Interestingly, the Fourth Circuit rejected this argument by reasoning that "[m]ootness arises out of Article III's 'case-or-controversy' requirement. … But since bankruptcy courts are not Article III courts, they do not wield the United States's judicial Power. So they can constitutionally adjudicate cases that would be moot if heard in an Article III court."

Further, in response to the Kivitis' argument that bankruptcy courts derive their jurisdiction from the district courts' delegation of jurisdiction, the Fourth Circuit stated that Article III's "limit on the district court's authority does not constrain the bankruptcy court. Once a case is validly referred to the bankruptcy court, the Constitution does not require it be an Article III case or controversy for the bankruptcy court to act."

Noting that bankruptcy courts instead are "statutory creatures [that] have whatever power Congress lawfully gives them," the circuit court stated that:

> Congress said that bankruptcy courts may hear and determine *all* bankruptcy cases and *all* core proceedings referred to them by a district court. … By [28 U.S.C.] § 157's text, a bankruptcy court's jurisdiction requires only that the case or core proceeding arise under Title 11 and be referred to the bankruptcy court. Section 157 does not require every discrete dispute arising post-referral to satisfy Article III. Nor does any other [statutory] provision (internal citations and quotation marks omitted, emphasis in original).

Takeaways

How can one reconcile *Stern*, in which the Supreme Court found that a bankruptcy court could not issue a final order resolving a dispute within the traditional "at law" jurisdiction of Article III courts, and *Kiviti*'s holding that, although an Article III court could not determine Count 1 under the constitutional mootness doctrine, an Article I court could?

The basis can only be the Fourth Circuit's implicit recognition that, when Congress legislates within its power to enact uniform laws on bankruptcy — and determining the amount of a claim against the bankrupt debtor clearly falls within that power — the bankruptcy court's authority may exceed that of Article III courts.

The implications extend beyond the odd procedural history of *Kiviti* to any attack on a bankruptcy court's decision based on an allegation that it exceeded its constitutional power. The *Kiviti* decision suggests that the question in such cases should be: Was the bankruptcy court's decision permitted by the Bankruptcy Code, and was the applicable provision of the Code consistent with Congress' bankruptcy power?

Insights From Delaware Litigators: What We're Watching in 2024

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Key Points

- In a key ruling, the Delaware Chancery Court held that corporate officers, as well as directors, may owe *Caremark* duties of oversight.
- In two cases, the court held that acquirers were justified in terminating deals because the "bring-down" terms in the respective merger agreements — which required representations and warranties to be reaffirmed at closing — were not qualified by a materiality provision, and the representations and warranties were not strictly satisfied.
- In five rulings involving breach of fiduciary duty claims arising from de-SPAC transactions, the court refused to grant motions to dismiss, finding in each case that the plaintiffs had adequately alleged that fiduciary duties had been breached.
- The court, in the context of a mootness fee decision, commented on a novel issue involving a common merger provision that allows target companies to seek "lost premium" damages from a buyer in the event of a "busted deal" where specific performance is unavailable, strongly indicating that the target company was not able to seek such damages, and that stockholders likely had third-party standing to pursue lost premium damages directly.

In 2023, the Delaware courts continued to be called upon to elaborate important rules of corporate law. The year's docket brought further development in a number of areas, including oversight liability, "busted deal" disputes, SPAC litigation, *Revlon* liability and *Con Ed* provisions. We will be watching as new cases in 2024 explore the implications of those rulings.

The Continued Evolution of Oversight Liability

In 2023, the Court of Chancery issued several notable opinions defining the scope of oversight (also known as "*Caremark*") liability and the ability of a corporation to control any such litigation.

In early 2023, the court expanded oversight liability beyond the boardroom and held that the fiduciary duties of corporate officers also include oversight liability.[1] It stated that the scope of the liability can vary with the officer's responsibilities. For example, CEOs have responsibility for the entire company and would thus have broader oversight duties than an officer who is responsible for only a segment of the company.

> The year's docket brought further development in a number of areas, including oversight liability, "busted deal" disputes, SPAC litigation, *Revlon* liability and *Con Ed* provisions.

In contrast, the court refused to expand oversight liability to cover the management of ordinary "business risk."[2] In another subsequent case, it also dismissed a derivative action containing oversight claims that had previously survived a motion to dismiss after the corporation established a special litigation committee (SLC) to investigate those claims, conducted an exhaustive seven-month investigation and concluded that the claims should not continue.[3]

1 *In re McDonald's Corp. S'holder Deriv. Litig.*

2 *In re ProAssurance Corp. S'holder Deriv. Litig.*

3 *Teamsters Local 443 Health Servs. & Ins. Plan v. Chou.*

What we're monitoring: The refinement of officer-level oversight liability and "business risk," as well as the continued evaluation of SLC investigations of oversight claims.

'Busted Deal' Litigation

In 2023, the Court of Chancery issued several opinions addressing situations where buyers sought to escape from contracts to acquire corporations because of purported breaches of representations and warranties. In two cases, the court determined after trial that the buyers were not required to close because the so-called bring-down conditions — representations and warranties made at signing that were affirmed as true at closing — were "flat," *i.e*., they did not include any materiality qualifier. The sellers were required to, but did not, maintain their representations and warranties in all respects, the court found.

In one of these cases, the seller's representation regarding its capitalization table was found inaccurate.[4] While the court described the financial value of the discrepancy as "minor" and flagged potential reputational issues for the acquirer, it held that Delaware law will enforce the agreements of sophisticated parties and noted that it was not for the court to question the wisdom of the acquirer's decision to terminate.

In the second case, the court agreed with the acquirer that multiple "flat" bring-down breaches occurred.[5] The court reiterated that Delaware is a "pro-sandbagging jurisdiction" and rejected an argument that the acquirer should be required to close because it knew at signing that certain representations and warranties had not been satisfied.

What we're monitoring: Changes in deal terms in response to these decisions and the other "busted deal" cases currently before the Court of Chancery.

SPAC Litigation

The Court of Chancery continued to issue rulings on challenges to transactions related to special purpose acquisition companies (SPACs) in 2023. In five rulings, the court denied motions to dismiss, in whole or in part, where there were allegations of breach of fiduciary duty arising from disclosures issued in connection with de-SPAC transactions (where a SPAC merges with an operating company).[6]

In each instance, the court held that the entire fairness standard applied to breach of fiduciary duty claims arising from the de-SPAC transaction, and that there were reasonably conceivable claims for breach of the fiduciary duty of loyalty arising from materially misleading public filings issued in connection with each transaction.

These claims included the omission of the "net cash per share" number — a per-share basis of the amount of total cash that will be invested by the SPAC in the target — which plaintiffs alleged was materially below the $10-per-share redemption price. The court found that, based on allegations raised and arguments presented, it was reasonably conceivable that this information was material to SPAC stockholders evaluating the proposed transaction.

An additional opinion addressed whether a de-SPAC transaction was required to close (and thus also qualifies as a "busted deal" transaction, as discussed above).[7] The request for specific performance was unusually complicated because the target-entity defendant was a Philippine corporation with its assets outside the United States, and there was a *status quo ante* order in place from the Supreme Court of the Philippines arising from a dispute about the proper governing body of the target. Citing these impediments and the fact that the SPAC's own actions were not entirely forthright, the court denied the SPAC's request for specific performance.

What we're monitoring: Continued de-SPAC litigation.

Revlon Judgments

This year, plaintiffs prevailed in two cases seeking damages for violation of fiduciary duties that were evaluated under a *Revlon* standard of review.[8] In both cases, the Court of Chancery found that the officers of the target preferred the eventual acquirer and took actions that steered the target to the officers' favored counterparty — and they did so for unique, personal reasons. In both cases, the officers were held to have violated their fiduciary duty of loyalty. In addition, the court also found the acquirers in both cases liable for aiding and abetting the officers' breaches.

Both cases awarded "nominal" per-share damages for the fiduciary breaches between $0.50 per share and $1 per share. However, each target had tens of millions of shares outstanding at the time of the transaction, resulting in sizable damages awards. In each case, some defendants also settled before trial. Both cases also saw additional litigation over the availability of any "settlement credit" for payments made by parties who settled out, with one such request being rejected so far.[9]

4 *HControl Holdings LLC v. Antin Infrastructure Partners S.A.S.*

5 *Restanca, LLC v. House of Lithium, Ltd.*

6 *Delman v. GigAcquisitions3, LLC*; *Laidlaw v. GigAcquisitions2, LLC*; *In re XL Fleet (Pivotal) S'holder Litig.*; *Malork v. Anderson*; *In re FinServ Acquisition Corp. SPAC Litig.*

7 *26 Capital Acquisition Corp. v. Tiger Resort Asia Ltd.*

8 *In re Mindbody, Inc. S'holder Litig.*; *In re Columbia Pipeline Grp., Inc. Merger Litig.*

9 *In re Mindbody, Inc. S'holder Litig.*

What we're monitoring: The continued evaluation and evolution of the Court of Chancery's post-closing *Revlon* jurisprudence, the damages (and set-offs) flowing from those decisions and any appeals from the 2023 cases.

Con Ed Provision Held Unenforceable

In 2023, the Court of Chancery explained that a "lost premium provision" in a merger agreement could not be enforced either by the target (a social media company) or its stockholders (given that the transaction had closed).[10] The court's ruling arose in an odd procedural context — a mootness fee application by a stockholder plaintiff seeking $3 million in attorneys' fees arising from the closing of the target's merger — which the court rejected because his complaint was not meritorious when filed.

The outcome turned on whether the plaintiff had third-party beneficiary rights to enforce the lost premium provision.

The provision required the contractual acquirer, in the event of a breach of the merger agreement, to be liable for the benefits of the transaction, including "lost stockholder premium."

The court recognized this provision as one of the so-called *Con Ed* provisions that M&A practitioners implemented to address the U.S. Court of Appeals for the Second Circuit's 2005 decision in *Consolidated Edison, Inc. v. Northeast Utilities*. In that case, the Second Circuit held that Northeast's stockholders did not have standing to sue Con Ed when it terminated its merger agreement with Northeast.

The Court of Chancery held that the lost premium provision could not define the target's damages in the event of a breach because the company would never have received the merger consideration; it would have flowed directly from the acquirer to the target's stockholders.

In addition, the target's stockholders could not enforce the provision unless they were granted third-party beneficiary status under the merger agreement. The court found this doubtful under the plain language of the merger agreement.

The court conceded that an alternative construction of the agreement was possible, which could convey third-party standing to stockholders to enforce the lost premium provision in "exceptionally narrow circumstances" when specific performance was no longer available. However, ultimately, those circumstances could not have arisen — and the stockholder plaintiff's claim under the provision never had merit — because the target company was pursuing specific performance of the merger agreement at all relevant times.

What we're monitoring: The court's continued evaluation of lost premium and other *Con Ed* provisions.

[10] *Crispo v. Musk.*