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ANALYSIS

SHAPING THE BOARD AGENDA IN A DYNAMIC ENVIRONMENT

By Holly J. Gregory[1]

A well-focused board agenda is fundamental to a board's ability to function effectively in a dynamic and uncertain business environment, particularly given ever-increasing expectations from shareholders, regulators, and other constituents. Ensuring that the board attends to priority matters in an appropriate timeframe but without overstepping into management's role requires periodic assessment of agenda priorities and the related structures, processes, and controls in place to ensure that the board is well informed, on a timely basis, of matters requiring attention. This article:

- summarizes key trends defining the current dynamic environment
- identifies priorities for board attention (while recognizing that each company has unique needs)
- highlights important takeaways for further consideration

Key Trends Defining the Current Environment

In a recent survey on global risks by the World Economic Forum (WEF), experts presented "a predominantly negative outlook for the world over the next two years that is expected to worsen over the next decade." The structural forces that the WEF expects to shape global risks over the next decade include material evolution in the concentration and sources of geopolitical power; changes in the size, growth, and structure of populations around the world; technological acceleration; and climate change and related consequences. Risks that were identified as the most likely to present a material crisis on a global scale in 2024 include political or societal polarization (or both), a cost-of-living crisis, artificial intelligence (AI)-generated misinformation and disinformation, cyberattacks, and extreme weather.

While optimism remains regarding the ability to avoid recession, global conflicts and climate change threaten to disrupt supply chains by increasing shipping time and costs. For example, in Panama, drought conditions have lowered water levels, forcing Panamanian authorities to limit the number of ships that can pass through the Panama Canal. Additionally, Houthi rebels have attacked ships in the Suez Canal. In this environment, companies are working to contain costs while pursuing investment capital and growth opportunities that are likely to be more expensive.

At the same time, business continues to be broadly perceived as more competent and ethical than government or the media, according to the 2024 Edelman Trust Barometer, and most trusted to integrate innovation into society. However, in business, as in life, the only constant is change. Nearly half (45%) of global CEOs question their company's economic viability in 10 years if it remains on its current course, up from 39% in 2023.[2] As the pace and complexity of change continues to accelerate, boards need to ensure that directors understand the changing environment and its implications for corporate strategy, risk, performance, competitiveness, and reputation. By doing so, they can help the corporation maintain its resilience and business sustainability.

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2 Source: PwC's 27th Annual Global CEO Survey: Thriving in an Age of Continuous Reinvention (2024).

Economic Uncertainty and Growth Challenges

The Congressional Budget Office recently projected that economic growth would slow in 2024, the rate of inflation will lessen, and the Federal Reserve may respond by lowering the federal funds rate, which reached its highest level since 2001.[3] However, recent declines in unemployment may bring increased pressures for wage growth, and the impact on inflation, interest rates, and economic growth remains uncertain. Additionally, consumer spending is under pressure as pandemic savings become depleted and the burden of continued inflation, increased debt loads, higher interest rates, housing prices, and other expenses is felt.

Geopolitical Risk, Protectionism, and Domestic Polarization

Conflicts in the Middle East and Europe, continued tensions with China, and numerous elections around the globe add to the uncertainty and potential for business and supply chain disruption. Geopolitical power is becoming more dispersed, alliances are shifting, and nations are becoming more protectionist and emphasizing reduced dependency on foreign trade in key industries.

In the U.S., presidential election years are traditionally accompanied by uncertainty about the policies that will impact business over the next presidential term, and that uncertainty may be reflected in heightened volatility in financial markets. The degree of uncertainty about the policy direction is exacerbated in 2024 by concerns about the state of the U.S. democracy in a highly polarized society in which economic, social, and cultural divides may be reinforced by increasingly isolated "news bubbles" and misinformation campaigns. The political divide both highlights and may further fuel tensions related to income, race, and gender inequality as well as climate change.

The political divide is playing out in "culture wars" that put increased pressures on companies to take (or avoid taking) positions on sensitive issues, support political candidates, or both. Overall, it appears that political polarization regarding environmental and social issues, as well as concerns about the implications of the U.S. Supreme Court's decision on diversity in college admissions, is leading companies to be less vocal regarding their commitments to environmental and social causes. However, from a business perspective, companies continue to have a legitimate interest in material environmental and social matters that are likely to have an impact on financial performance over the long term.

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The Disruptive Potential of AI and Other Emerging Technologies

AI has the capacity to disrupt entire industries, with implications for corporate strategy and risk, stakeholder relationships, and compliance that require the attention of the board. With any potentially disruptive emerging technology, boards need to understand how it impacts the company's business, industry, obligations, opportunities, risks, policies, and internal controls. When considering these issues, boards should apply the same fiduciary mindset and diligent oversight they apply to other matters of strategy, risk, compliance, and controls. (For more information, see AI and the Role of the Board of Directors.)

Increased Regulatory and Enforcement Activity

Companies are operating in an environment of increased regulation and enforcement in the areas of climate change, cybersecurity, privacy, and anti-fraud and anti-money laundering obligations. On March 6, 2024, the U.S. Securities and Exchange Commission (SEC) adopted final rules that impose substantial new mandatory climate change-related disclosure requirements on public companies. In 2023, the SEC finalized cybersecurity disclosure rules requiring, among other things, disclosure of cybersecurity incidents within four business days of a materiality determination and disclosure regarding risk management and governance related to cybersecurity threats on an annual basis.

3 Source: Congressional Budget Office Report, The Budget and Economic Outlook: 2024 to 2034 (Feb. 2024).

Additionally, companies face new disclosure requirements related to the implementation of the Corporate Transparency Act (CTA), which requires certain companies to disclose information regarding their beneficial owners and individuals who file corporate paperwork on the companies' behalf with the U.S. Department of the Treasury's Financial Crimes Enforcement Network.

Boards need to stay up to date on these new requirements, including legal challenges to the adoption of the new climate change rules that have been consolidated in the Eighth Circuit. In April 2024, the SEC voluntarily stayed the final climate disclosure rules pending completion of judicial review. Additionally, the National Small Business Association and some of its individual members have challenged the constitutionality of the CTA. In March 2024, the U.S. District Court for the Northern District of Alabama found the CTA to be unconstitutional and permanently enjoined the government from enforcing it with respect to the plaintiffs in the case. The court did not issue a nationwide injunction preventing the CTA from being enforced against others. The U.S. Department of Justice (DOJ) has filed a notice of appeal to the Eleventh Circuit.

Federal regulators continue to increase their focus on both disclosure of material risks and enforcement and corporate compliance, including the mitigating impact of voluntary self-reporting to regulators of misconduct and the importance of risk-based compliance programs that are appropriately resourced and regularly evaluated for effectiveness. In March 2024, Deputy Attorney General Lisa Monaco announced an initiative to amend the DOJ Criminal Division guidance on Evaluation of Corporate Compliance Programs to include assessment of the risks associated with disruptive technology, including AI.

Continuing Shareholder Scrutiny and Activism

With the advent of universal proxies, it has become easier for activists to target individual directors. Boards can expect well-capitalized activists to exploit the enhanced vulnerability of target companies. Boards should ensure that the company is well prepared to respond to shareholder activists, including through a review of activism preparedness with financial and legal advisors. This includes ensuring that an appropriate team and communications protocols are in place, state-of-the-art bylaw protections are in place, and up-to-date poison pills are on the shelf. If the company is approached by an activist, the board and management should be prepared to consider the issues they raise and not automatically default to a defensive mode.

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Average shareholder support for shareholder proposals declined from 31% in 2022 to 23% in 2023, and it may continue to decline in 2024.[4] Governance-focused proposals received the highest levels of average shareholder support in 2023 but declined from 37% in 2022 to 30% in 2023. Support for environmental proposals declined the most, from 35% in 2022 to 21% in 2023. This is likely due to companies providing more and better-quality environmental, social, and governance (ESG) disclosure. Based on their review of the 2022 and 2023 proxy seasons, The Conference Board predicts further declines in average support for environmental and social proposals and noted additional potential trends for the 2024 proxy season, including:

- an increasing number of shareholder proposals from conservative groups.
- new topics for shareholder proposals, including on clean energy financing ratios, biodiversity, AI, and resignation requirements for director nominees who fail to receive majority support in multiple years.
- increased targeting of nominating and governance committee chairs as a result of company positions on board diversity, director overboarding, restrictive bylaw amendments, combined CEO and chair roles, and officer exculpation.

4 Source: The Conference Board, 2024 Proxy Season Preview: Looking for a Silver Lining (2024).

Priority Issues for Board Focus

Board responsibilities are both durable and context dependent. A board's primary responsibilities are to oversee management's performance, strategic direction, and risk management (while attending to areas not delegated to management, such as governance matters, CEO compensation and succession, retention and oversight of the independent auditor, approval of major transactions, determination of dividend payments, and bylaw amendments). (For more on the board's oversight role, see Three Key Roles of the Board of Directors.) The centerpiece of most board activity is attending to the company's long-term business strategy, the risks related to that strategy, and management's performance in carrying out the strategy and managing associated risks.

In the dynamic, fast-paced environment described above, boards need to:

- be attentive and agile
- avoid becoming unduly anxious and overstepping into the zone of management
- understand the forces driving change
- maintain their focus on the fundamental drivers of the business, the long-term strategy, the most critical risks facing the company, and management performance

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Extend the Focus on Strategy and Risk to Polarized Issues

Board attention to economic, geopolitical, technological, and other developments can help management focus on how these trends may impact both near-term and longer-term opportunities for growth, associated risks, and compliance with emerging regulations and shifts in enforcement priorities. Clearly, boards have much to attend to, but they should not be distracted from providing guidance and oversight on critical issues of corporate strategy and risk, and management performance. These are the issues that should dominate the agenda for most boards.

In an environment of rising expectations about the role of corporations in society, and given the high level of polarization with respect to environmental and social issues, boards need to continue to assess the link between these issues and the strategies for, and risks posed in achieving, the company's purpose, based on business judgment. While each company's purpose is unique in strategic focus and implementation, fundamentally, the corporate purpose involves providing goods or services (or both) that customers need or want in a competitive manner that provides financial returns to shareholders while satisfying interests of a range of stakeholders on whom success depends.

Directors are required to act in the best interests of the corporation and its shareholders and have considerable discretion (outside of a sale of control) to consider non-shareholder interests if there is a rational business purpose intended to benefit the corporation and its shareholders over the long term. Articulating the link between the company's approach to environmental and social issues, long-term strategy, risk mitigation, and financial performance will help ensure consistency with the company's best interests and enhancement of long-term value.

Maintain Strong Board-Management Relations and Board Culture

While the board oversees corporate strategy, monitors management performance, and provides direction, it should also act as a sounding board where management can test and hone ideas, taking advantage of directors' experience and expertise. Strong board-management relationships require a constructive and respectful give-and-take, a recognition of the distinction between board and management roles, and transparency grounded in the expectation that management will deliver bad news promptly. The board needs to maintain a

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Similarly, the board needs to develop its own culture of trust, respect, and openness. The ability to bring objective judgment to bear and to express and consider diverse viewpoints while driving toward consensus are necessary qualities. Boards need to consider in connection with their annual evaluation and re-nomination processes whether new skills and perspectives are needed (or would be beneficial) and attend to refreshment mechanisms. Board composition and refreshment are under increased scrutiny by shareholders (including activists), who are paying closer attention to the degree of alignment between director qualifications and company needs as well as diversity and director time commitments and are scrutinizing company disclosure on these issues.

Proxy advisors and institutional investors are mindful of the increased demands on directors' time and are evaluating directors in part on the number of boards on which they serve. They will often recommend or vote against directors they consider overboarded. Some have adopted proxy voting guidelines that consider whether a board has adopted express director service commitments or limitations. For example, since January 2024, Glass Lewis tracks whether Russell 1000 companies have a director commitments policy with a numerical limit, includes this information as a data point in its report, and will consider the board's disclosure of this policy in its analysis of overcommitted directors.

Shareholder activists will also assess director commitments as well as the alignment of board composition (in terms of expertise matched to the company's business, strategic direction, and risks) and will highlight issues in their campaigns for board seats.

Focus on Talent Management and Workforce Issues

In an increasingly knowledge-based and data-driven economy, human capital management issues are critical to the ability of the company to perform and to its culture. Key areas for board oversight include:

- talent management, including employee recruitment, promotion, retention, and development
- employee health and safety
- employee compensation and benefits policies
- workforce management issues, including layoffs
- corporate culture and compliance, including equity and inclusion at all levels of the organization and efforts to combat discrimination, harassment, and bullying
- the treatment of whistleblowers

Management development and succession continue to be key board priorities, and boards should review emergency succession plans to ensure they are up to date for the CEO and other key officer roles.

Prepare for a Crisis

Attention to both board and company culture is one aspect of crisis preparedness that can help reduce the inevitable tensions that arise when a company is under significant pressures.

At some point, every board faces a crisis that requires it to become more actively engaged in overseeing management's response. The board may even develop and undertake the response itself if the crisis involves issues of management integrity, credibility, or capacity. Together, the board and management should take steps to plan for a crisis to position the company to react quickly and with assurance. External or internal events can give rise to a crisis, and the board should identify with management potential sources of crisis and plan how to address them. Attention to both board and company culture is one aspect of crisis preparedness that can help reduce the inevitable tensions that arise when a company is under significant pressures.

In most circumstances, management is well positioned to address a crisis on a day-to-day basis, but the board should expect to meet more frequently and be kept up to date during the crisis. Directors should understand what is known, what information is still needed, what management is doing to investigate the matter further, and who is on the crisis team (both within management and with respect to key advisors). Management typically handles communications and keeps the board informed of the communication plan and high-level messaging. The board (and management) should avoid making statements that assume a positive outcome when there is not yet full visibility into the circumstances.

In matters that involve management conflicts of interest or integrity, the board will need to take a more active role, usually through an existing committee or by creating a special committee composed of independent and disinterested (unconflicted) directors. The board should expect to hire counsel and potentially other advisors and to direct counsel in the investigation of the facts. It bears emphasizing that the board should avoid making statements in the early stages about confidence in management or an assumed positive outcome when the full set of facts is not yet known.

In both types of situations described above, the board should focus on:

- ensuring that the attorney-client privilege is not waived (to the extent appropriate)
- seeking guidance from counsel about notifying regulators and auditors, who may expect to be informed early of the issue and what the company is doing to investigate
- considering when and how to engage with employees, customers, suppliers, regulators, and shareholders
- ensuring that the corporation speaks with one voice
- once the crisis has been addressed, considering lessons learned and whether compliance or internal control systems (or both) need strengthening

Attend to Shareholder Engagement

A corporation that ignores the impact of corporate actions on constituents or the viewpoints of shareholders and other key stakeholders will not succeed over the long term.

One benefit of developing a relationship with key shareholders built on trust, transparency, and understanding is that they may be more willing to support the board and management in the face of shareholder activism.

Engagement provides an opportunity to gain insights into shareholder and stakeholder viewpoints, which can be valuable in formulating approaches to strategy and understanding risk and potential impact. While directors should consider (but not defer to) shareholder viewpoints, they must always make informed business judgments that they believe are in the best interests of the corporation as they help management focus on corporate resiliency and sustainable performance for the long term. One benefit of developing a relationship with key shareholders built on trust, transparency, and understanding is that they may be more willing to support the board and management in the face of shareholder activism and other pressures.

Important Takeaways

Each board must define its own priorities based on the unique circumstances facing the company. Demands for board time and attention continue to expand, and boards must ensure that they are focused on the most important matters consistent with their fiduciary obligations. While the fiduciary duties of directors remain durable, expectations of shareholders, regulators, employees, other important constituents, and society at large continue to expand. Boards are expected to provide clear oversight of corporate strategy, significant risks facing the company, and management performance. To do so effectively in this dynamic environment, they need to understand the context in which the company is operating, including the key trends outlined above. They need to understand shareholder interests as well as the interests of customers, employees, suppliers, regulators, and other key stakeholders.

In this environment, it is particularly important for boards (including through relevant board committees) to consider:

- strategy, risk, and polarized issues
- board culture and board-management relations
- talent management and workforce issues
- crisis management
- shareholder engagement

Strategy, Risk, and Polarized Issues

- Stay up to date on macroeconomic, technological, and regulatory trends likely to impact the company's business.
- Ensure that risk management systems, compliance policies, and internal controls are well matched to changing risks and regulatory developments.
- Understand the risks associated with strategic decisions and operations, and the processes management has in place to identify, monitor, and manage risks, especially risks deemed "mission critical."
- Ensure that a considerable proportion of board time is focused on strategic issues, including not only specific strategic plans and transactions but also the broader long-term direction.
- Consider with management what opportunities are likely to emerge in the current environment (including with respect to AI), how the company's corporate purpose and environmental and social issues relate to corporate strategy, and what risks these issues pose.
- Consider whether the board is well positioned for oversight of AI strategy and risk in terms of board attention, information, and education, regulatory compliance, committee responsibilities, and composition.
- Monitor corporate speech in the social and political sphere, including political contributions.

Board Culture and Board-Management Relations

- Prepare directors to engage on a more agile basis while resisting micromanaging.
- Ensure that board culture, dynamics, and relations with management are appropriately collegial and respectful in support of trust and decision effectiveness.
- Consider whether the board's approach to board refreshment is aligned with the pace of change affecting the business.

Talent Management and Workforce Issues

- Understand how the current market for talent is affecting the company, including the impact of return-to-work policies, and how management is addressing these topics, including plans regarding management development, worker training, wages, and benefits.
- With management, set a tone at the top through communications and policies designed to protect employee well-being and support diversity, equity and inclusion (DEI).
- Discuss with management their efforts to:
  - improve DEI in the workforce, including at the senior-most levels, and extending to pay and opportunity equity (such as access to training and promotions)
  - protect against discriminatory practices in the hiring, pay, and promotion of employees

Crisis Management

- Consider whether business continuity plans are in place and appropriate to the potential risks of disruption identified, including through a discussion with management of relevant contingencies, and continually reassess the adequacy of the plans in light of developments.

- Consider whether an up-to-date crisis management plan is in place to help the company react appropriately, without either under- or overreacting.
- Ensure that the board can act effectively when a crisis occurs by embracing governance structures and practices that support a board culture in which consensus can be readily achieved after full and informed discussion, independent viewpoints are respected and valued, and confidentiality is protected.

Shareholder Engagement

- Continue to actively oversee and participate as appropriate in engagement with key shareholders, with an emphasis on learning about shareholder viewpoints (*e.g.*, "listening mode") and developing enduring relationships. Seek their views about the corporate purpose, which is often intertwined with ESG issues, including climate change, DEI, and the corporate culture.
- Stay informed of proxy advisor perspectives (without assuming that they necessarily reflect shareholders' views).
- Consider with management how various types of shareholder activists are likely to view the company and its strategies and governance practices, with a focus on identifying vulnerabilities.
- Confirm that management is monitoring for changes in stock ownership.
- Update or activate defense preparation plans with management, including by identifying special proxy contest counsel, reviewing structural defenses, putting a poison pill "on the shelf," and developing a "break the glass" communications plan.

THE U.S. FTC VOTED TO BAN NONCOMPETES. WHAT HAPPENS NOW?

By Benjamin R. Nagin, Laura Collins, Margaret H. Allen, Wendy M. Lazerson, Katherine A. Roberts, and Eric Kauffman[5]

On April 23, 2024, the U.S. Federal Trade Commission (FTC) voted 3–2 along party lines to ban noncompete clauses in employment contracts. The following contains a high-level overview of this new rule, and you can access the full text of the rule here.

In anticipation of litigation challenging the noncompete rule, the Democratic FTC Commissioners have doubled down on the FTC's rulemaking authority as defined by the text of Section 6(g) of the FTC Act and the U.S. Court of Appeals for the D.C. Circuit's ruling in *National Petroleum Refiners Association v. FTC*. Litigation may delay or stop the rule from coming into effect, but if it is unsuccessful, the rule will go into effect on September 4, 2024, 120 days after publication in the *Federal Register*.

What is considered a noncompete for purposes of the FTC's prohibition?

The new rule prohibits contractual agreements between an employer and employee that (1) prohibit a worker from, (2) penalize a worker for, or (3) function to prevent a worker from, seeking or accepting other employment in the U.S., including operating a U.S. business, after the employee stops working for the employer. While this encompasses traditional noncompetition agreements, it also purports to include other contractual provisions that create a *de facto* noncompete clause. For example, a nondisclosure agreement that defines "confidential information" as information that is "usable in" or "relates to" a particular industry may be construed as overbroad by effectively preventing a worker from working in the industry after his or her employment ends. Another *de facto* noncompete may be found

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in an employment agreement that contains a liquidated damages provision or analogous financial penalty that is triggered if the employee leaves his or her employment within a certain period of time.

What employees are covered by the new rule?

The new rule covers workers beyond just the traditional paid employee. It also covers independent contractors, consultants, unpaid employees, externs, interns, volunteers, apprentices, and workers who are hired by one party to work for another (*e.g.*, staffing agencies).

What about senior executives or highly compensated employees?

For senior executives—defined as workers earning more than $151,164 annually who are in a "policy-making position"—*existing* noncompetes can remain in force. Noncompetes with senior executives after the rule's effective date will be prohibited.

What happens to noncompetes that are already in place?

The new rule applies retroactively, meaning that it will ban noncompetes that were already entered into prior to the passing of this rule (with the exception of senior executives). The rule will cover prospective noncompetes for all workers (including senior executives).

The new ban on noncompetes does not prohibit other types of restrictive employment covenants such as nondisclosure agreements and nonsolicitation agreements so long as they are not so broad that they create a de facto *noncompete.*

What about nondisclosure agreements or nonsolicitation agreements?

The new ban on noncompetes does not prohibit other types of restrictive employment covenants such as nondisclosure agreements and nonsolicitation agreements so long as they are not so broad that they create a *de facto* noncompete. Specifically, a nondisclosure agreement is not a noncompete if the agreement's prohibitions on disclosure do not apply to information that (1) arises from the worker's general training, knowledge, skill, or experience, gained on the job or otherwise, or (2) is readily ascertainable to other employees or the general public.

What about compensation-based or training-repayment agreements?

Compensation-based agreements such as garden leave and severance agreements are generally not prohibited under the new rule so long as there are no restrictions on what the employee can do after they are no longer employed. Training-repayment agreements are also not prohibited so long as they do not prevent an employee from seeking or accepting other employment or starting a business after the employment associated with the agreement.

What about forfeiture-for-competition clauses?

The rule specifically prohibits terms that "penalize" workers for working for a competitor after leaving. This includes a prohibition of forfeiture-for-competition clauses, including severance agreements where a worker is paid only if they refrain from competing.

Is there an exception for the sale of a business?

Yes. The new rule does contain an exception to allow noncompetes in bona fide sale-of-business agreements made in good faith between two independent parties at arm's length. A qualifying sale of a business must involve the sale of (1) a business entity, (2) all or substantially all of a business's operating assets, or (3) an individual's ownership interest in the business entity. This reflects a change from the proposed rule, which contained a 25% ownership threshold for the exception to apply.

What if my state law allows noncompetes?

The new FTC rule purports to supersede any state statute, regulation, or order to the extent the state law is inconsistent with the new rule. State laws that are more stringent than the FTC's rule will still apply.

Unless litigation delays or stops the rule from taking effect, September 4, 2024 will be the effective date and deadline by which employers must provide notice to current employees and any former employees currently bound by a noncompete to inform them that the employee's noncompete clause is no longer valid.

When does the rule take effect?

The rule is scheduled to take effect 120 days after it is published in the *Federal Register*. The FTC announced the publication date as May 7, 2024, making the rule's effective date September 4, 2024. This is the deadline by which employers must provide notice to current employees and any former employees currently bound by a noncompete to inform them that the employee's noncompete clause is no longer valid. There is model language included in the new rule, available here.

If my noncompete is not covered by this rule, or if the rule does not go into effect or is stayed during litigation, is my noncompete legal?

The FTC has begun using its authority under Section 5 of the FTC Act to bring enforcement actions against noncompetes and *de facto* noncompetes that it thinks are anticompetitive, and it may continue to do so even if this rule does not go into effect. For instance, on January 4, 2023, the FTC announced that three companies had settled anticompetitive enforcement actions in which they agreed to cease use of current and future noncompete restrictions in employment contracts. The FTC's press release related to those enforcement actions can be found here.

NEWS[6]

JUDICIAL DEVELOPMENTS

Even After *MultiPlan*, Pleading Standards Still Have Teeth in SPAC Cases

In 2022, the Delaware Chancery Court decided *In re MultiPlan Corp. S'holders Litig.*, 268 A.3d 784 (Del. Ch. 2022) (*MultiPlan*), a landmark case setting the legal framework for assessing claims that the directors of a special purpose acquisition company (SPAC) breached their fiduciary duties in connection with "de-SPAC" mergers. Given the popularity of de-SPAC mergers, in which the SPAC merges with a private target company and takes it public, the Delaware courts have been faced with a series of cases initiated by public stockholders who did not redeem their shares at the time of the merger but became unhappy when the post-merger public companies underperformed. The focus of those cases is the redemption right: whether stockholders in the SPAC were properly informed when they made the critical decision at the time of the merger to either redeem their shares or remain invested in the newly public company.

Since *MultiPlan*, the Delaware Chancery Court has applied entire fairness review to these claims. Entire fairness review, which requires defendants to show that both the process and the price were entirely fair, is fact-intensive in nature and often precludes dismissal at the pleadings stage. But not always.

In a May 2024 opinion, *White v. Hennessy*, the Delaware Chancery Court for the first time dismissed a complaint alleging breach of fiduciary duty claims similar to those in *MultiPlan*. Vice Chancellor Lori Will clarified that allegations that SPAC insiders were conflicted, and the merged company's stock fell below the $10 redemption price—facts common to nearly every de-SPAC that spawns a *MultiPlan* claim—are not enough to survive a motion to dismiss. Even where entire fairness review applies, the plaintiff must still plead facts showing an impairment of the stockholders' redemption rights.

In June 2020, a SPAC called Hennessy Capital Acquisition Corp. IV (Hennessy) identified Canoo (Legacy Canoo), a start-up electric vehicle company, as a potential target. In

6 The following Sidley lawyers contributed to the research and writing of the pieces in this section: Jaime A. Bartlett, Thomas H. Collier, Diana P. DuBois, Christine Duque, Jim Ducayet, Yolanda C. Garcia, Claire H. Holland, Erica Mellon, Heather Benzmiller Sultanian, and summer associate Hadley E. Delany. Some of the pieces first appeared in Sidley's Enhanced Scrutiny blog, which provides timely updates and thoughtful analysis on M&A and corporate governance matters from the Delaware courts and, on occasion, from other jurisdictions.

December 2020, Hennessy issued a proxy statement recommending that its investors approve the merger with Legacy Canoo. The proxy disclosed that Legacy Canoo's business model was based on three revenue streams and discussed the analysis and opportunities supporting the model. The proxy also disclosed the potential conflicts inherent in the structure of the de-SPAC merger, including the issuance of founder shares and the relationships among the founder, directors, and officers of the SPAC. Just 0.03% of Hennessy's public stockholders opted to redeem their shares before the merger closed, and 99.85% of Hennessy's stockholders voting approved the merger, after which the post-merger company was renamed Canoo Inc. (New Canoo).

Three months after the merger, in March 2021, New Canoo's board received a presentation on business strategy. During the presentation, Executive Chairman Tony Aquila—who had been appointed to that position in October 2020, before the merger—said that the company's business strategy needed a "reboot," including because he was skeptical of the engineering services business line that involved the sale of "core IP." An outside consultant then presented an analysis of the company's business and recommended a move away from using a subscription business model for sales to consumers. Three days later, New Canoo held an earnings call during which Aquila announced that the board had decided to "deemphasize" the company's subscription model and engineering services business lines. New Canoo's stock dropped more than 21% after the earnings call, recovered for a time, but then began falling again in 2022.

In June 2022, a Hennessy investor brought a putative class action against the Hennessy officers and directors in the Delaware Chancery Court, alleging that they had breached their fiduciary duties by failing to disclose that Legacy Canoo was changing its business model to deemphasize contract engineering services and the subscription model.[7]

The court dismissed that complaint with prejudice, notwithstanding that the conflicts inherent in the SPAC structure and the relationships between the SPAC sponsor and the directors and officers triggered application of the entire fairness standard. As Vice Chancellor Will noted, "[e]ntire fairness is not…a free pass to trial" and Delaware pleading standards are not "relaxed" in a SPAC case. A plaintiff must still allege facts making it "reasonably conceivable" that the conflicted directors and officers deprived stockholders of "a fair chance to exercise their redemption rights."

Specifically, the court concluded that the plaintiff failed to allege an impairment of his redemption right for two reasons. *First*, plaintiff's theory that the decision to change Legacy Canoo's business model had been made before the merger was contradicted by the board materials on which he relied and other public documents. Although plaintiff relied on the March 2021 board presentation's use of the past tense to allege that changes to the company's business model had already been made by that time, the presentation did not say that any decision had been made months earlier before the merger closed. Other materials showed that the decision to change the business model was made *after* the merger, under the direction and advice of new leadership and the new board.

Second, even if a decision had been made to change the business model before the merger, plaintiff failed to allege any facts showing that this information was known or knowable to the SPAC officers and directors. As Vice Chancellor Will commented, the notion that the SPAC defendants "must have known" about a "target's nascent internal analysis is strained," as compared to "the sort of knowable facts that faithless fiduciaries purportedly failed to uncover in prior [SPAC] decisions" like *MultiPlan*. And, of course, the defendants could not have breached a duty to disclose information that was unknown to them.

Since *MultiPlan* established that entire fairness review applies to claims alleging breach of fiduciary duty in de-SPAC mergers, dozens of cases in its mold have been filed. And, to date, the application of entire fairness review has allowed those cases to proceed into costly

7 Sidley represented the defendants in the Delaware Chancery Court.

In Hennessy, *Delaware Chancery Court Vice Chancellor Will was clear that the application of entire fairness review is not a free pass for plaintiffs to fall short of the ordinary Delaware pleading standards.*

discovery, even on threadbare allegations of a disclosure violation, emboldening the plaintiffs' bar to pursue these claims on the assumption that allegations of an inherently conflicted SPAC structure, some nebulous flaw in the proxy statement, and poor performance post-closing will be sufficient to withstand a motion to dismiss. The *Hennessy* decision is the first to deviate from that pattern.

Although too soon to tell, the *Hennessy* decision may signal a shift in the Delaware Chancery Court's receptiveness to *MultiPlan*-style allegations. Certainly, Vice Chancellor Will was clear that the application of entire fairness review is not a free pass for plaintiffs to fall short of the ordinary Delaware pleading standards. Even in this context, if stockholders claim their redemption rights were impaired by a disclosure violation, they must plead facts showing that the SPAC directors and officers knew or should have known of material information that they failed to disclose before the merger. The reassertion of these fundamental pleading standards in the *Hennessy* decision may serve as an important check on the onslaught of SPAC cases.

Carvana Special Litigation Committee Drives Away Derivative Case

On March 27, 2024, Chancellor Kathaleen McCormick of the Delaware Chancery Court granted the Carvana Special Litigation Committee's motion to dismiss after finding no wrongdoing by the company's controlling stockholders in connection with its March 2020 direct offering and the controlling stockholders' subsequent sale of company stock for over $1 billion.

Carvana—an e-commerce platform dedicated to selling used cars—conducted a direct offering in March 2020. Controlling stockholders Ernest Garcia II and Ernest Garcia III (the Garcias) participated in the direct offering. Later in 2020, Garcia II sold over $1 billion of his Carvana shares. A derivative claim was filed accusing the Garcias of breach of fiduciary duty for allegedly enriching themselves through purchase at a depressed price in the direct offering. The Chancery Court denied the Garcias' motion to dismiss in August 2022, as discussed in a Sidley blog post.

Carvana thereafter formed a two-director Special Litigation Committee (SLC). Over seven months and with the assistance of counsel and financial advisors, the SLC reviewed 18,000 documents, conducted 16 witness interviews, and issued a 170-page report concluding that there had been no wrongdoing by the Garcias and that the direct offering was entirely fair.

Following conclusion of its process, the SLC moved to dismiss the derivative action, and Chancellor McCormick granted the motion, finding that the SLC satisfied the two-step analysis called for in *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981). The court first considered whether the SLC members were independent and conducted a good-faith investigation of "reasonable scope that yielded [a] reasonable basis supporting its conclusions." For the second step, the court applied its own business judgment to the facts to determine whether Carvana's best interests would be served by dismissal of the derivative action.

To evaluate the SLC's independence, the court considered whether *"for any substantial reason"* the SLC members were incapable of making a decision in the sole best interests of the company. The court's considerations included, for example, "lesser affiliations" that nevertheless could impair independence. Chancellor McCormick rejected each attack on the SLC's independence:

- Management's recommendation of the SLC's law firm was insufficient to demonstrate improper influence on the SLC by outside counsel.
- The facts of two other pending securities and fiduciary lawsuits against the SLC members were unrelated to the instant litigation, and thus do not raise a question of independence.

- The SLC did not prejudice the investigation. Approval of the underlying transaction alone did not establish inability to be impartial as to the transaction later. And the SLC members' "mere presence" on the board when it moved to dismiss the derivative action originally did "not create a disabling conflict." The SLC members had not participated in a substantive way or voted to approve the motion to dismiss.
- The allegations of one SLC member's prior business dealings with the Garcias did not describe the magnitude of those dealings or how they might have affected the member and thus were not significant.

Regarding the investigation itself, although the SLC's investigation efforts "compare[d] favorably with SLC investigations upheld" by the court in the past, plaintiffs attacked its thoroughness and scope and the reasonableness of its conclusions. The court was not persuaded. Of note, in considering the thoroughness of the SLC's work, the court acknowledged that comments by one SLC member that he was not "honored" to be on the committee and implying time constraints on his SLC work were "not helpful to an SLC's cause." Nevertheless, the court found no evidence that the lack of enthusiasm affected the member's diligence. The court concluded that "none of Plaintiffs' arguments raise a genuine question of material fact as to the thoroughness of the investigation, the reasonableness of the scope of the SLC's investigation, or the presence of reasonable bases for the SLC's conclusion."

Having conducted a detailed review of the SLC's process and conclusions, the court, without more, also was able to take the second step under *Zapata* and determine based on its own business judgment that dismissal was in the interest of Carvana. As stated in the order, "[t]hat analysis informed the conclusion that the recommended result is appropriate. At bottom, a disinterested and independent decision-maker for the Company, not acting under any compulsion and with the benefit of the information available to the SLC, could reasonably accept the SLC's recommendation to dismiss Plaintiffs' claims."

"No Better Than a Racket": Seventh Circuit Cracks Down on Merger Objection Strike Suits

In a recent decision, the U.S. Court of Appeals for the Seventh Circuit outlined a mechanism by which stockholders can object to mootness fees paid to plaintiffs' attorneys in merger objection suits. *See Alcarez v. Akorn, Inc.*, 99 F.4th 368 (7th Cir. 2024). By allowing a stockholder to intervene and inviting the district court to scrutinize the propriety of the suit, the Seventh Circuit took a further step in its battle against the frivolous strike suits that have plagued M&A transactions for many years.

The case addresses a controversial practice in which plaintiffs file class action suits seeking additional proxy disclosures without alleging that any of the existing disclosures is false or materially misleading. After the defendant company agrees to amend its proxy statement, the plaintiffs voluntarily dismiss the suit, and the plaintiffs' attorneys collect mootness fees from the company. By settling the cases before moving for class certification, the plaintiffs circumvent Rule 23(e) of the Federal Rules of Civil Procedure, which requires judicial approval of settlements or voluntary dismissals of class actions. In a 2016 case, Judge Richard Posner of the Seventh Circuit described these suits as "no better than a racket," explaining that they "yield[] fees for class counsel but nothing for the class." *In re Walgreen Co. S'holder Litig.*, 832 F.3d 718, 724 (7th Cir. 2016).

Historically, most suits seeking supplemental disclosures were filed in Delaware; but in 2016, the Delaware Chancery Court held that such suits would be subject to "disfavor in the future unless the supplemental disclosures address a plainly material misrepresentation or omission." *Trulia, Inc. S'holder Litig.*, 129 A.3d 884, 898 (Del. Ch. 2016). The suits have continued, but plaintiffs' attorneys have changed their strategy to filing in federal court, thereby dodging the "plainly material" standard that would defeat their claims in state court.

Alcarez v. Akorn involves six suits challenging Akorn, Inc.'s proposed merger with Fresenius Kabi AG, which alleged that the proxy statement required additional disclosures. Akorn agreed to amend its proxy statement but maintained that none of the additions was legally required. Plaintiffs then dismissed their suits on the basis that Akorn's acquiescence rendered their claims moot, and plaintiffs' attorneys collected a $322,500 payment from Akorn.

An Akorn stockholder named Theodore Frank filed a motion to intervene in the case, seeking, among other things, disgorgement of the mootness fees as unjust enrichment. The district court denied Frank's motion but reopened the suits, citing its "inherent powers to police potential abuse of the judicial process." The court ultimately concluded that the complaints were frivolous and ordered plaintiffs' counsel to return the mootness fees to Akorn.

On appeal, the Seventh Circuit held that the district court did not have inherent authority to reopen the suit following voluntary dismissal; rather, it could do so only after the filing of a Rule 60(b) motion. Importantly, however, the Seventh Circuit also held that the district court erred in denying Frank's motion to intervene. Recognizing that Frank could have filed a Rule 60(b) motion if he were a party to the suit, the Seventh Circuit remanded the case and instructed the district court to treat Frank as an intervenor, permit him to file a Rule 60(b) motion, and decide what relief is appropriate.

The court reasoned that the suit is subject to the Private Securities Litigation Reform Act of 1995 (PSLRA), explaining that the PSLRA "applies to all securities suits 'brought' as class actions, whether or not they are so certified." *See* 15 U.S.C. § 78u–4. Under the PSLRA, upon final adjudication of such actions, courts must conduct a mandatory review of compliance with Rule 11(b), which prohibits lawsuits "presented for any improper purpose, such as… needlessly increas[ing] the cost of litigation," among other things. The Seventh Circuit noted that the district court may order counsel to return the mootness fees under Rule 11(c)(4), which gives the district judge discretion to impose sanctions.

Alcarez v. Akorn solidifies the Seventh Circuit's disfavor of frivolous merger objection suits in which "money moves from corporate treasuries to plaintiffs' lawyers," yet "the investors get nothing." Such litigation is precisely the type of abuse of the judicial system that the Federal Rules of Civil Procedure and the PSLRA seek to eradicate. By permitting stockholder intervention, the Seventh Circuit has fashioned a potential remedy for the current status quo, under which companies frequently opt to settle rather than deal with the nuisance of litigating the matter. Perhaps other jurisdictions will follow the Seventh Circuit's lead in promoting efficiency in M&A transactions by deterring unnecessary disruptions.

U.S. Supreme Court Holds That "Pure Omissions" in MD&A Are Not Actionable Under Exchange Act Rule 10b-5(b)

In April 2024, the U.S. Supreme Court unanimously ruled that a failure to disclose information required under Regulation S-K Item 303 cannot support a private securities fraud claim under the SEC's Exchange Act Rule 10b-5(b) without an otherwise misleading statement. *Macquarie Infrastructure Corp. v. Moab Partners, L.P.* (U.S. Apr. 16, 2024). Rule 10b-5(b) prohibits omitting material facts necessary "to make the statements made…not misleading." The court held that "pure omissions"—where no statements are made at all—are not actionable under Rule 10b-5(b). While Item 303 requires companies to disclose certain information, the court noted that failure to disclose Item 303 information can violate Rule 10b-5(b) only if it renders affirmative statements misleading. However, the SEC still has authority to investigate and prosecute violations of its rules, including Item 303. And private parties can still bring claims based on Item 303 omissions that create misleading half-truths. In addition, the ruling does not affect liability based on omissions under other laws like Section 11 of the Securities Act, which can be based on either material omissions or statements that are misleading due to omissions.

LEGISLATIVE DEVELOPMENTS

Proposed DGCL Amendments Seek to Address Issues Raised by Delaware Chancery Court Decisions

In March 2024, the Council of the Corporation Law Section of the Delaware State Bar Association proposed amendments to the Delaware General Corporation Law (DGCL) to address uncertainties created by three recent Delaware Chancery Court decisions that have disrupted various common practices. Most notably, the decisions have called into doubt contractual constraints on board authority (*Moelis*), the enforceability and administration of the merger agreement approval process (*Activision*), and provisions enabling the target to recover lost-premium damages in a failed merger (*Crispo*). The Delaware Legislature approved the amendments on June 20, 2024. If signed into law by the Delaware Governor, the proposed amendments will take effect on August 1, 2024.

Proposed DGCL Amendment in Response to Moelis *(New DGCL Section 122(18))*

In February 2024, the Delaware Chancery Court issued an opinion in *West Palm Beach Firefighters' Pension Fund v. Moelis & Co.* (Del. Ch. Feb. 23, 2024) finding that certain provisions in a stockholders' agreement granting a founding stockholder broad pre-approval rights over corporate actions—such as fixing the size of the board, nominating and voting for directors, entering into major transactions, and hiring and firing management—improperly restricted the board's authority in violation of DGCL Section 141(a) and therefore should have been included in the certificate of incorporation to be valid. See this Sidley blog post for more information on the *Moelis* decision.

In response to *Moelis*, a proposed amendment would add a new subsection (18) to DGCL Section 122 expressly authorizing a corporation to enter into contracts with stockholders in exchange for minimum consideration as determined by the board. Proposed Section 122(18) sets forth a non-exhaustive list of certain types of contract provisions that may be entered into with stockholders, even if those provisions are not set forth in the certificate of incorporation pursuant to DGCL Section 141(a). Proposed Section 122(18) would also provide that the corporation may be subject to the remedies available under applicable contract law, including in connection with any breach or deemed breach of the contract.

Proposed DGCL Amendments in Response to Activision *(New DGCL Sections 147, 268, and 232(g))*

In February 2024, the Delaware Chancery Court issued an opinion in *Sjunde AP-Fonden v. Activision Blizzard, Inc.* (Del. Ch. Feb. 29, 2024) (corrected Mar. 19, 2024) that called into question a number of common M&A practices, including the process of obtaining board approval for a merger agreement and the required contents of the notice of the stockholder meeting to approve the merger agreement. The court denied the defendants' motion to dismiss claims that the board of directors failed to properly authorize a merger agreement pursuant to DGCL Section 251. According to the court in *Activision*, board approval of a merger requires that the merger agreement presented for board approval be at least an "essentially complete version" that includes (1) the purchase price, (2) the company disclosure letter, (3) the surviving corporation's certificate of incorporation, and (4) all finalized key terms. The court also held that the text of DGCL Section 251(c) requires that notice to stockholders of a stockholder meeting to approve a merger must contain the merger agreement or a summary thereof and that attaching the merger proxy statement is insufficient to satisfy the notice requirements. See this Sidley blog post for more information on the *Activision* decision.

Proposed new DGCL Section 147 is intended to clarify the merger agreement approval process by permitting a board of directors to approve any agreement, instrument, or other document requiring board approval under the DGCL, so long as such agreement, instrument, or other document is in either "final form" or "substantially final form" at the time of board approval, meaning that all of the material terms are set forth therein or are determinable through other information or materials presented to or known by the board.

Proposed new DGCL Section 268 clarifies when a merger agreement need not include the surviving corporation's certificate of incorporation nor the disclosure schedules to be considered in final or substantially form at the time of board approval. Proposed Section 268(a) sets forth a limited set of circumstances under which the surviving corporation's certificate of incorporation is not required to be attached to the merger agreement or approved by stockholders. This proposed amendment would give a buyer in a reverse triangular merger the flexibility to adopt the terms of the charter of the corporation that will be wholly owned or controlled by the buyer post-closing. A target company could still require that the merger agreement expressly provide that the surviving corporation's certificate of incorporation be approved in a specified form or contain particular provisions (*e.g.*, provisions providing for indemnification and advancement of expenses).

Proposed Section 268(b) provides that disclosure letters, disclosure schedules, and similar documents will not be deemed part of the merger agreement unless a merger agreement expressly provides otherwise and as such, as a statutory matter, would not be required to be presented to or approved by the board or stockholders but regardless maintain their intended effects as provided for in the merger agreement. This proposed amendment is meant to avoid any implication from *Activision* that the board would have had to approve the final or substantially final disclosure schedules for the merger agreement to have been duly authorized.

Also in response to *Activision*, a new subsection (g) is proposed to be added to DGCL Section 232 to provide that any notice given by a corporation to its stockholders is deemed to include any document enclosed with, or appended or annexed to, that notice (*e.g.*, a proxy statement provided with a notice of stockholder meeting to approve a merger agreement), and all information in any such document is incorporated in the notice.

Proposed DGCL Amendments in Response to Crispo *(New DGCL Section 261(a)(1) and (2))*

In *Crispo v. Musk* (Del. Ch. Oct. 31, 2023), the Delaware Chancery Court addressed the validity of lost-premium damages provisions, which, in a scenario where a buyer wrongfully terminates the merger agreement, would require the buyer to pay the target the amount of premium the target's stockholders would have received in the merger. Because the target company does not directly receive merger consideration, and payment goes directly to stockholders, the court reasoned that the lost-premium damages provision at issue could not be enforced, as the entity doing the enforcing (the target) was not entitled to the premium being sought. Therefore, lost-premium damages could be recovered only if the agreement granted third-party beneficiary status to the stockholders who were to receive the premium. Because the merger agreement in *Crispo* expressly disclaimed third-party beneficiaries, the lost-premium amount could not be recovered. See this Sidley blog post for more information on the *Crispo* decision.

To resolve any uncertainty arising from *Crispo*, proposed new DGCL Section 261(a)(1) would permit target companies to seek lost-premium damages for failed deals, which they may retain or distribute to stockholders. Furthermore, proposed new DGCL Section 261(a)(2) would allow for a merger agreement to expressly provide for the appointment of a person to act as stockholders' representative with exclusive authority to enforce stockholders' rights in connection with a merger, including the right to payment of merger consideration or in respect of escrow or indemnification arrangements and settlements. As proposed, the appointment of the stockholders' representative may be made effective as of adoption of the merger agreement by stockholders or any later time and thereafter would be binding on all stockholders.

If enacted, the amendments will take effect August 1, 2024, and will apply to all agreements made by a corporation or approved by the board of directors and all merger agreements entered into by a corporation, in each case, whether made, approved, or entered into before or after August 1, 2024. The proposed amendments would not apply to or affect any litigation completed or pending before August 1, 2024.

SEC DEVELOPMENTS

SEC Issues CDIs About Form 8-K Disclosure Requirements for Cybersecurity Incidents Involving Ransomware Attacks

On June 24, 2024, the SEC issued guidance in the form of five new compliance and disclosure interpretations (CDIs) about Form 8-K disclosure requirements for cybersecurity incidents involving ransomware attacks. The new CDIs clarify the following:

- The actual or apparent cessation of a cybersecurity incident before making a materiality determination, including as a result of the company's making a ransomware payment, does not relieve the company of the requirement to determine whether the incident was material and thus reportable under Item 1.05 of Form 8-K.
- If a company experiences a cybersecurity incident that it determines to be material, a subsequent ransomware payment and actual or apparent cessation of the incident does not relieve the company of the requirement to report the incident under Item 1.05 of Form 8-K within four business days of its determination that the incident was material.
- The fact that a company may be reimbursed for a ransomware payment under an insurance policy does not mean that a cybersecurity incident involving a ransomware attack is necessarily not material. The availability of, or increase in the cost to the company of, insurance policies that cover cybersecurity incidents is just one of all relevant facts and circumstances the company should consider when assessing the materiality of a cybersecurity incident.
- The size of a ransomware payment is not, by itself, determinative as to whether a cybersecurity incident is material—it is just one of the facts and circumstances a company should consider when making its materiality determination. Furthermore, as stated in the SEC's adopting release for the cybersecurity disclosure rules, the SEC declined "to use a quantifiable trigger for Item 1.05 because some cybersecurity incidents may be material yet not cross a particular financial threshold."
- If a company experiences a series of cybersecurity incidents involving ransomware attacks over time that it determines are individually immaterial, disclosure may still be required under Item 1.05 of Form 8-K if, depending on the particular facts and circumstances, the company determines that the incidents were related and the related incidents, collectively, were material.

Public companies that experience a cybersecurity incident involving a ransomware attack should pay close attention to this new SEC guidance when complying with the Form 8-K disclosure requirements under Item 1.05.

SEC Corp Fin Director Provides Guidance Regarding Form 8-K Cybersecurity Incident Disclosures

In a May 2024 statement, Erik Gerding, Director of the SEC's Division of Corporation Finance, provided guidance on disclosing cybersecurity incidents on Form 8-K. Most notably, he clarified that companies are encouraged to use Item 8.01 (Other Events) of Form 8-K rather than new Item 1.05 (Material Cybersecurity Incidents) to voluntarily disclose an immaterial cybersecurity incident or incident for which the company has not yet made a materiality determination.

As of December 18, 2023, SEC rules mandate that a company disclose any material cybersecurity incident within four business days of the incident's determination as material unless the U.S. Attorney General determines that immediate disclosure poses a substantial risk to national security or public safety. The materiality determination that controls whether an incident should be filed under Item 1.05 must occur "without unreasonable delay." The company must describe under Item 1.05 (1) the material aspects of the nature, scope, and timing of the incident and (2) the material impact or reasonably likely material impact on the company, including its financial condition and results of operations. The company must amend the Form 8-K if any required information was not available when the initial Form 8-K was filed.

In his statement clarifying these requirements, Gerding explained that companies have been reporting both material and immaterial cybersecurity incidents under new Item 1.05, which may confuse investors. While not trying to discourage companies from voluntarily disclosing immaterial cybersecurity incidents or incidents for which they have not yet made a materiality determination, he directed them to use Item 8.01 for such disclosures and to limit Item 1.05 to material incidents.

If an incident that was initially disclosed under Item 8.01 is later determined to be material, the company must report it under Item 1.05 of Form 8-K within four business days of the subsequent materiality determination. Referencing the Item 8.01 Form 8-K is permissible, but the disclosure in the later Form 8-K must satisfy all Item 1.05 requirements.

SEC Corp Fin Director Erik Gerding's statement clarifying the Form 8-K cybersecurity incident disclosure requirements "is intended to encourage the filing of...voluntary disclosures in a manner that does not result in investor confusion or dilute the value of Item 1.05 disclosures regarding material cybersecurity incidents."

Gerding also reminded companies that in determining whether a cybersecurity incident is material and assessing its impact or reasonably likely impact, they should assess both qualitative and quantitative factors. In addition to the incident's financial impact, they should consider factors such as reputational or competitive harm, effect on customer and vendor relationships, and the possibility of litigation or regulatory action.

Finally, if a company determines that a cybersecurity incident is material but has not yet determined its impact or reasonably likely impact, Gerding stated that the company should disclose the incident in a Form 8-K under Item 1.05 providing information necessary for investors to understand the material aspects of the nature, scope, and timing of the incident along with a statement noting that the company has not yet determined the incident's impact or reasonably likely impact and then amend the Form 8-K to disclose the impact once known.

In June 2024, Gerding issued another statement, this time providing guidance about selective disclosure of information about cybersecurity incidents. He clarified that the new cybersecurity incident disclosure requirements do not prohibit a company from (1) privately discussing a material cybersecurity incident with commercial counterparties, law enforcement and national security agencies, or others or (2) providing such parties with information about the incident beyond what was disclosed in the Item 1.05 Form 8-K.

Gerding acknowledged that private discussions about a cybersecurity incident may implicate Regulation FD depending on the information disclosed and the recipients of the information but clarified that nothing in Item 1.05 alters Regulation FD and that Regulation FD "should not pose an undue impediment to the mutually beneficial sharing of information regarding material cybersecurity incidents." He also reminded that Regulation FD will not be implicated if any of the following are true:

- The information disclosed is immaterial.
- The recipients of the information are not the types of persons covered by Regulation FD (*e.g.*, securities market professionals or shareholders).
- An exclusion to Regulation FD applies (*e.g.*, the recipient of the information owes a duty of trust or confidence to, or has entered into a confidentiality agreement with, the company).

These recent statements follow Gerding's initial statement about the cybersecurity disclosure rules in December 2023 in which, among other things, he encouraged "public companies to work with the FBI, the Cybersecurity and Infrastructure Security Agency, and other law enforcement and national security agencies at the earliest possible moment after cybersecurity incidents occur." In addition to reviewing the relevant SEC rules and CDIs, public companies that experience cybersecurity incident incidents should consider the informal guidance Gerding provides in these statements on cybersecurity incident disclosures.

Recent Remarks and Enforcement Actions Illustrate the SEC's Increasing Scrutiny of AI Disclosures

In a speech at Yale Law School in February 2024, SEC Chair Gary Gensler reminded companies to consider the following when making statements and disclosures about their use of AI:

- Do not engage in "AI washing" or make claims that cannot be supported.
- Claims about AI prospects should have a reasonable basis.
- Avoid boilerplate language on AI disclosures.
  - Provide specific, particularized disclosures instead.
  - Consider all types of risk, *e.g.*, operational, legal, and competitive risks.
- Consider whether AI statements or discussions are potentially material.
- Define what AI means for your particular company.
  - How and where is the company using it?
  - Is it being developed by the company or supplied by others?

Furthermore, Erik Gerding, Director of the SEC's Division of Corporation Finance has advised that the Division Staff will be looking carefully at AI disclosures. At the Practising Law Institute's recent "The SEC Speaks in 2024" conference, members of the Division Staff shared the following insights regarding AI disclosures (some of which were reiterated in a statement Gerding issued on June 24, 2024):

- 59% of annual reports filed by large accelerated filers this year made some mention of AI (up from 27% in 2022).
- Disclosures appeared most frequently in the Risk Factors, Business, and MD&A sections of annual reports (33% of filings included disclosure in both the Risk Factors and Business sections).
- Some companies are disclosing the impact of the EU AI Act, where applicable.
- While existing disclosure requirements do not explicitly refer to AI, existing rules may require disclosure on how a company uses AI and the risks related to its use.
  - Risk Factors
  - Business
  - MD&A
  - Financial Statements
  - Board's Role in Risk Oversight
  - Disclosure Controls and Procedures
- Consistent with the guidance provided in Gensler's speech referenced above, the Division Staff noted that they will consider how companies describe the opportunities and risks associated with AI including, to the extent material, whether or not the company:
  - clearly defines what it means by AI and how the technology could improve the company's results of operations, financial condition, and future prospects
  - provides tailored, rather than boilerplate, disclosures, commensurate with its materiality to the company, about material risks and the impact the technology is reasonably likely to have on its business and financial results
  - focuses on the company's current or proposed use of AI technology rather than generic buzz not relating to its business
  - has a reasonable basis for its claims when discussing AI prospects

In March 2024, the SEC settled charges against two investment advisers for falsely claiming that they used AI to analyze client data and AI-driven forecasts to make investment decisions and recommendations. The investment advisers agreed to pay civil penalties of $400,000 in total. These enforcement actions indicate that the SEC will actively pursue "AI washing" claims similarly to how it addressed "greenwashing" claims. In a press release about the settlements, Gurbir Grewal, Director of the SEC's Division of Enforcement, said: "As today's enforcement actions make clear to the investment industry—if you claim to use AI in your investment processes, you need to ensure that your representations are not false or misleading. And public issuers making claims about their AI adoption must also remain vigilant about similar misstatements that may be material to individuals' investing decisions."

In June 2024, the SEC brought a civil suit against a start-up founder for alleged fraud, including AI washing, in tandem with a criminal indictment of the founder from the U.S. Attorney's Office for the Southern District of New York (SDNY). The company claimed to use AI-based and automated technology to identify and match diverse and underrepresented candidates with job opportunities at customer companies. The SEC and the SDNY alleged that the founder had lied to potential investors about the number and identity of the company's customers, its revenues, and the size of its database of employment candidates. The board of the company had fired the founder and put the company into bankruptcy liquidation when it learned of the misstatements.

Given these recent remarks and enforcement actions, we expect to see an increase in AI-focused comments in comment letters from the Corp Fin Division Staff and in enforcement actions by the Enforcement Division. Accordingly, public companies should continue to carefully review their AI-related disclosures to make sure they are accurate, up to date, not exaggerated, and appropriately tailored to the company's particular facts and circumstances.

ANTITRUST DEVELOPMENTS

Significant Changes to Hart-Scott-Rodino (HSR) Premerger Notification Form Expected Soon

During the American Bar Association Antitrust Spring Meeting held from April 10–12, 2024, top officials from the FTC and the DOJ Antitrust Division previewed that they expect final changes to the HSR premerger notification form to be finalized soon. DOJ Deputy Assistant Attorney General Andrew Forman stated his belief that these changes are coming in a matter of weeks, not months. Both he and Henry Liu, Director of the FTC's Bureau of Competition, echoed concerns from agency staff regarding deficiencies in the current forms, though they previewed that the final amendments to the HSR form will differ materially from the proposed amendments the FTC announced in June 2023, which were summarized in this Sidley Update. Liu noted that the new forms will likely require filing parties to provide information regarding supplier-customer relationships, as well as the transaction's potential effect on labor markets.

In their initial proposal, the agencies estimated that the time required to prepare compliant HSR filings would increase fourfold, although antitrust practitioners largely agreed that the increased burden would, in fact, be significantly higher. The agencies received thousands of public comments regarding the initial proposal, which consistently expressed the sentiment that the increased burden would overwhelmingly outweigh the potential benefits to the agencies' review, especially for transactions that do not raise competitive concerns. While the final requirements remain uncertain, parties anticipating near-term M&A activity should be prepared for HSR filings that may require significantly more time and resources to prepare than in prior transactions.

SIDLEY EVENTS

Sidley AI Webinar Series

July 16 | Virtual

In the second session of Sidley's ongoing Key Issues in AI webinar series, Sidley lawyers will discuss key issues, challenges, and considerations in global antitrust and government strategies. Click here to RSVP and contact nyevents@sidley.com for more information or questions.

September 17 | Virtual

In the third session of Sidley's ongoing Key Issues in AI webinar series, Sidley lawyers will discuss key issues, challenges, and considerations in products liability, export control, and labor and employment matters. Click here to RSVP and contact nyevents@sidley.com for more information or questions.

Sidley Bay Area Lifesciences Roundtable

July 17 | San Francisco

Sidley will host its annual Bay Area Lifesciences Roundtable in San Francisco on July 17. The program will involve an afternoon of provocative discussions addressing cutting-edge trends and hot topics impacting the life sciences industry. The featured panels on China & Beyond: Opportunities Across Asia, AI-Enabled Life Sciences Technologies: Exploring the Frontiers of Innovation and Boundaries of Responsibility, and Taking Stock of Paradigm-Shifting Developments from FDA will be followed by a cocktail reception. Click here to RSVP and contact globallifesci@sidley.com for questions.

Sidley Corporate College

September 10-11 | Chicago, New York City, and Virtual

Sidley will host its annual Corporate College program in Chicago, New York City, and virtually on September 10-11. Sidley's Corporate College is a program intended to expose participants to a broad spectrum of topics that a transactional lawyer is likely to encounter. In-house lawyers of all levels are invited to attend this program. Anyone interested in attending should contact chevents@sidley.com.

SIDLEY RESOURCES

Antitrust/Competition

The Digital Markets, Competition and Consumers Act is Approved: Key Things to Know About the UK's New Competition and Consumers Powers (May 24, 2024). After over a year of debate since the initial bill's draft, the landmark Digital Markets, Competition and Consumers Bill was finally approved on May 23, 2024. This marks the most significant reform to competition and consumer law in a decade. Despite numerous amendments on isolated points throughout the bill's lifetime, the substance remains the same: the Competition and Markets Authority (CMA) has a broad suite of enhanced investigative, information-gathering, and enforcement powers that will significantly change the way competition law is enforced in the UK. The CMA has also released draft guidance on how it will apply some of these new powers in relation to digital markets and is seeking to consult with interested parties.

Sidley Antitrust and Competition Bulletins: Top-of-Mind Global Antitrust Issues. These monthly bulletins provide thoughts on topics that are top-of-mind for Sidley's antitrust team and why they matter to our clients.

May Antitrust Bulletin (May 31, 2024). The federal district court in Nevada granted a motion to dismiss a class action that alleged algorithmic price-fixing. On May 9, the DOJ Antitrust Division announced the formation of the Task Force on Health Care Monopolies and Collusion, and on May 13, the DOJ secured a guilty plea in connection with criminal bid-rigging charges. The European Commission (EC) recently published a policy brief on EU antitrust law in labor markets.

April Antitrust Bulletin (April 30, 2024). On April 23, the FTC voted to enact a rule that would ban noncompete agreements imposed by employers on workers. Earlier in the month, officials from the FTC and the DOJ Antitrust Division previewed that changes to the HSR premerger notification forms are expected to be finalized soon. The EC recently used a number of its powers under the EU Foreign Subsidies Regulation and sent a statement of objections to a notifying party alleging that it provided incomplete, inaccurate, or misleading information in the context of its merger notification from 2021. And on April 11, the UK CMA published an updated report on AI foundation models.

March Antitrust Bulletin (March 29, 2024). The FTC recently filed a complaint to stop the merger of two major U.S. supermarket chains in part by alleging for the first time that the transaction would substantially harm a unionized labor market. On March 21, Advocate General Nicholas Emiliou advised the Court of Justice of the European Union to rethink the approach of the EC to reviewing mergers that fall below notification thresholds. The EC conditionally cleared an airline merger requiring a broad remedial package to address competition concerns. On March 5, the FTC hosted a virtual workshop examining the role of private equity investment in healthcare markets. In late February, Assistant Attorney General Jonathan Kanter remarked on how the U.S. agencies' antitrust enforcement efforts have focused on, and will continue to focus on, gatekeeper power. At the end of February, several European media organizations launched a civil action in the Netherlands seeking €2.1 billion in damages from Google, alleging that it had abused its dominant position in adtech, adding to several ongoing investigations by various competition authorities into the same practices.

Artificial Intelligence

Sidley Launches AI Monitor. AI is requiring executives, directors, in-house counsel, investors, and regulators worldwide to confront a rapidly evolving list of questions across different areas of law, and they are hungry for the latest information to help guide them in their most important decisions. That is why Sidley has launched the AI Monitor, a centralized resource of content related to AI including Sidley thought leadership, the latest laws and regulations, and access to our AI lawyers. If you would like to receive AI-related news from Sidley, please click here to subscribe to the mailing list.

Corporate Governance and SEC Disclosure

Roundup of Overboarding Policies Applicable to U.S. Public Company Directors (June 3, 2024). Overboarding concerns have become a key driver for recommendations or votes against director elections. This Sidley Update summarizes the overboarding policies applicable to U.S. public company directors of proxy advisory firms Glass Lewis and Institutional Shareholder Services as well as several large institutional investors. Notably, for 2024, Glass Lewis and certain institutional investors have increased their expectations with respect to public companies adopting overboarding policies and making related disclosures.

Lexology Panoramic—Corporate Governance USA 2024 (May 31, 2024). Sidley lawyers Holly Gregory and Claire Holland authored the United States chapter of *Panoramic—Corporate Governance 2024*, an annual summary of key corporate governance practices in 18 jurisdictions worldwide. Topics addressed in the chapter include sources of governance rules and practice, shareholders' rights, duties and liability, anti-takeover devices, board structures, legal duties of the board, and disclosure and reporting requirements. Holly Gregory has served as a contributing author since 2015. Reproduced with permission from Law Business Research Ltd.

Is Your Company Ready For the SEC's New Climate Disclosure Rules? We Break Them Down (April 2024). The SEC had planned to usher in a new era of corporate disclosure, but now it may be on hold. Its new rules would require public companies to report extensive climate-related information. The rules are intended to improve the consistency, comparability, and reliability of climate-related data and to provide detailed, decision-useful information for investors seeking company information before they invest. But already some states and business groups are mounting legal challenges, arguing that the rules exceed the SEC's statutory authority and violate the First Amendment. Environmental advocates are also suing, claiming the rules don't go far enough. Now in the wake of that litigation, the SEC has issued a voluntary stay of the rules, hoping it will speed resolution of the case. In this episode of *The Sidley Podcast*, host Sam Gandhi speaks with Sidley partners Sonia Barros and Heather Palmer about the SEC's newly adopted climate disclosure rules, the status of legal challenges, and how companies should prepare to comply with the requirements.

Litigation

Corporate Personal Jurisdiction, Mallory, and Forum-Shopping: What's Next for Multistate or International Corporations? (April 9, 2024). Last year, the U.S. Supreme Court held that a state's courts can hear any and all claims against a corporate defendant registered to do business there—at least if state law provides clear notice and the company has substantial in-state operations. If applied broadly, that decision could give plaintiffs suing national or international corporations free rein to shop for the most favorable forum. But a recent federal court decision concludes that many states' laws do not assert this kind of jurisdiction, highlighting arguments that all corporations with multistate operations should be ready to assert.

M&A

UK Supreme Court Refuses Permission to Appeal in Preference Claim Arising From Liquidation of Comet: Key Takeaways for M&A Deals (May 14, 2024). The UK Supreme Court recently refused an application by the liquidator of CGL Realizations Limited for permission to appeal an English Court of Appeal judgment in which Sidley successfully represented Darty Holdings SAS, overturning what is believed to be the largest preference claim ever considered by the English courts by value. The Court of Appeal's judgment resulted in £120 million being repayable to Darty along with costs. In this Sidley Update, we consider key takeaways from the litigation for parties to M&A deals.

SEC Enforcement

Practical Takeaways for PE Sponsors From the SEC's Victory in First Ever "Shadow Trading" Case (May 30, 2024). On April 5, 2024, a federal jury in the Northern District of California found a former pharma executive liable for insider trading after he used information learned from his employer to trade in the securities of another, allegedly comparable, company. The verdict followed several pre-trial motion wins by the SEC, including a ruling by the court that the executive owed his employer a duty of confidentiality under agency law, separate and apart from any obligations imposed by written policies or express agreement. The case represents the SEC's first successful application of the long-established misappropriation theory of insider trading to a so-called "shadow trading" fact pattern. For PE sponsors and other fund managers, the case creates potential new risks when the firm or its employees are exposed to confidential information about a current or potential portfolio company, and that information is also potentially material to the securities of another public or private company. If the firm or its employees then invest in the other company's securities, the conduct may raise insider trading concerns under the shadow trading theory. Firms should therefore consider ways to address this new area of risk in their policies, procedures and training programs. This article from the Private Equity Law Report explores the role the company's written policies and confidentiality agreement played in the case; the facts the SEC relied on to show the economic link necessary to establish its shadow trading theory; and practical takeaways for how PE sponsors and other fund managers can adjust their compliance programs accordingly.

White Collar: Government Litigation and Investigations; Corporate Compliance

Buyer Beware: What to Know About the DOJ's Policy on Self-Reporting in M&A (April 2024). What happens when you buy somebody else's problems? A new policy from the DOJ is encouraging companies to disclose the misconduct of the companies they buy. The DOJ says it won't prosecute businesses that voluntarily report wrongdoing found during the M&A process. The government especially wants to detect misconduct that threatens national security or involves cybersecurity or foreign corruption. But detractors say the new rule could give a free pass to corporate crime. How do businesses know exactly what they should self-report both before and after a deal is done? And how do they stand to benefit from the new policy? In this episode of *The Sidley Podcast*, host Sam Gandhi speaks with Sidley partner Kenneth Polite about the DOJ's new policy for M&A, how various parties across industries are responding, and what companies should know to protect their businesses.

SIDLEY SPEAKERS

The SEC All-Stars: Proxy Season Insights and Your Next 10-K: Navigating Key Updates

October 14 | San Francisco or Video Webcast

During the Proxy Disclosure Conference hosted by TheCorporateCounsel.net in San Francisco on October 14, Sidley partner Sonia Barros will participate in panels titled "The SEC All-Stars: Proxy Season Insights" and "Your Next 10-K: Navigating Key Updates." Click here for more information and to register.