2023 Insights

Skadden

Five Critical Areas for the Year Ahead

Editorial Board

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A Possible Recession

US M&A Levels Remain Healthy, but Due Diligence and Deal Protections Will Become Even More Critical

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Key Points

- Volatile global financial markets and recessionary fears have led to declining boardroom confidence and a decrease in deal activity from 2021's record levels but are still healthy by historical standards.
- Strategic drivers of M&A activity are in place, and high levels of corporate and financial sponsor dry powder are available to support deal activity.
- Economic stresses, uncertain financing markets and heightened regulatory scrutiny make it crucial for parties to conduct robust due diligence and negotiate deal terms to address downside and termination risks.
- In a down market, buyers may find opportunities to acquire appealing targets that were previously out of reach.

Acquisition market participants in the U.S. approached dealmaking with greater caution in 2022 than they did in 2021. Steadily rising interest rates and financing costs, persistent inflation, geopolitical uncertainty, heightened global regulatory scrutiny and a general decline in boardroom and investor confidence have all contributed to this change. Unpredictable market dynamics have made sellers wary of overly opportunistic buyers, while buyers have been cautious of overpaying in what they may see as a new normal. It has become more difficult to reach agreement than it was during the booming M&A market of 2021.

However, M&A has proven to be a permanent fixture of companies' capital allocation toolkits, and M&A engagement continues even as general market sentiment shifts. Factors that have driven M&A over the years are as present today as ever, including strong corporate earnings; the sentiment that a "buy" strategy can prevail over a "build" strategy in adapting to meet changing customer needs quickly and well; and the desire to manage corporate portfolios to align with goals announced to investors.

Despite the more cautious approach in 2022, deal volume globally remained on par with 2018, 2019 and 2020, and aggregate deal value was higher in 2022 than in 2019 and 2020, at roughly the 2018 level, according to investment data company Preqin.

> M&A has proven to be a permanent fixture of companies' capital allocation toolkits, and M&A engagement continues even as general market sentiment shifts.

As markets remain volatile in a low-growth or recessionary economy, the M&A environment will likely be challenging, so mitigating deal risks effectively will be a critical priority. For those who can navigate these challenges, successfully assessing and minimizing risks, there may be opportunities for substantial rewards.

Efficient Capital Deployment and Financing

Investors and lenders are becoming increasingly selective with their capital allocation given the meaningful rise in interest rates and cost of capital. Buyers who require third-party acquisition financing face more reluctant lenders and higher borrowing costs. As acquirers turn more regularly to private lenders and other sources of capital (as opposed to syndicated or traditional credit lines or bank loans), they may have to shoulder increased risks or other tighter terms that de-risk the loans for the lenders. (See "A Playbook for Borrowers Facing Economic and Debt Market Pressures.") The specter of further market pullback adds to the uncertainty about financing and could limit market engagement.

> For those who can navigate these challenges, successfully assessing and minimizing risks, there may be opportunities for substantial rewards.

Still, both strategic buyers and private equity funds have dry powder. While down from the record levels in 2020 and 2021, dry powder in private equity funds remained at $1.2 trillion as of the third quarter of 2022, according to the PitchBook Global Private Market Fundraising Report. And U.S. corporations' cash on hand in U.S. banks remained higher as of mid-2022 than at any point prior to 2020, according to the U.S. Census Bureau. While financing may limit the number of buyouts at the largest valuations, private equity will likely find opportunity in carve-outs as corporations dispose of assets to streamline and focus their businesses.

Together, these forces make it likely that there will continue to be engagement in the market, even if overall economic performance lags. Those with considerable cash reserves and the willingness to transact with less leverage will likely see ample opportunities to buy at potentially significant discounts. Strategic acquirers and investors with longer-term investment horizons will also have an advantage.

Disciplined Approach to Due Diligence

As a buyer's market begins to emerge, acquirers will find it easier to insist on robust due diligence. They should seize the opportunity to do so, to mitigate the risks of an unpredictable market in which company values may be declining. Disciplined diligence can help expose deficiencies in a target, including legal and business liabilities and other vulnerabilities that are material to its valuation and the ultimate decision of whether or not to proceed with an acquisition.

Declining markets do not always provide the luxury of extended due diligence, though. There may even be greater urgency from investors to deploy capital quickly, exploit narrow windows of opportunity and produce returns (to avoid having unutilized cash, particularly in this inflationary environment).

We expect participants who are able to strike a balance and conduct meticulous yet efficient due diligence to be rewarded by the market.

Downside Protection and Termination

In the current environment, both sides need to consider what could go wrong.

That includes understanding the path to regulatory approval. Competition regulators around the world are adopting new approaches to assessing mergers and are scrutinizing transactions that they would have waved through in the past. In addition, sanctions directed at Russia and newly imposed national security reviews and trade regulations can complicate and delay some transactions. Further regulatory clearances are sometimes required under those regimes. (See "Disparate US, EU and UK Sanctions Rules Complicate Multinationals' Exits From Russia.")

Termination and deal withdrawal considerations tend to become more central in negotiations during a lagging market. A terminated or withdrawn transaction may result in costly termination fees, litigation and other undesirable consequences, particularly for public companies that may be sensitive to market perception.

Conversely, being forced to consummate an unfavorable or unaffordable transaction in a down market can also be costly and complicated.

Well-considered deal terms can provide flexibility and additional risk mitigation for buyers and sellers. They include:

- covenants and conditions that take into account volatile market conditions;
- the duration of the contract term and outside date;
- the scope of the material adverse effect (MAE) clause and its exceptions;
- the size of any termination fee and regulatory "ticking fees" to compensate for delays; and
- termination triggers.

(For perspective on the U.K. market and due diligence and deal terms there, see "The Widely Forecast Recession in the UK Will Likely Reshape M&A.")

Innovative Opportunities

In a down market, we expect dealmakers to hunt for targets that were previously too expensive. For instance, the falling valuations and performance headwinds in the technology sector present opportunity for incumbent businesses to acquire previously unattainable disruptors, likely for far less than it would cost to build their own modernizing technology.

Sound acquisition strategies among participants who can remain nimble should yield opportunities to unlock value through acquisitions that would not have been possible in a more expensive marketplace.

(For perspective on China M&A, see "Focus of China Cross-Border M&A Turns to Government-Favored Sectors and Away From West.")

The Widely Forecast Recession in the UK Will Likely Reshape M&A

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Key Points

- Economic strain in the U.K. is expected to lead to the sale of more stressed and distressed businesses. Some are likely to be more attractive to U.S. buyers because of the decline of the pound against the dollar.
- Challenges in obtaining acquisition financing on acceptable terms seem likely to persist and continue to put a strain on the M&A market.
- Market uncertainties will focus buyers on thorough due diligence, although distressed sales sometimes take place on accelerated timetables.
- Deferred and contingent payment terms are likely to be used more frequently to bridge gaps in the parties' estimates of value and to address economic unknowns, even though they can be contentious to negotiate. These terms will allow deals to continue to flow.

In the U.K., looming economic uncertainties are expected to play a significant role in M&A activity at almost all stages of the acquisition life cycle, from sourcing deals to financing, due diligence, negotiation and execution.

Sourcing Deals

With the Bank of England predicting that the contraction of the U.K. economy that began in 2022 will continue into 2024, the M&A market is likely to see a decline in the pipeline of large strategic acquisitions, most likely because companies are focusing on their internal challenges rather than exploring acquisitive growth opportunities. Companies face increased finance costs due to rising interest rates, supply chain challenges, inflationary pressures, employment-related issues (filling job vacancies and an upward push in remuneration) and currency fluctuations. Many companies are also preparing for the downturn and looking to cut costs where possible to protect profit margins.

While this is a trying period in the U.K., it may create opportunities for U.S. investors to acquire U.K. businesses, particularly those that have dollar revenue streams but whose values in dollar terms have been depressed by sterling's fall against the dollar.

Financing Challenges

As a result of higher interest rates, existing financing will become more burdensome and expensive, decreasing available cash reserves and therefore possibly deterring companies from exploring acquisitions. If a company has identified a target, it may also find that the financing available is not viable due to the cost and/or a tightening of the covenants required by lenders.

In addition, for public companies, shareholders may question the rationale, or at least the timing, of a deal in the current environment, which could make equity financing difficult.

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A further challenge on the buy side is the increasing scrutiny by financial sponsor investment committees, where the merits and financing of deals are questioned. That scrutiny is also leading to more involved due diligence processes (discussed in greater detail below). Some financial sponsors do believe, however, that financing acquisitions will become easier in the next year or so as public and private credit markets begin to adjust to the economic environment. As in the U.S., nontraditional financing sources may help alleviate the problem and provide solutions for some deals.

Due Diligence

Stress-testing a target's financials. During the legal and financial diligence phase of acquisitions, there is an increased focus on stress testing the target's financials as well as its revenue and contracting model to ensure the economics of the business are sustainable, and that the target's customer and supplier bases are robust and diversified. In addition, buyers will want to understand a target's supply chain exposure. For all of these reasons, we expect to see a greater focus on undertaking a vigorous diligence exercise on customer relationships and contracts.

Timing considerations. In a stressed or distressed M&A process, timing is of the essence, especially as the value of the business may continue to decrease over time. Notwithstanding that distressed M&A is typically a buyer's market, the buyer will come under pressure to make decisions quickly, and there may not be time to conduct in-depth due diligence. There may also be more limited sell-side marketing information. If, however, the company is at the less distressed end of the spectrum and not subject to imminent insolvency, the sale can be conducted more like a traditional auction/private bilateral process where more time is afforded for due diligence. In any event, the time that is available should be used to examine fundamental areas of the business, key regulatory risks and tax exposure.

Negotiation Dynamics

A buyer's market. During negotiations, we are starting to see a shift in the balance of the bargaining position from the seller to the buyer, in particular where: (i) the seller is in a stressed or distressed position, or is keen to divest assets in order to re-focus its business; or (ii) the buyer finds it necessary to require deferred or contingent consideration to allow post-closing adjustments to the purchase price based on valuation or market uncertainty.

Pricing adjustments. Deferred and contingent consideration mechanics are most typically used to incentivize sellers post-sale. However, now they are increasingly employed to deal with uncertainties and valuation gaps in the current environment (*i.e.*, caused by country, sector, inflationary or operating cost risks). Such mechanics can often be sources of contention during negotiations, as buyer and seller will have very different views on the adjustments, typically resulting in prolonged discussions. (Where the target has entered a formal insolvency procedure, these mechanics are not relevant.)

We also expect to see negotiations over transaction documentation stretch out where parties are sensitive to tailoring the deal to cover a wide range of uncertainties. Parties will be alert to business risks between signing and completion, and we expect negotiations around conduct-of-business provisions (which can, for instance, restrict certain activity or levels of indebtedness) to become critical.

Understanding where the value breaks. In the context of a distressed M&A situation, the list of potential buyers may be more limited, and the seller's need for liquidity is likely to be the paramount driver in forcing the sale. Where a business is stressed or distressed, it becomes imperative to understand where the "value breaks" — that is, which creditors, and possibly shareholders, will receive a payout. The value of the business will typically break in the debt, leaving the shareholders out of the money. The creditor where the value breaks (also known as the "fulcrum creditor") will usually be the one driving the sale process. This can create competing interests on the sell side as to how the sale process should be run, who is running it and who is perceived as the preferred bidder.

Getting the Deal Done

Allocation of risk is the essence of the legal process for any M&A deal. In the current economic climate, the parties are likely to be more risk averse. Buyers are likely to place more emphasis on deal protections such as:

- break fees and cost coverage arrangements;
- escrow mechanics to ring-fence a portion of the purchase price to cover any breaches of the warranty and indemnity (W&I) insurnce package; and/or
- holdbacks for post-close price adjustments.

We expect to continue to see the trend toward the use of buy-side W&I insurance where it can be obtained, giving the buyer a direct claim against the insurer rather than taking the risk of exposure to the seller. In a distressed M&A situation, warranty packages may be limited, and indemnity and other forms of clawback are rarely available. We expect W&I insurance solutions to be available on these types of transactions, but with more limited coverage than in a typical buyout deal and with higher premiums. This will place more emphasis on the alternative solutions available, including holdbacks and escrows. All these options will need to be considered and balanced against the overall competitiveness of the deal.

We expect parties to run health checks on deal terms already negotiated for ongoing deals. Revised modeling for valuation purposes could trigger renegotiation of the price or require revisions to add more aggressive price adjustment mechanics. Other deal protection tactics may be introduced in light of increased market uncertainty, while some deals may be put on hold and others taken off the table entirely.

(For perspective on the U.S. market and due diligence and deal terms there, see "US M&A Levels Remain Healthy, but Due Diligence and Deal Protections Will Become Even More Critical.")

In Sum

Notwithstanding these obstacles, transactions will continue to get done. In particular, due to the economic downturn, many companies will be conducting strategic reviews, potentially leading to divestments and carve-outs that could be snapped up by financial sponsors. Meanwhile, start-ups that are feeling the cash crunch could be forced to sell in a bid to protect the future of the business. Overall, the private M&A market may suffer less in a downturn than public M&A, given that private companies are less exposed than public companies to retail investor market skepticism and have greater access to quick and nontraditional financing. While transaction terms are likely to become more complex, deals will continue to flow.

(For perspective on China M&A, see "Focus of China Cross-Border M&A Turns to Government-Favored Sectors and Away From West.")

Focus of China Cross-Border M&A Turns to Government-Favored Sectors and Away From West

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Key Points

- Buyers are fine-tuning their strategies to focus on sectors perceived to be favored by Chinese government policy, such as industrials, technology and health care.
- Chinese buyers have begun to turn their attention away from Western companies toward those in Asia and the Middle East, partly due to an increasingly unfriendly regulatory environment in the West.
- Chinese competition law and new data privacy protections are complicating deals and might deter some.
- As in Europe and North America, financial buyers are sitting on large sums of dry powder, which may find its way into transactions.

China's cross-border M&A market continued to face strong headwinds in 2022, with a slowing economy and new COVID-19 restrictions weighing on the market. There have been fewer outbound and inbound transactions, with total deal value at a multiyear low, and financial buyers accounting for a sizable portion of that value. And volatile public equity prices and increasing regulatory scrutiny of sectors such as technology, internet, critical resources, gaming and education have led to fewer megadeals.

Buyers have also become more selective, gravitating toward acquisitions in the energy, technology, health care, industrial and consumer sectors. Notable megadeals, such as the $15.5 billion acquisition of Aramco Gas Pipelines Company by an investor group that included China Merchants Capital and the Silk Road Fund, demonstrate the state-owned enterprises' emphasis on strategically important sectors.

Furthermore, while the U.S. and other Western countries generally remain attractive destinations for certain outbound investments, Chinese buyers have been pivoting more resources and attention toward Asia and the Middle East, especially ASEAN (Association of Southeast Asian Nations) countries, partly due to an increasingly unfriendly regulatory environment in the West. For example, Canadian and British governments recently ordered several Chinese firms to exit their investments in lithium mining and microchip companies, citing national security concerns.

Investing in Favored Sectors

A prominent theme for market participants is investment decisions informed by the Chinese government's policy initiatives. With an economic downcycle looming, buyers are fine-tuning their acquisition strategies toward sectors such as industrials, technology and health care. Financial buyers under pressure to deploy capital may capture buying opportunities within these favored sectors and take advantage of beneficial government policies as well as softening valuation.

> Buyers have become more selective, gravitating toward acquisitions in the energy, technology, health care, industrial and consumer sectors.

U.S.-listed SPACs have been active in acquiring China-based targets in the technology, clean energy vehicle and digital health care sectors. The large number of SPACs still searching for acquisition targets suggests that this source of M&A deal activity could continue, at least until existing SPACs reach the end of their life cycles.

Regulatory Trends Affecting China M&A

Myriad merger-related regulations, including those on data privacy, competition and national security, bring both challenges and opportunities to M&A in China.

Data privacy. Critical legal frameworks on cross-border data protection, such as the recently implemented Cybersecurity Law, Data Security Law and Personal Information Protection Law, regulate how companies collect and transfer data across borders. As a result, data compliance by target enterprises is becoming a prominent factor affecting a transaction's valuation, deal structure and certainty.

Competition. China's Anti-Monopoly Law, meanwhile, has forestalled large companies from pursuing acquisition opportunities and dampened strategic M&A in the technology sector. This has opened the door for private equity firms and venture capital funds to approach technology targets. Strategic buyers are also seeking alternative ways to enter sectors heavily scrutinized by the anti-monopoly regime, such as through early stage investments in targets. (See "Demystifying China's Merger Review Process.")

National security reviews. In addition, opaque and unpredictable national security review processes under both Chinese and U.S. law have made cross-border M&A transactions in strategically critical sectors difficult.

In light of pre-closing regulatory filings and reviews, parties in inbound and outbound M&A transactions need to plan for longer deal timelines.

External Factors and Outlook

China's forceful measures to combat the COVID-19 pandemic and the country's economic slowdown due in part to those measures will continue to affect market sentiment for cross-border M&A. As future COVID-19 quarantine policies and travel restrictions have not been clearly declared, market uncertainty will remain high, hindering M&A deal activity. Nonetheless, pressure to deploy the record level of dry powder held by financial sponsors will likely support M&A dealmaking, especially if asset valuations continue to soften.

New opportunities may also arise as the Chinese government continues to institute market-stimulating policies in certain sectors. In addition, some multinational companies reassessing their existing presence in China may pursue divestment, spin-off or joint venture opportunities.

A contentious global geopolitical landscape characterized by competition between the U.S. and China will continue to influence M&A deal flow. For example, the latest U.S. export controls on semiconductors to China cast further doubt on the political and economic viability of private sector collaboration between the two countries. This does not, however, necessarily imply depressed cross-border M&A activity overall.

Buyers and targets from China shunning U.S.-connected deals will prioritize M&A opportunities in Asia, and alternatives to change-of-control transactions — such as minority investments and joint ventures that attract less regulatory scrutiny — may provide strategic alternatives.

(For perspective on the U.S. and U.K. markets, see "US M&A Levels Remain Healthy, but Due Diligence and Deal Protections Will Become Even More Critical" and "The Widely Forecast Recession in the UK Will Likely Reshape M&A," respectively.)

A Playbook for Borrowers Facing Economic and Debt Market Pressures

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Key Points

- Common borrower-friendly terms in loans and bond indentures can provide struggling companies with a number of options to extend their runway in a distressed environment.
- Options include swapping existing debt for new loans or bonds with higher payments or lien priorities, transferring assets to subsidiaries that can borrow freely, and buying existing debt at a discount to reduce a company's leverage and interest cost.
- Winning support from creditors can be difficult, and holdouts can complicate the process.

The U.S. capital markets have experienced significant volatility since the arrival of COVID-19. After lockdowns resulted in a short recession in early 2020, the markets reopened in booming fashion, with M&A, equity and debt issuances reaching record levels from mid-2020 through 2021. The pace then abruptly slowed in 2022, with high inflation and rising interest rates. New debt issuances fell and IPO markets ground to a virtual halt.

While nontraditional sources of capital are expected to fill a portion of the lending gap (private credit funds are estimated to have $150 billion in dry powder), capital costs are likely to continue to climb, and debt terms are expected to become less borrower-friendly.

If this trend continues and the economy transitions into a recession, borrowers will need to maximize optionality by accessing additional funding and addressing obstacles such as shrinking profits and impending maturities. Lenders and bondholders, meanwhile, will try to assert themselves to ensure repayment, to the extent that they have rights under covenant-lite and permissive debt documents that impose few restrictions on borrowers.

Below, we outline key items and issues for companies and their boards and management to consider in the event the economic environment gets worse before it improves.

Liquidity and Business Plan Scenarios

Having access to sufficient cash reserves expands a company's ability to weather recessionary pressures and preserves optionality for restructuring or acquisition transactions. Before the onset of a potential economic downturn, companies should examine their business plans and potential sources of capital to maximize liquidity and anticipate legal issues they may face if economic headwinds persist. Planning well in advance (*i.e.*, several months before a debt becomes due for repayment) is important so that companies can avoid losing out on certain options, as each takes time to implement.

Representation and Warranty 'Bringdowns'

In tightening credit markets, borrowers should evaluate their ability to access undrawn credit lines. Lenders that previously were accommodating may resist a draw request if they perceive that the borrower is headed toward a default. Revolving credit facilities typically include a "bringdown" condition to borrowing, requiring the borrower to reaffirm all the representations and warranties it made when the loan was extended, in addition to there being no default. For borrowers in a distressed or deteriorating financial situation, lenders may cite the solvency and no "material adverse change" representations as reasons to resist funding the revolver draw. For the solvency representation, the borrower typically represents that it and its subsidiaries are solvent on a consolidated basis. For the no "material adverse change" representation, the borrower typically represents that there has been no material adverse change in its business, assets, operations or condition — financial or otherwise — since a certain date (usually the most recent fiscal year end date prior to the effectiveness of the credit agreement).

Borrowers weighing a drawdown of their credit line should closely examine the representations and warranties in their credit agreements and make sure those continue to remain accurate.

Financial Covenant Compliance and EBITDA Add-Backs

Before accessing additional debt, borrowers need to assess whether they are in compliance with any required financial maintenance covenants (which may include maximum leverage, minimum coverage and liquidity). Leverage-based covenants are the most common and are generally tested at the end of each fiscal quarter to the extent there are any revolving loans outstanding or, in some cases, when a certain percentage of revolving commitments has been utilized. Borrowers will need to make sure that they have a sufficient cushion to satisfy the covenants, taking into account both changes in EBITDA (earnings before interest, taxes, depreciation and amortization) and the debt component of the leverage calculation.

Many credit agreements allow myriad borrower-friendly "add-backs" that can result in a higher EBITDA for covenant purposes than would be calculated using GAAP (generally accepted accounting principles) measures alone. In addition, leverage ratios are often calculated on a "net" basis, allowing all or a portion of a borrower's unrestricted cash to be subtracted from the amount of debt. Borrowers should review their credit agreements and cash positions to take maximum advantage of these favorable provisions if they appear in their agreements when calculating their leverage ratios.

> Having access to sufficient cash reserves expands a company's ability to weather recessionary pressures and preserves optionality for restructuring or acquisition transactions.

While debt-related covenants for bonds are typically measured only at the time the company seeks to take on new debt and do not require maintenance of specified ratios or the bringdown of representations and warranties over the lifetime of the bond, issuers should carefully assess any bond terms that could affect debt exchanges or buybacks, such as debt incurrence or restricted payment covenants. Often the timing and structure of such transactions is impacted by the release of the issuer's financial statements, which may determine whether such covenants are satisfied.

Liability Management and Other Liquidity-Enhancing Techniques

In addition to maintaining ample cash, companies with leveraged balance sheets may find opportunities to explore holistic capital structure solutions during a downturn. They may have multiple means to deal with looming maturities and to right-size their capital structures.

Uptier Exchanges and Unrestricted Subsidiary Transactions

Borrowers may consider a so-called "uptier" exchange, in which a portion of existing secured or unsecured debt is exchanged for new "superpriority" debt. Uptier transactions allow borrowers to issue new debt or exchange existing debt to access additional liquidity or address impending maturities. These transactions can also be attractive to participating lenders, as they usually offer improved terms for lenders, enhanced priority and sometimes premiums on the debt being exchanged.

Companies may also look to their subsidiaries that are not subject to covenants under the loan documents. In recent years, for example, some borrowers have taken advantage of standard credit document "baskets" to transfer assets to unrestricted subsidiaries, increasing the amount of debt those entities can support. Other borrowers have designated existing asset-owning subsidiaries as unrestricted pursuant to the applicable credit documents.

These types of transactions can lead to litigation, however. Lenders may allege that an asset transfer was actually or constructively fraudulent, or did not comply with the applicable credit documents. In response to several high-profile cases involving the use of unrestricted subsidiaries, including a transaction by the retailer J. Crew, some recent credit agreements and indentures limit a borrower's ability to transfer material assets outside of the credit group covered in the loan documents. Similarly, as a result of the Serta transaction in 2020, where the company repurchased existing debt for new superpriority loans, some recent credit agreements now require unanimous lender consent with respect to any subordination of existing debt or any changes in waterfall provisions. However, such provisions are not yet widespread, and most earlier agreements do not include such restrictions and protections.

The consent needed to amend a credit agreement (unanimous versus majority) can have a significant impact on the ability to complete an uptier exchange or an unrestricted subsidiary transaction. For example, while a borrower typically only needs "required lender" consent (*i.e.*, consent of lenders holding more than 50% of commitments and loans) to amend existing loan documents, certain changes — such as modification of principal and interest rates, extensions of maturity and amendments to pro rata sharing provisions — are typically treated as "sacred rights" requiring unanimous lender consent. As a result of companies using the flexibility in their agreements to do uptier transactions with only required lender consent, certain recent credit agreements now limit the ability of borrowers to undertake such uptier transactions by requiring unanimous consent, and borrowers need to be cognizant of the consent thresholds required in their specific agreement.

> Uptier transactions allow borrowers to issue new debt or exchange existing debt to access additional liquidity or address impending maturities.

In bond transactions, exchanges are often structured as exchange offers to comply with securities laws and are coupled with an "exit consent" that allows participating bondholders to simultaneously provide a consent to amendments to the existing bond documents that would bind any nonparticipating bondholders, further incentivizing participation. Like credit agreements, however, certain "sacred rights" require unanimous bondholder consent.

Debt Repurchases/Buybacks

Companies with sufficient liquidity may consider repurchasing debt to reduce leverage and interest expense, and potentially to capture discounts in debt trading prices. Many credit agreements permit borrowers to repurchase debt through open market purchases or a Dutch auction, but open market purchases of bonds may be limited by securities laws regulating tender offers. Borrowers should also be aware that the meanings of "open market purchase" and "Dutch auction" have been the subject of recent litigation. They also will need to weigh the risk of a ratings downgrade if the repurchase price is so low that it is considered a "distressed exchange." Repurchases below par may also result in the company realizing taxable cancellation-of-indebtedness income.

Legal Considerations

Minority lenders and bondholders who opt not to participate in the liability management transactions described above increasingly resort to litigation against borrowers and participating creditors. (This has given rise to the term "lender-on-lender violence.") In several cases in recent years, nonparticipating creditors challenged uptier transactions, alleging that they constituted breaches of contract and violations of the implied covenant of good faith and fair dealing. A number of those suits survived motions to dismiss, creating the prospect of protracted litigation that effectively ensured the plaintiffs a seat at the table.

Given these dynamics, borrowers considering these types of transactions should combine a transactional legal review with a litigation strategy. Having a strong record demonstrating why a particular transaction complies with applicable credit documents can help lessen the likelihood of litigation and increase the chances of winning dismissal should a complaint be filed.

Practical Considerations

In addition to potential legal hurdles, there are important practical factors to consider in evaluating a strategic transaction.

Debt terms are expected to become more lender-friendly. It is important for borrowers to evaluate potential changes to debt market dynamics — in particular, the risk that debt will become more expensive and that lenders and bond investors will push for lender-friendly credit terms, especially in exchange transactions. It is therefore important for borrowers to establish competitive processes to obtain the best possible terms.

Know your creditors. Another important consideration when structuring strategic transactions is the identity of the creditor base, and any institutional or contractual limitations. Some financing vehicles such as collateralized loan obligations (CLOs) may be prohibited by their terms from receiving certain types of debt or equity instruments. Other institutions may not be strictly barred from receiving certain consideration, but they may have a strong preference for either cash, debt or equity. Understanding these dynamics enables borrowers and issuers to maximize negotiating potential.

Strong nondisclosure agreements with potential transaction partners are also important because, if news of a prospective transaction leaks, some lenders might seek to block it. Borrowers should also be aware that cooperation agreements among lenders are becoming more prevalent. They can establish required lender blocks to protect lenders from transactions that freeze some of them out.

Addressing Bond Maturities

Companies with outstanding bond debt face an additional layer of complexity because, in many cases, they must negotiate refinancings or exchange transactions with a highly dispersed creditor base, particularly if there are retail holders. Seeking consents in such cases can be extremely burdensome and costly as well as time-consuming, and issuers are frequently forced to negotiate with holders of relatively small positions — often distressed debt investors who purchase bonds at heavily discounted prices with a view toward short-term gains.

Exchanges. Traditional tools such as bond tenders and exchanges generally are available to issuers facing maturities. However, these transactions may take substantial time to negotiate and document, and many tender offers for bonds must remain open for at least 20 business days. Additionally, bondholders may face restrictions on trading for a lengthy period during the negotiation, and it is imperative to properly time the request for restriction to avoid the need for public disclosures before a transaction can be announced.

In light of these constraints, some issuers have turned to private transactions to address pending maturities. But these require a careful review of the indenture's consent provisions and applicable securities laws.

Staple Chapter 11 pre-packs. Even in exchange transactions that enjoy strong support from the holder base, some bondholders may hold out and not participate in the transaction simply to try to extract additional value from the issuer. In these instances, issuers might consider the "staple Chapter 11 pre-pack" — a consent solicitation distributed to bondholders along with a pre-packaged Chapter 11 bankruptcy plan. Holders that participate in the exchange also vote in favor of the pre-packaged plan.

If acceptances exceed a specified threshold (usually above 90% of outstanding bonds), the borrower closes the exchange, and the Chapter 11 plan is disregarded. If the issuer fails to reach its threshold but receives the participation of over 67% of the issuance, it can opt for an expeditious pre-packaged bankruptcy, using the votes of the participating holders to bind holdouts. Often the staple pre-pack, and the pre-negotiated support of over 67% of the holders, is enough to dissuade them. And if not, the Chapter 11 case can still be completed within a short period of time (one to 60 days, depending on the facts and circumstances).

In Sum

Years of generous credit terms have left many companies with flexibility to adjust their debt structures should they find themselves under financial stress. However, creditors may resort to litigation if they believe a borrower is sidestepping minority creditors' legal protections and jeopardizing those creditors' security or priority. Borrowers also need to consider that, in a tightening credit market, lenders and bondholders may insist on greater protections in any new debt that is extended or when asked to consent to amendments or refinancing of existing debt.

(See also "UK-Listed Issuers Under Financial Stress Gain Latitude in Secondary Capital Raisings" and "HKEX Initiatives Present Opportunities Even in a Down Market.")

UK-Listed Issuers Under Financial Stress Gain Latitude in Secondary Capital Raisings

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Key Points

- Updated guidelines allow London-listed issuers to raise up to 20% new capital on a non-preemptive basis, which may be used to strengthen their working capital position.
- Issuers nonetheless need to approach non-preemptive offerings with sensitivity, given the dilutive effect for existing shareholders.
- Close attention must be given to the substance and timing of disclosures to the market, particularly when an issuer is in financial difficulty.

As the U.K. faces what the Bank of England recently described as "very challenging" times, with the possibility of the U.K.'s "longest recession since records began," issuers listed on the London Stock Exchange should pay close attention to updated guidance on secondary capital raisings as well as disclosure and governance considerations.

Capital Raisings

In the aftermath of the 2007-09 global financial crisis and during the COVID-19 pandemic, many listed issuers sought to shore up their balance sheets through secondary capital raisings. As we confront a possible economic downturn in 2023, issuers considering raising funds to meet their working capital needs through the secondary capital markets should carefully consider new rules related to the U.K. preemption rights regime.

What are preemption rights? Preemption rights give existing shareholders the right of first refusal on the issuance of new shares. This is considered an important safeguard to protect existing shareholders against dilution. The U.K.'s Pre-Emption Group, representing a range of listed issuers, investors and intermediaries, is responsible for setting recommendations. While not legally binding, the recommendations are generally followed by the market.

Revised guidance. The recommendations were updated in November 2022 following the U.K. Treasury's UK Secondary Capital Raising Review, which was published in July 2022. (See our *2022 Insights* article "Wide-Ranging Reforms of UK Capital Markets: A Watershed Moment?") In line with the latitude the Pre-Emption Group offered at the height of the COVID-19 pandemic, the revised recommendations generally allow for the annual disapplication of preemption rights up to a limit of 20% of a company's issued share capital (double the previous 10% threshold), consisting of: (i) 10% of the company's issued share capital on an unrestricted basis, and (ii) 10% for an acquisition or specified capital investment.

The Pre-Emption Group suggests a number of actions an issuer should consider taking as part of a non-preemptive offer, including making the issue on a "soft preemptive" basis. Soft preemption (in the context of a placing of shares) is where the bookrunner allocates shares to investors in accordance with a policy that seeks to preserve the principle of preemption so far as is practical, to replicate the existing shareholder base (recognizing that not all shareholders will be able to participate).

> The revised recommendations generally allow for the annual disapplication of preemption rights up to a limit of 20% of a company's issued share capital.

For each 10% limb, companies can seek authority to disapply preemption rights for up to an additional 2% of a company's issued share capital as a "follow-on offer" to retail shareholders and other investors who were not allocated shares in the soft preemptive issue. This should meet the objective of encouraging retail participation in non-preemptive offers and further guard against the dilutive effect and price impact of a discounted offer.

(For perspective on secondary capital offerings in the Hong Kong market, see "HKEX Initiatives Present Opportunities Even in a Down Market.")

Disclosure of Information

Disclosures become a particular focus of regulators and investors during periods of economic stress. On an ongoing basis, listed issuers must pay particular attention to making timely and accurate disclosures. Under the U.K. Listing Rules, an issuer is required to take reasonable steps to establish and maintain adequate procedures, systems and controls to enable it to comply with its continuing obligations, which includes its disclosure requirements and corporate governance infrastructure. In addition, the Listing Rules require a premium listed issuer (which meets the exchange's most stringent standards) to act with integrity toward its shareholders and prospective shareholders.

A true picture of an issuer's position. An issuer must take reasonable care to ensure that disclosures to the market are not misleading, false or deceptive and do not omit anything likely to affect the import of the information. With an uncertain economic outlook, disclosures to the market (whether periodic or *ad hoc*) must reflect a true picture of an issuer's trading position (*i.e.*, its financial and operational status).

It is imperative that an issuer's personnel avoid adopting aggressive accounting policies to overstate the company's financial performance. Warning signs from internal financial reports highlighting disparities between actual revenues and those reflected in budgeted forecasts or reports of material financial risks and exposures should be escalated to the board and audit committee. Boards and senior management should challenge forecasts and ensure that market expectations are managed in light of pressures on profit margins caused by higher costs in supply chains.

Disclosures of inside information must be made as soon as possible, unless there are recognized grounds for delay, which can include a delay to protect the legitimate interests of the issuer. The U.K. Financial Conduct Authority has stated that a company should not delay disclosure of:

- the fact that it is in financial difficulty or of its deteriorating financial condition (a permitted delay would only relate to the fact or substance of the negotiations to deal with such a situation); or
- information about its financial condition on the basis that its position in subsequent negotiations to deal with the situation (such as in respect of a rescue refinancing) will be jeopardized.

Companies experiencing financial difficulties that are uncertain about what information to disclose or when should consult their professional advisers. Companies should avoid adopting a wait-and-see approach, hoping for a recovery in financial performance or other offsetting news before updating the market.

(For a discussion of directors' duties when a company is in financial difficulty, see "How Directors Can Manage the UK Supreme Court's 'Balancing Exercise' in Difficult Times.")

In Sum

The board of directors and senior management team have primary responsibility for safeguarding the company's assets for and on behalf of shareholders. Non-executive directors have a particular role in the oversight of the executive management team, being one step removed from the operations of the business.

(See also "A Playbook for Borrowers Facing Economic and Debt Market Pressures.")

HKEX Initiatives Present Opportunities Even in a Down Market

Contributing Partner

Paloma Wang / Hong Kong

Key Points

- HKEX has modified its rules to make it easier for companies to have dual primary and secondary listings.
- SPAC listings have been allowed for the first time, with rigorous requirements, and start-ups pursuing specified "specialist technologies" will be able to list even if they have little or no revenue.
- Listed companies seeking new capital can issue up to 20% new stock without offering preemptive rights, while companies are allowed to repurchase up to 10% of their outstanding stock — an option for those with solid balance sheets.
- Rules put in place after the 2008 financial crisis place limits on highly dilutive and deeply discounted capital raisings.

Like other global financial centers, Hong Kong has seen falling IPO volumes and volatile markets in 2022 in the face of challenging macroeconomic conditions and rising geopolitical tensions, including between China and the U.S. But several new initiatives by the Hong Kong stock exchange (HKEX) intend to make it more attractive and competitive for issuers. The exchange also allows capital management strategies such as secondary capital raisings and share repurchases — options companies may want to consider, depending on their financial circumstances.

More Options for Listing in Hong Kong

In the face of increasing competition from other regional exchanges, HKEX has introduced a number of measures over the past year to attract more listings.

These initiatives have included rule changes to facilitate the following:

Secondary and dual primary listings by Greater China and overseas issuers. HKEX has amended its listing rules to permit any overseas company, including a Greater China issuer, to undertake a secondary listing on HKEX, subject to meeting certain minimum market capitalization requirements. (Previously, to be accepted for listing, Greater China issuers — broadly, companies with their main business, operations, assets and/or place of central management and control in Greater China — were required to make Hong Kong their primary listing venue.) In addition, companies that are either non-Greater China companies, or Greater China companies listed on the New York or London stock exchanges prior to December 2017, may apply for a dual primary listing in Hong Kong even where their dual-class share structure or variable interest entity arrangements do not comply with HKEX requirements.

SPACs. Following similar initiatives in a number of other global markets, including HKEX's traditional regional rival Singapore, HKEX in 2022 introduced a new regime permitting SPAC listings and setting out requirements for de-SPAC transactions (mergers of SPACs with operating companies). The rules set a high bar, including a "professional investors only" requirement, rigorous eligibility criteria for SPAC promoters and a requirement to ring-fence 100% of IPO proceeds with full pro rata redemption rights offered to investors if no de-SPAC transaction is completed, or for investors wishing to redeem rather than participate in the de-SPAC transaction. HKEX treats de-SPAC transactions as new listing applications, with the same procedural and documentary requirements as a regular IPO, and it requires a substantial

PIPE (private investment in public equity) deal to be undertaken simultaneous with the de-SPAC transaction. To date, four SPACs have successfully listed on HKEX, though none have announced a de-SPAC transaction.

> HKEX in 2022 introduced a new regime permitting SPAC listings and setting out requirements for de-SPAC transactions.

Listing of "specialist technology companies," including pre-commercial companies. In its latest initiative, HKEX proposes to permit the listing of companies engaged in certain specified "specialist technology" sectors, including next-generation information technology, advanced hardware, advanced materials, new energy and environmental protection, and new food and agriculture technologies. HKEX proposes to allow listings by both (i) companies that have already reached commercialization with recorded revenue and (ii) pre-revenue, pre-commercial companies, subject to a number of requirements, including minimum market capitalization and pre-IPO investments from sophisticated investors. This initiative is currently undergoing market consultation, with the new rules expected to be finalized in early 2023.

Capital Management

Capital raisings. Should economic pressures prompt companies to shore up their balance sheets through capital raisings by way of rights issuances to existing shareholders or through private placements to institutional investors, they will need to bear in mind HKEX rules that restrict highly dilutive and deeply discounted capital raisings. These rules were introduced recently and were not in place during the 2008 financial crisis and its aftermath, when many companies raised new capital in the secondary market.

While deeply discounted issues can be a legitimate means for companies to raise capital, HKEX had observed some companies taking advantage of this tool at the expense of excessive dilution to minority shareholders. As a result, HKEX now prohibits any capital raising — including by way of rights to existing shareholders — at a discount, on a fully diluted post-issuance basis, of 25% or more to the market price. Companies in genuine financial distress may apply for a waiver from this rule.

HKEX rules also permit companies to issue up to 20% of new stock on a non-preemptive basis at a discount of not more than 20% to the market price, provided the board has obtained a "general mandate" from shareholders at the most recent annual general meeting to make such issuances. (Meanwhile, in the U.K., updated guidelines also allow issuers listed there to raise up to 20% new capital on a non-preemptive basis. For a discussion of secondary equity offerings in the U.K., see "UK-Listed Issuers Under Financial Stress Gain Latitude in Secondary Capital Raisings.")

Share repurchases. While some companies may seek to raise new capital, with pressure on valuations, many HKEX-listed companies are seeing an opportunity to expend capital to repurchase their own shares. In addition to being a means for companies to return value to shareholders, on-market repurchases help support a share price that management believes does not reflect the true underlying value of the company.

HKEX rules permit on-market repurchases of up to 10% of existing issued share capital, provided a company has obtained a "repurchase mandate" from shareholders at its annual general meeting. Repurchases must be made at prices not more than 5% above the average closing price for the five preceding trading days. No new issues of shares are permitted within 30 days of any repurchase. By contrast, off-market purchases in Hong Kong require prior approval of shareholders.

In Sum

While the current economic climate poses challenges, Hong Kong — as the premier international financial market for the Greater China region — continues to present attractive opportunities for companies and investors. HKEX and Hong Kong's regulators have also implemented policies to ensure those opportunities continue through the market cycle.

(See also "A Playbook for Borrowers Facing Economic and Debt Market Pressures.")

Reductions in Force: Legal Do's and Don'ts

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Key Points

- Reductions in force can be accomplished through voluntary employment terminations (such as offering early retirement incentives), involuntary terminations or both. They should be designed and implemented in a nondiscriminatory and nonretaliatory manner.
- Employers should review severance pay policies as well as incentive and equity compensation plans and arrangements. If a severance plan is not already in place, consider implementing one.
- A WARN Act (or similar state law) analysis will determine whether advance notice of employment termination is required.
- Assess whether a RIF must be disclosed on an SEC Form 8-K, and assess the impact on key employees and stakeholders.

Reductions in force (RIFs) are making headlines as companies trim their worker ranks in the face of a weakening economy. Employers must decide whether to implement voluntary or involuntary RIFs (or both); the considerations for each vary greatly. We take a high-level look at the options, next steps and other considerations for companies anticipating downsizing.

Option 1: Voluntary RIFs

Voluntary RIFs include offering current employees severance pay or "buyout" programs, early retirement packages, job sharing agreements and/or reduced workweeks. If the employee does not voluntarily agree to accept the offer, he or she can continue working, unless the employer also conducts an involuntary RIF.

Why voluntary RIFs? These types of reductions may make it easier for employers to obtain releases of claims from employees in return for separation payments or benefits they would not be entitled to otherwise.

What releases of claims entail. To be valid, an employee release of claims must be (among other things):

- supported by legal consideration (*i.e.*, a payment or benefit to which an employee is not otherwise entitled);
- consented to "knowingly and voluntarily"; and
- written in a manner that can be understood by the individual waiving his or her rights or claims, or by the average individual eligible to participate in an "exit incentive" or employment termination program.

To effectively release age discrimination claims for employees age 40 and older, the waiver must also:

- specifically refer to rights or claims arising under the Age Discrimination in Employment Act of 1967 (ADEA) (discussed in detail below); and
- include any requirements under the Older Workers Benefit Protection Act, such as a 21-day or 45-day consideration period, coupled with a seven-day revocation period.

Option 2: Involuntary RIFs

An involuntary RIF is designed on the basis of a variety of criteria, such as seniority, job performance, position eliminations or closings of entire operations.

Seniority. RIFs based on seniority are likely straightforward. However, this approach does not consider individual employee qualifications and post-RIF staffing requirements.

Position eliminations. An employer should be prepared to demonstrate:

- the legitimate business reasons for a position elimination;
- that any new positions differ substantially from former ones; and
- that employee qualifications for new or existing alternative positions were assessed objectively.

Closing entire plants or departments. It is more difficult to challenge a RIF conducted in this manner because elimination of entire plants or departments is generally an objective process. An employer should:

- ensure that its business justification for the closing is well documented;
- if duplicative departments are to be combined:
  - consider whether employees have any transfer or "bumping" rights — which would allow otherwise laid-off workers to displace other employees — under established past practices, personnel policies or collective bargaining agreements, and
  - where such rights do exist, ensure that the transfers are offered to employees on a nondiscriminatory and nonretaliatory basis; and
- where a facility or department has a relatively greater number of protected classes of employees in the organization, consider whether the closure could lead to an adverse inference of unlawful discrimination.

As with a voluntary RIF, employers can opt to seek releases of claims from employees in connection with an involuntary RIF in return for separation payments or benefits that employees would not be entitled to otherwise.

Other Important Steps in a RIF

Review severance pay policies — written or established by past practice — to determine whether employees affected by the proposed RIF would be entitled to any severance pay. Companies should consider implementing a severance plan if they do not have one. A severance plan can be implemented for the RIF only.

Review incentive and equity compensation plans and arrangements to determine the impact of a proposed RIF on outstanding equity compensation awards and bonus entitlements.

Design and implement RIFs in a nondiscriminatory manner. Proscribed factors, such as age, race, color, sex, religion, national origin or disability, should not be factors.

A RIF may be perceived as a violation of the following or other anti-discrimination laws if certain protected categories are intentionally or disproportionately impacted:

- Title VII of the Civil Rights Act of 1964 prohibits discrimination on the basis of race, color, sex, religion or national origin.
- The Age Discrimination in Employment Act prohibits discrimination on the basis of age for individuals who are age 40 or older.
- The Americans With Disabilities Act of 1990 (ADA) extends anti-discrimination protections to disabled persons.

Design and implement RIF programs in a nonretaliatory manner, without regard to prior employee complaints.

Provide notice under the WARN Act, if applicable. The federal Worker Adjustment and Retraining Notification Act of 1988 requires certain employers to give employees, their representatives and local officials 60 days' notice of "plant closings" and "mass layoffs." If notice is not provided, employers are subject to civil penalties and may owe employees up to 60 days' pay and benefits in lieu of notice.

The WARN Act defines:

- a "plant closing" as a permanent or temporary shutdown — of either an entire site of employment, or one or more facilities or operating units within a single facility — if the shutdown results in employment loss for 50 or more employees during any 30-day period; and
- a "mass layoff" as a RIF resulting in an employment loss at a single site of employment during any 30-day period of at least (i) 50 employees and 33% of the employees at the site, or (ii) 500 employees at the site.

State-specific WARN Acts may also be triggered by a RIF.

Additional Considerations

Maintain a solid record to demonstrate the rationale and objective criteria used in determining which employees to lay off. Performance-based termination decisions are more likely to withstand scrutiny under equal employment opportunity laws if they are supported by well-documented personnel records and based on sufficiently objective criteria.

One possible means of decreasing the likelihood of discriminatory decision-making is to **establish a committee of legal staff, human resources officials or other representatives** to assess managers' initial selection of employees for a RIF.

Consider whether any employees are on a **legally protected leave of absence**, including under the Family and Medical Leave Act, and any related job reinstatement and anti-interference rights.

Assess the **impact of a RIF on remaining employees** and any retention programs for key employees, and **on relationships with vendors, customers, clients and other stakeholders**. Prepare a communication plan and/or public relations strategy.

Have a plan regarding remaining employees, customers and stakeholders. Public company employers should assess whether a Form 8-K disclosure with the Securities and Exchange Commission is required.

Provide impacted employees with documents including any notices, final pay, and separation and release agreements.

Consider meeting individually with each affected employee (although not legally required) to explain the reason for termination, present the separation documents noted above, and discuss the return of any company property and other administrative tasks ahead of departure.

How Directors Can Manage the UK Supreme Court's 'Balancing Exercise' in Difficult Times

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Key Points

- Under a recent U.K. Supreme Court decision, directors may be required to consider the interests of creditors as well as those of shareholders if their company is nearing insolvency.
- To fulfill their fiduciary duties at a company in financial distress, directors should rigorously assess risks to the business, and they may need to hold more frequent board meetings.
- Thorough documentation of the board's efforts is essential in case the company's position deteriorates and the board's actions are later questioned.
- Above all, directors must be scrupulous about avoiding conflicts of interest and adhere to decision-making formalities.

Economic downturns can put both companies and their boards to the test. An important judgment from the U.K. Supreme Court in October 2022, the *Sequana* case,[1] clarifies the obligations of directors of a company facing the possibility of insolvent liquidation or administration, a condition sometimes referred to as the "zone of insolvency."

The Supreme Court confirmed that, in those circumstances, directors must assess the interests of both the companies' shareholders and creditors generally and, to the extent those interests conflict, the directors must undertake a "balancing exercise." In some circumstances, the directors may even be required to treat shareholders' interests as subordinate to those of the creditors. Much will depend on whether a course of action proposed by the directors was likely to "lead the company away from threatened insolvency, or back out of actual insolvency."

(In contrast, under Delaware law, which governs most publicly traded U.S. companies, directors owe fiduciary duties solely to the corporation and its stockholders, and that duty is never modified to include creditors' interests, even as the corporation approaches the zone of insolvency and after it becomes insolvent. Once a Delaware corporation is insolvent, however, its creditors, as the residual stakeholders of the corporation, do have standing to bring derivative claims against directors on behalf of the corporation to enforce the fiduciary duties the directors owe to the corporation.)

> *Sequana* clarifies the obligations of directors of a company facing the possibility of insolvent liquidation or administration.

Under English law, as under Delaware corporate law, courts do not second-guess disinterested directors' decisions made in good faith or demand that every commercial decision such directors make results in a positive outcome. Unless it is shown that the directors lacked good faith, were self-interested or failed to follow a proper process, courts will nearly always defer to directors' business judgment.

Best Practices

There are concrete steps directors can take to navigate an uncertain environment, achieve the balance the *Sequana* judgment spoke of and protect themselves against criticism in the event of a later failure.

1 *BTI 2014 LLC v Sequana SA [2022] UKSC 25.* Skadden represented Sequana SA and the former directors of one of its subsidiaries, AWA, in this case.

Assess risks. Directors should undertake regular reviews of the risks the company faces (including with assistance from professional advisers, as discussed below). These reviews should encompass legal and regulatory issues as well as commercial risks. Questions to ask include:

- Are there parts of the business that are likely to encounter increased regulation, and what impact could that have?
- Is the business overly reliant on a specific customer or supplier? If so, what are the contingency plans if that commercial counterparty is taken over or shuts down?
- Is the company overly reliant on a particular group of employees? What are the plans to retain them, or the contingency plans if they leave?
- Is the business dependent on a particular product? If so, is it coming to the end of its product life, and what are the plans to replace it?
- What happens if the territory in which a business partner is based becomes a pariah state?

When a company's operations encounter challenges, an additional set of questions focused on the financials should be raised:

- What is the company's liquidity position?
- If cash reserves were to be depleted (or its working capital requirements increased, for example, due to changes in customer or supplier payment terms or as a seasonal variation in the cashflows), what credit facilities are available to the company to allow it to continue to trade?
- Are those facilities subject to imminent termination or suspension? If so, does it make sense to draw down existing facilities now, while still available?
- What are the company's short-term and long-term liabilities, and what provisions are in place for the company to meet them as they fall due?

Directors are not expected to make risks disappear, but they are expected to assess the risks that exist, and, to the extent possible, make plans to address them.

Hold regular meetings. Typically, board meetings are held six to 10 times per year. At these sessions, management is expected to present updates on operations and take questions on financial performance. It is important for meetings to be held regularly, with detailed board packs so that directors have access to the best available information. If meetings are only quarterly, or if they are not well attended or board packs are not sufficiently detailed, directors put themselves at risk of being criticized for not closely monitoring the company's financial health.

When a company enters financial stress, it may be appropriate for the board to convene more often, and directors should be prepared to commit more time. Weekly, or even daily, board meetings may be necessary to allow directors to receive real-time updates and to give management appropriate guidance. Expectations are different for executive and nonexecutive directors but, when the company faces difficulties, nonexecutives are expected to devote more time to their role and to challenge the executive team more closely.

Keep diligent records. When a company enters a formal insolvency process, an investigation of past decisions will start with a review of its books and records. Although additional paperwork may be unwelcome at a time of financial distress, to protect directors, it is essential that detailed papers are formally presented at board meetings and that fulsome board minutes of discussions are taken (including, within reason, the range of differing views around the board table). It is important that the minutes accurately reflect the actual position of the company and are not contradicted by internal correspondence and documentation, which is also likely to be reviewed.

A full record should demonstrate that directors sought the best available information, made an assessment of the options available and chose a particular option with good reason. Where such a record exists, it will be much harder to assert that directors neglected their duties or acted in bad faith.

Focus on probity. Matters such as conflicts of interest and formal decision-making processes gain heightened importance after a company enters into an insolvency procedure. Any issue that can be seen to have tainted the integrity of decisions puts directors at risk. Directors should therefore pursue clarification from the company secretary or the company's lawyers that conflicts have been identified and addressed, and that corporate approvals have been obtained, as required by corporate law and the company's constitutional documents.

Directors should also feel free to ask that a review be undertaken to confirm that the company has not exposed itself to the risk of premature termination of key commercial contracts by not fully complying with ongoing terms.

Directors would also be well advised to ask for confirmation that appropriate directors' and officers' (D&O) insurance policies are in place.

Seek advice. Directors are not expected to have all the answers. Professional advisers will often have experience dealing with the kinds of difficulties a company faces. Directors should therefore insist on direct access to the company's financial, business and legal consultants. Good ones can also bring perspective and ideas, which can provide the directors with a route through to the survival of the company. And to achieve those goals, it may be appropriate to augment or replace existing advisers and bring in fresh expertise. Directors should feel empowered to require such changes.

Enforcement Priorities Could Shift in a Downturn

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Key Points

- In economic downturns, companies perceived to have been overvalued or closely linked to the causes of the slowdown often face increased scrutiny from government enforcement authorities.
- Industries viewed as high-risk are likely to receive increased attention, with enforcement agencies prioritizing transparency, consumer protection and individual accountability.
- The unique aspects of the current social and political climate — notably, ESG priorities, geopolitical issues involving Russia and China, and the ongoing pandemic — could also shape enforcement efforts.

In 2022, we saw steep drops in the U.S. stock market, comparable to the bursting of the dot-com bubble of 2000-01 and the crash set off by the global financial crisis of 2007-09. Additionally, cryptocurrency markets have lost more than $2 trillion in value over the past two years. As in those earlier periods, these losses follow a period in which price-earnings ratios rose to historic highs and many investors prioritized short-term growth potential.

During economic downturns, governments often adjust their enforcement strategies. Although it is difficult, if not impossible, to predict any particular enforcement action, examining enforcement authorities' activities during previous downturns can reveal patterns and help companies prepare for potential government scrutiny.

Enforcement Activity During Past Economic Downturns

When the dot-com bubble burst, resulting in significant losses for investors, enforcement authorities, including the U.S. Department of Justice (DOJ) and the Securities and Exchange Commission (SEC), launched investigations into some of the largest and most high-flying companies of the late 1990s. Those investigations revealed a variety of misconduct, including fraudulent accounting and inaccurate or incomplete disclosures by senior executives. SEC Chair Bill Donaldson spoke of "a serious erosion in business principles … [and] the grossest displays of greed and malfeasance: taking excessive risks without disclosing the potential consequences, hiding the true state of their finances, and self-dealing."

Examining enforcement authorities' activities during previous downturns can reveal patterns and help companies prepare for potential government scrutiny.

One of the largest corporate enforcement actions during this period involved the telecommunications firm WorldCom, Inc. According to the SEC, WorldCom fraudulently overstated its income and understated its operating expenses, leading to estimated losses of as much as $200 billion. WorldCom ultimately settled with the SEC for $2.25 billion and with private investors for $6.13 billion. The DOJ brought criminal securities fraud charges and obtained convictions and prison sentences against WorldCom's co-founder and CEO, and its CFO, treasurer and secretary, as well as its senior vice president and controller.

Criminal and civil enforcement actions were brought against other companies and their executives, as well, including Adelphia Communications, Enron and Tyco International, and Congress increased accounting controls and disclosure obligations for public companies via the Sarbanes-Oxley Act.

The 2007-09 financial crisis involved similar patterns of corporate misconduct and government enforcement actions. The economic crash was tied closely to the housing market, as high-risk lending practices combined with massive growth securitization and related derivatives left financial institutions vulnerable. Subsequent enforcement actions focused heavily on the sectors related to the market crash. The SEC, for example, charged more than 20 companies in the housing and mortgage markets for mortgage-related misconduct, alleging that they concealed from investors risks, terms and improper pricing in collateralized debt obligations (CDO) and other complex structured products.

The DOJ entered into multibillion-dollar settlements with a number of large financial institutions for allegedly misleading the investing public with respect to the packaging, marketing, sale and issuance of residential mortgage-backed securities. Many of those settlements involved the appointment of independent monitors to ensure the institutions' compliance with their obligations under their agreements with the government.

In addition, the so-called Great Recession resulted in the 2010 passage of the Dodd-Frank Act, which the Obama White House hailed as the "most far-reaching Wall Street reform in history" that would "prevent the excessive risk-taking that led to the financial crisis."

Notwithstanding the large institutional settlements, very few individuals were prosecuted in connection with conduct related to the financial crisis, which led to criticism of the DOJ's Criminal Division and resulted in increased emphasis on individual enforcement actions.

In both economic downturns in the 2000s, enforcement authorities focused on companies (and, to some extent, individuals) engaged in what the government perceived to be extreme speculation and risk-taking. Legislative and regulatory reforms in the wake of the downturns generally sought to require greater corporate transparency, encourage proactive compliance measures and protect consumers.

What Enforcement Activity To Expect in a Downturn

What, then, can companies expect from enforcement authorities in the event of an economic downturn in 2023?

Past Trends

Perceived high-risk economic sectors. Enforcement action in a future economic downturn is likely to focus on emerging and growth sectors that are perceived to have aggressive business and earnings models or to lack mature compliance systems. In this regard, cryptocurrency and decentralized finance (DeFi) may attract particular scrutiny. As digital assets have entered the mainstream over the past several years, they also have attracted more enforcement scrutiny, especially as a number of high-profile cryptocurrency companies failed in 2022.

Both the SEC and DOJ already are active in this area. The SEC filed several noteworthy first-of-their-kind actions alleging violations of the securities laws involving DeFi technology. The SEC also has nearly doubled the size of its Crypto Assets and Cyber Unit, a specialized team focused on enforcement actions involving the cryptocurrency markets and cyber-related threats. (See "Rise in Crypto Securities Filings Could Persist.") The DOJ, meanwhile, created a National Cryptocurrency Enforcement Team of prosecutors experienced in cybersecurity fraud and money laundering to investigate and prosecute digital assets-related crimes, as well as a specialized Virtual Asset Exploitation Unit within the Federal Bureau of Investigation.

Transparency and consumer protection. As in prior downturns, companies in all sectors (but especially those in industries seen to be responsible for, or emblematic of, the country's economic woes) can expect that the SEC and DOJ will scrutinize their disclosures to investors and consumers.

Individuals. Both the SEC and DOJ have recently signaled that they are likely to increasingly pursue enforcement actions against individual defendants, as they did in the wake of the dot-com bubble, including seeking novel remedies in certain cases. For example, as part of a June 2022 settlement with a New Jersey-based software company for alleged accounting fraud, the SEC required the company's CEO to reimburse the company from his compensation package, even though the CEO had not personally engaged in misconduct.

For its part, the DOJ has announced that a company seeking cooperation credit must disclose all nonprivileged information about any employee involved in misconduct. In addition, it has made clear that its evaluation of a company's compliance program will consider whether the company's compensation structure for individual executives promotes compliance.

Novel Areas

Although the enforcement actions that followed prior economic downturns can provide clues as to where the government is likely to focus in the event of another slump, every era is different, and companies also should consider how the lessons of the past interact with present conditions. The current social and political climate could result in additional enforcement scrutiny in these areas:

ESG. With the growing interest in companies' environmental, social and governance (ESG) activity, the SEC created a Climate and ESG Task Force in March 2021, and it has increased enforcement actions based on allegedly misleading ESG disclosures. The SEC has also proposed new rules to enhance and standardize ESG disclosures. (See "ESG Momentum Remains Strong but May Face Headwinds in 2023.")

Geopolitical issues. After Russia's invasion of Ukraine in February 2022, the U.S. and many of its allies, including the U.K. and the EU, imposed significant new sanctions on Russia and Russian interests around the globe. (See "Disparate US, EU and UK Sanctions Rules Complicate Multinationals' Exits From Russia.") Like its predecessor, the Biden administration has used export controls and other tools, such as the Foreign Agents Registration Act, to counter the perceived national security threat from China.

Pandemic overhang. Congress authorized massive economic stimulus and relief programs during the COVID-19 pandemic. And, just as a special inspector general was appointed to investigate potential fraud, waste and abuse under the Troubled Assets Relief Program (TARP) after the Great Recession, a special inspector general position was created to examine misconduct relating to pandemic relief funds. The DOJ also has brought a number of prosecutions alleging fraud in obtaining or using relief funds.

In Sum

Even if the economy does not move into recession, companies can expect enforcement authorities to devote attention to their ESG-related activity, interactions with Russia- or China-based entities or individuals, and receipt or use of pandemic relief funds. In the event of a downturn, those factors could combine with the historical areas of enforcement focus during hard economic times to shine an even harsher spotlight on companies and their senior executives.

Convertible Notes, Accelerated Share Repurchases and Other Equity-Linked Instruments: Challenges and Opportunities in 2023

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Key Points

- With lower stock prices, some companies with maturing convertible debt may be forced to repay or refinance. Issuers with strong balance sheets may be able to exchange or buy back convertible notes at attractive discounts.
- Companies may find terms for accelerated share repurchase programs appealing because of depressed share prices, but the new excise tax on share buybacks starting in 2023 should be taken into consideration.
- Margin borrowers that post equity as collateral may want to take preemptive measures to avoid margin calls.

Increased volatility and reductions in asset values in the equity markets, coupled with rising interest rates and a slowing macroeconomic environment, have affected a wide range of equity-linked products. Continuation of these trends in 2023 will present both challenges and opportunities for publicly traded companies and their shareholders. We discuss trends we have observed and issues we expect to encounter in 2023 with regard to equity-linked products.

Convertible Notes

The convertible note market has seen several years of healthy activity, both pre-COVID-19 and during 2020-21, as convertible notes have provided low-interest, covenant-light financing. The convertible note issuance market slowed considerably in the first half of 2022, falling below 2017-18 levels. While the new issuance market improved considerably in the third quarter of 2022, with activity eclipsing the first two quarters combined, the environment is still less favorable to new issuances than it had been.

A growing number of convertible note issuers face upcoming maturities. Depressed stock price levels mean that a significant number of these convertible notes are unlikely to mature "in the money" (*i.e.*, for the underlying stock to trade above the conversion price so that holders will convert their notes). As a result, issuers must be ready to repay the convertible notes in cash upon maturity.

With rising interest rates, issuing new convertible debt to refinance existing notes has become significantly more expensive. As an alternative to issuing convertible debt in a traditional capital markets transaction, some issuers have been placing convertible notes with concentrated groups of investors, allowing for more negotiation over terms, including with respect to covenants, security packages and, in some cases, registration rights.

Declining prices of outstanding convertible notes have made it possible for issuers, especially those with strong balance sheets, to retire such notes at attractive terms. Issuers have been able to explore repurchases of convertible notes at significant discounts to par, generating meaningful savings. In some cases, repurchases are effected solely with cash, but they can also be structured as an exchange, in which holders that tender their notes receive other securities — often the issuer's shares. Exchanges can also be structured so that holders receive new convertible notes for their existing ones. Alternatively, convertible-for-convertible exchanges may effectively be structured as new issuances of convertible notes alongside concurrent repurchases of convertible notes from existing investors, allowing issuers to attract new investors.

The equity-linked nature of convertible notes makes it imperative that the repurchase not trigger the creeping tender rules.

Whether a particular repurchase plan will give rise to tender offer concerns is heavily driven by facts and circumstances.

Many issuers have entered into hedging transactions in connection with issuing convertible notes, in particular call spread and capped call transactions. Ordinarily, these hedging arrangements would be unwound in connection with the retirement of the associated convertible notes, but careful analysis of the terms of the particular instrument must be conducted to determine the outcome in each case.

Retiring convertible notes and their associated hedging arrangements may have significant tax and accounting consequences, so those must be evaluated carefully at the inception of the process.

Accelerated Share Repurchases

Accelerated share repurchase programs, or ASRs, have seen an unprecedented level of activity in the last several months, far exceeding the volumes in prior years. The surge can be attributed to depressed stock prices, coupled with high volatility and rising interest rates. In a typical ASR, the company makes an upfront payment to the bank counterparty, which concurrently delivers a number of shares (commonly set at 85% of the number equal to the upfront payment divided by the current stock price), which the bank counterparty borrows from stock lenders in the open market. The bank counterparty then purchases shares in the market during the term of the ASR in order to return them to the stock lenders. In the current environment, companies can expect quite attractive ASR terms, with high guaranteed discounts to their volume-weighted average share price over the term of the ASR.

> The equity-linked nature of convertible notes makes it imperative that the repurchase not trigger the creeping tender rules.

While structuring ASRs and other buybacks has traditionally not been particularly sensitive to tax considerations, recent legislation imposing a 1% excise tax on buybacks by publicly traded companies beginning in 2023 resulted in a push to enter into ASRs in 2022, with particular focus on upfront delivery of shares before year-end. (See "New Corporate Minimum Tax and Stock Repurchase Tax Will Take Effect in 2023, but Questions Remain.")

Bilateral Derivatives

Significant shareholders, oftentimes affiliates, have continued to explore bilateral over-the-counter derivatives transactions, such as variable prepaid forward and collar transactions. These arrangements can be highly customized and may be structured to provide shareholders protection against stock price declines while retaining some appreciation and offering immediate liquidity, all in a tax-efficient manner. We have witnessed a significant increase in interest in these instruments over the course of the last several months and expect the trend to continue.

Margin Loans

A financing tool frequently used by founders, sponsors and other private equity funds, margin loans have been utilized over the last few years to generate liquidity while retaining the economics of equity holdings. While margin loans are invariably overcollateralized, lenders often have no recourse other than to a special purpose vehicle used for the financing and the shares those borrowers own, exposing the lenders to stock price declines.

Declining prices of the pledged equity may result in loan-to-value ratios that trigger margin calls, requiring the borrowers to either post additional collateral or partially repay the loans. In addition, some margin loans include stock price triggers that may result in adjustments to the terms of the margin loan and/or mandatory repayment in the event of specified stock price events.

In light of the market's volatility, borrowers may wish to take proactive measures to avoid margin calls and stock price triggers, including by posting additional collateral before a margin call occurs and seeking preemptive waivers with respect to stock price triggers.

New Regulatory Challenges

Disparate US, EU and UK Sanctions Rules Complicate Multinationals' Exits From Russia

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Key Points

- Multinationals working to exit operations and investments in Russia face a process complicated by differences in U.S., U.K. and EU sanctions and export controls, as well as Russian countermeasures.
- The lists of sanctioned individuals and businesses differ in Western jurisdictions, as do the scope of many restrictions and the definitions of control and ownership.
- Exiting companies need to navigate the U.S., U.K. and EU restrictions as they manage day-to-day operations, conduct due diligence on counterparties, draft sale agreements and plan for any post-closing transitional services.

The withdrawal of Western companies from Russia in the wake of the war in Ukraine has garnered a lot of attention. But the process does not take place overnight, and many foreign companies that have operated in Russia face ongoing legal hurdles as they work to complete exits in 2023. That involves navigating a dense web of regulations promulgated by the U.S., U.K. and EU, which have consequential differences. In addition, Russia has begun imposing controls on some exits, adding another layer of complexity.

Below, we highlight important differences among the three primary sanctions regimes that companies must factor in when planning an exit.[1]

Overlapping but Varied Restrictions

Historically, the U.S. has been the most aggressive in imposing and enforcing economic sanctions and export controls. Before Brexit, the U.K.'s rules typically mirrored the EU's. This year, however, all three jurisdictions have created independent, robust regimes targeted at Russia, with the U.K. and EU frequently staking out more aggressive sanctions positions.

The three have generally sought to thematically align the measures they impose, but divergences among the regimes have complicated compliance for multinational companies with distributed operations and an array of jurisdictional touchpoints. These restrictions have affected the management of day-to-day operations for companies as they plan for exit, as well as the way exit transactions are carried out. In some cases, multinationals may also have to consider rules imposed by Switzerland, Australia, Canada, Japan and other countries.

Navigating Sanctions While Preparing for Exit

Because the process of reaching and closing a deal can be protracted, companies must consider how to operate in Russia in the meantime — *e.g.*, how to pay rent, utilities, taxes, payroll and intercompany loans. Sanctions have made these routine activities difficult. Employees' accounts may be at sanctioned banks, global credit card networks have suspended services in Russia and there are restrictions on the entities and individuals with which U.S., U.K. and EU entities operating in Russia may deal.

1 These articles are for informational purposes only and do not constitute legal advice. Complex assessments often have to be made as to which sanctions regime applies in any given instance, given the multinational touch points of many entities and individuals. In that regard, given the complex and dynamic nature of these sanctions regimes, there may be developments not captured in these summaries. Moreover, while the summaries were accurate when written, they may become inaccurate over time given developments. For all of these reasons, you should consult with a qualified attorney before making any judgments relating to sanctions, as there are potentially severe consequences of failing to adhere fully to sanctions restrictions.

Restrictions on software and hardware exports may also impinge on day-to-day operations.

Here are some of the key differences in U.S., U.K. and EU sanctions rules that can come into play while companies wind down a business or seek a potential buyer.

Sanctions Targets

The U.S., U.K. and EU have sanctioned Russian targets since 2014, when Russia annexed Crimea. The scale and pace of new sanctions targets has significantly increased since the February 2022 Russian invasion of Ukraine, with important differences in the three jurisdictions' lists of sanctioned individuals and entities. For multinationals that operate their Russian business or dealings with Russian counterparties through multiple corporate offices or subsidiaries, these jurisdictional differences have frequently resulted in the need to reconsider existing structures, workflows and supply chains to ensure only those offices, systems and personnel permitted to engage with the relevant Russian party do so.

A key divergence in the regimes has been a heightened focus by the U.K. on sanctioning wealthy Russians outside government. In adding individuals and companies to its sanctions lists, the U.K. appears to have focused on those with the greatest economic interest in the U.K. Given the automatic application of sanctions to certain entities owned or controlled by listed persons (see discussion below), the U.K.'s approach has had far-reaching implications for multinationals that have dealings with the often vast business holdings some sanctioned wealthy Russians maintain.

Ownership Versus Control

The U.S. has long maintained a "50% rule" in applying sanctions to nonlisted entities held by sanctioned parties, a relatively straightforward criterion based solely on ownership. If a sanctioned person owns 50% or more of a legal entity, that entity will be considered a sanctioned business. There is no separate U.S. control test for the automatic application of sanctions to a nonlisted entity.

EU and U.K. blocking sanctions, however, apply where there is either ownership or control. An entity falls under the sanctions when over 50% of it is owned, directly or indirectly, by a person listed by one of their jurisdictions. Thus, in contrast to the U.S., a 50-50 joint venture with a listed person is not automatically subject to sanctions.

> A key divergence in the regimes has been a heightened focus by the U.K. on sanctioning wealthy Russians outside government.

Significantly, EU and U.K. sanctions generally also apply to any entity "controlled" by a person on their respective lists, so such entities can be subject to the prohibitions even if the sanctioned party's ownership interest does not exceed 50%. Control involves a much less clear-cut, more fact-specific analysis than ownership. Moreover, the definitions of control in the EU and U.K. are different, and the information required to test for control may not be readily available, or Russian counterparties may be unwilling to provide it. Discrepancies in the application of the control test by parties in the private sector, and thus whether an entity is sanctioned, have sometimes resulted in market confusion.

Investment Bans

Though the U.S., U.K. and EU have each imposed a ban on new investment in Russia, the scope of those bans differ, as do the jurisdictions' approaches to exclusions from the bans.

The U.S. has the broadest investment ban, restricting any new "commitment of capital or other assets for the purpose of generating returns or appreciation." "New investment" includes any purchase of equity or extension of credit, and the ban extends not only to investment in a company located in Russia but can also apply to a new investment in a company located outside of Russia that derives a predominant portion of its revenues from its investments in Russia. Maintenance of preexisting activities is generally carved out, but expansion is prohibited. Similarly, transactions in furtherance of divestment of a preexisting investment in Russia are generally not prohibited by the new investment restrictions.

By contrast, the EU investment ban is much more limited in scope. It prohibits investments in non-EU entities operating in the energy sector in Russia. Within this sector, the ban prohibits the:

- purchase of equity;
- creation of joint ventures; and
- provision of loans, credit or financing.

Under narrow circumstances, EU entities can apply for authorizations, but there is no general authorization mechanism for divestments or exit transactions. As a result, the prohibition of loans, credit and financing requires particular attention in an exit context.

The U.K. ban does not apply to as wide an array of "investments" as the U.S. one, but it is still broad. It focuses on:

- direct acquisitions of land;
- interests in legal entities connected with Russia;
- joint ventures and the opening of representative offices, branches or subsidiaries in Russia; and
- any related investment services.

Indirect acquisitions of land, interests in legal entities connected with Russia and establishing joint ventures with persons connected with Russia are also prohibited where these activities are for the purpose of making funds or economic resources available to a person connected with Russia or for their benefit. There are no carve-outs for divestments related to Russia, although there are exceptions set out in the legislation, including for the satisfaction of some prior obligations.

Bans on Provision of Services

The three jurisdictions have all banned the provision of certain services to persons located in Russia. While there is overlap in these bans, there are also significant differences in the prohibitions and corresponding exceptions, which have yielded a web of compliance complications for companies.

The U.S. has banned the provision of accounting (including audit), trust and corporate formation, management consulting and quantum computing services to persons located in Russia, or where the benefit of the service is ultimately received by a person in Russia. Importantly, the U.S. has excluded from these prohibitions any service to an entity in Russia that is owned or controlled by a U.S. person (*i.e.*, any U.S. citizen (including dual citizens) or permanent resident, any entity organized under U.S. laws or under any jurisdiction within the U.S. (including its foreign branches), and any person while physically present in the U.S.), and any service in connection with the wind-down or divestiture of an entity in Russia (unless that entity is owned by a Russian person). These exceptions have made maintaining operational links between U.S. companies and their subsidiaries in Russia more manageable. Effective December 5, 2022, the U.S. also banned the provision of certain services related to the maritime transport of crude oil of Russian origin.

The U.K. has banned the provision of professional and business services to persons connected with Russia, which like the U.S. includes certain accounting, business and management consulting services as well as public relations services. Unlike the U.S. and EU, however, the U.K. has not included an exemption for services to U.K. subsidiaries. Instead, it has indicated in guidance that a license may be granted for services required by non-Russian business customers in order to divest from Russia, to wind down other business operations in Russia or for services to a person connected with Russia by a U.K. parent company or U.K. subsidiary of that parent company. This affirmative licensing requirement has complicated intragroup operations for many multinationals. Separately, the U.K. has also announced that it will soon prohibit the provision of IT consultancy, architecture, engineering, advertising, auditing and certain transactional legal advisory services.

The EU has similarly banned the provision of accounting, architectural, auditing, bookkeeping, IT consultancy, engineering, legal advisory, tax consulting, business and management consulting, and public relations services to legal persons established in Russia. There is an exemption, however, for subsidiaries of entities incorporated or constituted in the EU, the European Economic Area, Japan, South Korea, Switzerland, the U.K. or the U.S.

Russian Restrictions

Recently, Russia has imposed its own restrictions that complicate exits and make them more unpredictable. For example, most direct and indirect transfers of any type of a Russian subsidiary now require an approval by the Russian Government Commission for Control Over Foreign Investments if a multinational from an "unfriendly" country (*i.e.*, one that commits "unamicable" actions against Russian legal entities and individuals) is involved.

In addition, transactions involving direct or indirect transfers of an equity stake in, among others, certain named banks and companies engaged in the energy and related sectors are banned unless approved by the Russian president himself. The companies listed include a number of Russian subsidiaries of international banks and energy companies.

Best Practices for Exit Transactions

The exit transaction process itself presents challenges. As with other stages of the exit, companies must pay heed to an array of cross-jurisdictional sanctions considerations.

Evaluate potential buyers. It is vital to understand and assess one's potential counterparties, the source of a buyer's financing, who the intermediaries (if any) are and which banks are involved. With non-Russian parties often hesitant to make new investments in Russia in the current geopolitical environment, most potential purchasers in exit transactions are Russian parties. Given the large number of Russian sanctions targets across the U.S., U.K. and EU sanctions regimes and the continuing targeting of additional individuals and entities, the pool of qualified buyers in several sectors has narrowed, and the risk of potential sanctions touchpoints has increased. In a number of circumstances, restrictions have left local management teams as the only possible buyers.

Monitor changes in sanctions. Sanctions in one or more jurisdictions can change midway through a transaction, presenting new obstacles or prohibiting completion. Transactions are taking much longer to close, particularly where regulatory approval is needed, making this risk more pronounced. In many cases, there is extensive press coverage of the exit, so a company's compliance with sanctions may come under governmental or public scrutiny.

Maintain continuous, two-way communication. Deal teams need to be informed of any sanctions modifications that could affect the transaction and they, in turn, need to keep counsel apprised of any changes in the structure or important terms of the deal to ensure they are compliant. It may be necessary to "wall off" certain offices or employees from any involvement in a transaction due to the sanction that would apply to them. There are sanctions risks not only for the parties to the transactions but also for third-party advisers, and there may be occasions where a third-party adviser's involvement invokes an added jurisdictional nexus that would not otherwise have been present in the transaction.

Seek appropriate authorizations. Understanding up front whether any governmental authorizations are required to complete the exit transaction is essential. Licenses can, in the ordinary course, take months to receive, and regulators in the U.S., U.K. and EU are currently inundated with requests for Russia-related guidance and licenses. Timely engagement with relevant regulators can provide early indication of the likelihood a regulator may grant the necessary authorization and mitigate the risk of delays in an exit transaction timeline.

Furthermore, EU sanctions regulations typically predefine certain circumstances under which a competent authority can grant an authorization. That means the authorities have limited wiggle room, so parties should determine at the outset of a transaction whether there is legal authority to approve certain types of activities.

Protect against Russian law risks. While the exit process is underway, companies need to take steps to guard against putting their employees in Russia at risk of liability for violations of local law.

Review deal terms. Care must be taken to ensure terms are consistent with all applicable sanctions rules. Questions can arise, for example, with restructuring steps to prepare for sale, potential payment arrangements (*e.g.*, deferred payments), call options or other rights for the exiting party to claw back the sold business, transitional services and transfers of equipment or technology.

Assess whether transitional services are compliant. Post-closing transitional services agreements are often necessary to facilitate the transfer of a business, particularly where a Russian business was substantially dependent on its parent or a non-Russian affiliate, or a buyer does not have the capacity to provide full business support immediately upon closing. Any planning for the provision of transitional services requires close review to evaluate whether any may be prohibited and whether any previously relied-on exceptions may not be available post-closing. In addition, any transitional services agreement should be carefully drafted to ensure they can be modified or terminated as necessary to comply with relevant future sanctions.

Pay attention to disclosure obligations. As the exit processes unfold, publicly traded companies will need to bear in mind their disclosure obligations to investors, and regulated business such as banks and insurers may need to keep their regulators apprised of developments.

(See also "Why Directors and Executives Need To Pay Attention to Sanctions, Money Laundering and Export Rules.")

Why Directors and Executives Need To Pay Attention to Sanctions, Money Laundering and Export Rules

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Key Points

- Directors and officers can and have been named personally in both civil and criminal enforcement actions involving sanctions, export restrictions, anti-money laundering and anti-bribery rules.
- Enforcement agencies expect boards and senior managements to ensure their companies' compliance with these rules, which are viewed as key instruments of U.S. foreign policy.
- The same conduct can run afoul of multiple regulatory regimes, and enforcement authorities regularly cooperate and bring joint actions.
- Companies will only receive credit for voluntarily disclosing violations if they do so before enforcement officials discover the problems.

Recent developments, including Russia's invasion of Ukraine, ongoing tensions between the U.S. and China, and turmoil in the digital assets sector, have made it essential for companies — including their directors and senior executives — to pay close attention to compliance with U.S. sanctions, export controls, anti-money laundering (AML) and anti-bribery and corruption (ABC) laws. While most boards have long been alert to the issues raised by the Foreign Corrupt Practices Act, these other regulatory regimes have grown in importance as the U.S. government has increasingly and aggressively turned to them to shine a spotlight on corporate conduct. The U.S. government uses these laws as critical tools to advance its foreign policy, protect the financial system and prevent sensitive U.S. technology and information from falling into the wrong hands.

Key Enforcement Agencies and Laws — and Their Acronyms

BIS: The Department of Commerce's Bureau of Industry Security is the primary federal agency responsible for administering and enforcing U.S. export control laws.

DOJ: The Department of Justice is responsible for investigating and prosecuting violations of U.S. federal law, including the Foreign Corrupt Practices Act and referrals for criminal prosecution from other agencies.

FinCEN: The Department of the Treasury's Financial Crimes Enforcement Network is responsible for implementing, administering and enforcing compliance with the Bank Secrecy Act (BSA) and associated regulations.

OFAC: The Department of the Treasury's Office of Foreign Assets Control is the primary federal agency responsible for administering and enforcing U.S. economic sanctions laws.

Other Federal Regulators, including the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission, conduct compliance examinations and bring enforcement actions for violations of the BSA and associated regulations.

Boards and senior management need to be especially vigilant because they can become the targets of enforcement actions if there are violations. In recent years, the U.S. government has sought stiff fines and brought criminal charges against dozens of companies, and in some cases their executives and officers, for failing to comply with these laws. In addition to the potential legal penalties, media coverage of possible violations and enforcement actions heightens the reputational risks to companies and individuals. Disclosure of violations, or even of an investigation of potential violations, often is quickly followed by securities class actions litigation and derivative lawsuits claiming that directors failed in their duties to appropriately oversee these risks.

Boards and senior management play a critical role by instilling a culture of compliance, ensuring that compliance functions are adequately resourced and providing continuous and meaningful oversight. Here is a quick guide to the different offices responsible for enforcement, some key compliance risks and the obligations of directors and C-suite officers.

Focus on Company Officers and Directors

The agencies that implement and enforce these laws are increasingly focused on how senior management oversees and manages compliance risk. Even inadvertent violations of sanctions, AML, ABC or export control laws can expose executives and officers to liability if they fail to take steps to ensure compliance. Willful violations can lead to criminal prosecution.

For example, in April 2021, SAP SE, a software company headquartered in Germany, agreed to pay more than $8 million in penalties as part of a global resolution with the DOJ, BIS and OFAC after the company disclosed thousands of export violations, including illegally releasing U.S.-origin software, upgrades and patches to users in Iran. SAP had also allowed Iranian users to access U.S.-based cloud services. Of note, some SAP senior executives were aware that neither the company nor its U.S.-based provider used geolocation filters to identify and block Iranian downloads, yet they did not remedy the issue. In announcing the resolution and penalties, the DOJ prosecutor stated that the case "should serve as a strong deterrent message to others that the release of software and sale of product and services on the internet are subject to U.S. export laws and regulations."

> Boards and senior management need to be especially vigilant because they can become the targets of enforcement actions if there are violations.

At the Treasury Department, OFAC and FinCEN have brought several enforcement actions against individuals in recent years for violations of sanctions and export control laws. One case brought by FinCEN resulted in a $450,000 civil fine against the former chief risk officer of a large U.S. bank.

At the Commerce Department, BIS, in cooperation with the DOJ, routinely brings enforcement actions against individuals, including company executives. In 2021 — the last year for which BIS published this data — BIS investigations resulted in criminal convictions of 50 individuals and companies, resulting in a total of 1,118 months of prison time for individual defendants.

A significant policy statement by Deputy Attorney General Lisa Monaco published in September 2022 (the Monaco memorandum) highlighted DOJ's renewed focus on individual misconduct.

Parallel Enforcement

It is important to understand that incidents of company wrongdoing often implicate multiple enforcement regimes. Shipping a U.S. product to Iran, for instance, can violate U.S. sanctions prohibitions, export control laws and money laundering regulations.

In April 2022, FinCEN issued an Advisory on Kleptocracy and Foreign Public Corruption urging financial institutions to focus efforts on detecting the proceeds of foreign public corruption —activity that can involve violations of several U.S. laws. The advisory included 10 red flag indicators to assist financial institutions in detecting, preventing and reporting suspicious transactions associated with kleptocracy and foreign public corruption. And in June 2022, FinCEN and BIS issued a joint alert urging companies to be alert to Russian and Belarusian attempts to evade U.S. export controls and reminding financial institutions of their obligation to report suspicious activities, including potential sanctions and export control violations.

In such cases, OFAC, FinCEN and BIS may cooperate in their investigations and bring parallel civil enforcement actions alleging violations of multiple laws. Any one of these agencies can refer cases to the DOJ where there is evidence of willful violations.

Examples of joint enforcement cases:

- In October 2022, OFAC and FinCEN announced settlements of approximately $24 million and $29 million, respectively, with a virtual currency exchange for alleged violations of sanctions and AML laws.
- In July 2021, OFAC and BIS brought parallel enforcement actions against two U.S. and United Arab Emirates companies for violations of sanctions and export control laws stemming from the sale of U.S. tank storage cleaning units to Iran.

The DOJ routinely brings criminal enforcement actions in conjunction with civil enforcement actions pursued by OFAC, FinCEN, BIS and other agencies.

The Importance of Disclosure

OFAC, FinCEN and BIS have emphasized the importance of voluntary disclosure of potential violations of laws and regulations. Depending on the facts, companies that voluntarily disclose may avoid civil fines or see them reduced because of the disclosure.

Similarly, the Monaco memorandum emphasized that, absent aggravating factors, the DOJ will not seek a guilty plea to criminal charges where a company has voluntarily disclosed conduct, fully cooperated and remediated its conduct appropriately and promptly. On the flip side, failing to voluntarily disclose can lead to higher fines and more onerous settlement conditions.

That said, voluntary disclosure is not always the right call in all circumstances, and companies considering a voluntary disclosure should keep in mind a few important considerations.

Disclosure after the government learns of the violation will not be considered voluntary. The Monaco memorandum makes clear that a company will only receive credit for self-disclosure if that is made prior to an imminent threat of disclosure or government investigation. Companies should therefore ensure that their compliance programs incentivize employees to surface problems to management, and that management surfaces problems to the board, before the conduct becomes known to the government (often through a whistleblower and sometimes a disgruntled employee who positions himself as such. Boards should carefully review whether current reporting mechanisms, up to management and the board, are effectively alerting the company's leadership and those responsible for oversight, including the board, to problems.

Disclosure to one agency is not necessarily disclosure to others. The U.S. government agencies typically expect that a company will disclose a possible violation to all relevant agencies. An agency may not extend voluntary disclosure credit if it learned of the conduct from another agency. Therefore, if a company identifies an issue that involves a potential violation of multiple legal regimes, it should carefully consider agencies it should contact and coordinate disclosure to help ensure voluntary cooperation credit. Further, in instances where companies have specific filing obligations, such as a suspicious activity report filing in the AML context, they should not consider their obligations satisfied by virtue of, for example, a disclosure to OFAC or BIS.

U.S. agencies expect companies to name the individuals involved in misconduct. Following disclosure of a possible violation of law — whether or not voluntary — U.S. government agencies expect companies to identify the individuals involved. The Monaco memorandum, for example, emphasizes the DOJ's expectation that companies disclose all nonprivileged information related to all individuals involved in corporate misconduct to receive cooperation credit.

What Regulators Expect From Companies and Their Managements

Regulators expect U.S. companies to maintain effective risk-based compliance programs that are reasonably designed to prevent violations of the law. Companies in the financial services industry are typically required to design and implement an effective anti-money laundering compliance program that is risk-based and meets the minimum requirements of the BSA and related regulations. Boards of directors are expected — and in some cases required — to oversee compliance programs to guard against violations, including ensuring that adequate resources are provided for the compliance function and that there is a strong pro-compliance culture at every level of the company.

In the event of a potential violation, U.S. government agencies will consider the nature and quality of a company's compliance program when determining whether an enforcement action is appropriate and, if it is, what form it takes. In weighing a criminal prosecution, the DOJ will consider whether a company deters misconduct by, for instance, creating incentives for compliance, enforcing personal accountability and instituting compensation clawback provisions.

This SEC Press Release Is a Compliance Checklist for Corporations and Their Boards

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Key Points

- The SEC collected a record $4.2 billion in penalties in enforcement actions in 2022, nearly three times the figure in 2021.
- Recent enforcement actions involving ESG issues, 10b5-1 plans and cybersecurity align with the SEC's rulemaking initiatives on those topics.
- Increasingly, as part of settlements, the commission has insisted that companies retain an independent compliance consultant who will report back to the staff of the SEC's Division of Enforcement on compliance-related undertakings.
- Accounting and disclosure issues, including earnings manipulation, sales practices that impact revenue disclosures and non-GAAP metrics, remain a high priority for enforcement.

The Enforcement Division of the U.S. Securities and Exchange Commission (SEC) recently reported a robust enforcement year with record-breaking results. The summary is an indicator of where the division is concentrating efforts, and thus a forward indicator of areas where companies need be sure they do not run afoul of securities laws.

In the fiscal year ended September 30, 2022, the division initiated 462 new enforcement actions, and 760 actions in total (including follow-on actions and cases involving missing and delinquent filings) and imposed $6.4 billion in penalties and disgorgement, according to the November 15, 2022, press release summarizing the results.

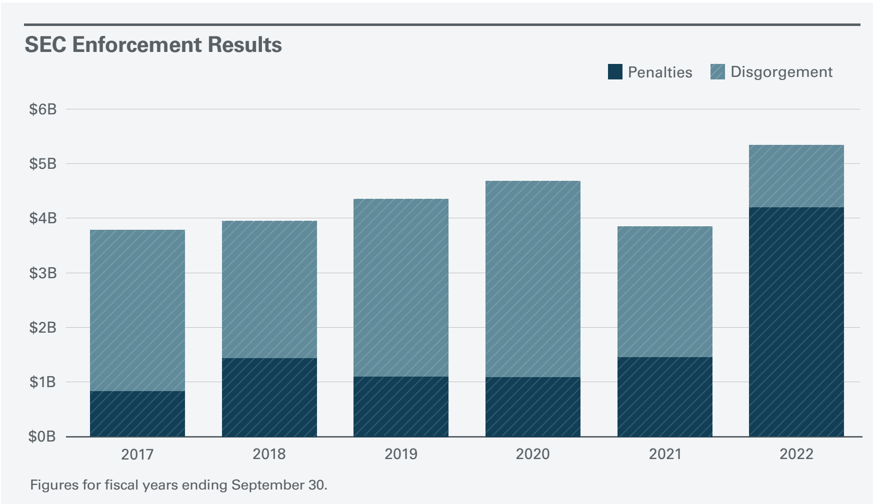
Notable Trends

Higher penalties and a higher penalty/disgorgement ratio. The Enforcement Division views significant penalties as one of its tools to deter future misconduct. Officials have said in recent public remarks that they believe penalties should be calibrated to convey to market participants that complying with the securities laws is less costly than violating them.

Mixed messages about cooperation. The division continues to emphasize the benefits of full cooperation. However, while we did see actions where cooperation resulted in no penalties, we also saw others where significant penalties were imposed despite self-reporting and cooperation. The division has emphasized that the amount of cooperation credit will depend on the facts and circumstances of a particular action.

Imposition of independent compliance consultants (ICCs). Increasingly, we have seen the division requiring parties to engage an ICC who will report back compliance-related findings to staff of the division as part of a settlement, especially in cases where there has not been enough time for the division to assess the effectiveness of the company's compliance program.

Increased gatekeeper accountability. There is a continued focus on gatekeepers, including auditors and compliance and legal personnel. In one case, a former general counsel of a public company settled an action alleging *unintentional* misconduct.



Financial Fraud and Issuer Disclosure

The SEC views public company disclosures as the bedrock of the securities markets and it continues to view this area as an enforcement priority. In FY 2022, the SEC brought and obtained settlements in several cases that show how broad a view it is taking of necessary disclosures. For example:

- A mining company was alleged to have misled investors about a technology upgrade it claimed would reduce costs but ultimately increased them, and for failing to properly assess whether to disclose financial risks stemming from excessive discharges of mercury in Brazil.
- In a first-of-its-kind action against a multinational technology company, the defendant was charged with failing to disclose that rising sales of products designed for gaming were driven in part by cryptocurrency mining. Even though the company's stated revenue and accounting were accurate, the SEC alleged that the Risks and Management Discussion and Analysis sections of its disclosures did not adequately disclose that earnings and cash flow fluctuations reflected in part the volatile crypto mining industry.

Earnings-per-share (EPS) initiative. The SEC continues to closely monitor earnings management practices, such as accounting adjustments that may be quantitatively immaterial but impact EPS or earnings guidance in way that have a qualitatively material impact — *e.g.*, a penny per share that was the difference between "making or missing" the quarter. This ongoing program, begun in 2020, leverages data analytics to generate leads about companies that are making post-quarter adjustments in discretionary accounts in order to round up reported EPS to meet or beat publicly announced earnings guidance.

In 2022, as part of this initiative, the SEC brought actions against two companies and charged senior executives in both actions. In one case, the SEC alleged that the company made unsupported reductions in a reserve account that allowed it to round up its EPS reporting, while in the other case, the company allegedly pulled forward revenue and shipped customer orders without approval.

Sales practices disclosure cases. The SEC continues to monitor sales practices, including "pull-in" practices and order backlog management where the revenue recognition is correct under the Financial Accounting Standards Board's rules, but disclosures surrounding financial performance — such as ability to meet revenue guidance, maintain year-over-year growth or have customer demand for a product — may be inaccurate or misleading.

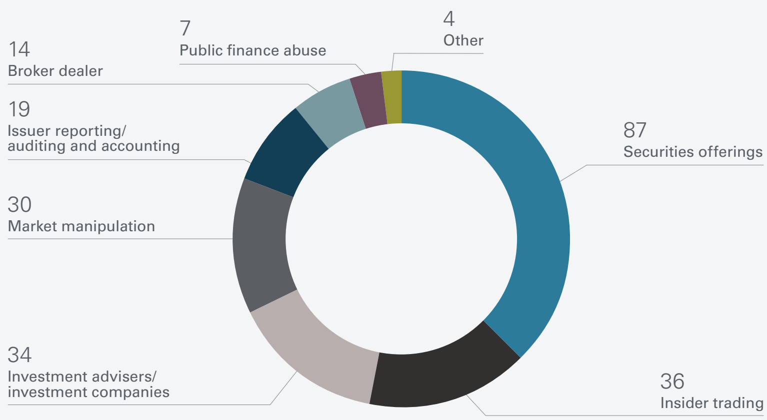
For example, the division brought a case last year, later settled, against a cloud computing and virtualization company that allegedly did not properly disclose (i) its order backlog management practices, which enabled the company to push revenue into future quarters by delaying deliveries to customers and (ii) the company's slowing performance relative to its projections. Again, the financial accounting itself was not challenged, only the misleading overall financial picture these practices were alleged to have created.

Cybersecurity and Compliance

Most of the key cybersecurity cases brought in FY 2022 concerned broker-dealers and investment advisers. However, the SEC has repeatedly emphasized the importance it places public companies having appropriate systems to assess vulnerabilities and meet disclosure obligations during a cybersecurity incident.

SEC Enforcement Cases by Type

By primary action type. Fiscal year ended September 30, 2022.



A proposed SEC rulemaking would require:

- reporting material cybersecurity incidents on Form 8-K within four business days of discovery, disclosing updates on previously reported cyber incidents on Forms 10-K and 10-Q,
- disclosing the company's policies and procedures concerning cybersecurity risks,
- maintaining internal controls over information systems that are used (not just owned) by the company, and
- disclosing board members with cybersecurity expertise.

Even before rules are finalized, these proposals are likely indicators of the SEC's expectations.

We expect continued SEC enforcement activity in this area in 2023.

Environmental, Social and Governance (ESG) Issues

The division has focused attention on ESG issues for public companies, as well as investment products and strategies. The SEC has applied principles from existing law and regulations concerning materiality and accuracy of disclosures to challenge what it believes to misleading statements and "greenwashing." In March 2021, the division created a Climate and ESG Task Force that is charged with analyzing ESG voluntary disclosures companies make in filings and proactively identifying ESG-related misconduct.

In one notable ESG enforcement action, the SEC litigated against a publicly traded South American metals and mining company, alleging that it made false and misleading claims to local governments, communities and investors about the safety of its dams prior to the collapse of one in Brazil, which caused environmental and social harm. The SEC's complaint cited several market and financial factors to support its assertion that the disclosures were material, including that the dam failure led to $4 billion decline in the company's market cap; its ADRs traded on the New York Stock Exchange lost more than 25% of their value; and its credit rating was downgraded to junk status.

Proposed ESG rules in the pipeline at the SEC could make enforcement easier for the commission. In addition, in 2023, we expect the Climate and ESG Task Force within the Enforcement Division to continue to analyze voluntary ESG disclosures in filings and proactively identify ESG-related misconduct.

Market Abuses: 10b5-1 Plans

As we have mentioned above, in 2022, the Enforcement Division brought cases in areas that are the subject of SEC rulemakings to reinforce the need for additional, and likely more prescriptive, regulation. One such area was 10b5-1 predetermined stock sales plans for insiders. The SEC has proposed a rulemaking that would significantly alter the Rule 10b5-1 requirements, aimed at curbing perceived abuses.

In one enforcement action in FY 2022, the SEC charged a public company's executives with insider trading, alleging that they established a 10b5-1 plan after becoming aware of a significant decline in the revenue from the company's largest advertising partner. The settlement included several undertakings that align with aspects of the SEC's proposed rulemaking on 10b5-1 plans, including, for example, an agreement to include a 120-day cooling off period (*i.e.*, when trading is prohibited) after the adoption or modification of a 10b5-1 plan.

Non-GAAP Financial Reporting

The Enforcement Division and the Division of Corporation Finance continue to scrutinize non-GAAP financial metrics and related disclosures and internal controls. The SEC has made it clear that, if a company presents non-GAAP metrics, they must be appropriately labeled, accurate and consistent, and any assumptions or judgment calls should be disclosed.

For example, the SEC sued a multinational health care company alleging that it entered into intra-company foreign exchange transactions for the sole purpose of generating foreign exchange gains, or avoiding foreign exchange losses, on revenue received in foreign currencies using a non-GAAP conversion process. That had the effect of materially misstating the company's net income, the suit charged. The SEC also found that the company did not have adequate internal controls to monitor and quantify the difference between the non-GAAP and GAAP calculations of the foreign exchange gains and losses.

New Corporate Minimum Tax and Stock Repurchase Tax Will Take Effect in 2023, but Questions Remain

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Key Points

- Whether a corporation is subject to the new 15% corporate alternative minimum tax may be difficult to determine in some cases, and there is unlikely to be much IRS guidance before the law comes into effect for taxable years beginning after December 31, 2022.
- Companies pursuing M&A transactions will need to consider carefully if and how a transaction could affect their liability for the new minimum tax.
- The broad definition of stock repurchase used in the new excise tax, which includes "redemptions," has implications for a wide range of transactions that do not involve conventional stock buyback programs, including de-SPACs and other M&A transactions.

The corporate alternative minimum tax (CAMT) and the excise tax on stock repurchases, each enacted as part of the Inflation Reduction Act of 2022, will soon become effective — for the CAMT, for taxable years beginning after December 31, 2022, and in the case of the stock repurchase excise tax, for repurchases occurring after that date. Both provisions establish novel tax regimes that will require expert tax guidance for affected companies to navigate successfully.

Corporate Alternative Minimum Tax

The CAMT generally requires corporations to pay at least a 15% minimum rate of U.S. federal income tax on their adjusted financial statement income (AFSI) if the corporation's controlled group averages over $1 billion in such income during any applicable prior three-year period. Many corporations will need to expend considerable time and expense to determine whether they are subject to the CAMT and, if so, how much additional tax they will owe, if any. Very little guidance from the Internal Revenue Service (IRS) is expected to be available before companies have to determine the CAMT's impact on their financial reporting, estimated tax payments, or transactions or investments closing in 2023.

Impact on M&A. The CAMT may require additional diligence and tax planning for M&A transactions because, once a corporation becomes subject to the CAMT, it generally remains so until certain conditions are met (including a determination from the IRS that the corporation should not continue to be subject to the CAMT). Buyers and sellers in the M&A market will need expert tax advice regarding the potential application of the CAMT or may find themselves unexpectedly bearing costly and complicated tax consequences.

Impact on partnerships (including LLCs classified as partnerships). Though entities classified as partnerships for U.S. federal income tax purposes, including many LLCs, are not themselves subject to the CAMT, they may nevertheless feel its impact. For CAMT purposes, a corporate partner in a partnership must determine its distributive share of the partnership's AFSI. A corporate investor entering into a partnership should ensure it has adequate contractual rights to obtain the information it needs to comply with the CAMT.

Impact on multinational corporations. U.S.-parented multinationals that may be subject to the CAMT may want to revisit their foreign corporate structures in light of the new law. The CAMT allows financial statement losses from pass-through entities to offset financial statement income in determining the U.S. group's AFSI and generally allows all foreign tax credits from pass-through entities to be claimed. Financial statement losses from controlled foreign corporations cannot offset financial statement income of the U.S. group, and the use of foreign tax credits generated by controlled foreign corporations is capped.

Foreign-parented multinationals with a U.S. taxable presence are not spared from the CAMT. U.S. corporate subsidiaries in a foreign-parented multinational group are subject to the CAMT if the group exceeds the $1 billion threshold and the U.S. corporate subsidiary averages $100 million or more in AFSI during the same three-year testing period.

Stock Repurchase Excise Tax

The stock repurchase excise tax consists of a 1% corporate-level tax on the fair market value of stock repurchased by publicly traded corporations (either directly or through certain subsidiary entities).

Uncertain and potentially broad scope. The excise tax applies to repurchases of stock by publicly traded corporations. It generally includes any "redemption" within the meaning of the U.S. tax code and any transaction the IRS determines to be "economically similar" to such a redemption. This definition's scope is far broader than the conventional stock buyback programs that appear to have been the intended target of the excise tax. Accordingly, publicly traded corporations will need to consider potential excise tax exposure for a wide range of transactions.

M&A transactions often include elements that are treated as "redemptions" for U.S. federal income tax purposes. For example, this "redemption" treatment can occur in a taxable transaction where some of the consideration paid to target shareholders is sourced from the target or from debt incurred or assumed by the target, or in a partially tax-free reorganization where "boot" (*i.e.*, cash or other nonstock consideration) is paid. Further, distributions by a corporation undergoing a liquidation and dissolution process could potentially be viewed as "repurchases," even though such distributions do not appear to raise the policy concerns underlying the new tax.

Absent IRS guidance to the contrary, the excise tax will also seemingly apply to redemptions by SPACs (such as in connection with a de-SPAC or an extension request), even if the SPAC was formed prior to the provision's enactment date. Redemptions of preferred stock with only limited equity features could also be taxed, even if the stock is redeemable pursuant to its terms and was issued prior to the enactment date.

Distributions by a corporation undergoing a liquidation and dissolution process could potentially be viewed as "repurchases," even though such distributions do not appear to raise the policy concerns underlying the new tax.

"Repurchase" exceptions. Certain transactions that otherwise constitute "repurchases" are explicitly excluded from the base of the excise tax, including a repurchase that is part of a reorganization (and in which no gain or loss is recognized on the repurchase by reason of the reorganization). This exception will require clarification in several respects, including its application to tax-free "split-off" transactions and to the payment of boot in acquisitive reorganizations and equity recapitalizations where the corporation may not be able to ascertain the amount of gain or loss recognized by particular shareholders.

Under another important exception, a repurchase is not subject to the excise tax in any case in which the repurchased stock (or other stock of equal value) is contributed to an employer-sponsored retirement plan, employee stock ownership plan or similar plan.

Netting of issuances against repurchases. The excise tax is applied to a net, rather than gross, measure of stock repurchases during each taxable year. To determine the net amount that is taxed in a given taxable year, the fair market value of stock issuances by a corporation during the year are generally netted against the fair market value of its stock repurchases during the year. Forthcoming IRS guidance is expected to address how to determine these values as well as whether tax-free stock dividends, stock splits and similar transactions should be credited as "issuances" for purposes of the netting rule. Public corporations will need to track stock issuances relative to repurchases to determine their excise tax liability.

(See also "Tax Enforcement: A Spotlight On Complex Partnership Structures.")

Tax Enforcement: A Spotlight on Complex Partnership Structures

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Key Points

- A 10-year, $80 billion increase in funding for IRS enforcement will bolster and expand the agency's existing programs examining large, complex partnerships.
- Some of the new funding is expected to go toward improving data analytics technology, to make it easier for the service to identify taxpayers for audits based on the likelihood of noncompliance.
- These additional resources will supplement existing enforcement programs focused on issues such as partnership transactions, partners' tax bases and limited partners' self-employment tax exceptions.

The boost in funding for the Internal Revenue Service (IRS) provided in the Inflation Reduction Act of 2022 (IRA) comes just as it has started rolling out in earnest programs focusing on auditing complex partnership structures. While specific plans over the next 10 years for the $80 billion of increased funding are not yet known, at least $45 billion will be used to increase enforcement efforts, and auditing complex partnerships remains a priority.

Focus on Partnership Compliance

Increasing enforcement efforts against large, complex partnerships has been in the works for nearly a decade. Beginning with 2018 tax returns, the IRS has had the ability to collect tax directly from a partnership, unless the partnership and its partners take certain steps to ensure the tax is otherwise paid by the partners themselves (thereby shifting the burden of collection from the IRS to the taxpayers).

The IRA funding for tax enforcement enhances the IRS' efforts to train and organize examination teams with specialized knowledge to audit complex partnership structures. The IRS' Global High Wealth Industry Group (GHW) audits high-net-worth individuals who often invest through partnerships, which has led to increased enforcement relating to conservation easements, self-employment tax and nonfiling of foreign entities. The GHW frequently opens simultaneous audits of both high-net-worth individuals and the entities through which they invest.

The IRS has also launched the Large Partnership Compliance Program (LPCP), based on a similar program for large corporations. The LPCP is intended to audit some of the largest partnerships in a comprehensive fashion, not focused on a single issue or topic. Large partnerships are selected based on data analytics identifying those with the highest risk of noncompliance.

Data Gathering: Updates to Filing Requirements and Improved Technology

While the IRS has a sense of the types of issues it wants to audit, it needs a method to identify entities and specific returns for audits. Selection can be hampered by lack of data from partnership tax returns as well as limited IRS capabilities to analyze big data using analytics and machine learning.

The IRS has taken significant steps in recent years to address the first of these issues, particularly in the context of partnerships with cross-border activities. In 2021, the IRS introduced Forms K-2 and K-3, which require partnerships to report myriad data regarding their foreign activities (as might relate to U.S. taxpayers) and their U.S. activities (as might relate to foreign taxpayers). The IRS recently announced that it would not require partnerships without foreign activities or partners to prepare and submit these two forms.

> Increasing enforcement efforts against large, complex partnerships has been in the works for nearly a decade.

The extensive information the forms collect follows other IRS efforts to increase the amount of data partnerships must provide to the IRS and their partners, including:

- the required calculation of a partner's tax basis by the partnership;
- disclosure of partners' share of "hot assets" generating ordinary income on sale; and
- other targeted improvements to partnership informational tax returns.

But increased data only helps if the IRS can evaluate that information to target entities that are potentially not in compliance. The IRS' new funding provides over $25 billion for increased operational support, including improved technology. One expected area of spending is improved data analytics technology, to allow the IRS to better identify taxpayers for issue-specific audits.

Compliance Campaigns and Priority Plans

Many of the IRS' strategies surrounding partnership compliance and its GHW initiatives over the last decade, as well as issues developed from audits of large corporations, have been formalized and centralized into compliance campaigns of the Large Business & International Division. Many of these impact partnership businesses and investment structures more broadly.

Ongoing campaigns include:

Transactions in partnership interests: A trio of campaigns focusing on transactions relating to partners' bases in their partnership interests, including specifically on deductions of partnership losses in excess of partner basis, distributions in excess of partner basis and sales of partnership interests. All three campaigns focus on partnership loss limitation rules and the application of partnership basis rules to calculation of gain. In addition, the IRS is seeking to identify taxpayers who fail to report partnership gain and/or misreport the character of gain.

Self-employment tax exception for limited partner interests: A campaign evaluating the extent and application of the exemption from self-employment tax for limited partners' distributive shares of partnership income. The attention is on partnerships engaging in businesses that the IRS considers service based, including investment advisory firms.

Financial service entities and U.S. trades or businesses from lending activities: Audits evaluating whether financial service entities with lending activities are engaged in a U.S. trade or business. This impacts credit-focused investment funds in particular and often is an audit of those entities' withholding tax information reporting forms.

FATCA filing accuracy: A focus on whether foreign financial institutions and certain other foreign entities satisfy their Foreign Account Tax Compliance Act (FATCA) reporting and withholding obligations. This can impact foreign partnerships qualifying as foreign financial institutions.

Inbound investment compliance: A series of campaigns focused on inbound investment, which is often made via pass-through entities. These include:

- the adequacy of Foreign Investment in Real Property Tax Act (FIRPTA) reporting for gain and certain other income from U.S. real estate investments;
- compliance with Forms 1042 and 1042-S filing requirements (often involving documentation of exemptions and rate reductions);
- Form 1120-F filing and general compliance (often an issue for non-U.S. "feeder" funds into U.S. partnerships); and
- satisfaction of documentation and substantiation rules for applying nonresident alien treaty exemptions.

In Sum

The IRS continues to develop formal campaigns and evaluate issues that will likely feed into large partnership audits and drive targeted audits of pass-through entities. In fact, the 2022-23 IRS Priority Guidance Plan lists developing "guidance on abusive use of partnerships for inappropriate basis adjustments." One official informally described this effort as taking a closer look at related partners' use of nontaxable transfers of partnership interests as well as an election under Section 754 to increase and shift basis between related parties. Taxpayers can expect that ongoing audit efforts will result in new coordinated approaches to enforcement.

(See also "New Corporate Minimum Tax and Stock Repurchase Tax Will Take Effect in 2023, but Questions Remain.")

More Intense Merger Reviews

US and EU Regulators Increase Scrutiny of Vertical Mergers

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Key Points

- On both sides of the Atlantic, regulators are taking expansive approaches to merger control, scrutinizing vertical combinations they previously would have approved and asking whether deals are likely to stifle nascent competition.
- In the U.S., the DOJ and FTC are increasingly reluctant to settle reviews with divestitures and instead are challenging more deals in court, pressing their "big is bad" approach to consolidation.
- As the EU has grown more receptive to behavioral remedies, Biden administration officials have expressed skepticism about their effectiveness.
- Different jurisdictions are increasingly coordinating their reviews, but that does not guarantee similar outcomes. Parties need to plan for the possibility of divergent results when negotiating merger agreements.

US Regulators Pursue an Expansive View of Antitrust Laws

For almost two years, industry participants have felt the effects of the Biden administration's "big is bad" approach to antitrust — not only in technology sectors, but also in health care, pharmaceuticals, transportation and manufacturing. This is not expected to change in 2023, even though Republicans will control the House of Representatives. In 2022, the antitrust agencies showed through word (policy changes) and deed (more litigation) that they are committed to pressing various theories to challenge mergers that historically faced little scrutiny, creating uncertainty for firms seeking to do deals. Despite several losses in court in 2022, the agencies show no signs of slowing their efforts to gain acceptance of their approach in the courts.

DOJ and FTC Continue To Litigate Aggressively

The leadership of both the Department of Justice (DOJ) Antitrust Division and the Federal Trade Commission (FTC) lived up to their articulated goal of litigating more merger challenges in 2022. Through November 2022, the agencies filed a total of nine complaints challenging mergers this year and tried four to conclusion. As Assistant Attorney General (AAG) Jonathan Kanter noted in a recent speech, this level of activity means the DOJ "litigate[d] more merger trials this year than in any fiscal year on record."

These cases reflect the administration's preference to take matters to court rather than accept divestitures that may not fully address alleged anticompetitive effects of a merger. Divestitures are now "the exception, not the rule," AAG Kanter said in a January 2022 speech.

> In 2022, the antitrust agencies showed through word (policy changes) and deed (more litigation) that they are committed to pressing various theories to challenge mergers that historically faced little scrutiny.

The agencies were largely unsuccessful in court this year. The DOJ's Antitrust Division sustained three back-to-back losses in September 2022 before winning an injunction against the tie-up between publishers Penguin Random House and Simon & Schuster. (The deal has since been terminated.) But the FTC and DOJ appear undeterred. In April 2022 remarks, AAG Kanter suggested that the agencies' "capacity for litigation must grow with the demands of modern antitrust enforcement" and that the DOJ "must have the scale to litigate multiples of [its] current docket."

Bases for Agency Challenges

This year, the agencies continued to pursue numerous theories that both go beyond traditional concerns about vertical consolidation and inject further uncertainty into the review process.

Vertical mergers. FTC Chair Lina Khan testified before Congress in September 2022 that the FTC has reoriented its "enforcement efforts to better capture harm from mergers involving firms at different levels of the supply chain," as part of a push to ensure enforcement "better correspond[s] to new market realities."

While the agencies historically considered vertical integrations to be largely pro-competitive — potentially generating efficiencies that could result in lower consumer prices, for instance — challenges filed this year embraced vertical theories of antitrust harm. They included attempts to block two health care deals, both unsuccessfully: one between insurer UnitedHealth and Change Healthcare, which operates a network for health care providers to seek reimbursement, and another between Illumina and GRAIL, two medical technology businesses.

Nascent competition. Enforcers continue to challenge mergers involving supposed nascent competitors, particularly in the technology sector. Such competition theories play a central role in the administration's push to rein in purported consolidation. As Chair Khan explained in a March 2022 speech, "The particular business strategies that digital markets reward require [enforcers] to look beyond concepts like foreclosure and exclusion."

One example is the FTC's ongoing challenge to Facebook parent Meta's acquisition of virtual reality app developer Within. There, the FTC alleges that Meta is attempting to buy out a potential competitor in the virtual reality fitness app market rather than compete on the merits by developing its own virtual reality fitness app.

Illumina/GRAIL is another example. There, the FTC and the European Commission (EC) adopted the same approach, arguing that a vertical merger could foreclose nascent competition. Illumina supplies next-generation sequencing technology (upstream market), while GRAIL develops early cancer detection tests using that sequencing technology (downstream market). Both regulators contended that Illumina could prevent GRAIL's rivals from accessing its essential technology to develop and bring tests to market in the future.

In September 2022, an FTC administrative law judge rejected the agency's challenge, finding that Illumina's proposal to supply GRAIL's rivals under standard conditions was sufficient to protect innovation and competition. The EC, however, blocked the deal (see discussion below). Both decisions have been appealed — by the FTC in the U.S. and by the companies in Europe.

Monopsony theories. The DOJ's sole successful lawsuit this year, which prevented a merger between publishers Penguin Random House and Simon & Schuster, reveals an increasing emphasis on labor issues and monopsony theories in antitrust enforcement. Rather than focusing on prices to consumers, the DOJ advanced a theory of harm based on decreasing commissions paid to authors. This case reflects the Biden administration's increased focus on labor markets and will likely incentivize greater attention to the effects of mergers on labor interests.

Policy Changes That Further a 'Big Is Bad' Approach

The FTC and DOJ are expected by year-end to issue revised Merger Guidelines that likely will reflect their expansive approach to enforcement. The FTC foreshadowed this in September 2021, when it withdrew the 2020 Vertical Merger Guidelines. In remarks when the public comment period on new guidelines began in January 2022, AAG Kanter said that the old guidelines "overstate the potential efficiencies of vertical mergers and fail to identify important relevant theories of harm." The heads of both agencies advocate assessing the impact of vertical mergers broadly, looking beyond traditional effects in a relevant market.

Consistent with this position, in November 2022, the FTC issued a policy statement providing guidance for the application of Section 5 of the FTC Act. Historically, Section 5, which makes unlawful "unfair methods of competition," has mostly been applied to conduct that violates the Sherman or Clayton Acts, or to attempted collusion. The new policy would extend Section 5 to conduct and mergers that may not violate the Sherman or Clayton Acts, using a relaxed analytical framework that eschews the rule of reason and questions the need to define a market or prove effects. It is possible that, in 2023, the FTC will look to Section 5 to challenge vertical deals, acquisitions of nascent or future competitors and deals implicating labor concerns.

The Bottom Line

There is no doubt 2023 will bring continued uncertainty for companies engaged in transactions. Despite a poor track record in court, the FTC and DOJ are likely to continue challenging mergers based on an expansive vision of antitrust law. With little to no judicial support to date for their "big is bad" approach, however, the agencies may find courts unwilling to break from precedent no matter how many cases are filed.

EU Regulators' New Focus on Vertical Mergers Makes for More Complex Reviews

In the European Union, as in the U.S., vertical mergers historically have been seen as less harmful than horizontal mergers from a competition perspective. But regulators in the EU and U.K., like their U.S. counterparts, have recently stepped up their scrutiny of vertical deals.

Novel Theories of Harm

The EC, in its review of vertical mergers, has started to test less traditional theories of harm that were previously typically seen in the context of horizontal mergers.

The EC's Phase II review of the Illumina/GRAIL combination was a test case for the new approach. It was the first time the regulator had applied a "loss of innovation" theory of harm to a vertical merger, and the first time since the introduction of the Non-Horizontal Merger Guidelines in 2007 that the EU had prohibited a deal purely on vertical concerns.

> The European Commission, in its review of vertical mergers, has started to test less traditional theories of harm that were previously typically seen in the context of horizontal mergers.

The EC's emphasis of the merger's impact on the innovation efforts of third parties, rather than of the merging parties, made it challenging to agree on a suitable remedy. The EC rejected the proposed behavioral remedies put forward by Illumina, which the FTC administrative law judge cited in approving the deal (providing Illumina competitors with access to GRAIL technology). The EC concluded that those remedies were complex and would be hard to monitor.

Parallel Reviews May Lead to Divergent Outcomes

As can be seen in the Illumina/GRAIL example, while regulators globally are taking steps to coordinate with one another — including on their more detailed parallel reviews of vertical mergers — cross-border coordination does not necessarily prevent divergent outcomes. Each regulator has a unique legal framework, process and priorities.

Substance. Meta's acquisition of Kustomer (a start-up that provides customer relationship management software to businesses) was cleared unconditionally at Phase I in the U.K. in September 2021, but was cleared subject to remedies following a Phase II review by the EC in January 2022. The EC and the U.K.'s Competition and Markets Authority (CMA) pursued similar theories of harm but ultimately reached different conclusions. Moreover, in a rare exception to the EU one-stop-shop principle, Germany's merger control agency, the Bundeskartellamt, opened its own investigation in parallel to the EC's. It ultimately took into account the remedies already accepted by the EC and cleared the deal unconditionally in February 2022.

Timetable. Extended reviews of vertical mergers in some jurisdictions may impact the timing in others. Coordination among regulators in the U.S., EU, U.K. and China was the likely reason behind the protracted eight-month pre-filing investigation in China of the NVIDIA/Arm merger. The parties, which operate at different levels of the global semiconductor supply chain, eventually abandoned their proposed tie-up in February 2022 following an administrative challenge by the FTC.

Remedies. An increasing number of vertical mergers that might previously have been cleared unconditionally are now being approved conditioned on remedies. While there are examples of regulators coordinating to avoid conflicting remedy packages, this may not always be possible in cross-border cases. In particular, while some regulators (EU) are willing to consider behavioral remedies, others (among them the U.S., U.K. and Australia) remain highly skeptical.

The EC has shown a greater willingness in recent years to consider and, in some cases, accept behavioral remedies in vertical mergers, in particular to address concerns regarding data. Approved remedies include interoperability requirements, open access remedies and "data silo" commitments under which merging firms segregate their data.

Looking Ahead

The heightened focus on vertical merger enforcement, in innovation-driven sectors in particular, appears set to continue into 2023. Like U.S. regulators, the CMA has been updating its merger guidelines to reflect its less lenient approach.

The increased focus on vertical mergers in the EU, U.K. and U.S. may also influence other regulators, some of which are showing a growing interest in, and questioning, vertical mergers. For example, the Australian Competition and Consumer Commission (ACCC) identified vertical concerns that led to a divestment remedy in the proposed merger of business software providers Dye & Durham and Link Administration in September 2022. (The deal collapsed a month later.)

The bottom line. While many vertical mergers will continue to be cleared unconditionally in the EU in Phase I, the transactions most likely to attract closer competition attention are those involving:

- a party that holds a degree of market power;
- a target that is the only credible supplier of an essential input; or
- the acquisition of an innovative start-up or potential entrant (particularly in the life sciences and tech sectors).

How Should Dealmakers Prepare To Ensure the Best Outcome?

Parties may need to factor into their deal timetables the possibility of extended regulatory reviews and conditional clearances. They should also be prepared to address potential vertical concerns — including those based on speculative theories of harm — with credible factual and economic evidence or with acceptable remedies.

The risk of divergent regulatory outcomes will remain a key challenge. Ultimately, it only takes one regulator to prohibit a deal. Competition clearance strategies may need to reflect the risk that offering a global remedy may not be successful. In these cases, early consideration of possible remedies will allow more time to design a flexible package that addresses potential competition concerns while preserving the synergies of the transaction.

(See also "Demystifying China's Merger Review Process.")

Demystifying China's Merger Review Process

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China's merger clearance authority plays a critical role in global M&A, even for deals that have few obvious ties to China. Particularly in the technology area, China is often the last hurdle to clear. Moreover, unlike those in other major jurisdictions, China's competition regulator must consider the impact of a deal not only on competition but also on China's national economic interests.

Hong Kong-based partner **Drew Foster** answers some common questions about the merger clearance process in China, which can seem opaque to many, and how best to navigate it.

1. What cases have to be submitted for review?

China's Anti-Monopoly Law requires parties to submit transactions that entail a change of "control." These include mergers and acquisitions, of course, but also joint venture (JV) transactions (sometimes even when the JV has no current or planned operations in China) and certain minority investments where no party is based in China.

China's competition authority, the State Administration for Market Regulation (SAMR), interprets a change of "control" broadly and has significant discretion in directing parties to file. Even the acquisition of a minority stake may be subject to filing if it comes with board representation, important veto rights such as appointment or removal of the CEO, or approval of the annual budget or business plan.

The revenue thresholds (converted to U.S. dollars) currently are:

1. at least two parties to the transaction each has revenue of $55 million or more in mainland China, and
2. the parties' combined annual group revenues globally are at least $1.4 billion, or they have combined revenue of at least $277 million in mainland China.

These thresholds are under review and are likely to be increased by the end of 2022 or early 2023.

The breadth of deals that fall under the filing requirement can surprise some. Revenue is calculated at the parent level (including the entire group), and SAMR does not require any nexus to China, other than group revenues. Thus, if two American parents form a JV in the U.S. to provide services in California, and the JV does not plan to have China activities but the parents otherwise meet the China revenue thresholds, SAMR requires a filing. (The deal may be eligible for expedited review, however, as explained below.)

SAMR also has the power to investigate transactions that do not meet the filing thresholds but might otherwise negatively affect competition in China or worldwide, as SAMR determines.

2. What does China consider in its review?

SAMR will conduct conventional competition analyses, examining transactions among competitors, looking at combined market shares and evaluating the risk that the transaction will raise consumer prices or stifle innovation. It will also review vertical and conglomerate mergers where the parties are active in related but nonoverlapping markets. Here, SAMR looks at whether a combined firm could block competitors' access to important inputs, unlawfully tie sales of a "must have" product together with sales of a weaker product or gain access to sensitive information about competitors (*e.g.*, where a competitor of one party is a customer of the other).

(U.S. and EU merger control agencies also are increasingly scrutinizing vertical combinations. See "US and EU Regulators Increase Scrutiny of Vertical Mergers.")

Unlike other jurisdictions, Chinese law requires that, in addition to competition concerns, SAMR consider the impact of a transaction on the "national economic development of China," *i.e.*, whether it runs counter to China's industrial policies or domestic interests. This means that, in most ordinary merger reviews, SAMR must solicit input from and take into account the views of a wide range of Chinese stakeholders.

If Chinese stakeholders object to a transaction, SAMR will try to achieve a consensus on the terms of a clearance.

3. How long does the review take?

China has a fast-track "simplified procedure," and about 99% of such cases are approved within three months from the initial submission. Deals are eligible where the parties' combined market shares are below 15% and their individual shares in related markets are below 25%. Overseas JVs with no operations in China also qualify. But SAMR has full discretion to determine which deals ostensibly meeting these requirements will in fact be allowed onto this fast track.

All other cases will be reviewed under the ordinary procedure, which typically takes six to nine months or more, even for cases that pose no serious competition or industrial policy issues. Complex cases usually take nine to 12 months — longer if they pose particular problems for stakeholders in China. Although SAMR's statutory time frames for reviews are shorter, in practice there are no consequences for the agency when it misses its deadlines. Indeed, SAMR was recently granted the ability to stop the review clock altogether, giving it even more power to delay reviews.

SAMR will not accelerate ordinary procedure reviews unless there is extraordinary political will on the China side to do so. Usually, this only occurs where a deal brings significant, incontrovertible benefit to China.

4. Why does the review take so long?

Because SAMR must consider China's national economic interests, it cannot unilaterally approve a transaction without factoring in the views of major stakeholders. Those include not only customers but also competitors, trade associations and important government ministries. If Chinese stakeholders object to a transaction, SAMR will try to achieve a consensus on the terms of a clearance. That can take many months, especially when there are commercial or geopolitical incentives to delay or obstruct a deal and/or there are serial negotiations with stakeholders (with sometimes competing interests themselves). SAMR's outreach process to domestic stakeholders is kept confidential from the parties, which makes assessing the situation at any given time extraordinarily challenging.

Fortunately, for deals that qualify, the simplified procedure replaces this stakeholder consultation with a 10-day public comment period. If no negative comments are received in that window, SAMR usually approves the transaction within a week or two.

5. Do Chinese regulators coordinate their investigations or remedies with authorities in other jurisdictions?

In complex global transactions, SAMR commonly coordinates with other peer regulators, especially those in the European Union, U.K. and U.S. The regulators will typically coordinate on theories of harm and timing expectations, though SAMR generally does not share large numbers of documents with other regulators. Traditionally, it has preferred to see what other major regulators will do before finalizing its own approach, often by addressing China-specific interests in addition to aligning with those dealt with at the global level.

6. What are the chances China will block our deal?

Of the thousands of deals that China has reviewed, only three (less than 0.01%) have been prohibited. The overwhelming majority (99%) are cleared unconditionally. Conditions typically are imposed in only about four to 10 cases each year (less than 1%). There have also been a handful of transactions where China delayed its decision for so long that the parties abandoned the deal.

It is noteworthy that nearly all of the prohibitions, conditional approvals and abandonments over the past 10 years have occurred in the technology sectors that are important to China's national growth, such as semiconductors, automotive/aviation, and industrial equipment and supplies.

China has not wanted to discourage investment or create geopolitical tensions by blocking deals, but many Chinese stakeholders are adept at using the SAMR process to extract commercial benefits or delay foreign deals. The agency is also very willing to insist on China-specific remedies, even where all other global regulators have approved unconditionally.

7. What impact do current geopolitical tensions have on the SAMR review process?

Particular incidents, sanctions or legislation may cause temporary delays or reactions through SAMR, and deals in sensitive sectors are more likely to experience political delays or remedy requests. For example, the China-U.S. trade disputes of the last five years, coupled with China's determination to achieve "chip independence," have led to significant scrutiny of semiconductor and related deals. Fortunately, geopolitical tensions usually do not affect the deals that SAMR permits to be reviewed in the simplified procedure.

8. How do we maximize our chances of getting through the review process quickly and unscathed?

Advance planning is the key. Well before signing, parties must assess China's likely level of interest in a deal, identify potential Chinese stakeholders with an incentive to use SAMR's review to their advantage and scope out competitive, geopolitical and industrial policy issues that could affect a decision. There is no substitute for undertaking thorough and detailed stakeholder mapping and using that to develop an action plan for the potential challenges.

It cannot be stressed enough that there is no silver bullet, and no single person, consultant or politician who can cut short SAMR's review or consultation procedures and deliver a miraculous unconditional approval. In almost all instances, the only way through the process is through it. Nonetheless, parties should use their own China government relations teams to navigate stakeholder demands. These contacts can also be supplemented by expert local counsel who can offer insight into the SAMR process.

Finally, it is best to keep a low profile politically to minimize the odds of attracting adverse attention.

9. What if we just don't file or, if we run into trouble, close without Chinese approval?

If the filing thresholds are met, Chinese law prohibits closing any part of the deal prior to approval. SAMR will not allow the parties to hold separate the China portion of a deal while closing elsewhere or "park" China assets with a financial buyer with no China revenues in order to circumvent the filing obligation.

China recently increased the fines for gun-jumping (closing before approval) tenfold to about $700,000 for cases that do not pose issues. For a high-profile transaction raising real competition or industrial policy concerns, the fine can now be up to 10% of the acquirer's global turnover in the previous year. In addition, SAMR can, in theory, order the parties to unwind the transaction and/or revert to the status quo prior to the transaction, although that power has only been used once in China's merger review history, and that was done in a domestic combination.

Litigation Developments

Supreme Court Term May Upend Precedent, Push Back Regulation

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Key Points

- The Supreme Court's 2022 docket raises politically and socially charged questions concerning race, election law and civil rights, as well as potentially wide-ranging business issues.
- The Court could dramatically shift the law in several areas if its willingness to reexamine precedent continues.
- The justices may be more likely to forge consensus in business cases, agreeing on narrow issues without sacrificing their broader worldviews.
- The Court's tendency to question the basis for government regulation may continue to create new opportunities for businesses to challenge administrative action.

The U.S. Supreme Court's 2022 term opened in October with another docket that is teeming with controversial issues, ranging from affirmative action in college admissions and third-party liability for social media posts to corporations' consent to being sued in jurisdictions outside their home state. Many of these cases won't be decided until the term draws to a close in June 2023. In the meantime, businesses should be watching for meaningful trends as the term unfolds.

How Dramatically Will the Court Shift the Legal Landscape?

The 2021 term revealed the Court's willingness to revisit precedent. The most obvious example was *Dobbs v. Jackson Women's Health Organization*, in which five justices voted to overrule *Roe v. Wade*. The *Dobbs* majority's articulation of a weakened version of *stare decisis* — one that applies only to "very concrete reliance interests, like those that develop in property or contract rights" — may allow the Court to reshape the law in other areas.

The Court also signaled its inclination to narrowly construe other precedent, including by undermining the force of *Chevron* — the long-standing framework for deferring to an agency's reasonable interpretation of an ambiguous statute — by conspicuously omitting it from several important administrative law decisions.

The 2022 term provides additional opportunities for the Court to reconsider precedent, on issues such as affirmative action, the Clean Water Act's regulatory reach, the intersection between LGBTQ+ rights and religious freedom, and the scope of the Voting Rights Act's protections against racial gerrymandering.

Impacts on Businesses

The justices are also poised to tackle important questions that could have broad nationwide ramifications for businesses.

Where companies can be sued. In *Mallory v. Norfolk Southern Railway Co.*, the Court will address the constitutionality of a Pennsylvania law requiring corporations to consent to personal jurisdiction in order to do business in the state, a decision that could significantly affect the number of states in which a business can be sued.

Whether states can regulate out-of-state conduct. *National Pork Producers Council v. Ross* requires the justices to revisit the scope of the dormant commerce clause — the doctrine that restricts states from burdening interstate commerce by regulating conduct in other states. The Court will decide whether California, which imports more than 99% of its pork, can require farms outside California to meet certain animal welfare criteria before selling their pork there. The answer could greatly impact states' ability to regulate other types of out-of-state conduct, from using pesticides and union labor to mailing abortion pills. The decision will also shed light on the current justices' views of the dormant commerce clause, which has long divided the Court across ideological lines. Justice Samuel Alito embraces the doctrine, while Justice Clarence Thomas rejects it, and the views of the newest justices remain to be seen.

Who is accountable for social media posts. In *Gonzalez v. Google LLC* and *Twitter, Inc. v. Taamneh*, the Court will consider the extent to which social media companies may be held liable for content third parties post on their platforms. The answer could have significant implications for users and hosts alike.

How U.S. law applies abroad. In *Abitron Austria GmbH v. Hetronic International, Inc.*, the Court will revisit decisions governing the extraterritorial application of U.S. law — specifically, whether the Lanham Act's protections for U.S. trademarks apply to purely foreign sales. The decision could change the Court's framework for assessing extraterritoriality, considerably expanding or restricting the scope of liability for conduct that takes place abroad.

The Bottom Line

Just how far the Court will move the law in any of these instances remains to be seen, but if last term is any indication, the justices may not shy away from major changes. Businesses will want to monitor these and other cases so they can anticipate potential ramifications.

Will the Court Continue To Find Common Ground in Business Cases?

Any of these business cases could result in a watershed decision, but they might also once again unite the justices in a term filled with divisive social issues.

Overall unanimity fell in the last term to 29% (compared to 43% over the last decade), marking it the first term in many years when 9-0 wasn't the most common voting alignment. Instead, 6-3 decisions predominated.

But business cases provided a noteworthy exception. Of the 10 signed decisions from last term in which the U.S. Chamber of Commerce filed an *amicus* brief, seven were unanimous and two were 8-1. Only one decision in a Chamber-supported case divided the justices along ideological lines. And of the signed decisions in Chamber-supported matters, businesses prevailed in six.

> Any of these business cases could result in a watershed decision, but they might also once again unite the justices in a term filled with divisive social issues.

In other words, the justices largely agreed on business cases, regardless of which side won. It may be that, against the backdrop of highly controversial issues like abortion, guns, religion and climate change, the justices were more willing to find common ground in the 2021 term's business cases, where they could agree on narrow questions without sacrificing their broader views. If that trend continues, the 2022 term's docket might once again encourage them to forge consensus in this area.

The Bottom Line

Business litigants in particular may want to think strategically about offering narrower approaches for deciding cases. Advocates still need to present strong doctrinal arguments — which can sometimes lead to sweeping positions — but they also must consider how to appeal to some of the justices to vote, potentially atypically, in a way that builds institutional legitimacy but does not undermine their long-term worldviews.

Will Skepticism of Government Regulation Continue To Create Opportunities for Businesses?

In recent years, the Court has been increasingly willing to question the basis for government regulation. It has narrowed doctrines that afford agencies latitude, as in *Chevron* and *Auer*. And it has christened new limitations on agency action: In *West Virginia v. EPA*, the Court approved the "major questions" doctrine, which restricts federal agencies' power to act on "decisions of vast economic and political significance" absent clear congressional authorization. That rule, which may hamper agency action across the executive branch, dovetails with several justices' interest in reinvigorating the nondelegation doctrine — a move that would restrict Congress' ability to delegate its lawmaking authority to other branches.

The 2022 term provides another opportunity for the Court to cabin administrative power. In *Axon Enterprise, Inc. v. FTC* and *SEC v. Cochran*, the Court will consider whether individuals and businesses that seek to contest agencies' ability to regulate their conduct can go directly to federal court with their jurisdictional and constitutional challenges, or instead must first litigate them before the agency. The answer could make it easier to challenge administrative action, adding to the line of recent decisions limiting the administrative state.

It might also impact the validity of agencies' adjudicative proceedings more generally, an issue that is percolating in the lower courts. The U.S. Court of Appeals for the Fifth Circuit's May 2022 decision in *Jarkesy v. SEC* dealt a considerable blow to the SEC's in-house enforcement actions, holding that they violate the Seventh Amendment right to a jury trial and unconstitutionally delegate legislative power. While those questions are not currently before the Court, the justices are likely to be thinking about them as they consider *Axon Enterprise, Inc.* and *Cochran*.

The Bottom Line

The Court's willingness to question the basis for government action often works in businesses' favor, as it did last term — perhaps most notably in *West Virginia* and *NFIB v. OSHA* (staying the Occupational Safety and Health Administration's rule regarding COVID-19 vaccines). Both decisions limited administrative power and represented victories for the business interests that opposed the challenged regulations. If that trend continues this term, it may open new avenues for businesses to challenge government action. And if the Court also continues to be open to revisiting precedent, there may be more room to bring novel or creative challenges to government regulation.

* * *

While we won't know the full impact of the 2022 term until June 2023, the trends discussed here may shed early light on where the Court is heading.

Trends in Forum Selection Provisions, Merger Objection Class Actions and SPACs Continue To Shape Securities Litigation

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Key Points

- State courts are enforcing federal forum provisions for cases under the Securities Act, encouraging companies to amend their charters or bylaws to add these clauses.
- The previous boom in SPAC IPOs and subsequent mergers is likely to sustain a flow of class actions involving those transactions.
- Suits challenging mergers have not declined, but most are now brought as individual suits rather than class actions.

In the first nine months of 2022, plaintiffs filed 157 securities class action lawsuits, according to Cornerstone Research — a figure only slightly lower than the 162 filings in the same period in 2021. Looking behind the numbers, class actions relating to SPACs and cryptocurrencies are expected to remain elevated in 2023 (see "Rise in Crypto Securities Filings Could Persist"), while state courts rulings on federal forum provisions and a shift in tactic for plaintiffs challenging mergers will continue to play out and shape securities litigation in the coming year.

State Courts Continue To Uphold Federal Forum Provisions, Further Diminishing the Impact of *Cyan*

Plaintiffs filed 10 suits under the Securities Act in state court in the first nine months of 2022, compared to 15 in the same period in 2021. State filings are now at roughly one quarter of their 2019 levels. Indeed, Cornerstone reports that no plaintiff brought a state Securities Act claim in the third quarter of 2022.

These declines suggest that the Delaware Supreme Court's endorsement of federal forum provisions (FFPs) in the 2020 *Sciabacucchi* decision is having its anticipated effect by persuading more corporations to add these clauses to their corporate charters or bylaws, thereby steering Securities Act cases away from state courts.

In 2021, trial courts in New York (*Hook v. Casa Systems, Inc.*) and Utah (*Volonte v. Domo, Inc.*) joined California and Delaware in enforcing FFPs. And in May 2022, the first appellate court outside of Delaware — the California Court of Appeal — added to this string of victories by enforcing an FFP in *Wong v. Restoration Robotics, Inc.*

These rulings may weaken the effect of *Cyan, Inc. v. Beaver County Employees Retirement Fund*, the 2018 U.S. Supreme Court decision that affirmed the ability of state courts to hear Securities Act class actions and foreclosed defendants from removing such cases to federal court.

The Bottom Line

Because New York and California state courts are popular jurisdictions for Securities Act claims, corporations could be well positioned to avoid them by including FFPs in their charters, provided that doing so is otherwise viable and appropriate. That said, because courts have not universally adopted FFPs, we expect state court Securities Act litigation to continue, though with less frequency than in previous years.

SPAC-Related Filings Remain Elevated as Courts Begin To Rule on Motions To Dismiss

Filings related to SPACs this year are on track to surpass the number in 2021.

While the market for SPAC IPOs has cooled, litigation is likely to persist due to the record numbers of SPAC IPOs and de-SPAC transactions conducted in 2021 and early 2022.

Nearly 500 SPACs are still searching for acquisition partners. These searches, if successful, will likely attract scrutiny as they move toward closing and beyond. In addition, Cornerstone recently observed that the median lag time between a de-SPAC transaction and the commencement of litigation is relatively long — 240 days, or just under eight months. Given the large number of deals completed in 2021, this figure suggests the potential pipeline of cases will not dry up anytime soon.

> While the market for SPAC IPOs has cooled, litigation is likely to persist due to the record numbers of SPAC IPOs and de-SPAC transactions conducted in 2021 and early 2022.

In 2022, courts also started deciding SPAC-related motions to dismiss. So far, the results have been mixed. While it is too early to detect trend lines or draw definitive conclusions, several recent decisions have sustained plaintiffs' allegations, either in whole or in part. These results will likely encourage plaintiffs to continue filing SPAC-related suits.

The Bottom Line

We expect to gain more insight into how courts are treating SPAC-related allegations in the coming year as more motions to dismiss are decided.

Merger Objection Class Actions Decline as Plaintiffs Pivot Toward Individual Actions

Merger objection cases continued to decline in 2022, with only five class actions filed in federal court during the first nine months of the year. This trend aligns with a decrease that we first observed in 2020. According to Cornerstone, federal M&A class action filings are now just a fraction of the 198 filings we saw in 2017, the peak year for such suits.

Merger objection litigation, however, has not vanished — or even receded in a meaningful way. Instead, several plaintiffs' firms are filing disclosure challenges in federal court as individual rather than class action lawsuits. This shift is likely motivated in part by a desire to evade the Private Securities Litigation Reform Act, which bars an individual from serving as lead plaintiff in more than five securities class actions in a three-year period. The data appear to bear this out. They show, for instance, that one plaintiff, represented by the same law firm, has filed over two dozen individual merger objection actions in federal court thus far in 2022.

Many of these complaints are voluntarily dismissed quickly. According to Bloomberg, individual actions filed in 2022 were open, on average, for only 40 days — a sign that plaintiffs are routinely procuring a so-called mootness fee in exchange for the company making supplemental disclosures in its proxy statement.

Because the suits are styled as individual actions, plaintiffs' firms typically can strike these deals while avoiding judicial scrutiny. A proposed class action settlement, by contrast, requires the court's approval.

> Several plaintiffs' firms are filing disclosure challenges in federal court as individual rather than class action lawsuits.

Some defendants, however, have pushed back and refused to pay this "deal tax." Earlier this year, in a case involving Microsoft's $19.7 billion acquisition of Nuance Communications, the defendant, Nuance, mooted the plaintiff's allegations by filing supplemental disclosures and then rejected counsel's $250,000 fee demand, forcing the plaintiff to seek judicial relief. In February 2022, Judge J. Paul Oetken of the U.S. District Court for the Southern District of New York denied the application, holding that the disclosures were immaterial and had not conferred a "substantial benefit" on Nuance's shareholders. Similarly, in 2021, Judge Ronnie Abrams of the same court denied a firm's request for $400,000 in fees in a case brought against SemGroup Corp., citing similar reasons.

The Bottom Line

Litigation costs may discourage many companies from fighting requests for mootness fees in courts. For that reason, we consider it unlikely that merger objection suits will recede in any substantial way without legislative reform. At the same time, the Nuance and SemGroup Corp. decisions may provide corporate defendants with leverage to negotiate for a lower fee — or, if so inclined, to lodge an objection with the court.

Rise in Crypto Securities Filings Could Persist

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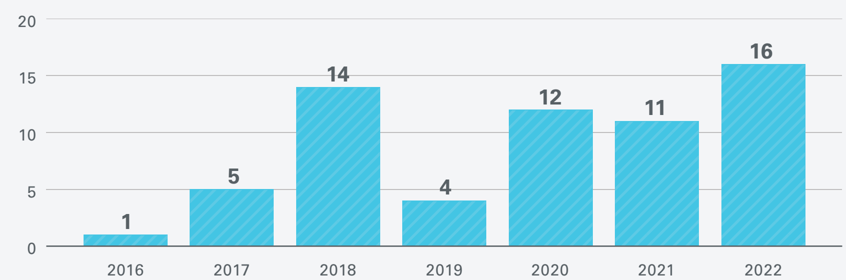
Key Points

- The number of cryptocurrency-related class action securities litigation filings has been building in recent years and may set records in 2023.
- The SEC's newly added resources and attention to the digital asset space are expected to lead to an uptick in enforcement actions next year.
- The question of extraterritoriality and the *Howey* test will likely remain a central debate in future lawsuits given the global nature of the industry and the ever-evolving question of whether cryptocurrencies are securities.

Increased regulatory oversight and recent turmoil in the digital asset market have led to a rising number of securities litigations focusing on cryptocurrencies. Sixteen cryptocurrency-related class actions have been filed this year — more than in any single year since the first such filing was recorded in 2016, according to Stanford Law School's Securities Class Action Clearinghouse.

Cryptocurrency-Related Class Action Securities Claims, 2016-22



Source: Stanford Law School's Securities Class Action Clearinghouse (a collaboration with Cornerstone Research)

Suits against cryptocurrency exchanges in particular are up significantly, according to Cornerstone Research, accounting for almost half of all cryptocurrency-related class action filings since the start of 2020. This stands in contrast to filing activity between 2016-19, when less than 10% included exchange-related allegations.

Despite recent turmoil in the cryptocurrency market, it is unclear whether the pace of filings will continue. It may slow due to lack of investor interest, but on the other hand, securities litigation is often driven by decreases in the underlying asset's value. (Consider, for example, the number of mortgage-backed securities cases in the wake of the 2007-09 global financial crisis.) If the cryptocurrency sector remains turbulent, and if enforcement ramps up as expected, 2023 could be another record-breaking year.

(For a broader discussion on securities litigation trends, see "Trends in Forum Selection Provisions, Merger Objection Class Actions and SPACs Continue To Shape Securities Litigation.")

SEC Enforcement

The Securities and Exchange Commission (SEC) continues to be a main regulator in the cryptocurrency space. Its actions have focused on two allegations: (1) unregistered securities offerings and (2) fraudulent securities offerings or sales.

Actions rise. The number of cryptocurrency-related enforcement actions brought by the SEC has increased in recent years, from 97 total in 2013-21, to 20 in 2021 alone, according to Cornerstone.

Forces expand. The SEC has increased its resources devoted to the digital asset space. In the first half of 2022, it nearly doubled the size of its Crypto Assets and Cyber Unit, with six dedicated trial counsel and an expanded leadership team, including a new permanent chief and deputy chief. Additionally, the SEC's Division of Corporation Finance created an Office of Crypto Assets within its Disclosure Review Program. While these resources are not all directed at litigation, the SEC's increase in spending and attention to the digital asset space will likely lead to an uptick in related enforcement actions in 2023.

Other enforcement trends we're watching:

- the SEC's apparently increased commitment to resolving digital asset cases through litigation rather than settlement when compared to the general trend across all the agency's enforcement actions;
- more scrutiny of market intermediaries, such as exchanges and broker-dealers, rather than issuers or promoters of single tokens. As such, these intermediaries may bear the brunt of any increased enforcement activity; and
- the SEC's interest in a relatively new area of digital asset enforcement: insider trading. In its July 2022 complaint in *SEC v. Wahi*, the agency asserted insider trading claims against a former Coinbase product manager, his brother and a friend. The SEC alleged that nine of the digital assets purchased and sold by the defendants were securities under *Howey*. A concurrent Department of Justice (DOJ) indictment alleged that the same defendants engaged in insider trading with respect to 25 digital assets. Why the SEC and DOJ amounts differed remains unsolved, but it presumably relates to the former's determinations under the *Howey* framework.

(See also "Enforcement Priorities Could Shift in a Downturn.")

Recent Case Law Developments and Areas of Focus

With respect to recent case law developments, the question of extraterritoriality and the so-called *Howey* test have been areas of focus that will likely extend into 2023, given the industry's global nature and the ever-evolving question of whether cryptocurrencies are securities.

Extraterritoriality: Plaintiffs Hit Roadblocks

Anderson v. Binance. In a March 2022 decision involving cryptocurrency trading platform Binance, Judge Andrew Carter of the U.S. District Court for the Southern District of New York granted the defendants' motion to dismiss after concluding that the plaintiffs had failed to plead an adequate connection to the U.S., as required by the U.S. Supreme Court's decision in *Morrison v. National Australia Bank Ltd*. The court held that Binance's alleged use of U.S.-based servers was not enough to demonstrate that either it was a domestic exchange or the transactions themselves were otherwise domestic.

Williams v. Block.one. In an August 2022 ruling involving blockchain software developer Block.one, Judge Lewis Kaplan of the Southern District of New York rejected the plaintiffs' theory that the location of the token purchaser in the U.S. was dispositive under *Morrison*. Consistent with the holding in *Binance*, Judge Kaplan observed that such a theory "arguably is at odds with Second Circuit cases holding that the purchaser's location is not determinative."

The bottom line. Given the global nature of the industry, litigants undoubtedly will continue arguing about the question of extraterritoriality and whether transactions are or are not domestic.

The *Howey* Test: Continued Development

The application of the *Howey* test remains a developing area and highly fact dependent. The test sets out factors to determine what qualifies as an investment contract, and thus a security: (1) whether there is an investment of money (2) in a common enterprise (3) with a reasonable expectation of profits from the efforts of others.

Audet v. Fraser. In a June 2022 ruling, Judge Michael Shea of the U.S. District Court for the District of Connecticut reviewed the first-ever jury verdict that considered whether digital assets were securities (and concluded they were not). Notably, with respect to assets called "Hashlets," which allegedly represented shares in profits from the defendants' computing power, Judge Shea upheld the jury's verdict that they were not securities under *Howey*, because they lacked a common enterprise or expectation of profits based on others' efforts. Judge Shea, however, did grant a new trial with respect to whether Paycoin was a potential investment contract.

SEC v. LBRY, Inc. In November 2022, Judge Peter Barbadoro of the U.S. District Court for the District of New Hampshire granted the SEC's motion for summary judgment as to whether software company LBRY, Inc. offered tokens (called "LBRY

Credits" or "LBC") in securities transactions. Among other things, Judge Barbadoro ruled that potential investors would understand that "LBRY's overall messaging … was pitching a speculative value proposition for its digital token," thus satisfying the expectation-of-profits prong of the *Howey* test.

The bottom line. We anticipate that, as more cryptocurrency litigations are filed, the application of the *Howey* framework will continue to evolve.

In Sum

Cryptocurrency market participants may face continued cases in 2023 — whether in the form of private securities litigation or SEC enforcement actions — and they will likely focus on complex issues such as the application of the *Morrison* and *Howey* tests. Other forces, such as continuing market turmoil and changing regulatory scrutiny, could result in new and unpredictable developments in this evolving industry.

The Evolving Climates in the US and UK for Environmental Damage Claims

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Key Points

– The U.S. Supreme Court may hear cases asking whether the federal Clean Air Act preempts state common law claims for injuries allegedly caused by climate change, an issue on which circuit courts have split.

– English courts have been willing to entertain claims involving alleged climate change-related harms caused by foreign subsidiaries of U.K. companies.

– Directors of U.K. companies could come under pressure from derivative actions challenging their roles in responding to climate change issues, though such cases must be approved by a court.

The November 2022 United Nations Framework Convention on Climate Change (COP27) spotlighted the political and diplomatic challenges of compensating damages caused by climate change. At the same time, fundamental questions about who should be held responsible, and how, remain. Parties are increasingly turning to the courts to settle claims of climate change-related injuries.

Recent developments in U.S. and U.K. courts illustrate the varying approaches. This term, the U.S. Supreme Court may consider whether a federal statute preempts climate change-related claims under state common law. Meanwhile, claims arising from environmental incidents across the world are finding a platform in the U.K. courts — and companies and directors are under increasing scrutiny for their approaches to climate change.

Federal Versus State Common Law in the US

After the U.S. Supreme Court limited the federal government's ability to regulate greenhouse gas emissions in its last term, it may once again wade into climate change litigation. Two cases with pending petitions for *certiorari — BP P.L.C. v. Mayor & City Council of Baltimore* and *Suncor Energy (U.S.A.) Inc. v. Board of County Commissioners of Boulder County* — have the potential to determine whether state law tort claims can provide redress to climate change's victims.

Background. Both petitions present a sequel to the Court's 2011 decision in *American Electric Power Co. v. Connecticut*. There, the Court held that the plaintiffs could not bring federal common law public nuisance claims to seek abatement of greenhouse gas emissions from fossil fuel-fired power plants. The Court found these claims had been displaced by the Clean Air Act, which authorizes the Environmental Protection Agency to regulate carbon emissions. Yet the Court left unresolved whether the Clean Air Act also preempted state common law claims involving climate change.

Seeking removal to federal court. In the pending petitions, municipalities asserted state common law tort claims against energy companies for their alleged role in exacerbating climate change. The defendants sought removal to federal court, arguing that federal common law necessarily and exclusively governs claims seeking redress for injuries allegedly caused by the effect of interstate greenhouse gas emissions on the global climate.

Circuit split. The U.S. Courts of Appeals for the Fourth and Tenth Circuits both rejected this argument, affirming the district courts' orders remanding the cases to state court based on lack of jurisdiction. However, in a similar case in 2021, the U.S. Courts of Appeals for the Second Circuit refused to remand similar claims and held that the plaintiffs could not use state tort law to hold multinational oil companies liable for damages caused by greenhouse gas emissions, because these claims fell within the domain of federal common law.

Far-reaching implications. Should the Supreme Court decide to take up the pending petitions, it could close a significant potential route of climate change litigation. If it concludes that plaintiffs' claims arise exclusively under federal common law, then all of their claims will likely be dismissed under *American Electric Power* as displaced by the Clean Air Act. Conversely, if plaintiffs are permitted to litigate their claims under state common law, courthouse doors could be open for damages claims seeking redress for the effects of rising sea levels and extreme precipitation events, among others.

The outcome could be far-reaching. As of the filing of the cert petitions, more than 20 pending cases in federal courts were contesting related questions.

The Supreme Court recently invited the U.S. solicitor general to file a brief expressing the federal government's views on the *Suncor Energy* petition, signaling a degree of interest in hearing the case.

(For a broader discussion on what the Supreme Court's 2022 term may bring, see "Supreme Court Term May Upend Precedent, Push Back Regulation.")

Potential for Corporate Liability in the UK

English courts appear to be increasingly willing to hear claims for damages against U.K. parent companies for actions of their foreign subsidiaries. The focus has been predominantly on energy companies being pursued for alleged environmental damage around the world.

In July 2022, the Court of Appeal overruled a finding of *forum non conveniens* as to a class action sought to be brought against mining company BHP for the collapse of the Fundao Dam in Brazil in 2015. The Court of Appeal was not concerned by the potentially "unmanageable" nature of the proceedings, nor by the risk of inconsistent findings in parallel Brazilian proceedings. It also found that there was a legitimate advantage to pursuing the English proceedings because it might improve the chance of a settlement.

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Other examples of environmental claims in the English courts include those pursued by Zambian villagers against U.K.-based Vedanta and its Zambian subsidiary (*Vedanta Resources PLC v Lungowe*), and by Nigerian individuals regarding Shell's alleged pollution of the Niger Delta (*Okpabi v Royal Dutch Shell Plc*).

The coming year will be illuminating as the stages of liability unfold and damages, if any, are quantified. Both areas will encompass complex and novel issues of environmental law, tort and company law.

Recourse to the Competition Appeal Tribunal. We are also likely to see increased recourse to the Competition Appeal Tribunal (CAT)'s collective proceedings procedure for ESG-based claims. A recently announced class action application against U.K. water companies for allegedly illegal discharges into waterways is the latest example of a trend of imaginatively framing claims in competition law terms to benefit from this regime. This will be the first "environmental" class action the CAT has considered and will be formulated in terms of excessive pricing and financial loss connected to the water companies' alleged abuse of dominance.

Derivative claims. Another related and significant development in 2022 was the emergence of derivative claims as a mechanism for holding directors to account for climate change issues. (Derivative claims are brought in the name of a company against its directors.) The environmental law group ClientEarth, for instance, has signaled an intention to bring a derivative claim against Shell's board for allegedly failing to prepare properly for the net-zero transition and setting inadequate targets for reductions in greenhouse gas emissions. Although a derivative claim requires the court's permission and ultimately may be unlikely to result in a finding of liability, it is potentially an effective tool for those aiming to challenge corporate policies and create reputational difficulties. Applicants for permission to bring a derivative claim need only hold one share, so ClientEarth's approach would be relatively easy to replicate.

A Divided Congress Will Have an Active Investigations Agenda Over the Next Two Years

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Key Points

- Democrats are likely to have the same investigative priorities in 2023 as they did leading up to the midterm elections, both as the majority in the Senate and the minority in the House.
- Republicans' victory in the House could lead to oversight of Big Tech and corporate ESG policies, among other priorities.
- Congressional oversight likely will dominate both parties' agendas as lawmaking grinds to a halt and both sides gear up for the 2024 presidential election.

Democrats, having maintained narrow control of the upper chamber in the midterm elections, likely will remain focused on the issues and industries they prioritized in 2022.

Meanwhile, with Republicans taking control of the House in January 2023, we expect an aggressive investigative agenda aimed at government actors and the private sector. Congressional oversight will be a critical tool for House Republicans limited on the legislative front by their slim majority.

Digital assets likely will receive attention from both sides of the aisle. The two parties also may focus on climate change and Big Tech, but any inquiries will be from opposing views.

Continued Democrat Oversight Initiatives

Although not directly impacting the business community, we would be remiss not to mention congressional investigations into high-profile political issues. Most notably, the House Select Committee to Investigate the January 6th Attack on the United States Capitol has garnered much attention, particularly after issuing a subpoena to former President Donald Trump.

However, Democrats have conducted other investigations with greater implications for private companies, including:

Cryptocurrency-related fraud. Various committees and members have initiated inquiries into alleged fraud in the digital asset space. Moreover, following the recent collapse of a cryptocurrency exchange, leaders from both sides of the aisle have made public statements calling for greater oversight.

Climate change. While Congress was passing key aspects of the Biden administration's legislative agenda on climate change, committees in both chambers homed in on oil and gas companies and their impact on global climate change. The House Oversight and Reform Committee has been the most active, holding three hearings on the industry's prices, profits, climate pledges and alleged role in spreading "climate disinformation." Meanwhile, the House Natural Resources Committee focused on whether public relations (PR) firms played a part in broadcasting allegedly misleading information on climate change. After holding a hearing on the topic, the committee released a report in September 2022 concluding that PR firms helped oil and gas companies challenge climate policies and allegedly mislead the public about their "green" initiatives.

Other industries. Democrats convened hearings, sent letters and requested Government Accountability Office reports aimed at other industries, including:

- **internet providers**, for alleged price hikes, speed cuts and fraud risks;
- **commercial banks**, relating to consumer protection, inflation, diversity and inclusion, enforcement actions and recidivism, mergers and acquisitions, emerging technologies, workers' rights and abortion access;
- **the cryptocurrency and bitcoin mining industry**, regarding its impact on the Texas power grid, climate change and consumers;
- **drug manufacturers**, for their tax practices; and
- **hospitals**, relating to compliance with the Hospital Price Transparency rule.

Republican Priorities in 2023

House Republicans are expected to launch a series of investigations into the Biden administration. Republicans have signaled their intention to investigate President Joe Biden's response to the pandemic, U.S.-Mexico border issues, the withdrawal from Afghanistan, the Mar-a-Lago warrant, President Biden's son Hunter and industries in the private sector with ties to the Biden administration.

> Congressional oversight will be a critical tool for House Republicans limited on the legislative front by their slim majority.

Prior to the midterm elections, House Minority Leader Kevin McCarthy held regular training sessions for Republican members and staff on oversight, including two titled "Oversight Education Series: Investigations 101" and "How To Conduct Detailed Depositions."

Although Republicans are typically less adversarial toward business and industry, Republican members have expressed an interest in conducting investigations targeting the following areas.

Big Tech. In August 2022, Republican congressional staffers reportedly met with several think tanks to strategize potential investigations aimed at Big Tech. Such probes could focus on the technology industry's ties to the Biden administration, censorship and partisan bias. As a preview of potential oversight in this area, Rep. Jim Jordan, R-Ohio, and 34 other House Republicans sent a letter in September 2022 to a technology company CEO outlining concerns about the company's role in the 2020 presidential campaign. The Republicans requested that the company preserve all existing and future records related to their inquiry.

ESG policies. Republican lawmakers are expected to focus on what they describe as "woke capitalism," — the belief that banks and Wall Street have prioritized environmental, social and governance (ESG) causes traditionally associated with left-leaning politics. (See "ESG Momentum Remains Strong but May Face Headwinds in 2023.") News sources suggest that CEOs of major financial firms could be called to testify about their ESG policies, specifically any efforts to curb climate change and end investments in the fossil fuel industry.

Climate change. Several conservative organizations have lobbied to disband the House Select Committee on the Climate Crisis, as the Republican House leadership did in 2011. While Republicans have not publicly addressed the future of the committee, they may decide to use the panel as a platform to challenge the Biden administration's climate and energy policies if they reauthorize it. Republican lawmakers also have vowed to investigate climate-related disclosure regulations initiated by the Securities and Exchange Commission.

Focus on China. Several Republican lawmakers have expressed interest in focusing on China as it relates to supply chains, foreign policy and national security. These probes could impact drug manufacturers, the wind and solar industry, electric vehicle manufacturers, technology companies and financial institutions. Republicans also may establish a select committee to address issues related to China.

In Sum

With a divided government, Republicans holding only a narrow majority in the House and both parties gearing up for the next presidential election, we can expect congressional activity to be dominated by oversight battles as gridlock prevents the parties from achieving their respective legislative agendas.

Companies should continue to monitor developments inside the Beltway and determine whether their industry attracts the attention of either party and how they can prepare for any potential probes or inquiries.

Pressure for ESG Policies

ESG Momentum Remains Strong but May Face Headwinds in 2023

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Key Points

- ESG is expected to remain a priority in 2023, with investors, employees and other stakeholders continuing to press for climate change and diversity policies and disclosures.
- Companies in the U.S., U.K. and EU will face new government ESG mandates and proposals in the new year.
- Businesses should closely monitor developments in legal challenges to companies' diversity, equity and inclusion programs. U.S. Supreme Court rulings on affirmative action cases also have the potential to impact corporate diversity efforts.

As companies grapple with the business challenges that rising interest rates and an uncertain economic outlook present, there are the inevitable questions about whether companies should worry less about environmental, social and governance (ESG) matters. While stakeholders and regulators in the U.S., Europe and elsewhere seemed to be moving in the same direction regarding ESG concerns in 2021 and 2022, it is possible that 2023 will see divergences. This is particularly the case in the U.S., where ESG has become highly politicized and is likely to remain so for at least the next two years, given a divided Congress.

Nevertheless, companies will still have plenty to grapple with in 2023: the plethora of regulations and other initiatives already in place or in the works, and investors, employees, customers, communities and other stakeholders continuing to push companies along in their "ESG journey."

Legal Guardrails

For U.S. companies generally, and particularly those incorporated in Delaware, the north star continues to be shareholder welfare. As companies and boards of directors consider the wide array of topics that fall under the ESG umbrella, they should assess how those topics ultimately accrue to the benefit of shareholders. This shareholder benefit may be long-term, even if imposing near-term costs. It can take the form of an increased ability to attract and retain a skilled workforce, or managing and mitigating a company's exposure to climate transition risks or the risks of a toxic workplace culture.

Disclosure Controls and Procedures

More U.S. proposals on the way. The U.S. Securities and Exchange Commission (SEC) has a number of ESG-related proposals pending, with more expected in 2023. These include extensive proposals covering climate-related disclosure and cybersecurity matters, as well as measures relating to human capital management and board diversity disclosures. Companies need to assess their methods of collecting and analyzing the relevant information should these rule proposals become effective.

Voluntary disclosures. Regardless of the SEC proposals, investors and proxy advisory firms continue to call on companies to voluntarily disclose information relating to ESG topics, either within or outside of their SEC filings. These voluntary disclosures can subject companies to potential liability, and companies are encouraged to approach them with the same rigor they apply to their SEC-mandated disclosures.

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New reporting rules in the EU. Meanwhile, public and other large companies with a presence in the European Union will need to consider the new Corporate Sustainability Reporting Directive (CSRD), effective January 1, 2024, with the first reports due in 2025. Any large EU company, and any non-EU company with net turnover in the EU in excess of €150 million, will be within scope of the rules. Companies will need to review in 2023 whether they have appropriate systems in place to gather the data required for these new reports.

Continued climate-related disclosures in the U.K. In the U.K., the plans to develop U.K.-specific sustainability disclosure rules may have been paused due to shifting legislative agendas arising from changes in government, but companies listed on the London Stock Exchange have had to include climate-related disclosures on a "comply or explain" basis in their reporting since January 1, 2022 (or January 1, 2021, in the case of premium-listed companies).

Shareholder Proposals

The 2022 proxy season in the U.S., U.K. and Europe brought a significant increase in the number of shareholder proposals related to environmental and social topics submitted for shareholder votes, and a marked decline in average support for those proposals compared to 2021.

In the U.S., the averages conceal a pattern: The 2022 proposals that were highly prescriptive fared poorly, while proposals regarding topics such as racial equity audits, efforts to combat workplace harassment and discrimination, disclosure of greenhouse gas emissions reduction targets and reducing the use of plastics did well.

Board and Workforce Diversity Matters

Investors and proxy advisory firms continue to focus on board composition generally and director diversity in particular. Investors also have focused on companies' efforts to enhance the diversity of their workforce and to consider the impacts of their business practices and policies on diverse communities. Investor attention to these topics shows no sign of abating.

Gender balance efforts in the EU. In October 2022, the Council of the European Union finalized legislation intended to improve the gender balance on boards of public companies. Under these rules, companies listed in the EU will be required to meet certain quantitative objectives and report on gender representation in their annual reports.

Diversity target progress disclosures in the U.K. Companies listed on the London Stock Exchange have had to disclose progress toward diversity targets on a comply-or-explain basis for financial years starting April 1, 2022.

Challenges to diversity programs in the U.S. There are potential countervailing forces, however. In 2023, the U.S. Supreme Court is expected to rule on challenges to the use of race as a factor in college admissions. A ruling against affirmative action could have implications for corporate diversity initiatives. In addition, private groups in the U.S. have started to bring challenges to diversity, equity and inclusion programs at companies, alleging that those result in illegal racial discrimination. Companies will need to monitor these developments over the coming months.

In Sum

ESG will continue to be an important business landscape feature in 2023, whether mandated by governments or initiated by companies to create long-term shareholder value, mitigate risk or respond to campaigns by investors, customers, employees and other stakeholders. Companies and their boards need to prepare to navigate the sometimes conflicting legal, regulatory and political challenges that ESG is likely to present in the new year.