Skadden

The Informed Board

Spring 2023

Changing CEOs is one of the most critical decisions any board faces. In this issue of *The Informed Board*, we offer tips on how to avoid the mistakes we most often see. We also explain the problems companies could face if the FTC goes forward with its proposal to ban and rescind noncompetition agreements.

As artificial intelligence finds more and more commercial applications, we discuss the risks that directors need to understand before their companies employ the technology. In a separate piece, we survey the potential regulatory responses to the recent tremors in the banking world. Finally, in our latest podcast, three Skadden partners discuss the impact of U.S. moves to restrict technology exports to China and investments in startups there.

01 Nine Mistakes To Avoid When Transitioning CEOs

05 What Is Generative AI and How Does It Work?

11 The FTC's Plan To Limit Noncompetes Could Pose an Array of Practical Problems

16 The Impact of Banking System Turmoil: What's Next?

21 Podcast: What a New Executive Order and Tighter Controls on Tech Exports Mean for Companies Doing Business in China

Nine Mistakes To Avoid When Transitioning CEOs

- Boards must consider contractual obligations, governance and reporting standards, and communication strategies before replacing a CEO.
- The time it takes to prepare and announce a change can be quite extended because of legal notice requirements, negotiations with the outgoing and incoming CEOs and the need to reach consensus within the board.
- Boards need to understand the legal implications that replacing a CEO may have for the rights of other executives and on existing noncompete agreements.
- Communications about the transition in regulatory filings and internal and external announcements need to be unambiguous while avoiding legal pitfalls.

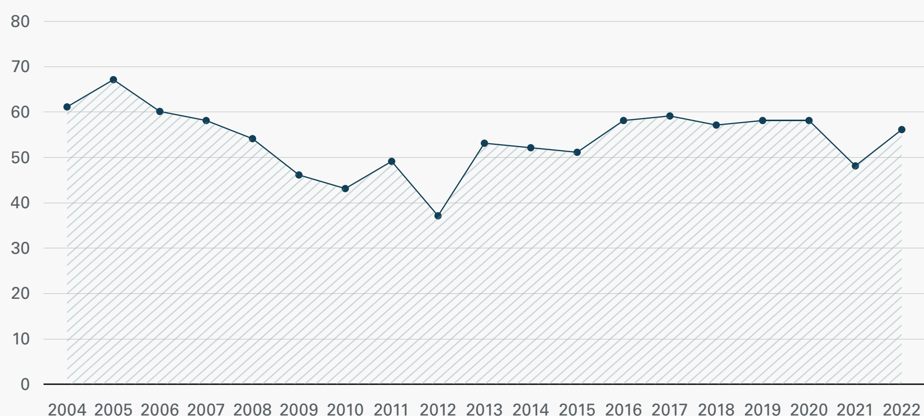
Transitioning CEOs is a complex process and is often fraught with business and legal challenges. Boards of directors must navigate a web of contractual obligations, corporate governance requirements, reporting standards, as well as communications with shareholders, employees and other stakeholders. Based on our work with boards, here is a list of common mistakes companies make along the way. Avoiding these will minimize legal risks and ensure a successful transition.

Unrealistic Timelines

Speed is often important in a transition, but some elements require sufficient time to execute and require thoughtful board deliberation. Boards must account for contractually- and legally-mandated notice periods, carefully consider when to inform the outgoing CEO and mobilize and communicate with the internal team. They also have to determine whether there are any notice obligations or other timing considerations relating to the incoming CEO.

Board and committee meetings will need to be properly scheduled and noticed (which can be challenging if the current CEO is required to be legally notified before the board is ready to act). The terms of the outgoing CEO's departure will often be heavily negotiated and will typically be documented in a separation agreement. Likewise, the incoming CEO's terms of employment and compensation will typically be negotiated and documented. Internal and external communications plans will need to be developed and approved along with required securities disclosures. What triggers the duty to make those filings, and when, should be carefully understood and contemplated in discussions within the board and with various stakeholders. Each of these critical steps has a habit of taking longer than anticipated.

CEO Transitions at S&P 500 Companies



Source: Spencer Stuart

Excluding Relevant Stakeholders From the Process (or Including Them Too Late)

The transition of the CEO is ultimately the board's responsibility, but it requires coordination with internal stakeholders (the company's communications, HR, finance and legal teams, for example) as well as external stakeholders (e.g., public relations advisers, compensation consultants and external legal counsel). Boards often attempt to minimize stakeholder involvement to ensure confidentiality. While confidentiality is critical, as the process progresses — and well in advance of a public announcement — boards should ensure that they are receiving advice from the right internal and external experts at every step so the transition goes smoothly.

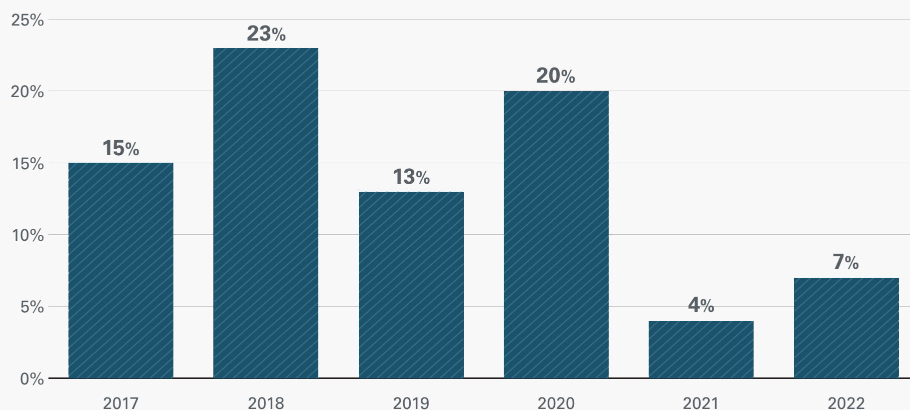
Skipping Over the Company's Obligations to the Current CEO

A clear understanding of the company's obligations to its current CEO under his or her employment agreement, equity awards, severance plans and other arrangements is critical to structuring the CEO's termination. The board should have access to a quantitative analysis of the compensation payable to the departing CEO and the potential cost to the company of modifications to existing arrangements. Failure to comply with outstanding contractual obligations to the CEO can result in financial liabilities and disputes (including litigation), and in some cases, it can excuse the CEO's non-performance.

Underestimating the Need To Formulate a Detailed Offer to the Future CEO

Similarly, advice from the compensation committee's outside consultant in formulating the proposed new CEO's compensation arrangement is vital. The board must have a clear understanding of the new CEO's existing compensation arrangements. This will allow the board to properly assess and negotiate the terms of

Share of Transitions Made With CEO Under Pressure



Source: Spencer Stuart

employment, address the need for "make-whole" equity compensation awards, if any, as well as understand any limitations under the company's existing compensation programs.

Leaving the Reasons for Terminating the CEO's Employment Ambiguous

When terminating a CEO's employment, the Securities and Exchange Commission and proxy advisory firms expect the company to disclose the reasons for termination clearly and accurately, specifying whether the termination is voluntary or involuntary and whether it is for cause or without cause. Failure to do so can create ambiguity and potentially expose the company to legal claims. It may also lead to disputes concerning severance and other termination-related entitlements.

Often we find that there is not a ready consensus among board members on any of these determinations, which is why it might be left ambiguous. And driving to a consensus view that is appropriately and accurately recorded in board minutes can take time. But skipping over this step, and not having a well-thought out and documented basis for the board's conclusions, can lead to later criticism of the board and litigation claims against board members. Internal communications should likewise be drafted to mitigate confusion about the reasons for the CEO's termination.

Rushing the Communications or Transition Plan

A well-structured communications plan is crucial to manage both internal and external stakeholder expectations and relationships during a CEO transition. Boards must ensure the communications plan is proactive and comprehensive, and addresses any disclosure or reporting requirements. Failing to do so can result in reputational damage and, potentially, legal claims.

Separately, boards must consider whether the outgoing CEO should remain available to consult or otherwise assist with the transfer of knowledge or duties to the new CEO. The company may also want the outgoing CEO's cooperation in active or anticipated litigation. These types of arrangements can help effect an orderly transition and should be incorporated into the written agreements with the outgoing CEO.

Overlooking the Legal Implications of Public Announcements

Boards must carefully consider the legal implications of public announcements related to a CEO transition. There can be tensions between making forthright, required securities disclosures, on the one hand, and respecting confidentiality provisions in employment contracts and avoiding defamatory statements, on the other.

Failing To Consider How the Rights of Other Senior Executives May Be Triggered by the CEO's Termination

The termination of a CEO may trigger contractual rights for other senior executives within the organization, such as "good reason" provisions. Boards should carefully review the provisions in those employment agreements to ensure compliance and avoid potential legal disputes.

Apart from any legal rights, the impact of a CEO transition on retention of other key leaders (who often were, or considered themselves, candidates for the CEO role) should also be considered, and a plan should be developed to address those concerns via compensation or some other means.

Neglecting the Impact of Termination on Noncompetes and Restrictive Covenants

The nature of a CEO's discharge can impact the enforceability of noncompetition covenants and other restrictive covenants. In some states, for instance, non-competition and similar covenants may not be enforced against an employee who was discharged without cause.

Authors
Joseph M. Yaffe, Ryne C. Posey

What Is Generative AI and How Does It Work?

- Generative AI systems have already found widespread application in the business world and their capacity to disrupt a broad range of industries is now apparent.
- The technology has enormous potential, but comes with many risks, including the potential for copyright and privacy infringements, contractual violations, the disclosure of trade secrets and untrustworthy outputs.
- Directors weighing opportunities for a company to use, build or contribute content for these AI platforms need to understand in broad terms what generative AI systems are, as well as the legal issues they pose and what steps companies can take to mitigate the risks.

What Is Generative AI and How Does It Work?

OpenAI's ChatGPT platform is reportedly the fastest-growing consumer application in history. It uses generative AI models, which produce new content based on training on vast quantities of data. The system underlying ChatGPT reportedly trained for months on hundreds of billions of words pulled from the Internet. Through this process, OpenAI's systems and similar "large language models" have achieved near-human level abilities to answer questions, write poetry, compose essays and even perform in the 90th-99th percentile across a wide range of college, graduate and post-graduate exams.

But boards should be aware of the risks associated with models trained on data from the Internet, including the intellectual property, privacy and contractual risks of relying on the outputs of such models.

How Generative AI Is Being Used Today

ChatGPT and other text-generating models are far from the only uses of generative AI. Companies across different industries are using the technology:

- **Financial services firms** are leveraging generative AI to streamline backend operations, bolster cybersecurity, support service chatbots, accelerate software development, enhance fraud detection and provide personalized financial advice.
- **Entertainment companies** are using text-to-image generators to create art for storyboards and visual content, including special effects, for films and video games.

- **Pharmaceutical researchers** are using generative AI to better understand the structure of proteins and design them specifically for medicines. For example, Canadian researchers trained an AI system on images of known proteins to generate new proteins with specific difficult-to-replicate protein folding.
- **The materials science industry** uses the technology to compose new materials with the desired physical properties.
- **In healthcare**, AI is being applied to electronic health records systems, and generative AI systems are also being used to produce synthetic data (*i.e.*, fictitious data that mimics real-world data without personally identifiable information) to allow data sharing and analysis otherwise restricted by privacy laws.

Boards will need to understand the risks these innovations bring as this technology expands across all sectors.

Frequently Asked Questions About the Use of Generative AI

1. What are the risks when inputting information into third-party generative AI platforms?

Generative AI platforms' terms of use often permit them to use inputs to improve their models and monitor system usage (including for compliance purposes), and some terms of use grant even broader rights to AI platforms to use and sublicense any inputs for any purpose.

But if the information input is owned by a third party, you may breach confidentiality obligations to them. Furthermore, it may be hard to anticipate the impact of supplying information for the model. The platform's use of your information to improve its model could result in that information being incorporated into a training dataset published by the platform provider, or used to train a model that ultimately discloses your information in response to another user's prompt. For instance, if your employees ask a generative AI system to debug confidential software source code, that source code could be used to train an improved model that releases the code in some form to subsequent users.

Moreover, AI systems typically store information on an external server. If the security of that server is breached, the user's information could be disclosed publicly, which potentially could be devastating to the user, the owner of the information or both.

2. Who owns the output (or results) of generative AI systems?

While the terms of use of generative AI platforms typically grant ownership of outputs to the user, whether

the technology can generate any protectable intellectual property rights remains unsettled. Citing established U.S. law that human authorship is required for a work to be copyrighted, the U.S. Copyright Office recently canceled the copyright registration of an AI-produced graphic novel. It reasoned that, because of the unpredictable nature of the image generation, the human author could not be considered the "mastermind" of the work.

In March 2023, the Copyright Office published guidance stating that that registrability of works including AI-created content depends on factors such as how the AI tool operates and how it is used to create the final work. Complex written, visual or musical works generated from simple human prompts by an AI system are not registrable, it said. In copyright registration forms, applicants now must disclose any AI-generated material in a work and explain the human author's contribution.

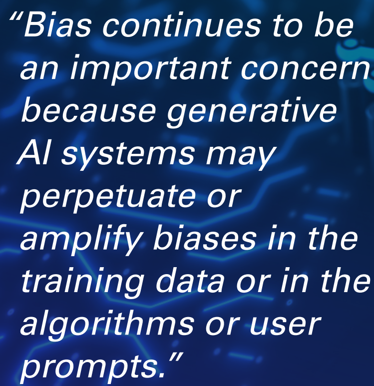
Regardless of whether generative AI outputs qualify for copyright protection, companies also need to consider whether their use may infringe third-party intellectual property rights. In a suit by Getty Images against Stability AI (developer of the text-to-image platform Stable Diffusion), for example, Getty claims that the output of the defendant's image generation platform often contains a modified version of a Getty Images watermark, creating confusion as to the source of the images. And most publicly available terms of use of generative AI systems expressly disclaim liability for third-party copyright infringement, leaving end users to take the risk that outputs they might incorporate into their products or publications are infringing.

Companies will therefore need to document the use of AI- and non-AI-generated content to ensure that their products can be copyrighted, and be alert to the possibility that the output of the models could infringe on the rights of others.

3. How trustworthy are the results of generative AI?

Today's technologies are far from perfect. Because these systems are trained to generate responses that appear similar to the training data based on probabilities, they are prone to "hallucinations," where the system generates inaccurate content and presents it as fact — often convincingly to non-experts.

Such inaccuracies could impact business outcomes or create liability issues if, say, false information is communicated to the public. That could result in reputational or operational damage, and even defamation claims.



AI text-to-image generators allow users to create amazingly realistic but fictitious images, such as the "deep fake" photos of Pope Francis wearing a white puffer jacket that went viral. The possibility of misuse of generative AI to spread disinformation and misinformation is a concern not just to organizations, but to society as a whole.

Bias also continues to be an important concern because generative AI systems may perpetuate or amplify biases in the training data or in the algorithms or user prompts. This is particularly concerning if the technology perpetuates or amplifies biases based on legally protected characteristics such as race, gender or sexual orientation. Regulators are already focused on this issue. The EU and U.K.'s General Data Protection Regulation and the California Consumer Privacy Act both give individuals the right to opt out of "automated decision-making" where AI may be used to build profiles and make individual decisions, such as extending employment or product offers.

4. Can companies face liability for training generative AI systems?

State-of-the-art generative AI is trained on vast amounts of data (including text or images). Boards considering deploying generative AI should understand if the training process violates copyrights, privacy requirements and/or contractual restrictions.

Copyright. Absent an express license, training generative AI may violate copyrights in the works included in the training data. Copyright owners have already filed infringement suits against generative AI providers in the U.S. and U.K.

There may be a "fair use" defense for a limited and "transformative" purpose, such as commenting on, criticizing or parodying a work. But fair use turns on the facts of a specific case and U.S. courts have not addressed the defense in the AI context, and other jurisdictions could come to different conclusions.

Privacy. An AI model trained on sensitive or personal information might unintentionally generate outputs that reflect this information. Even if the details are not explicitly in the training data, the systems might learn associations between individuals and sensitive attributes like race, gender or health status, potentially leading to privacy breaches. Individuals also may not be aware that their personal information is being used to train these systems, and they may not have given consent or been given an opportunity to opt out.

These types of privacy concerns recently led Italy's data protection authority to briefly halt the use of ChatGPT in Italy while OpenAI responded to inquiries regarding privacy risks. And in several cases where personal data used to train AI models was gathered or used in violation of privacy policies, the Federal Trade Commission has required "algorithmic disgorgement"— the permanent deletion of all models improperly trained on the personal data. After years spent developing AI training datasets and training models, companies facing algorithmic disgorgement need to start from scratch.

Breach of contract. Where content is gathered by crawling or scraping websites, website owners might contend that their websites' terms of use were violated.

What Should a Board Do?

Careful oversight remains critical. For a board, that entails taking reasonable measures to implement and oversee risk management and compliance controls.

Although courts in Delaware, whose law governs most large companies, have yet to weigh in on AI issues, some guidance can be found in a case involving a data breach that exposed customers' personal information. Stockholders alleged that directors violated their duty of oversight.

Although the breach stemmed in part from significant lapses (including the use of a simple generic password to secure critical data), the Delaware Court of Chancery ruled for the directors. It noted that the board had charged two committees with monitoring the company's data security processes, that those committees were well-functioning and met regularly, and that the committees set up appropriate reporting structures.

Boards should carefully consider how best to oversee a company's use of generative AI. That may entail:

- Establishing monitoring and compliance systems and paying ongoing attention to them, perhaps through a committee empowered to evaluate technology-related risks.
- Paying particular attention to "mission critical" issues involving the use of generative AI.
- Discussing with advisers issues on which the board should receive regular reports and identifying what "red flags" (*i.e.*, indications of potential operational deficiencies) may arise and how best to respond.

- Documenting in board minutes and materials the monitoring system reports to the board, and both directors' and officers' oversight efforts, so the company can respond to books-and-records demands and defend itself.
- Evaluating how generative AI may be used to enhance a company's oversight systems and processes, for example, by automating reports or by creating monitoring or analysis tools to spot potential deficiencies.

Jurisdictions including the U.S., U.K., European Union and China are grappling with the question of whether and how to regulate the technology. Boards will also need to stay abreast of those developments.

Authors

Resa Schlossberg, Jenness Parker, Pramode Chiruvolu, Matthew P. Majarian

The FTC's Plan To Limit Noncompetes Could Pose an Array of Practical Problems

- A proposed FTC rule would prohibit most noncompete agreements and federalize an area that has traditionally been left to state law.
- While some states already prohibit many types of noncompetes, the FTC rule would go much further, requiring companies to cancel existing noncompetes.
- Legal challenges to the proposed rule are expected, but new state laws governing noncompetes will continue to pose challenges for employers no matter the fate of the FTC rule.
- Employers should prepare for the possibility that the FTC rule will be adopted, or that more states will take a page from the FTC playbook and restrict noncompetes — establishing alternative, permissible restrictions on former employees, for instance.

As part of its declared focus on fostering competition in the labor market, the Federal Trade Commission (FTC) has proposed to ban most noncompetition agreements, or noncompetes, restricting the activities of former employees. Noncompetes can be a useful tool for employers to safeguard their confidential information, trade secrets and goodwill from unfair competition by former employees. This area has traditionally been governed by state law, and the FTC's proposal has provoked criticism. If the commission moves forward with a ban of noncompetes, that will almost certainly face legal challenges.

But the FTC is not alone in viewing noncompetes with suspicion. Several states have also moved to limit noncompetes in recent years, and other states could decide to follow the FTC's lead.

The Current Law of Noncompetes Is a Patchwork of State Laws

State laws governing post-employment noncompetes vary widely. A few states, notably California, generally prohibit post-employment noncompetes. California does have several exceptions, however, including an important one for individuals selling their interests in a business.

Other states, such as Delaware and New York, allow post-employment noncompetes, but they generally require that such agreements be reasonable in duration, geographic scope and the kinds of competition they prohibit. For example, in 2022, Delaware's Court of Chancery declined to enforce a noncompete in connection with the sale of a business that it found was too broad in terms of geography and the types of

competition it prohibited. Moreover, the court declined to "blue pencil" or rewrite the noncompete in order to make it enforceable, invalidating it in its entirety. This decision marked a shift in Delaware's approach to noncompetes and it is especially important since many noncompetes signed in connection with transactions are governed by Delaware law.

Many state legislatures have taken steps to limit post-employment noncompetes in recent years. For example:

- Several jurisdictions – including Colorado, the District of Columbia, Illinois, Oregon and Washington – now limit noncompetes to those who earn more than a certain amount each year. These salary thresholds can reach six figures — as high as $150,000 in the District of Columbia.
- Massachusetts has gone even further and requires former employees to be paid during any noncompete period.

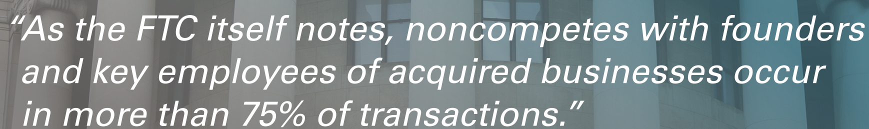
The FTC's Restrictions on Noncompetes Would Be Broader Than Most State Laws

- The FTC's proposed rule would bar even noncompetes that are reasonable under existing state law.
- The rule would declare noncompetes to be a form of "unfair competition."
- The rules would prohibit entering into new post-employment noncompetes.
- They would require employers to rescind any existing noncompetes with current or former employees, and notify them of the recission.

Other restrictive covenants that are often used to protect employees from unfair competition, such as confidentiality or non-solicitation agreements, would *not* be prohibited by the proposed rule. However, agreements that operate as *de facto* noncompetes would be.

In addition, the FTC would allow noncompetes as part of the sale of "all or substantially all" of a business's assets where the seller owns 25% or more of a business being sold.

The FTC's proposal is just one of a number of recent examples of federal antitrust regulators focusing on the intersection of competition and labor. The FTC has challenged noncompete clauses as "unfair methods of competition" in several cases that have been resolved through consent orders. The FTC and the Department of Justice (DOJ) have issued joint guidelines on the exchange of HR information on wages or benefits and its potential impact on competition in the labor markets, and the DOJ has aggressively pursued a number of criminal antitrust cases alleging "no-poach" agreements among firms competing in the labor markets.



The FTC Restrictions Could Complicate the Purchase of Businesses

The FTC's 25% ownership threshold would reduce the flexibility that buyers now have when negotiating to protect the goodwill of a business they are acquiring. By contrast, California and New York do not put a specific threshold on the percentage of ownership required to make a noncompete enforceable. By limiting the sale-of-business exception to substantial owners, the FTC rule would limit the protection the buyer of a business can obtain where an individual seller is responsible for a meaningful portion of a business's goodwill but owns less than 25% of its equity.

The rule would also limit buyers' ability to enter into noncompetes with key employees who are not owners or fall below the 25% threshold.

As the FTC itself notes, noncompetes with founders and key employees of acquired businesses occur in more than 75% of transactions. Limiting noncompetes with these key individuals would increase uncertainty among buyers about their ability to protect their investment in the acquired business, and that may affect the transaction value.

Legal Challenges to the FTC's Rule Are Likely

The FTC's proposed rule was published on January 19, 2023, and the comment period ran through April 19, 2023, with over 26,000 comments submitted. If adopted by the commission, the rule could go into effect as soon as October 16, 2023.

Legal challenges to the proposed rule, if enacted, are likely. The FTC approved the rule in a 3–1 vote with Commissioner Christine S. Wilson dissenting. She said that the proposed rule is susceptible to legal challenges on various grounds, including that Congress never authorized the FTC to restrict noncompetes and that it conflicts with Supreme Court precedent on administrative law. Wilson, who stepped down from the FTC in March 2023, also argued that the rule would ban conduct that is currently allowed in 47 states and that has been permitted by courts interpreting federal antitrust laws.

Interest groups have also weighed in. The U.S. Chamber of Commerce has called the proposed rule "blatantly unlawful" and an attack on "well-established state laws," and has said it is prepared to go to court if the rule is adopted.

Suits to block the rule would likely be filed when the measure is approved, well ahead of the effective date.

Companies Can Prepare Now for the Possibility of New Constraints on Noncompetes

If the FTC's proposed rule is finalized and survives legal challenges, employers will face the difficult task of rescinding their existing post-employment noncompetes and notifying affected workers of the rescissions in accordance with the regulation. Whether employers must do so while the issue is being litigated will depend on whether a court issues an injunction against the proposal while the case is pending.

Even if the FTC's proposal is struck down by legal challenges, state laws that narrow the scope and/or application of allowable noncompetes will remain. Some states may follow the FTC's lead and implement new or additional restrictions on noncompetes.

To prepare for these scenarios, employers will need to take an inventory of every noncompete to which they are a party — a potentially time-consuming process.

Employers can take proactive steps to protect themselves from allegations of unfair competition no matter the outcome of the FTC's proposal:

- Frequently review all existing restrictive covenants for compliance with applicable state law. Usually, the relevant law is that of the state where the employee regularly works. The law of the state where the employer is headquartered or otherwise located should be considered, as well.
- Consider what alternative restrictions are permitted to protect the employer's interests — requiring, for example, that employees sign broad agreements to protect trade secrets and other confidential information (with necessary carveouts for any disclosures that employees are permitted to make under applicable state or federal law).
- Where permitted, consider non-solicitation agreements with employees that bar them from recruiting customers or other employees (keeping in mind that such agreements are usually only enforceable where they are deemed to be reasonable under state law).
- In negotiating transactions, be mindful of any limitations on noncompetes that may apply. The value of a company may be reduced if the former owners or key employees are free to compete with it after a sale.

Restrictions on Noncompetition Agreements Vary Widely by Jurisdiction

While no means exhaustive, recent proposed and enacted laws regarding post-employment noncompetes at the federal and state level include:

Federal	
FTC proposal	Broad prohibition with narrow exception for sale of a business, limited to those selling >25% stake.
States	
California	Long-standing broad prohibition, but with an exception for certain sales of a business.
Colorado, District of Columbia, Illinois, Oregon and Washington	Laws enacted between 2020 and 2022 restrict noncompetes to employees making salaries over a certain threshold, ranging from $75,000 to $250,000, depending on the jurisdiction and the employee's profession.
Massachusetts	Former employees must be paid during noncompete period, which can last no longer than one year in most circumstances.

Authors

Anne E. Villanueva, Joseph M. Rancour, Luke J. Cole

The Impact of Banking System Turmoil: What's Next?

- The strain on regional U.S. banks could prompt more consolidation, and might make regulators more receptive to mergers.
- The rapid runs on Silicon Valley Bank, Signature Bank and First Republic highlighted the acute risks posed by social media and online banking, and showed that regulatory regimes created after the financial crisis have not kept pace with technology.
- There is renewed discussion on both sides of the Atlantic of the adequacy and structure of deposit insurance schemes.
- The Swiss government's decision to pay nothing to Credit Suisse contingent convertible bond investors left European investors concerned about the treatment of creditors in future failures.

The runs on Silicon Valley Bank (SVB) and Signature Bank in March 2023 created a "very high" risk of contagion in the U.S. banking system, according to Treasury Department officials. The intervention by banking regulators, using tools approved in response to the 2008 global financial crisis, bought some time for Congress and the Biden administration to consider whether existing tools are adequate.

But the deposit outflows and resulting government-arranged takeover of First Republic Bank on May 1, 2023, have fueled continuing concerns about regional U.S. banks and have kept this issue front of mind. For now, the likelihood is quite low that new banking legislation will be enacted in the near term, but the continuing turmoil could affect the U.S. banking landscape in a number of ways.

The European banking industry has not so far been subject to the same pressures, but the U.S. problems and the failure of Credit Suisse in Switzerland are forcing a reevaluation of banking regulation and resolution processes in Europe, as well.

Here's a high-level overview for directors of the fallout and possible regulatory responses.

Short-to-Medium-Term Concerns

Currently, the key risks to U.S. banks are:

- Continued tightening of monetary policy will likely reveal the institutions best and least able to manage interest rate risk.
- Continued high interest rates may adversely affect the commercial real estate sector and the mid-sized banks that lend to it.

- The concentration of uninsured deposits, particularly at mid-sized and regional banks (sometimes as high as 90%), will likely keep liquidity demand elevated and markets attentive to any sign of deposit flight.
- Social media and digital banking may pose existential risks to the traditional banking system, perpetuating volatility and instability for some institutions. These will not be effectively addressed by the Dodd-Frank Act process of systemic risk designation developed after the 2008 financial crisis.

M&A Implications: 'Too Big To Fail' or 'Too Small To Survive'

Following the recent failures, the conversations in regional and community bank board rooms have turned toward assessing the need for more consolidation. The "too big to fail" theme that surrounded the 2008 financial crisis has shifted to a "too small to survive" theme, as smaller banks look for ways to achieve more scale.

Several forces could converge to produce more consolidation in the U.S. banking industry.

- U.S. regional banks will likely bear the brunt of regulatory "reforms," facing more scrutiny during normal examinations and perhaps an increased compliance burden if the regulatory requirements applicable to large institutions are applied to regional banks. That could raise their operating costs and create pressure to seek economies of scale.
- One unexpected outcome may be greater willingness on the part of regulators to allow mergers by regional banks. The 2008 financial crisis and the legislation that followed accelerated consolidation. At the end of 2022, there were almost 50% fewer banking institutions with Federal Deposit Insurance Corporation (FDIC) insurance than in 2002.
- The historical lesson is that mergers and consolidations can strengthen and enhance the stability of the regional banking sector without a corresponding increase in complexity. Additionally, allowing combinations and arrangements between community banks and financial service providers may enhance their competitiveness and long-term viability.
- Depositor flight following SVB's failure benefited the largest depository institutions, in part, due to the perception that their size and the greater regulatory scrutiny they face made them safer. Such a perception may be a factor in allowing more mergers at the regional bank

level, especially if the resulting size of the institution leads to enhanced supervisory scrutiny and a larger, stronger institution.

Depositor Protections

Depository institutions with unstable depositor bases will likely keep pressure on policymakers to expand federal deposit insurance coverage or create new types of depositor protections, such as the "targeted coverage" included in the FDIC's "Options for Deposit Insurance Reform" that would provide "higher or unlimited" coverage for business payment accounts. However, while that might reduce or stop the destabilizing flight of uninsured deposits to larger banks considered too big to fail, or to money market funds, it remains unclear who would bear the cost. Consensus may be difficult to achieve.

"Some large private equity firms have said publicly that they are interested in providing capital to regional banks by buying loan assets."

Possible Role for Private Equity

In contrast to the aftermath of the 2008 financial crisis, we have not yet seen private equity investors play a significant role during the recent turmoil. However, given the need for new capital to support the banking sector, we expect that private equity will ultimately participate in a meaningful way. Some large private equity firms have said publicly that they are interested in providing capital to regional banks by buying loan assets.

However, we expect that financial sponsors will be selective in making investments and may be opportunistic in providing equity financing for M&A transactions that create larger and more diversified franchises.

Regulatory Recalibration

The Federal Reserve, in particular, will likely be under increasing pressure to respond to the supervisory deficiencies highlighted in its own review of the SVB failure. However, as the year progresses, it will become more challenging to balance tougher regulation of regional banks against the possibility that could cause them to contract lending.

Meanwhile, the FDIC resolution process may encounter greater congressional scrutiny as some policymakers question the bidders allowed to participate and the cost of rescues, asking if resolutions are conducted as fairly, openly and cost-effectively as possible.

The European Dimension

The three failures in the U.S. did not have a direct impact on banks in Europe, apart from the failure of SVB's U.K. subsidiary. But, together with the takeover of Credit Suisse by UBS orchestrated by the Swiss

government in March 2023, they have prompted a reassessment of European bank regulation.

Credit Suisse's failure was very different from those in the U.S. It was not the result of mismanaging interest rate risk. Instead, the bank was bedeviled by a series of scandals over several years that left it in a parlous financial situation.

The implications are likely to be different in Europe. It has not seen a wave of banking consolidation because, while banking is highly concentrated in most country markets, it is fragmented across the region, with no truly pan-European institutions. And protectionist impulses tend to militate against national banking champions falling under foreign ownership.

Nonetheless, bank failures on both sides of the Atlantic have called into question the efficacy and reliability of post-financial crisis bank regulatory reforms, as well as the quality of supervision by regulatory agencies.

- The wipe-out of subordinated bondholders of Credit Suisse without shareholders first being zeroed out, under the aegis of Swiss governmental action, has led to much angst and uncertainty about the valuation of contingent convertible (CoCo) bonds and the respect for the creditor hierarchy in a distressed situation. The hierarchy was inverted in the Credit Suisse case, which has led to litigation by the bondholders. In order to shore up market confidence, other European authorities were quick to reaffirm their adherence to the creditor hierarchy, but the market is not yet convinced that governments would not interfere with the rights of creditors beyond that prescribed in legislation. As a result, broader question marks have arisen about bank resolution regimes that are designed manage bank failures and mitigate their broader effects on financial stability.
- There is also renewed focus on the depositor protection. Both the amount of depositor protection as well as the contributions to depositor compensation funds are under scrutiny. The caps on insured deposits are lower Europe than the $250,000 per depositor in the U.S.: up to £85,000 per depositor in the U.K.; and €100,000 in Germany and France as a general matter. Any increases could be funded by one-off payments from banks, by way of levy.
- In addition, the liquidity requirements for banks are now being revisited. Rapid digital bank runs like those seen at SVB as well as concentrated and non-diversified depositor bases have almost completely blind-sided regulators, and have highlighted the inadequacies of the current regulatory standards regarding both short term and longer term bank liquidity. We expect reforms in this area at an international level to make the

rules more granular and sensitive to the composition of the depositor base as well as to the nature of liquid assets maintained by a bank.

Altering the treatment of assets poses more difficult issues, particularly where rising interests rates have left banks saddled with unrealized losses on sovereign bond holdings. Current bank regulations generally treat sovereign debt as very low risk, making it eligible for use in liquidity buffers and as high quality collateral for derivatives and other trades. If the market risks of those assets are recognized in a bank's capital base, or greater haircuts are required when they are used as collateral, that would diminish the utility of sovereign bonds for many banks, which in turn could impact the sovereign debt market. This is clearly a politically charged issue.

Conclusion

The turmoil in the banking system in both the U.S. and Europe seems far from over. The need for more capital and liquidity in the system, and the possibility of a recession, along with the regulatory and political response to the recent bank failures, make for a challenging environment for banks on both sides of the pond. Greater supervisory scrutiny may be directed at the selection of bank directors and the composition of bank boards, and encouraging their more active involvement in addressing unresolved supervisory concerns.

Authors

Sven G. Mickisch, Bao Nguyen, Simon Toms

Podcast: **What a New Executive Order and Tighter Controls on Tech Exports Mean for Companies Doing Business in China**

Listen to the podcast

In 2022, the U.S. restricted technology exports to China that might have military uses, and an executive order is expected soon limiting investments in certain Chinese tech companies. Skadden M&A partner Ann Beth Stebbins leads a discussion about the reasons for the rules and their impact on companies doing business in China. Joining her are Jessie Liu, a partner in Skadden's White Collar Defense and Investigations group, and partner Brian Egan of the firm's National Security, CFIUS and International Trade groups.

One takeaway: Companies will need to update their compliance programs to make sure they accord with the new prohibitions.

U.S. companies seeking to invest abroad have typically not faced scrutiny from U.S. regulators. Ann Beth asked if that is about to change.

The economic and military rivalry between the U.S. and China is not new, Jessie said, pointing to a 2018 Department of Justice initiative under the Trump administration to combat trade secret theft and economic espionage. But it has intensified under the Biden administration, she said.

Today, the government is concerned that we will be helping China advance its military capabilities using our technology and our investment dollars, Brian said.

The U.S. and Chinese economies are too closely linked to be decoupled, Jessie said.

New restrictions on investment in China, which are expected to be imposed by executive order, will likely be limited to a few specified technologies, Brian said, such as advanced artificial intelligence, advanced

"While companies have years of experience complying with the FCPA, some have not developed the same kind of robust compliance programs with regard to sanctions and export controls."

semiconductor manufacturing and development, and quantum computing. Battery technologies, autonomy and biotechnology have also been mentioned as possibilities, he said.

The rules are likely to limit capital investment and the transfer of know-how, Brian added, and may also include reporting requirements. He expects the rules will be administered by the Departments of Treasury and Commerce. The proposed rules are likely being discussed with allies, Brian said, and they are likely to implement their own, similar regulations.

The government has been putting new emphasis on sanctions enforcement, Jessie said, with Deputy Attorney General Lisa Monaco calling sanctions "the new FCPA," referring to the Foreign Corrupt Practices Act. Ms. Moncao's declaration sent the message that companies need very strong compliance programs, Jessie said, adding that the statement "caused quite a buzz in the white collar criminal defense community."

One example of a new enforcement effort in this area is the joint Commerce-Justice Department Disruptive Technology Strike Force, formed to investigate and prosecute export control violations, Jessie said. It reflects the government's view that national security can be threatened by technology transfer.

As a result of these various government actions, companies need to take a fresh look at their compliance programs, even if they have been doing business in China for a number of years, Brian said, because the new export controls are novel and extraterritorial.

While companies have years of experience complying with the FCPA, some have not developed the same kind of robust compliance programs with regard to sanctions and export controls, Jessie said. When making acquisitions, due diligence will now need to cover the target's compliance with sanctions and export controls, she added.

Because the export and investment controls are new, there will be unanswered questions, Brian noted. That means that companies will have to weigh whether to engage with the government to obtain clarity, though many companies are reluctant to do so.

Can companies report their own violations, Ann Beth asked?

Whether to self-report is always a difficult decision, said Jessie, even though the government has promised more lenient treatment for companies that self-report.

Brian noted that the Commerce Department recently encouraged companies not only to report their own violations but those of competitors.

Authors

Brian J. Egan, Jessie K. Liu, Ann Beth Stebbins

Contacts

Brian J. Egan
Partner / Washington, D.C.
202.371.7270
brian.egan@skadden.com

Jessie K. Liu
Partner / Washington, D.C.
202.371.7340
jessie.liu@skadden.com

Sven G. Mickisch
Partner / New York
212.735.3554
sven.mickisch@skadden.com

Bao Nguyen
Partner / Washington, D.C.
202.371.7160
bao.nguyen@skadden.com

Jenness Parker
Partner / Wilmington
302.651.3183
jenness.parker@skadden.com

Joseph M. Rancour
Partner / Washington, D.C.
202.371.7532
joseph.rancour@skadden.com

Resa Schlossberg
Partner / New York
212.735.3467
resa.schlossberg@skadden.com

Ann Beth Stebbins
Partner / New York
212.735.2660
annbeth.stebbins@skadden.com

Simon Toms
Partner / London
44.20.7519.7085
simon.toms@skadden.com

Anne E. Villanueva
Partner / Palo Alto
650.470.4596
anne.villanueva@skadden.com

Joseph M. Yaffe
Partner / Palo Alto
650.470.4650
joseph.yaffe@skadden.com

Pramode Chiruvolu
Counsel / Palo Alto
650.470.4569
pramode.chiruvolu@skadden.com

Ryne C. Posey
Counsel / Los Angeles
213.687.5053
ryne.posey@skadden.com

Luke J. Cole
Associate / New York
212.735.2306
luke.cole@skadden.com

Matthew P. Majarian
Associate / Wilmington
302.651.3131
matthew.majarian@skadden.com

View past editions / You can find all *Informed Board* articles here.

This communication is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This communication is considered advertising under applicable state laws.

Skadden, Arps, Slate, Meagher & Flom LLP
One Manhattan West
New York, NY 10001
212.735.3000

skadden.com