Skadden

The Informed Board

Fall 2023

Boards routinely confront an array of difficult issues. In the latest issue of *The Informed Board*, we tackle four of the thorniest and most topical:

- How to preserve the integrity of a deal process where a key fiduciary (say, a founder, CEO or major shareholder) has a conflict of interest?
- How much information can a company share from an internal investigation without waiving privilege?
- Will the Supreme Court's ruling on university affirmative action policies force changes in corporate DEI policies?
- What strategies can dealmakers adopt to deal with the Biden administration's tough approach to merger reviews?

We also describe how the IRS is using artificial intelligence and other technology to target high net wealth individuals, complex investment partnerships and intergenerational wealth transfers.

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Real World Examples Where Conflicts Tainted a Deal Process, and Other Deals That Were Insulated From Conflicts

- Four recent cases illustrate circumstances that may expose a deal to challenge because of a conflict of interest, and the ways a board or special committee may help insulate a deal process from someone with a potential conflict.
- There are no hard and fast rules to apply where there is a potential conflict because the factual backgrounds and relationships in strategic corporate transactions are always highly complex, and there is no "perfect" deal process ordained by the courts.

Sometimes when a board is considering a strategic transaction, it may find that a key figure who can influence the deal process — for example, a founder, controller or CEO-negotiator — has a potential conflict of interest. They may be on both sides of the deal, or they may simply have personal motivations and interests that are not shared by all stockholders. Such conflicts can arise on either the buy- or sell-side.

In this situation, it will fall to the board or a special committee to find the best way to address any conflict. Each situation comes with its own set of facts, so there are no all-purpose rules that apply in every case. But four recent Delaware decisions scrutinized deal processes that were challenged by stockholders because influential figures, negotiators or other fiduciaries involved in the process had conflicts. These rulings offer examples both of behavior that could be cast in an unfavorable light if a deal is challenged, and approaches boards have taken that courts found were helpful to insulate the conflicted person and preserve the integrity of the deal process.

A deal process need not be "pitch perfect," the Delaware Supreme Court stressed in one of the cases. Examining the facts of the four cases suggests what actions courts may find in-tune or off-key.

Factors the Courts Viewed Disfavorably

CEO Directing the Sale Process Was Set on One Buyer

- When the take-private of Mindbody was challenged by stockholders, the court described how a private equity firm groomed the seller's CEO to favor a deal with it. For example, the buyer invited the CEO to a conference it sponsored to prospect for acquisition targets where it emphasized how officers

of companies it acquired could become very wealthy post-acquisition. Enamored with the prospective buyer, the CEO told it that he was looking for a "good home" for his company and its management team.

- The court highlighted that the CEO rejected bidders that he disliked for personal reasons and signaled a lack of interest in competing offers by going on vacation during the go-shop process, telling management to decline presentations in his absence unless they were "urgent." He also adjusted his company's revenue guidance downward to depress the stock price and make a deal more attractive for his preferred buyer.
- The court took issue with the CEO's outsized role throughout the deal process and noted that the seller should have taken time to develop alternatives to promote competition and ensure a value-maximizing process.

Negotiator's Experience Level and Personality

- When TransCanada purchased Columbia Pipeline and the target's stockholders challenged the deal, the court noted that both Columbia's CEO and CFO hoped to retire early and, from the outset, sought to arrange a sale that would trigger change-of-control benefits for themselves.
- The court also detailed the missteps of the CFO, who was appointed to lead the sale process despite the fact that he had never had a major role in an M&A negotiation. During one early meeting with the eventual buyer, the CFO handed over his talking points about the deal price and timing. He also arranged one-on-one meetings with Columbia directors, which he used to manipulate the flow of information and steer the directors individually toward his desired result.
- The court said that qualities that may be laudable in other contexts can be undesirable during the deal process. For example, in Columbia Pipeline's case, the "trusting, team-oriented, and transparent" CFO who lacked "guile" and a "poker face" created vulnerabilities and undercut his company's negotiating leverage.
- By contrast, in the Tesla-SolarCity decision discussed below, the court praised the board for vesting negotiating power in an indisputably independent director who exercised mastery over the negotiations.

Interactions With Counterparties

- In both the Mindbody and Columbia Pipeline cases, the court reprimanded the negotiators for ignoring communication guidelines set by

their boards. For example, the negotiators privately tipped their preferred counterparties (directly and through their bankers) about their companies' target price and their personal motivations for a sale.

- The Mindbody court also criticized the CEO for permitting the company's banker to facilitate a connection for him with the potential private equity buyer before the formal sale process had begun and without board authorization.

Counterparty's Role Aiding and Abetting Conflicts

While the conflicts in the Mindbody and Columbia deals arose on the target side, in both cases the courts found the buyers — the counterparties — liable for damages as well because they took advantage of those conflicts.

- The Columbia Pipeline and Mindbody decisions chastised the buyers for inducing the sellers' conflicted negotiators to act against the interests of their stockholders by, for example, revealing inside information, including before due diligence, so that the buyers could move more quickly than other potential bidders.
- The Columbia court further admonished the executive who led negotiations for TransCanada for persistently violating Columbia's process boundaries, including standstill agreements, no-teaming agreements and prohibitions on unsupervised contacts with management.
- The court also criticized him for exploiting the conflicts of interest on the seller's side by reneging on an agreement in principle and then "ambushing" the seller with a lower bid, coupled with a coercive and false threat to publicly disclose that negotiations had ended, knowing the seller was by then wedded to making a deal happen.
- The court also held that TransCanada's lead negotiator manipulated his relationship with Columbia's lead negotiator by drawing on their past professional friendship and creating the impression that they were working together as partners behind the scenes.
- In the Mindbody and Columbia Pipeline cases, the courts also faulted the buyers for failing to correct misstatements or omissions in the sellers' proxy statements. In both cases, the buyers were contractually obligated to do so.

Factors the Courts Viewed Favorably

An Independent Board or Special Committee Making Its Own Decisions in the Best Interests of the Company

- When Tesla considered buying Solar City, Tesla's founder, who was presumed to control the company, also held a stake in Solar City and was therefore on both sides of the transaction. The court questioned the founder's involvement, which included making overtures to Tesla's board about the transaction, directing management to prepare presentations about the transaction, and participating in board meetings about the transaction.

- Notwithstanding those facts, the court found that the Tesla board was not coerced on the timing or terms of an offer, or how long to spend on due diligence. The board proved itself willing to vigorously debate assumptions and oppose the conflicted director's wishes.

- Similarly, when Oracle purchased a company co-founded by Oracle's founder, former CEO and largest shareholder, and on whose board he served, the court rejected a challenge to the deal. There the special committee implemented "rules of recusal" that prohibited the founder from discussing the transaction with anyone but the special committee, required employees who were involved in assessing the transaction to be informed of the recusal, and forbade officers and other employees from participating in the negotiation process absent the special committee's direction.[1]

- In contrast to the Mindbody situation, the court in Oracle praised the special committee's willingness to let the deal die if it was not in the company's best interests.

Helpful Independent Financial Advisors

- The courts in the Tesla, Oracle and Columbia Pipeline cases praised the boards or special committees for selecting top-tier financial advisors without longstanding relationships or conflicts with their companies or counterparties.

- In the Tesla case, the court positively noted that, during due diligence, the company's banker investigated the seller's financial state, had discussions with the seller's financial advisor, adjusted the focus of its work as concerns arose, reran analyses as needed, and kept the board apprised of new developments. The court also noted that, in response to information discovered during due diligence, the board lowered the offer price.

- In the Mindbody decision, the court applauded the company's banker for sharing its knowledge about the buyer, including its modus operandi and associated risks, but said that the company's CEO ignored that information.

In Sum

In sum, Delaware courts have long held that a deal process does not have to be perfect and there is no one-size-fits-all blueprint. The facts and circumstances of each deal process will be considered and any one of the potentially problematic issues described above alone may not be enough to doom the process. But these cases should help directors understand what circumstances may taint a deal process and, on the other hand, what guardrails they may want to consider to protect the integrity of a deal process.

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[1] Skadden advised Oracle's special committee.

Balancing Act: Sharing Information From an Internal Investigation Without Waiving Privilege

- If a company needs to disclose information from an internal investigation to auditors, regulators or shareholders, it must be alert to the risk that it could waive the legal protections for confidentiality.
- Providing high-level summaries or pure facts sometimes suffices and avoids a waiver of privilege.
- Throughout the internal investigation process, boards and audit committees need to bear in mind how documents could be used against the company later in litigation.

A whistleblower has triggered a race against time: An internal inquiry, directed by the audit committee and overseen by external counsel, has been launched in response to allegations that revenue was recorded without proper support. The catch? It is four weeks before quarter close, and the company's external auditors want real-time updates from the investigation. Without these downloads, the auditors will not sign off on the financials.

The audit committee faces a critical decision: How to share up to date information with auditors without compromising legal privilege. Share too little, and the auditors could halt its quarter-end process, potentially leading to a dreaded delayed filing announcement to the market. Share too much and regulators and shareholders may later claim any privilege was waived.

Internal investigations are a critical tool for companies to address potential misconduct, regulatory violations, or other issues that may threaten their operations, accurate financial reporting and reputation. These investigations often involve a delicate balance between providing necessary information to third parties like auditors, consultants, regulators and shareholders, all while preserving the attorney client privilege and protections for the work product of the company's lawyers. This article provides a framework for understanding that balancing process.

Understanding Attorney Client Privilege and Work Product Protection

First, it's crucial to understand the two key legal protections involved: attorney client privilege and work product protection.

Attorney-Client Privilege

Attorney-client privilege shields communications between an attorney and their client from disclosure to third parties. To establish this privilege, the communication must be made in confidence between an attorney and client in order to obtain legal advice. If other people who are not essential to the purpose of obtaining legal advice are privy to the conversation, it may not be protected. Privileged communications are generally exempt from discovery in legal proceedings.

Work Product Protection

Work product protection applies to materials prepared by an attorney (or in some cases a consultant) in anticipation of litigation. Work product includes attorney's mental impressions, opinions, conclusions and trial strategy, and may include compilations or analysis of facts. The material need not be communicated to the client to receive protection.

Sharing Information With External Auditors

External auditors play a crucial role in ensuring financial transparency and accountability for public companies, but sharing information with them can waive the attorney-client privilege. What is more, anything shared with the auditors could be included in their workpapers, and a regulator like the Securities and Exchange Commission (SEC) could subpoena those. Thus, it is vital to strike a balance between providing necessary information and safeguarding the privilege.

At the outset, the company and the external auditors should discuss what information the auditors need and why they need it. Often by discussing concerns about privilege with the auditors, solutions can be found that satisfy the auditor's requirements while protecting the company's interest in confidentiality. A company may, for instance, use redactions and high-level summaries, or rely on oral communications to convey information and provide transparency while protecting sensitive or privileged content.

It is important to keep detailed records of what was shared, and when and why, in case of future disputes or challenges to privilege.

Sharing Information With Regulators

A company may also need to share information from an internal investigation with regulators like the SEC or the Department of Justice (DOJ) in order to obtain credit for cooperation that could reduce any penalties and make it easier to reach a satisfactory resolution. Providing too little information runs the risk of the government arguing that the company is not cooperating; sharing too much information runs the risk of waiving the privilege.

For instance, one court held that a law firm waived its work-product privilege over interview memoranda and notes when it provided detailed oral summaries that were seen as equivalent to disclosing the lawyers' memoranda and notes of interviews. But that court and others have indicated that

A company may use redactions and high-level summaries, or rely on oral communications, to provide transparency while protecting sensitive or privileged content.

providing the government with high-level conclusions or impressions from the interviews would not result in work product waiver.

Disclosing information to a governmental authority can constitute a waiver vis-à-vis other parties. Take, for example, the case of a company under investigation for allegedly paying foreign bribes to obtain business. It cooperated with the DOJ, making voluntary self-disclosures from its internal investigation, including detailed accounts of interviews it conducted and documents reviewed in those interviews. The government did not charge the company, but when it indicted two former executives, the executives sought information from the internal investigation. A court concluded that the company waived its privilege over its interview memos, notes, summaries and the underlying documents and communications conveyed through those summaries by selectively sharing these materials with the DOJ.

This case highlights the balancing acts and complex decisions companies face when trying to cooperate with the government. As with auditors, one solution may be to provide high-level summaries based on the interviews as a whole, rather than detailed summaries of individual interviews. Moreover, the actual facts are not privileged, so another strategy is to produce documents that contain the underlying facts, rather than summaries of documents, which may include an attorney's conclusions and impressions.

Sharing Information With Experts and Consultants

Many internal investigations involve collaboration with experts and other consultants, including forensic accountants or subject matter experts. To effectively safeguard this privilege when working with third-party experts and consultants, it is advisable for them to be directly retained by the law firm overseeing the investigation, with a written agreement. By structuring the relationship this way, any exchange of information occurs within a framework designed to uphold work product protection.

In these situations, it is crucial that all communications and shared documents are clearly marked as privileged and confidential and that the consultants understand the importance of maintaining this confidentiality.

Sharing Information With Shareholders

A board may want to share information from a privileged internal investigation in response to a shareholder demand letter, but this, too, poses the risk of waiving the attorney-client privilege,

which then exposes that information to third-party legal threats. Moreover, if the information does not resolve the shareholder's demands, they may disclose it publicly or use it in a lawsuit.

Companies may be tempted to mitigate the risks by obtaining a non-disclosure agreement (NDA), but the act of disclosing privileged information can be viewed as waiving the privilege notwithstanding an NDA. Like the other situations discussed above, companies facing shareholder requests are best to focus on sharing factual information rather than conclusions that may contain attorney mental impressions.

Keeping the Possibility of Litigation in Mind

Throughout the internal investigation process, careful thought must be given to the preparation of reports, presentations, board minutes and other documents. Audit committees and others involved in in investigations need to ask: Should this be written down? How would this look if it had to be turned over? Is more context or nuance needed in this document to provide a complete picture? How would this affect potential or pending litigation claims or the company's reputation?

To minimize the risk of disclosure of privileged communications, it is crucial for boards and managers to expressly request legal advice (and for their attorneys to make sure that they state that they are providing legal advice), limit distribution of legal advice to those within the organization to those that need to be aware of it, and clearly and consistently mark privileged advice — but not in such a wholesale manner that a court might think the company is making a blanket assertion of privilege.

Conclusion

By carefully considering the scope of disclosure, the audience for it, by using redactions and summaries, and by maintaining control over who has access to information, companies can protect legal interests and confidential materials while fulfilling their obligations and ensuring necessary transparency.

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Key Insights for Dealmakers Confronting Washington's Aggressive Approach to Merger Reviews

- Courtroom losses have not deterred the Department of Justice and Federal Trade Commission from challenging mergers based on novel interpretations of the antitrust laws, and we expect the agencies to continue to scrutinize deals aggressively.
- With time, however, the losses may undercut the agencies' tough rhetoric and embolden companies. Already, the losses appear to have softened the regulators' hostility toward remedies such as divestitures.
- Even if the courts do not accept the government's reading of the law, the agencies may be able to stretch out the timeline for approvals, particularly where other jurisdictions must sign off.

As part of the Biden administration's avowedly aggressive approach to antitrust enforcement, it has challenged a number of high-profile mergers in court over the past two and a half years. While the track record of the Department of Justice (DOJ) and Federal Trade Commission (FTC) in court has been poor — just one win versus seven outcomes that count as losses — the antitrust agencies insist that they will continue to challenge mergers and push the limits of decades-old antitrust principles. That willingness to press novel antitrust theories has implications for M&A. Below we provide eight key takeaways for dealmakers.

1. The U.S. antitrust agencies will continue their aggressive merger enforcement.

Under the Biden administration, the antitrust agencies have moved on several fronts to police mergers more assertively: expanding notification requirements to gain insight into more deals, proposing updates to their merger guidelines to reflect novel theories of antitrust harm, and challenging more transactions in court. They aim to discourage M&A and make it easier to challenge transactions that they consider problematic.

While the agencies have suffered several high-profile losses in merger litigations, they appear to remain resolute, touting the number of abandoned transactions as evidence that their approach is succeeding. At a minimum, dealmakers should expect that more transactions will receive antitrust scrutiny, with extended investigations becoming more frequent and burdensome. Many deals that would have been waved through in prior administrations are likely to face questions.

2. Certain types of transactions are more likely to draw agency scrutiny.

The agencies' proposed changes to their merger guidelines — the statement of principles and standards that guide their approach to reviews —

would set low bars for what constitutes an anticompetitive merger. But, as a practical matter, the agencies do not have the resources to oppose every transaction and will have to be selective about bringing challenges. They are more likely to focus on transactions where they can press novel theories of harm alongside traditional horizontal and vertical theories. High-profile and high-value deals are also likely to garner the agencies' attention, as are those in industries of particular interest to the agencies, such as Big Tech, digital platforms, pharmaceuticals and healthcare.

3. While the agencies may win some incremental legal gains in court, novel theories can also backfire and result in bad precedents for them.

Regulators have suggested that their courtroom losses nevertheless enabled the government to achieve incremental gains in the form of judges' acknowledgments, minor extensions of the law, or solidification of more novel theories.

However, losses can also produce case law that limits regulators' ability to pursue those theories in the future. For example, over the last decade, rulings against the agencies in cases where they challenged vertical mergers have made future vertical merger challenges more difficult.

With time, it is likely that the courts' adherence to precedent and willingness to curb the agencies' efforts to rewrite antitrust principles will ultimately embolden companies and weaken the deterrent effect of the agencies' pro-enforcement stance.

4. The parties must be prepared to go the distance.

Agency losses diminish the credibility of enforcers' saber-rattling and demonstrate that difficult deals can still eventually close. To maximize the chance of success, however, parties should build enough time into merger agreements to allow for extended reviews and potential challenges, particularly where the deal must be approved in multiple jurisdictions.

Where a challenge is anticipated, it is critical to develop a credible litigation strategy early in the process, and the parties to the transaction must proactively evaluate all potential theories of harm that the government might assert under the new merger guidelines and be prepared to tackle them head on. (In an article last year, "Boards and M&A: Playing, and Winning, the Game of Regulatory Risk," we discussed in more detail how to address the risk of delay or a challenge in merger agreements.)

5. Parties should be ready to propose remedies and "litigate the fix."

Biden FTC and DOJ antitrust leaders have expressed skepticism and even outright hostility toward merger remedies. Indeed, the DOJ did not enter into a single merger consent decree outside of litigation for over two years — a common form of resolution in the past. But this resistance should not deter parties from proposing remedies to mitigate potential harm to competition, because "remedies self-help" can be a useful tool in litigation: Some of the DOJ and FTC losses have come where the merging parties cited their proposed remedies in defense

1W-7L: Biden Administration Antitrust Challenge Record

Losses

Cases where the DOJ or FTC has litigated to block a merger since January 2021 and either lost a ruling or settled during litigation on terms close to what the parties had proposed earlier. Note: Some losses have been appealed.

Microsoft/Activision Blizzard
(cloud gaming, consoles and multi-game content library)

- District court denied the FTC's request for an injunction and the FTC has appealed. FTC returned the administrative case to adjudication following defeat in the district court. The transaction closed after receiving approval from regulators in the U.K. and EU.

ASSA ABLOY/Spectrum Brands
(door locks)

- DOJ settled mid-trial, accepting a divestiture that Assay Abloy had earlier proposed as a remedy, withthe addition of several other oversight provisions.

Meta/Within
(virtual reality dedicated fitness applications)

- District court denied the FTC's request for an injunction, finding that the FTC had failed to meet its burden of proof. But the judge largely affirmed the FTC's potential competition precedent.

Booz Allen/EverWatch
(signals intelligence modeling and simulation for a single customer)

- District court denied the DOJ's request for an injunction, finding that the DOJ's proposed market defined as a single contract where the parties were the only bidders, was overly narrow.

UnitedHealth/Change Health
(medical claims processing)

- District court denied DOJ's request for an injunction, holding that a divestiture resolved horizontal concerns and a firewall to protect competitors' competitively valuable data would not reduce innovation.

U.S. Sugar/Imperial Sugar
(sugar refining)

- District court denied an injunction, saying that DOJ's proposed product and geographic markets were too narrow.

Illumina/GRAIL
(Research, development and commercialization of multi-cancer early detection tests)

- FTC administrative law judge ruled against the agency, finding that Illumina did not have the incentive to foreclose rivals. The FTC commissioners overturned the administrative law judge, and their decision has been appealed by the companies. The EU recently ordered Illumina to divest GRAIL, which the parties are challenging in the European Court of Justice.

Win

Penguin Random House/Simon & Schuster
(publishing of top-selling books)

- District court enjoined the transaction, agreeing that the merger would eliminate head-to-head competition in the market for top-selling books.

of the merger — *e.g.*, divestitures of business units or other contractual and commercial commitments — and judges agreed that the remedies would address antitrust concerns.

From an early stage, the parties to a transaction should evaluate the potential for remedies to resolve competition concerns and consider how they fit into the defense of the merger.

6. Recent agency losses may soften hostility toward remedies.

The courtroom losses appear to have softened the agencies' resistance to remedies. Over the past six months, the agencies have entered into several merger settlements, including the first settlement by the DOJ under President Biden. The agencies may see extracting remedies as an alternative way to claim victory without the risk of a merger trial. Dealmakers should therefore still consider engaging with the agencies about remedies throughout the investigation process and during litigation.

7. The agencies may continue to use timing as a lever and try to kill deals with process.

Challenging a deal in court is not the only lever the U.S. antitrust agencies have to try to stop a deal. They can also rely on the timing of other jurisdictions' reviews. Foreign antitrust reviews — particularly those in the U.K. and EU — can extend well past the U.S. statutory deadlines for the government to act, and those regulators can impose a global bar on closing a deal while their investigation is pending.

This can provide the U.S. agencies with more time to investigate, prepare for litigation and commence a challenge in court. Without sufficient cushion in the deal's outside date, these delays can force the abandonment of a deal. Prospective dealmakers need to provide for these scenarios in their merger agreements, including flexibility to extend outside dates.

8. Winning in federal court may not be the end of the matter.

An agency loss in federal court on a preliminary injunction motion historically meant the end of the challenge. However, the agencies now appear more willing to appeal, even where a transaction has closed, and despite the agencies' poor track record when attempting to reverse a district court.

The potential for delay is particularly significant in actions where the FTC initiated the challenge in its in-house administrative court. If it subsequently loses in district court, the case is returned to the FTC administrative court and its subsequent decision will ultimately go to the FTC commissioners before it can be appealed to the U.S. Circuit Court of Appeals. That process that can take two years or more.

In addition, even if the parties succeed in defending the transaction in the U.S., a foreign regulator, like the U.K.'s Competitions and Markets Authority or the European Commission, could nevertheless block the deal. Closing despite an adverse decision from those regulators, or while a proceeding is pending in a circuit court or the FTC's administrative court, could expose the parties to significant fines and, potentially, the costs of unwinding the transaction later. Managing this potential threat must be considered when deciding how to work with and litigate against regulators in the U.S. and abroad.

Conclusion

In sum, notwithstanding the Biden administration's failure to prevail in court where it has embraced novel theories and attempted to rewrite case law, prospective dealmakers should expect the pro-enforcement stance to continue, which means more transactions are likely to receive scrutiny and investigations will take longer and be more burdensome.

That said, difficult deals are still getting through the regulators and are being approved in court, so dealmakers should not be deterred so long as they plan from the outset, establish a credible litigation strategy and prepare to litigate if challenged by the agencies.

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The IRS Is Coming for Partnerships and High Net Wealth Individuals

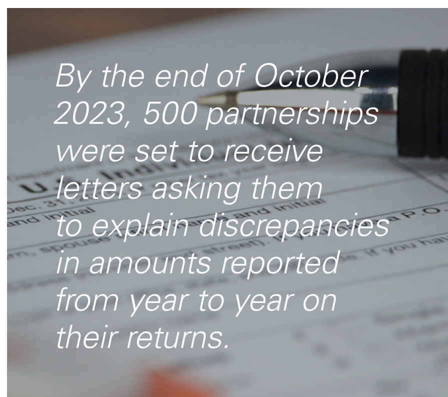
- The IRS is using artificial intelligence (AI) to focus audit efforts on complex partnerships and users of digital assets.
- New audit procedures allow the IRS to collect additional taxes directly from partnerships, unless the partnership decides to push out the liability to its investor-owners at the time of the audit.
- The IRS is also ramping up efforts to audit estate planning strategies designed to permit the tax-free transfer of wealth from generation to generation.

The Internal Revenue Service plans to deploy thousands of new hires to expand audits of partnerships and high net wealth individuals. As part of a larger transformation at the agency, it is using some of the $60 billion in supplemental funding provided by Congress to increase audit activity in areas that largely have been overlooked for many years.

Who Should Be Concerned?

The IRS is likely to focus on tax returns that have the greatest potential for audit adjustments that will yield more tax revenue. The staff does not need to devote audit time to returns that only reflect income from information returns such as wages, interest and dividends. Rather, we anticipate that the IRS will be looking for returns that might reflect complex planning, novel financial products or indicia of wealth, such as:

- Partnership returns that appear to involve tiered partnership structures. Unless the IRS is able to track what is happening at various levels in the structure, it will not know if income is being properly reported. The more complex the structure, the more likely the IRS will want to at least kick the tires through some audits.
- Investment vehicles, including partnerships and trusts, that do not withhold taxes on U.S. income earned through those vehicles by the foreign investors. If the IRS can show that withholding was required, it can try to recover the tax from the investors or from banks or withholding agents that may have had some responsibility.
- Estate or gift tax returns that appear to reflect low-tax or no-tax transfers of assets to younger generations. Whether through trust structures or aggressive valuation discounts, the IRS has its sights on structures and transactions that minimize taxes on intergenerational transfers.



- Individual returns that show the acquisition or trading of cryptocurrency or other digital assets. The IRS is trying to get its arms around the brave new world of cryptocurrencies, NFTs and similar products. Even if everything is fully disclosed, returns showing significant volumes (or amounts) of digital assets are likely targets for audits.

- Individual returns that reflect the ownership of private aircraft or yachts, donations of appreciated stock or donations of high-value artwork. Anything that smacks of wealth can attract attention, and in our experience tax return mistakes often abound in these areas, making it easy for the IRS to find additional taxes owed.

The IRS often tries to identify a few issues that might yield audit results (*i.e.*, more tax revenue), and then seeks returns to audit that implicate those issues. In the past it has done this by getting client lists from accountants or other tax advisers that provided the same advice to multiple clients. Now, using AI, the IRS is hoping to take advantage of data streams to connect the dots to find better returns to audit. This could include publicly available information pulled from press releases, Securities and Exchange Commission filings, news stories, blogs or social media, or from charitable giving reports issued by charities.

How Quickly Will the IRS Move on This Initiative?

It will take time for the IRS to hire thousands of new agents, but it is already moving forward with a number of new partnership audit efforts. For example, it announced plans to notify 75 partnerships with average assets of more than $10 billion that they will face new audits, with notices scheduled to go out by September 30, 2023. We anticipate that these partnerships will include hedge funds and private equity funds, renewable energy partnerships and publicly traded partnerships in various industries. And by the end of October 2023, another 500 partnerships were set to receive letters asking them to explain discrepancies in amounts reported from year to year on their returns.

To better coordinate and organize their efforts to audit partnerships and high net wealth taxpayers, the IRS is establishing a special work unit, in which existing employees and new hires will be housed, to focus on pass-through organizations, like partnerships. This work unit will also be looking at S corporation returns, so those entities should also be on the lookout for audit notices.

Although it will take time to hire, onboard and train the new hires, the IRS is already using AI to help select returns to audit. It is too soon to evaluate the effectiveness of this initiative, but presumably the IRS will only get better with experience using technology to focus its audit efforts.

What Can You Do To Prepare?

The first step in preparing for any IRS audit is to make sure that you are comfortable that your returns are prepared correctly. All too often we

have seen the IRS find mistakes on returns that result in clients owing significant taxes, and sometimes penalties too. For example, if you are planning a charitable contribution, whether it is artwork, a conservation easement, shares in a private company, or something else that might be hard to value, it is critical that you get timely appraisals that will stand up to scrutiny. It is also important to make sure that you receive contemporaneous written acknowledgments of your donations from the donee organizations.

Paying attention to make sure that all of the required information is included with your return is also an absolute must. Because the failure to include required information with a return, such as a properly completed donee acknowledgment for charitable contributions, ordinarily cannot be fixed on audit, you need to make sure that everything is done right before your return is filed.

In addition, certain types of information absolutely must be disclosed. For example, over the past 15 years, thousands of taxpayers have learned the hard way that you can face steep penalties for failure to fully disclose offshore bank accounts. The IRS is still focused on those issues, but it is also honing in on digital assets so, if you have transactions involving them, make sure that they are properly disclosed.

If you are invested in partnerships, or are considering making a partnership investment, find out how the partnership plans to handle any IRS audits. Under rules that took effect only a few years ago, partnerships can elect to pay additional tax due from an IRS audit, or to push out the tax adjustments for past years to current partners. In other words, if you purchase an interest in a partnership in 2023, and the partnership gets hit with tax adjustments for 2022 or earlier years, you might get stuck with a part of the tax bill for periods that pre-date your ownership.

Last, and certainly not least, if you receive an audit notice, make sure that you have the right adviser in place to help guide you through the process. Although your long-time accountant might know all of the details of your return, he or she may not be the best person to represent you in an audit. It can be awkward for the return preparer to defend his or her work. In addition, we find that some advisers are not familiar with current audit trends, or ways that the IRS might work with you to resolve disputes quickly and quietly. Particularly when significant amounts might be at stake, bringing in someone who regularly handles complex audits can pay dividends in the long run.

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Podcast: How Will Corporate DEI Policies Be Affected by the Supreme Court Ruling in the University Affirmative Action Cases?

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Skadden partners Ann Beth Stebbins, David Schwartz and Lara Flath discuss the implications for U.S. companies of the Supreme Court's decision in June striking down race-based affirmative action programs in higher education. David Schwartz is global head of Skadden's labor and employment group, and Lara Flath is a Skadden litigation partner who represented the University of North Carolina (UNC) in the litigation relating to its consideration of race in the admissions process.

There were three key aspects to the majority opinion, Lara explains. First, the interests the universities cited to support their consideration of race were not sufficiently measurable to satisfy the legal standard. Second, the Court focused on the zero-sum nature of admissions decisions; the benefit provided to some applicants on the basis of race is necessarily discriminatory. Third, the Court focused on the fact that there was no defined endpoint when the universities would no longer need to consider race in admissions.

Ann Beth asks about the impact of the decision on corporate diversity, equity and inclusion (DEI) policies.

David describes some typical corporate DEI policies, ranging from recruiting policies to affinity or resource groups supporting employees, to mentoring and training initiatives targeting typically underrepresented groups.

Plaintiffs looking to challenge DEI policies are focusing on what companies say about their DEI programs, in proxy statements and other filings, particularly statements that use race-conscious or zero-sum language, David says.

The plaintiffs in many of the corporate cases are not aggrieved themselves, Lara notes. Instead, they often describe themselves as public interest organizations suing in a representative capacity, or the plaintiff is a shareholder in a derivative suit against the directors and officers.

But some employee-plaintiffs do argue that they were aggrieved, David adds, including white men who allege reverse discrimination.

State attorneys general in red states have also recently challenged DEI policies, but states attorneys general in blue states have defended them, Lara notes.

Ann Beth asks about distinctions between affirmative action policies in university admissions and corporate affirmative action plans.

Government contractors and subcontractors are required by Executive Order to have affirmative action plans, and companies may also have affirmative action plans on a voluntary basis. Companies with affirmative action plans generally identify areas of underrepresentation in their organizations and take actions to remedy those over time, David says. The most common approach is casting a wider net in recruiting. Mentoring and training programs are another step that employers can take as part of their affirmative action plans.

DEI efforts should create a bigger pipeline with more people in entry-level positions and positioned for promotion over time.

Ann Beth asks what companies should consider when describing their DEI programs internally and externally.

First, companies should be truthful and accurate, Lara says. Today, everything a company says publicly or internally about DEI programming is likely to be scrutinized. The policies that are receiving the most scrutiny, are those that appear to be racially exclusionary or zero-sum.

The pressure applies both ways, Lara adds. Companies that have spoken about the importance of their DEI initiatives may get pressure from shareholders or other interested groups asking if the company is living up to those commitments.

Aspirational goals are okay from a legal perspective, David notes, but employers should be thoughtful about setting the goals and the rewards offered to achieve those goals. If a goal is tied to some kind of monetary reward, people may be incentivized to hit their targets in ways that are not entirely proper.

Ann Beth asks what boards should be doing in the wake of the Supreme Court decision.

Companies should review their public filings and statements and see if adjustments could and should be made in light of ruling, David says.

In addition, ask if your DEI objectives are clear and connected to specific business goals, Lara says. Can those initiatives succeed without the use

of impermissible racial quotas? Are there policies that could be viewed as providing a zero-sum advantage based on race? Periodically check the business rationale for these strategies. Is there evidence supporting the policy?

Companies are asking whether diversity should take into account factors such as socioeconomic status and background, first-generation college graduate status, geographic diversity, David says — categories that are not protected under Title VII, so employers can consider them without fear of being sued based on a protected category.

It is important to be careful about how you measure the success of initiatives, Lara says. Are you using a quota where you say, "We are going to hire to hit 25%"? That's different than saying, "We are at 22%, we'd like to be higher." You're not then using race to decide in a zero-sum situation.

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