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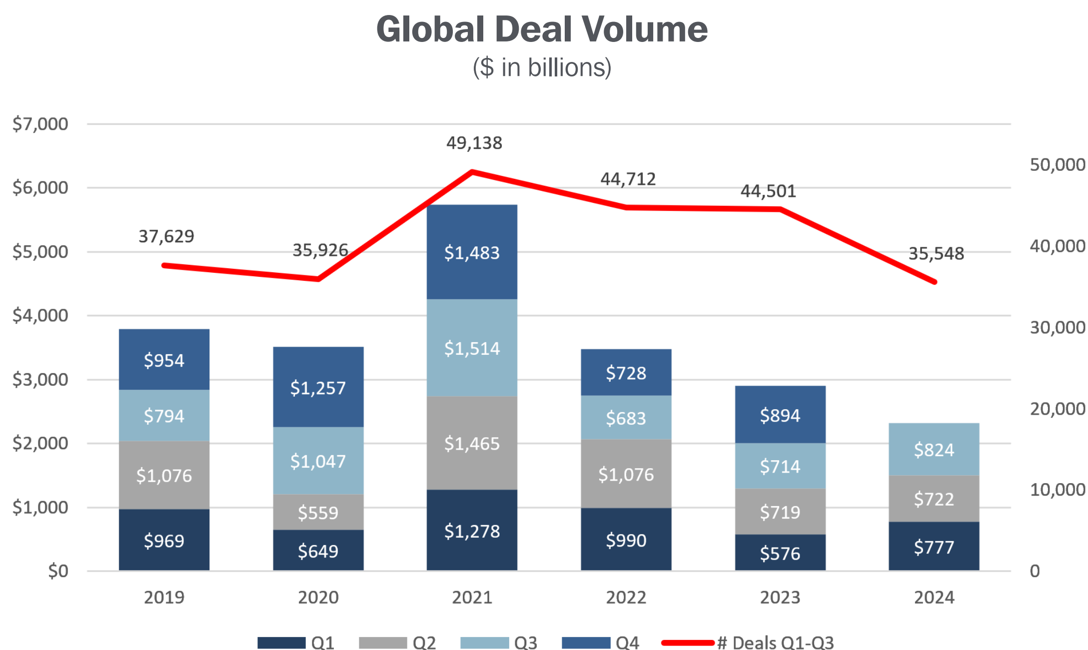
Cravath Quarterly Review

M&A, ACTIVISM AND CORPORATE GOVERNANCE

01

Mergers & Acquisitions

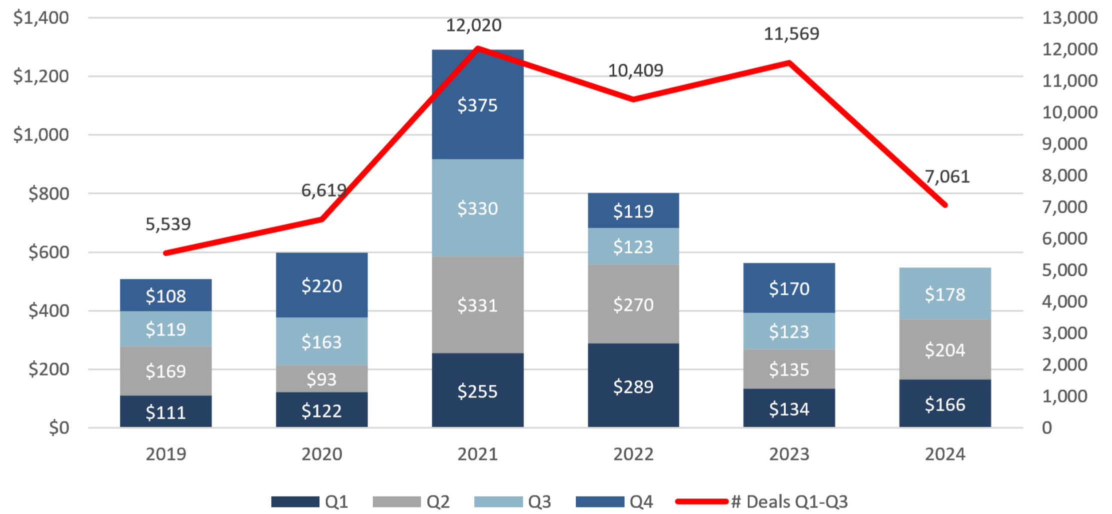
TRENDS[1]



SOURCE Refinitiv, An LSEG Business.

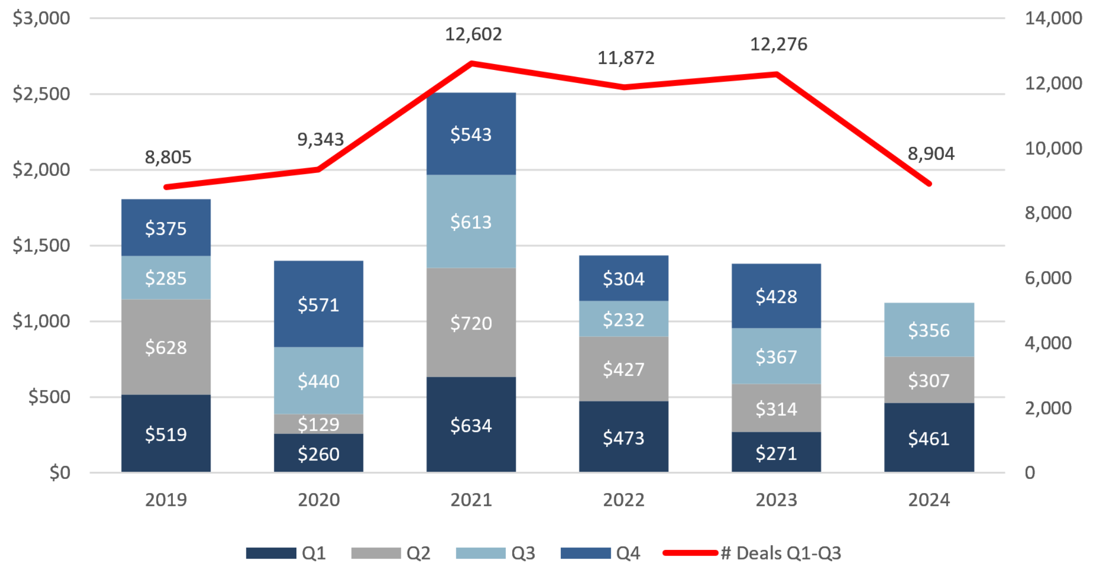
Q3 2024: M&A Volume Increases Year-over-Year, Announced Deal Volume Below $1 Trillion for Ninth Consecutive Quarter

Global M&A volume increased in the first nine months of 2024, with $2.3 trillion in announced deal volume, an increase of 16% compared to the first nine months of 2023. Q3 2024, with announced deal volume of $824 billion, saw an increase of ~14% compared to Q2 2024 but marked the ninth consecutive quarter to fall below $1 trillion in announced deal volume. Despite the increase in announced deal volume, the number of deals announced in the first nine months of 2024 (around 35,500 deals) decreased by ~20% compared to the same period in 2023, and the number of deals announced in Q3 2024 (around 10,500 deals) decreased by ~15% compared to Q2 2024.



SOURCE Refinitiv, An LSEG Business.

Private equity buyouts in the first nine months of 2024 reached $548 billion globally, an increase of ~40% compared to the first nine months of 2023. Slightly over 7,000 private equity-backed deals were announced in the first nine months of 2024, a decrease of ~39% compared to the same period in 2023. Compared to Q2 2024, Q3 2024 saw a decrease of ~13% in announced deal volume and a decrease of ~19% in the number of deals announced.



SOURCE Refinitiv, An LSEG Business.

Dealmaking Up in U.S. and Europe

M&A activity for U.S. targets amounted to $1.1 trillion in the first nine months of 2024, an increase of ~18% compared to the first nine months of 2023. Compared to Q2 2024, M&A activity for U.S. targets increased by ~16% in Q3 2024. M&A activity for European targets totaled $481 billion during the first nine months of 2024, an increase of ~30% compared to the first nine months of 2023 and a two-year high. Compared to Q2 2024, M&A activity for European targets saw a decrease of ~31% in Q3 2024.

In the Asia-Pacific region, dealmaking experienced the slowest first nine months since 2013, totaling $416 billion in the first nine months of 2024, a decrease of ~8% compared to the same period in 2023. Compared to Q2 2024, dealmaking in the Asia-Pacific region increased by ~56% in Q3 2024. Cross-border M&A activity totaled $808 billion in the first nine months of 2024, a ~24% increase compared to the same period in 2023, marking the strongest first nine months for cross-border M&A in two years. Compared to Q2 2024, cross-border M&A activity decreased by ~3% in Q3 2024.

LEGAL & REGULATORY DEVELOPMENTS

Cases

Q3 2024 featured a number of notable decisions by Delaware courts.

CONTROLLING STOCKHOLDER STATUS

SCIANNELLA V. ASTRAZENECA, C.A. NO. 2023-0125-PAF (DEL. CH. JULY 2, 2024)

In July 2024, the Delaware Court of Chancery dismissed claims that AstraZeneca UK Limited and AstraZeneca plc. (collectively, "AstraZeneca"), stockholders of Viela Bio, Inc. ("Viela"), breached fiduciary duties in connection with the $3 billion sale of Viela to Horizon Therapeutics plc ("Horizon"). Among other things, the Court held that AstraZeneca, which held a 26.7% stake in Viela, was not a controlling stockholder and therefore did not owe fiduciary duties to Viela's other stockholders.

AstraZeneca formed Viela in February 2018 via a spin-off, placing five former AstraZeneca executives in top management positions at Viela (including the CEO) and three AstraZeneca senior leaders on the Viela board of directors. In connection with the spin-off, Viela entered into a series of commercial agreements with AstraZeneca and certain of its affiliates. In 2021, the Viela board unanimously approved the sale of Viela to Horizon, and the transaction received stockholder approval. Dissenting Viela stockholders challenged the sale in the Delaware Court of Chancery, claiming that AstraZeneca was Viela's controlling stockholder and, as Viela's controlling stockholder, breached its fiduciary duties by pushing Viela into a rushed and unfair merger in order to accelerate the full separation of Viela and eliminate any antitrust impediment to AstraZeneca's acquisition of Alexion Pharmaceuticals, Inc. ("Alexion").

In dismissing the complaint, the Court first found that AstraZeneca did not exercise general control over Viela because it did not control decisions of the Viela board. While the plaintiffs argued that AstraZeneca's 26.7% stake in Viela allowed it to exercise blocking rights over certain decisions that required the approval of at least 75% of Viela's stockholders under Viela's certificate of incorporation and bylaws, such as stockholder removal of directors for cause, the Court found that these rights were "not nearly as formidable as the blocking rights highlighted in other cases." The Court also held that other factors that the plaintiffs cited were insufficient to establish control, such as AstraZeneca's designation of directors to Viela's board and its earlier selection of the Viela management team at the time of the spin-off, the commercial agreements between the two companies and Viela's disclosure in its SEC filings that it was "substantially reliant" on

AstraZeneca to manage its business operations. The Court also held that AstraZeneca did not have transaction-specific control over Viela, determining that, among other things and contrary to plaintiffs' allegations, AstraZeneca did not threaten to terminate any business arrangements with Viela if the Viela board did not approve the sale of Viela to Horizon. Since the Court held that AstraZeneca was not a controller, the Court further concluded that AstraZeneca did not owe fiduciary duties to Viela's stockholders, and that any purported fiduciary breaches by AstraZeneca's directors were cleansed under *Corwin*[2] because the sale was approved by a fully informed, uncoerced vote of the disinterested stockholders.

ADVANCE NOTICE BYLAWS

KELLNER V. AIM IMMUNOTECH INC., C.A. NO. 2023-0879 (DELAWARE SUPREME COURT, JULY 11, 2024)

In July 2024, the Delaware Supreme Court issued an opinion that clarified the standards of review for determining the validity and enforceability of advance notice bylaws.

The litigation arose from a stockholder group's attempt to nominate directors to the board of AIM ImmunoTech, Inc. ("AIM") ahead of AIM's 2023 annual meeting. The same stockholder group made two attempts in 2022 to nominate directors to AIM's board, and AIM rejected both nomination notices for noncompliance with AIM's then-existing advance notice bylaws and federal securities laws. Ahead of the 2023 annual meeting, the AIM board unanimously adopted a set of amendments to its advance notice bylaws. In 2023, the same stockholder group submitted another notice to nominate three directors to AIM's board. The AIM board rejected it for noncompliance with the amended bylaws and stated that the deadline for submitting a timely notice had passed.

The nominating stockholder brought suit challenging the amended bylaws in the Delaware Court of Chancery, arguing that they were inequitably designed to thwart the nomination effort. The Court of Chancery applied enhanced scrutiny because the board adopted the amendments on a "cloudy day" (in anticipation of a proxy contest), holding that four of the six challenged provisions were unenforceable because they "inequitably imperil the stockholder franchise to no legitimate end": (1) a provision requiring the nominating stockholder to disclose all agreements, arrangements or understandings ("AAUs") between the nominating stockholder and a broadly defined group of associated persons in the past 24 months (the "AAU Provision"); (2) a provision requiring the nominating stockholder to disclose all consulting-related AAUs and nomination-related AAUs between the nominating stockholder and a broadly defined group of associated persons in the past ten years (the "Consulting/Nomination Provision"); (3) a provision requiring the nominating stockholder to disclose the names and contact information of all other stockholders known to support the proposal (the "Known Supporter Provision"); and (4) a provision requiring the nominating stockholder to disclose any equity interest in AIM or any competitor of AIM held by the nominating stockholder and a broadly defined group of associated persons (the "Ownership Provision"). However, because the Court of Chancery agreed with the AIM board that the nomination notice contained misrepresentations and omissions that resulted in the notice not complying with other advance notice bylaw provisions that the Court of Chancery found to be valid, the Court of Chancery nonetheless affirmed the AIM board's rejection of the notice. The nominating stockholder appealed.

On appeal, the Delaware Supreme Court agreed that the same four amended bylaws at issue were unenforceable. The Court first disagreed with the standard of review applied by the Court of Chancery, noting that advance notice bylaws are presumed to be facially valid under Delaware law. It determined that all provisions at issue were facially valid with the exception of the Ownership Provision, which was a

"1,099-word single-sentence" provision that the Court found "indecipherable." The Court then confirmed that, when considering a challenge to bylaw amendments adopted by a board on a "cloudy day," a two-part enhanced scrutiny review will be applied, consisting of first discerning a threat and board motive and second determining whether the board's actions were proportionate to the threat posed and not preclusive or coercive. Applying this two-part test to the bylaw amendments adopted by the AIM board, the Court found that three of the provisions in the amended bylaws—the AAU Provision, the Consulting/Nomination Provision and the Known Supporter Provision—were unreasonable because they contained overbroad definitions, onerous duration requirements or imprecise terms that allowed for subjective interpretation. Having determined that the AIM board adopted one unintelligible bylaw and three unreasonable bylaws in the middle of a proxy contest, the Court concluded that the board's primary purpose in adopting the amendments was to interfere with the nominating stockholder's notice and, as a result, the Court held that the amended bylaws at issue were inequitable and therefore unenforceable. However, citing the Court of Chancery's findings that the nomination notice contained misrepresentations and omissions that resulted in the notice not complying with other valid provisions of the advance notice bylaws, the Court affirmed the Court of Chancery's determination that the AIM board acted reasonably and equitably in rejecting the notice.

EARNOUT PROVISION

SHAREHOLDER REPRESENTATIVE SERVICES LLC V. ALEXION PHARMACEUTICALS, INC., C.A. NO. 2020-1069-MTZ (DEL. CH. SEPT. 5, 2024)

In September 2024, the Delaware Court of Chancery issued a post-trial opinion holding that Alexion Pharmaceuticals, Inc. ("Alexion") breached the terms of a merger agreement by failing to make an earnout payment and by not using commercially reasonable efforts to achieve milestones for future earnout payments.

In November 2018, Alexion acquired Syntimmune, Inc. ("Syntimmune"), a pharmaceutical company developing a humanized monoclonal antibody later known as ALXN1830. The merger agreement contained a heavily negotiated earnout provision, which provided for a $400 million upfront payment to former stockholders of Syntimmune and another $800 million payable contingent on achieving eight milestones, each tied to a stage of ALXN1830's development. The agreement granted Alexion sole discretion over Syntimmune's business operations but required Alexion to use "commercially reasonable efforts" to achieve the milestones for seven years following the acquisition.

The ALXN1830 program encountered numerous hurdles following the acquisition. In early 2020, the ongoing Phase 1 trials were paused due to contaminated clinical drug supply, and the COVID-19 outbreak caused further delays and reallocation of resources. In April 2020, Alexion deprioritized the ALXN1830 program. After AstraZeneca acquired Alexion in July 2021, all programs at Alexion, including ALXN1830, came under review. Alexion terminated the program at the end of 2021, citing, among other factors, potential safety risks based on inconclusive data. Shareholder Representative Services LLC ("SRS"), representing former stockholders of Syntimmune, brought suit in the Delaware Court of Chancery, claiming that Alexion breached the merger agreement by failing to pay for the first milestone and failing to use commercially reasonable efforts to achieve the rest of the milestones.

In a lengthy and fact-intensive decision, the Court ruled in favor of SRS. It found that the first milestone had been achieved, holding that the terms of the earnout provision in the merger

agreement were ambiguous but that extrinsic evidence supported SRS's interpretation. The Court also held that Alexion failed to use commercially reasonable efforts to achieve the remaining milestones. It noted that the commercially reasonable efforts standard was an "outward facing" and objective standard and evaluated the efforts taken by Alexion against those of a hypothetical company of Alexion's size working on a similar drug at a similar stage of development, including based on what Alexion's competitors were doing with similar products around the same time. Applying that standard, the Court held that Alexion breached its obligation under the commercially reasonable efforts requirement because Alexion's termination of the ALXN1830 program fell short of the typical efforts that a similar hypothetical company would have contributed to the program given that the data about ALXN1830's safety issues were inconclusive and Alexion internally believed that ALXN1830 could be the first to market in at least two indications. The Court placed particular emphasis on the fact that AstraZeneca had targeted $500 million in recurring synergies from its acquisition of Alexion, and found that the desire to achieve these synergies substantially influenced the decision to terminate ALXN1830's development. The Court determined that this was an idiosyncratic corporate objective of AstraZeneca and Alexion that would not necessarily be pursued by the hypothetical company contemplated by the "outward-facing" efforts standard.

02

Antitrust

Federal Trade Commission Issues Final HSR Rules

On October 10, 2024, the Federal Trade Commission ("FTC"), with the concurrence of the Assistant Attorney General of the Department of Justice ("DOJ"), Antitrust Division (the FTC and DOJ together, the "Agencies"), issued the final version of the new Hart-Scott-Rodino ("HSR") rules (the "HSR Rules"),[3] which modify the initial proposed rules released on June 27, 2023 (the "Proposed Rules"),[4] discussed in our Q2 2023 Quarterly Review[5] and July 20, 2023 memo.[6] The stated purpose of the new rules is to provide the Agencies with "specific categories of information and documents . . . not required by the current Rules, but [that] would be highly probative to the initial antitrust screening of a transaction during the initial waiting period."[7] The HSR Rules will come into effect 90 days after their publication in the Federal Register, which will likely result in an effective date in mid-January 2025 (though possibly later). The Agencies also announced that grants of early termination (which have been suspended since February 2021) will resume for no-issue HSR filings, concurrent with the HSR Rules coming into effect. The HSR Rules narrow the Proposed Rules considerably, but still represent a significant expansion of the current filing requirements and are expected to require substantial additional time and effort from filers. For more information about the HSR Rules, please see our October 15, 2024 memo.[8]

ENFORCEMENT

Federal Trade Commission

In July 2024, the FTC moved to block a $4 billion acquisition of Mattress Firm Group, Inc. ("Mattress Firm") by Tempur Sealy International, Inc. ("Tempur Sealy").[9] The FTC alleged that the "vertical acquisition would harm competition across the premium mattress market" by allowing Tempur Sealy to "limit rivals' access to Mattress Firm's nationwide network of stores" and "dominate the market over those of its competitors."[10]

In September 2024, the FTC voted 3-2 to approve a proposed consent order to resolve

antitrust concerns surrounding Chevron Corporation's ("Chevron") $53 billion acquisition of oil producer Hess Corporation ("Hess"), allowing the transaction to close.[11] The consent order prohibits Chevron from nominating, designating or appointing Hess's CEO, John B. Hess, to the Chevron Board of Directors and prohibits Mr. Hess from "serv[ing] in an advisory or consulting capacity to, or as a representative of, Chevron or the Chevron Board", aside from a limited exception.[12] The FTC alleged that Mr. Hess had communications with competitors of the Organization of the Petroleum Exporting Countries about global oil output and other dimensions of the crude oil market competition, which disqualified him from serving on the Chevron Board.[13] The FTC alleged that Mr. Hess's appointment to the Chevron Board would "heighten the risk of harm to competition, including meaningfully increasing the risk of industry coordination" and "lessen competition, in violation of Section 7 of the Clayton Act and Section 5 of the FTC Act" and "is an unfair method of competition in violation of Section 5 of the FTC Act."[14] This mirrors the approach taken in the consent order that resolved the FTC's concerns with the Exxon/Pioneer transaction.[15]

Department of Justice

In July 2024, healthcare organization UnitedHealth Group ("UnitedHealth") abandoned its proposed acquisition of healthcare organization Stewardship Health Inc. ("Stewardship Health") following scrutiny from the DOJ's Antitrust Division.[16] Assistant Attorney General Jonathan Kanter of the DOJ's Antitrust Division stated that the transaction was "among UnitedHealth['s] latest proposed provider-related acquisitions", and it "raised questions about quality of care, cost of care and working conditions for doctors, nurses and other healthcare providers."[17]

In August 2024, airline group International Consolidated Airlines Group S.A. ("IAG") announced that it would abandon its proposed acquisition of sole control of airline group Air Europa Holding S.L. ("Air Europa").[18] Following this announcement, Deputy Assistant Attorney General Michael Kades of the DOJ's Antitrust Division stated that "[a]s a result of this abandonment, travelers between the United States and Europe will benefit from an industry rivalry that lowers prices, boosts quality and promotes choice."[19]

Also in August 2024, the DOJ brought a "civil action to obtain equitable and monetary relief in the form of civil penalties against Legends Hospitality Parent Holdings, LLC ("Legends") for violating the premerger notification and waiting period requirements of the HSR Antitrust Improvements Act of 1976."[20] In the complaint, the DOJ alleged that "Legends engaged in illegal premerger coordination in connection with its proposed acquisition of ASM Global Inc. [("ASM"), a venue services company primarily focused on venue management,[21]] by exercising operational control over aspects of ASM during the HSR waiting period [with regard to] venue management services for an arena in California."[22] In conjunction with its complaint, the DOJ announced a proposed settlement requiring that, among other things, Legends "pay a $3.5 million civil penalty, refrain from certain conduct, appoint an Antitrust Compliance Officer, implement an antitrust training and compliance program and submit regular compliance reporting to the department."[23]

03

CFIUS

Annual Report for Calendar Year 2023

In July 2024, the Committee on Foreign Investment in the United States ("CFIUS")

published the unclassified version of its Annual Report to Congress for the 2023 calendar year.[24] Key findings and insights from the report include:

- CFIUS reviewed 233 notices (*i.e.*, long-form filings) and 109 declarations (*i.e.*, short-form filings), or 342 total filings. This is a significant decrease from 2022's total of 440 filings (286 notices and 154 declarations).
- Of the 109 declarations, CFIUS approved 83 (~76%) in the 30-day assessment period, up significantly from 2022 (~58%) and the highest percentage since the advent of declarations in 2018. Further, CFIUS requested a notice in ~18% of the instances in which the parties initially filed a declaration, compared to ~32% in 2022. This suggests that declarations may be a more viable option for transaction parties to consider than previously thought.
- Of the 233 notices CFIUS reviewed in 2023, 128 (~55%) went to the second 45-day investigation period. This was slightly down from 2022 (~57%) but still above historical norms (excluding the outlier years of 2017 and 2018, when investigation rates increased significantly during the first years of the Trump administration).
- CFIUS approved 35 notices (~15%) with mitigation, up from 2022 (~14%) and the highest percentage of notices mitigated since 2018 (~16%), an outlier year. This figure confirms what many transaction parties and counsel have experienced: CFIUS mitigation continues on an upward trend.
- The number of "withdraw/re-files" was down from 2022 (~18% v. ~24%) but still remained well above historical averages.

Overall, the data present a somewhat mixed picture. On the one hand, CFIUS has improved its efficiency in certain areas, although this may be a product of fewer filings and thus a lightened workload for CFIUS case review staff. On the other hand, withdraw/re-files and mitigation agreements remain high, indicating a longer and more uncertain process for many filers relative to years past.

CFIUS Proposes to Expand Jurisdiction over Real Estate Transactions

On July 8, 2024, the U.S. Department of the Treasury ("Treasury") issued a proposed rule to expand CFIUS's jurisdiction over real estate transactions near U.S. military installations.[25]

The proposed rule, which was open for comment through August 19, 2024, would, among other things, expand CFIUS's jurisdiction over real estate transactions to include transactions within a one-mile radius of 40 additional military installations and within a 100-mile radius of 19 additional military installations.[26]

With only five of the 342 total CFIUS filings in 2023 pertaining to real estate transactions (~1%), real estate deals still account for only a very small portion of CFIUS's work. Nevertheless, the MineOne prohibition in May 2024 (see our Q2 2024 Quarterly Review)[27] and July's proposed rule emphasize that the U.S. Government remains deeply concerned about adversaries acquiring property in close proximity to sensitive installations. In this environment, real estate transactions are unlikely to remain at only 1% of CFIUS's caseload for long.

CFIUS Penalties and Enforcement Matters

In August 2024, Treasury unveiled a new CFIUS enforcement website in what it described as a "continuing evolution and sharpening of [CFIUS] as a critical national security tool."[28] The site described eight CFIUS enforcement actions imposing penalties—one each in 2018 and 2019, three in 2023 and three in 2024.

Of the eight actions, only one, an action against T-Mobile US, Inc. ("T-Mobile") for violating a CFIUS mitigation agreement, included the name of the penalized party.[29] T-Mobile was fined $60 million for violations of a CFIUS mitigation agreement.

The other seven enforcement actions, two of which CFIUS had previously acknowledged, included penalties ranging from $100,000 to $8 million for, among other things, material misstatements in a notice to CFIUS, violations of a CFIUS order and violations of mitigation agreements.

CFIUS's imposition of such a large number of penalties (compared to its historical norms) with such high dollar amounts (particularly the $60 million T-Mobile penalty) punctuates the U.S. Government's many recent statements about "sharpening" the CFIUS tool.

CFIUS has undoubtedly implemented a robust enforcement agenda. Whether this ultimately strengthens U.S. national security by increasing compliance, or weakens U.S. national security by deterring voluntary CFIUS filings or, worse, beneficial foreign investment, remains to be seen.

Update on U.S. Steel/Nippon Steel

As we noted in the Q1 2024 Quarterly Review, President Biden's public statements implicitly opposing the pending acquisition by Nippon Steel Corporation ("Nippon Steel"), a Japan-headquartered steelmaker, of United States Steel Corporation ("U.S. Steel"), a steel producer headquartered in Pennsylvania, marked a notable departure from the U.S. Government's general policy of not commenting on transactions under CFIUS review.[30]

In September 2024, Vice President Harris once again deviated from established norms by stating publicly that U.S. Steel should "remain American-owned and American-operated."[31] Concurrently, press reports indicated that CFIUS had sent a letter to the parties informing them that the transaction would pose a risk to U.S. national security.[32] Such a letter—referred to as a "Ralls" letter based on a 2014 court ruling requiring that CFIUS provide transaction parties with due process prior to blocking a transaction—often precedes a prohibition.[33]

According to public reports, Nippon Steel and U.S. Steel recently withdrew and re-filed their submission to CFIUS, thereby increasing the likelihood that CFIUS will put off a formal decision until after November's presidential election.[34]

Regardless of the ultimate disposition of the case, Washington's vocal opposition to an investment from Japan—its most important ally in east Asia—in such a politically charged transaction has likely tarnished CFIUS's reputation as a regulator driven by national security, rather than electoral, considerations. As we noted in the Q1 2024 Quarterly Review,[35] transaction parties planning for a CFIUS review would do well to consider how politics may affect the process.

04

Activism[36]

Observations regarding activist activity levels in the first nine months of 2024 include:

- Global activist activity in the first nine months of 2024 exceeded 2023's swift pace with ~220 new campaigns globally, representing a ~15% increase from the first nine months of 2023.
- U.S. activist activity increased in the first nine months of 2024, representing the largest regional share of global activist activity at ~55% of all new campaigns. The ~120 new campaigns launched in the United States in the first nine months of 2024 represented a ~60% increase from the same period in 2023.
- Activist activity in Europe maintained the same pace in the first nine months of 2024 compared to the same period in 2023. There were ~40 new campaigns launched in Europe in the first nine months of 2024 (~15% of all new campaigns globally), in line with the same period in 2023.
- Activist activity outside the United States and Europe decreased in the first nine months of

2024 compared to the same period in 2023. The ~60 new campaigns launched outside the United States and Europe in the first nine months of 2024 (~25% of all new campaigns globally) represented a ~20% decrease from the first nine months of 2023.

05

Tax

Proposed Regulations on Corporate Alternative Minimum Tax

On September 13, 2024, Treasury and the Internal Revenue Service released proposed regulations on the 15% corporate alternative minimum tax on book earnings (the "CAMT"), which was enacted as part of the Inflation Reduction Act. These regulations address a number of critical unanswered questions regarding the CAMT, while also formalizing interim guidance previously released by the government.

The CAMT is imposed on corporate groups with average adjusted financial statement income ("AFSI") of at least $1 billion calculated over a three-year period; the CAMT then applies to the extent the applicable group's regular tax liability is less than 15% of its annual AFSI. Although AFSI is calculated based on book concepts, the statute and proposed regulations call for a number of adjustments that conform AFSI with normal tax principles. Depending on the circumstances, these adjustments may help taxpayers (if the normal principles are more favorable than book) or hurt taxpayers (if the normal principles are less favorable than book). The adjustments take on special importance in the M&A context, given that the book characterization of M&A transactions frequently diverges from basic tax principles.

The proposed regulations address a number of important questions relevant to M&A transactions. First, consistent with prior guidance, book gain or loss resulting from many tax-free contributions and reorganizations is excluded for purposes of calculating AFSI. This is generally favorable to taxpayers in that it ensures that transactions that are tax-free under normal tax principles do not inadvertently create a substantial CAMT liability. That said, the proposed regulations make clear that this exclusion does not extend to transactions that are partially tax-free, such as a tax-free contribution with cash "boot"—this creates a "cliff effect" pursuant to which a small amount of cash consideration unleashes significant minimum tax. This is a significant trap for taxpayers engaging in tax-free transactions, especially corporate contributions and separate transactions.

Second, the proposed regulations disregard purchase accounting concepts for purposes of calculating AFSI after a taxable stock acquisition. Purchase accounting would have been beneficial to taxpayers, as it would have provided taxpayers with a CAMT shield following these acquisitions (even though no basis step-up is available for normal tax purposes).

Finally, the proposed regulations adopt complicated tax accounting rules applicable to partnerships between corporate counterparties. These rules will be difficult for many partnerships to administer and may produce unanticipated tax frictions. This will be an important area of focus for corporate taxpayers considering joint venture partnership structures that are intended to be tax-free.

06

Corporate Governance

SEC UPDATES

SEC Approves New PCAOB Quality Control Standard[37]

On September 9, 2024, the Securities and Exchange Commission ("SEC") approved a new Public Company Accounting Oversight Board ("PCAOB") quality control ("QC") standard, QC 1000. The PCAOB's current quality control standards have stood largely unchanged since the PCAOB's founding in 2002. QC 1000 addresses changes to audit practice over the past three decades.

Under QC 1000, audit firms must design a QC system subject to a number of requirements and, for larger firms, establish an external oversight function for the QC system, referred to as an External QC Function, composed of one or more persons who can exercise independent judgment related to the firm's QC system.

The new standard becomes effective on December 15, 2025, with the first annual evaluation period covering the period beginning on December 15, 2025 and ending on September 30, 2026. Additional discussion of QC 1000 can be found in our Q2 2024 Quarterly Review[38] covering the proposal of the standard.

SEC Adopts Improvements to EDGAR System to Enhance Security, Filer Access, and Account Management[39]

On September 27, 2024, the SEC adopted amendments intended to enhance the security of its Electronic Data Gathering, Analysis, and Retrieval ("EDGAR") system and improve filers' access and account management capabilities. The amendments update account access protocols to require EDGAR filers to authorize identified individuals who will be responsible for managing their accounts, and individuals acting on behalf of EDGAR filers will need to present individual account credentials to access EDGAR accounts and make filings. On September 23, 2024, the SEC opened a beta software environment designed for the new protocols in order for filers to test and provide feedback. All EDGAR filers must be in compliance with the new protocols by September 15, 2025.

SEC Proxy Firm Rule Repeal Survives Challenge in the Sixth Circuit[40]

On September 11, 2024, the United States Court of Appeals for the Sixth Circuit upheld the SEC's rollback of Trump-era regulations on proxy advisory firms. In 2022, the SEC repealed exemptions put in place in 2020 that required that proxy advisory firms allow companies to review the advice they planned to give investors on proxy matters. The Sixth Circuit ruled that the SEC did not act arbitrarily and capriciously by rolling back restraints on proxy advisory firms. The Sixth Circuit reiterated that "an agency may rescind a prior rule based solely on a change in the agency's policy preferences, so long as the change is reasonably explained."

Notably, the Sixth Circuit's opinion creates a circuit split following the June 2024 decision by the United States Court of Appeals for the Fifth Circuit, which held that the "SEC acted arbitrarily and capriciously . . . when it failed to respond to petitioners' comments and failed to conduct a proper cost-benefit analysis" in connection with the 2022 rules, thereby violating the Administrative Procedure Act.

Additional discussion of the Fifth Circuit's opinion can be found in our Q2 2024 Quarterly Review[41] covering the subject.

NEW LEGISLATION

European Artificial Intelligence Act Becomes Effective[42]

On July 31, 2024, the European Union's ("EU's") Artificial Intelligence ("AI") Act entered into force after being published in the EU Official Journal (the "AI Act"). The AI Act is a trailblazing piece of legislation, becoming the world's first standalone law governing the use of AI after an extensive legislative negotiation process.

The AI Act applies to providers, manufacturers, importers, distributors and deployers of "AI systems" and applies to all sectors and industries, regardless of geographic location, as long as they do any of the following within the EU:

- Market an AI system.
- Serve AI system users.
- Utilize the "output" of the AI system.

The AI Act provides limited exceptions for certain AI systems, such as those used for scientific research.

The AI Act adopts a risk-based approach with four categories of risk and obligations for high-risk AI systems depending on the role of the actor (*e.g.*, whether the actor is a provider, deployer or importer and distributor).

The provisions of the AI Act will take effect gradually over the next three years.

California Legislature Approves Amendments to Climate Disclosure Rules[43]

On September 27, 2024, Governor Newsom of California signed into law Senate Bill 219 ("SB 219"), thereby enacting amendments to the Climate Corporate Data Accountability Act ("SB 253") and the Climate-Related Financial Risk Act ("SB 261") (together, the "California Climate Rules"). In particular, SB 219 makes the following changes to SB 253:

- *Adoption delay*: SB 219 extends the rulemaking deadline for the California Air Resources Board ("CARB") for scopes 1, 2, and 3 emissions reporting from January 1, 2025 to July 1, 2025.
- *Timeline of scope 3 disclosure*: SB 219 entitles CARB to determine a schedule for disclosure of scope 3 emissions rather than the previous timeline requiring the disclosure of scope 3 emissions within 180 days after scopes 1 and 2 emissions disclosure.
- *Consolidated reporting at the parent-company level*: For the purposes of the scopes 1, 2, and 3 emissions disclosures, reports may now be consolidated at the parent-company level.
- *No payment requirement at filing*: Under SB 219, reporting companies are no longer required to pay a filing fee at the time of filing their disclosure reports for SB 253 and SB 261. While the fee is still required, the payment date is no longer specified.

A further discussion of the California Climate Rules can be found in our October 9, 2023 memo[44] on the subject.

TEXAS BUSINESS COURT[45]

On September 1, 2024, the Texas Business Court and the Fifteenth Court of Appeals began hearing cases. The Texas Business Court was created by House Bill 19 to provide a specific venue for commercial disputes, including contract disputes, fiduciary duty claims, and other corporate governance issues. The judges of the Texas Business Court will have smaller dockets than a typical state court and have specialized experience in complex commercial matters.

The Texas Business Court has 11 judicial regions, but only the first, third, fourth, eighth and 11th regions began hearing cases in September 2024. The remaining six divisions will be abolished September 1, 2026 unless the Texas legislature reauthorizes funding for the regions' operations.

07

Additional Updates

Texas Court Halts FTC's Rule "Banning" Non-Compete Clauses

On April 23, 2024, the FTC adopted a final rule (the "Final Rule")[46] broadly deeming non-compete clauses with "workers" to be an "unfair method of competition" under Section 5 of the Federal Trade Commission Act. The rule was scheduled to become effective on September 4, 2024 but was set aside by a federal district court in Texas[47] on statutory and Administrative Procedure Act grounds, halting its implementation nationwide. The FTC has appealed the district court's ruling to the United States Court of Appeals for the Fifth Circuit. The district court's ruling remains in effect unless the Fifth Circuit grants a stay of that ruling pending appeal.

In a separate case, the FTC has also appealed, to the United States Court of Appeals for the Eleventh Circuit, a ruling by a federal district court in Florida granting a preliminary injunction barring enforcement of the Final Rule against the plaintiff in that case.[48]

Non-compete agreements must still comply with state laws to be legal and enforceable. The FTC has also committed to continuing its case-by-case enforcement program against non-compete agreements.

R.R. Donnelley & Sons Co. (June 18, 2024 SEC Settlement)

On June 18, 2024, the SEC entered into a settlement with business communications and marketing provider R.R. Donnelley & Sons Co. ("RRD") for $2.1 million to resolve charges related to RRD's response to a 2021 ransomware attack.

Notably, the SEC alleged that RRD's cybersecurity practices violated the disclosure controls and procedures and internal accounting control provisions of the Securities Exchange Act of 1934 (the "Exchange Act"). Among other failures, the SEC alleged that (i) RRD's internal policies governing review of cybersecurity alerts and incident response failed to sufficiently identify lines of responsibility and authority, set out clear criteria for alert and incident prioritization, and establish clear workflows for alert review and incident response and reporting; (ii) RRD failed to design effective disclosure-related controls and procedures around cybersecurity incidents to ensure that relevant information was communicated to management to allow timely decisions regarding potentially required disclosure; (iii) RRD failed to design and maintain internal controls sufficient to provide reasonable assurances that access to RRD's assets was permitted only with management's authorization; and (iv) RRD's external and internal security personnel failed to adequately review alerts and take adequate investigative and remedial measures.

The settlement represents a potential expansion of the SEC's attempt to exercise direct oversight of cybersecurity practices. The allegations in the RRD settlement focused not only on disclosure of the incident but also purported infirmities in RRD's alert and access management practices purportedly exploited by the threat actors during the cybersecurity incident.

S.E.C. v. SolarWinds Corp. & Brown, No. 23-cv-9518 (S.D.N.Y. July 18, 2024)

On July 18, 2024, the U.S. District Court for the Southern District of New York granted in part SolarWinds' motion to dismiss, dismissing most of the SEC's claims against SolarWinds and its former Chief Information Security Officer ("CISO"), Timothy Brown. The SEC initially

filed suit against SolarWinds and its CISO in October 2023 after the highly publicized compromise of SolarWinds' software by the Russian Foreign Intelligence Service, which was publicly disclosed by SolarWinds in December 2020.

The Court dismissed the SEC's securities fraud claims based on (i) statements made by SolarWinds and the CISO in press releases, blog posts and podcasts, holding that the statements were non-actionable corporate puffery; (ii) SolarWinds' Form S-1 cybersecurity risk disclosure (incorporated by reference into other pre-incident public filings), holding that the risk disclosure "was sufficient to alert the investing public of the types and nature of the cybersecurity risks SolarWinds faced and the grave consequences" of such risks, and that, based on the information known at the time, SolarWinds was not required to update its risk disclosure after certain pre-December 2020 incidents had occurred; and (iii) SolarWinds' Form 8-K disclosures of the December 2020 incident, holding that the disclosures "captured the big picture"—the severity of the attack—and were not materially false or misleading for not referencing prior incidents.

The Court also dismissed the SEC's (i) internal accounting controls claims under the Exchange Act, holding that "cybersecurity controls are outside the scope of Section 13(b)(2)(B)", and that the "text of the statute strong[ly] supports that the term 'system of internal accounting controls' . . . refers to a company's *financial accounting*"; and (ii) disclosure controls and procedures claims, holding that SolarWinds had a system of controls for disclosure of cybersecurity risks and incidents and that the SEC had not adequately pled that the disclosure controls and procedures had systemic deficiencies or resulted in a failure to properly disclose prior incidents and vulnerabilities.

The only claims allowed to proceed were the SEC's securities fraud claims based on SolarWinds' website security statement. The Court held that the website security statement contained misleading representations as to the company's access controls and password protection policies, that such representations were material given the centrality of cybersecurity to the company's products and customers and that scienter was adequately pleaded. Given this holding, the Court concluded it was unnecessary to resolve on the pleadings whether three other aspects of the website security statement (compliance with the National Institute of Standards and Technology Cybersecurity Framework, network monitoring, and compliance with the secure development life cycle) were also misleading.

Coming soon after the *R.R. Donnelley* settlement, this ruling represents a potentially significant setback for the SEC's ability to exert direct oversight over cybersecurity practices. Notably, however, the SEC's July 2023 cybersecurity rules were not at issue in this case and provide an alternate avenue for the SEC to exert oversight in this space. The ruling may also limit some of the most far-reaching interpretations of controls-related claims previously advanced by the SEC.

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