PAUL HASTINGS

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Public Company Watch

Key Issues Impacting Public Companies

SEC Spotlight

SEC Climate Change Rules Litigation Update

Implementation of the SEC's new climate disclosure rules is currently subject to a **voluntary stay** issued by the SEC itself on April 4, 2024, pending resolution of various legal challenges that were consolidated in the Court of Appeals for the Eighth Circuit. By way of quick recap, the new rules were adopted on March 6, 2024 in a 3-2 vote by the SEC Commissioners along party lines.

Background of the legal challenges: Shortly after adoption of the new rules, a host of suits were filed in different circuit courts challenging the new rules – most asserting that the rules go too far, are outside of the SEC's rulemaking authority and would exact too high of a burden on public companies, but some arguing that the final rules, which contained significant cutbacks to the requirements contained in the proposed rules, do not go far enough to protect investors.

On March 15, 2024, the Fifth Circuit granted a petition for administrative stay of the climate rules as interim relief while the legal challenges are under review. On March 21, 2024, following a request by the SEC to consolidate the actions in a single circuit court, the Judicial Panel on Multidistrict Litigation issued an order consolidating all suits filed to date and, through a lottery draw, transferred them to the Eighth Circuit, at which point the Fifth Circuit administrative stay was lifted. On April 4, 2024, the SEC issued its own voluntary stay on the implementation of the climate rules until the conclusion of the Eighth Circuit's judicial review of the consolidated cases.

On April 10, 2024, Republicans in Congress added their own challenge, introducing a bill in the House to pass a resolution under the Congressional Review Act ("CRA") that would invalidate the rules. Under the CRA, Congress can pass a joint resolution preventing implementation of rules adopted by administrative agencies and once those rules are invalidated, the rules cannot be reissued unless they are substantially different. It is unclear whether this legislation will gain traction amongst a sufficient number of Democrats to ultimately succeed, but if it does, the rules will be nullified.

Key Takeaway: The consolidated case in the Eighth Circuit will take time to resolve – possibly years – and as a result, the implementation timeline of the new climate rules will likely be pushed back. The SEC has not yet confirmed whether the compliance deadlines will be extended and, if so, for how long. Depending on the outcome of the Eighth Circuit case and the success of a CRA resolution, the scope of the climate rules may change or they may not be implemented at all.

In This Edition

SEC Enforcement Action Against Investment Advisors for "AI Washing" Serves as Reminder for Public Companies

On March 18, 2024, the SEC announced a settlement with two investment advisers, Delphia (USA) Inc. and Global Predictions Inc., for making false and misleading statements about their purported use of artificial intelligence ("AI"), referred to as "AI washing." Gurbir S. Grewal, Director of the SEC's Division of Enforcement, stated that "[a]s more and more investors consider using AI tools in making their investment decisions or deciding to invest in companies claiming to harness its transformational power, we are committed to protecting them against those engaged in 'AI washing.'"[1]

The same day, SEC Chairman Gary Gensler stated, in remarks posted to YouTube, that "investment advisors and broker dealers should not mislead the public by saying they are using an AI model, when they are not, nor say that they are using an AI model in a particular way, but not do so."[2] He also remarked that "public companies should make sure they have a reasonable basis for the claims they make, and … the particular risk they face about their AI use and investors should be told that basis."[3]

The enforcement actions and statements follow Chairman Gensler's speech on AI on February 13, 2024 where he offered the following insights to public companies: "[a]s AI disclosures by SEC registrants increase, the basics of good securities lawyering still apply. Claims about prospects should have a reasonable basis, and investors should be told that basis. When disclosing material risks about AI—and a company may face multiple risks, including operational, legal, and competitive—investors benefit from disclosures particularized to the company, not from boilerplate language. Companies should ask themselves some basic questions, such as: 'If we are discussing AI in earnings calls or having extensive discussions with the board, is it potentially material?'"[4] Public companies should be mindful of their AI disclosures in this evolving landscape.

SEC Wins Trial Involving First-Ever Shadow Trading Case

On April 5, 2024, a federal jury in the Northern District of California found defendant Matthew Panuwat liable for insider trading in the SEC's first-ever case involving the so-called "shadow trading" theory of insider trading.

The SEC's shadow trading theory is an extension of the well-established misappropriation theory of insider trading adopted by the Supreme Court in 1997. Under the misappropriation theory of insider trading, a person who is not an insider at a company nevertheless engages in illicit insider trading if the person lawfully comes into possession of material, nonpublic information, but then breaches a duty of trust and confidence *owed to the source of the information* by trading on the basis of that information, or by conveying the information to another person to trade. For example, the clerk of a judge who trades in the stock of a company that is about to be the subject of a favorable decision by the judge violates a duty owed to the judge (not the company) if the clerk purchases the company's stock in advance of the decision. The shadow trading theory extends the misappropriation theory to situations where a person lawfully acquires material, nonpublic information but, instead of trading in the securities of the company to which the person owes a duty of trust and confidence, the person uses the information *to trade in the securities of another company* to which the person does not owe such a duty.

Background: In *Panuwat*, the SEC alleged that Panuwat, while serving as a Senior Director of Business Development at a biopharmaceutical company ("Company A"), received material, nonpublic information that Company A would be acquired by a larger pharmaceutical company and, after receiving this information, purchased out-of-the-money, short-term stock options in another biopharmaceutical company ("Company B"), anticipating that the price of the shares would increase following the announcement of the acquisition. Following the public announcement of the acquisition of Company A, both Company A's and Company B's stock prices rose significantly, and Panuwat exercised his Company B options. The SEC alleged that Panuwat owed Company A a duty to maintain in confidence the material, nonpublic information about the acquisition and to refrain from trading on the basis of Company A's confidential information because of his employment at Company A and the confidentiality and insider trading policies that he signed.[5] The SEC alleged that the information about the acquisition was material to both Company A and Company B because they were peer companies – both operating in the biopharmaceutical industry and both publicly traded, mid-cap companies focused on oncology – so the information would have been viewed by a reasonable investor of either company as having significantly altered the

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1 Press Release, SEC Charges Two Investment Advisers with Making False and Misleading Statements About Their Use of Artificial Intelligence (Mar. 18, 2024), *available at* **https://www.sec.gov/news/press-release/2024-36**.

2 SEC Chair Gary Gensler on AI Washing, YouTube (Mar. 18, 2024), *available at* **https://www.youtube.com/watch?v=4L_jxkZ9V6U**.

3 *Id*.

4 Prepared Remarks before the Yale Law School, AI, Finance, Movies, and the Law (February 13, 2024), *available at* **https://www.sec.gov/news/speech/gensler-ai-021324**.

5 See Complaint, *SEC v. Panuwat*, Case No. 3:21-cv-06322-WHO (N.D. Cal. Aug. 17, 2021), ECF No. 1 at 7–8.

total mix of information available.[6] Specifically, the SEC alleged that the public announcement of Company A's acquisition likely would have a positive effect on Company B's stock price.[7]

In denying Panuwat's motion to dismiss and subsequent motion for summary judgement, the district court focused on the plain language of Company A's insider trading policy, which the district court found prohibited trading in Company's B stock.[8] The district court also focused on Panuwat's duty of trust and confidentiality, finding that Panuwat owed a duty of trust and confidentiality to the Company because he signed a confidentiality agreement, obtained confidential information regarding the acquisition and then "exploited that information for his personal benefit when he bought [Company B] stock options . . . and later sold those options for a profit."[9] Last, the district court focused on the market connection between Company A and Company B, finding that a reasonable jury could infer that "a reasonable investor such as Panuwat—who paid careful attention to the biopharmaceutical market, and specifically to [Company B]—could have perceived [Company A] and [Company B] to be connected in the market such that pertinent information about one was material to the other."[10]

The SEC's shadow trading allegations, the district court's orders denying Panuwat's motion to dismiss and motion for summary judgment and the jury verdict provide several important lessons for companies, investment professionals and investors. For additional details and analysis on the case, please see our **client alert**.

Delaware Law Update

Proposed Amendments to DGCL Adopted in Response to Recent Delaware Chancery Court Decisions

On March 28, 2024, the Council of the Corporation Law Section of the Delaware State Bar Association released proposed amendments to the Delaware General Corporation Law ("DGCL") relating to certain statutory provisions at issue in recent Delaware Chancery Court decisions. The proposed amendments are generally intended to align the DGCL statutory provisions to current market practice. If enacted, the amendments will be effective as of August 1, 2024.

The proposed amendments relate to (i) the ability of a corporation to enter into stockholder agreements, (ii) board and stockholder approval of merger and other agreements and (iii) available remedies and the appointment of stockholders' representatives pursuant to merger agreements, as discussed more below.

Stockholder Agreements (§122(18))

New §122(18) is meant to provide a clear authorization for corporations to agree to certain provisions in contracts between the corporation and its current or prospective stockholders (provided that such provisions are not prohibited under the corporation's charter). The amendments are being proposed in response to the recent *Moelis* case, in which the Court stated that the "expansive use of stockholder agreements suggests that greater statutory guidance may be beneficial."[11] In ***West Palm Beach Firefighters' Pension Fund v. Moelis & Company***, the Delaware Chancery Court found that certain pre-approval rights, board composition requirements and board committee requirements in a stockholder agreement between Moelis & Company and its Chairman, Chief Executive Officer and founder violated, and therefore were facially invalid under, Section 141(a) of the DGCL because they foreclosed the directors from managing the company in accordance with their statutory duties pursuant to the DGCL. For a more fulsome analysis of the decision in *Moelis*, please see our **client alert**.

What proposed §122(18) allows: §122(18) provides that corporations may enter into stockholder agreements with current or prospective stockholders or beneficial owners where the corporation agrees to, among other things, (i) restrict or prohibit the corporation from taking certain actions, (ii) require board or stockholder approval before taking corporate action and (iii) covenant that the corporation, the board or any current or future directors or stockholders will take or refrain from taking certain future actions. In order to be valid, the corporation must have received consideration for entering into the agreement, and the

6 See *id*. at 7.

7 See *id*.

8 See Order Denying Motion to Dismiss, *SEC v. Panuwat*, Case No. 3:21-cv-06322-WHO (N.D. Cal. Jan. 14, 2022), ECF No. 26 at 9.

9 See Order Denying Defendant's Motion for Summary Judgment, *SEC v. Panuwat*, Case No. 3:21-cv-06322-WHO (N.D. Cal. Nov. 20, 2023), ECF No. 85 at 18.

10 *Id*. at 10.

11 *West Palm Beach Firefighters' Pension Fund v. Moelis & Company*, 2024 WL 747180 (Del. Ch. Feb. 23, 2024) at n.272.

minimum consideration must be approved by the board. The proposed amendments also provide that in the event of a breach of a stockholder agreement made pursuant to §122(18), the corporation would be subject to the remedies available under applicable contract law.

What proposed §122(18) does not allow: §122(18) does not authorize a corporation to agree to impose remedies on the board or individual directors, which means that any remedy for breach of contract could only be made against the corporation itself. In addition, board or stockholder approval must still be obtained for any contracted provisions that would otherwise require it. Moreover, §122(18) does not relieve the board of their fiduciary duties related to the decision to enter into a stockholder agreement, or prevent a court from granting equitable relief for a breach of fiduciary duties.

Board Approval of Merger and Other Agreements (§147, §232(g) and §268)

The proposed amendments related to the board approval process for mergers and other agreements are intended to close the gap between DGCL provisions and common market practice in response to the recent *Activision* case. In ***Sjunde AP-Fonden v. Activision Blizzard, Inc.***, the Court of Chancery denied the defendant's motion to dismiss claims alleging violations of Sections 251(b) and 251(c) of the DGCL based on a strict interpretation of the statutory provisions. The court, despite acknowledging that requiring a board to approve a final execution version of a merger agreement did not align with market practice, found that the merger agreement approved by the Activision board was not "essentially complete" for purposes of Section 251(b) because it was missing certain substantive terms enumerated in Section 251(b). Moreover, the Court found that the meeting notice for approval of the merger did not comply with Section 251(c) because the copy of the merger agreement attached to the notice was missing the surviving company's charter, a requirement under Section 251(c). For a further discussion on the decision in *Activision*, please see our March 2024 edition of **Public Company Watch**.

Board approval process for merger and other agreements (§147): New §147 provides that a board may approve an agreement, instrument or document in "final form or in substantially final form" (i.e., when the material terms are either set forth in the agreement or are able to be determined by the board from other information or materials). To address any uncertainty around whether an agreement is in final or substantially final form, §147 also provides the ability to ratify any agreement, instrument or document required to be filed with the Delaware Secretary of State or required to be referenced in a filed certificate (i.e., a certificate of merger) prior to the effectiveness of the filing. Any ratification under §147 would be deemed effective as of the time of the original approval and would satisfy any requirement under the DGCL that the board approve such agreement, instrument or document in a specific manner or sequence. §147 does not, however, allow the board to make changes to an agreement that would require stockholder approval after such approval has been obtained.

Notice of stockholder meetings (§232(g)): New §232(g) provides that, for purposes of complying with notice procedures under the DGCL, any document annexed or appended to a notice to stockholders will be deemed part of that notice.

Certificates of the surviving corporation (§268(a)): New §268(a) provides that in a merger in which all of the shares held by the target's stockholders are cashed out (other than a holding company reorganization), a merger agreement that does not include the surviving corporation's certificate of incorporation may still be deemed to be in final or substantially final form. In addition, the board may approve an amendment or restatement of the surviving corporation's certificate and any such amendment or change will not be deemed to be an amendment to the merger agreement.

Disclosure schedules or similar documents delivered in connection with a merger agreement (§268(b)): New §268(b) provides that unless otherwise expressly stipulated in the merger agreement, disclosure letters, schedules or similar documents delivered in connection with the agreement, which are in practice often incorporated by reference in the merger agreement, will not be deemed to be part of the agreement for purposes of determining if the agreement is in final or substantially final form.

Penalties for Breach of a Merger Agreement and Stockholders' Representatives (§261)

Failed merger transactions (§261(a)(1)): New §261(a)(1) provides, among other things, that parties to a merger agreement may contract for specific penalties, consequences and remedies for a breach of the agreement before the effective time of the merger, or in the event the transaction is not consummated in accordance with the merger agreement. Under §261(a)(1), these penalties may include damages to stockholders for any premium they would have received had the merger been effected, as well as any termination fees. A party may also enforce the payment of any penalties owed under the agreement, and is entitled to retain the penalty payment (rather than distributing it to stockholders). §261(a)(1), however, is not intended to preclude a party from pursuing any other remedies available at law or to affect a director's fiduciary duty in connection with determining if a provision of a merger agreement should be performed or enforced, including provisions related to lost premiums or termination fees.

Stockholders' representatives (§261(a)(2)): New §261(a)(2) allows parties to a merger agreement to include a provision appointing a stockholders' representative as the sole and exclusive authority to enforce the rights of the constituent corporation's stockholders, including stockholders whose shares will be converted or exchanged in the merger. Such enforcement authority may include the ability to cause the receipt of payments or the enforcement of stockholders' rights pursuant to escrow or indemnification arrangements, and to enter into related settlements. This provision would provide an express authorization for representative provisions already implied under the statutory provisions, confirming that provisions of a merger agreement may appoint a stockholders' representative and delegate to that representative powers exercisable following the effectiveness of the merger.

Key Takeaway: The proposed amendments aim to bring the provisions at issue in recent Delaware Chancery Court decisions in line with developing market practice by clarifying or expressly authorizing certain actions and processes available to a corporation. As such, for the most part, the proposed amendments may not result in considerable changes to market practices, with the exception of the amendments related to penalties for a failed merger, which may affect the allocation of risk in a merger transaction.

Other Regulatory Updates

FTC Announces Expansive and Unprecedented Non-compete Ban

On April 23, 2024, by a vote of 3 to 2, the Federal Trade Commission ("FTC") adopted a Non-Compete Clause Rule (the "Rule") prohibiting most employee non-compete agreements as unfair methods of competition. The Rule is a somewhat narrowed version of the regulation proposed in January 2023, which was subject to a 90-day public comment period. This marks the FTC's most notable attempt to date to use its authority under Section 5 of the FTC Act to expand enforcement efforts into new areas of the economy.

In voting for the passage of the Rule, FTC Chair Lina Khan took the position that non-compete agreements have a net negative impact on working conditions, labor markets, and product-and-service markets, and that "robbing people of their economic liberty also robs them of all sorts of other freedoms" and stifles innovation. Chair Khan also took the position that the FTC has the authority to issue the Rule, a statement that was disputed by the dissenting commissioners.

While legal challenges are anticipated, employers should take steps to minimize exposure and protect their interests. For more information, please see our **client alert** and **alert update**.

Antitrust Agency Update

The Antitrust Section of the American Bar Association hosted its annual Spring Meeting last week, assembling antitrust enforcers, private practitioners and in-house antitrust counsel from across the globe. Below are a few highlights and previews of things to come in US antitrust enforcement:

- From the Antitrust Division of the Department of Justice ("DOJ"), Deputy Assistant Attorney General Andrew Forman said the DOJ and the FTC have internalized feedback on the expansive overhaul to Hart-Scott-Rodino ("HSR") premerger filing requirements and anticipate issuing a scaled-back version of the rule in the upcoming weeks as opposed to months. He noted that the new HSR rules will aim to strike an appropriate balance between modernizing the filing system and avoiding the creation of a significant burden on merging companies. He did not disclose what changes the FTC and DOJ will make in the next HSR rule, but stated that it would not be as extensive as the original proposal issued last year.
- The DOJ's leadership also highlighted the agency's increased enforcement of Section 8 of the Clayton Act, which prohibits interlocking directorates of competing businesses. The DOJ has been proactively identifying corporate board overlaps based on publically available information, and the initiative will continue to be a priority for Assistant Attorney General Jonathan Kanter.
- FTC Commissioner Bedoya discussed the FTC's focus on reviving the Robinson-Patman Act (the "RPA"). The RPA is an antitrust law that protects competition by preventing sellers from charging competing buyers different prices for the same goods, commonly referred to as price discrimination. Commissioner Bedoya described the importance of the RPA to discourage price gouging for independent grocers and retailers in particular, and noted that he has seen no empirical evidence that the existence of the RPA results in higher prices to consumers. Although RPA enforcement has been lacking in recent years, he compared the FTC's interest to "taking the car out of the garage" to make sure it is running, stating that the FTC is committed to bringing a case under the RPA that includes an abuse of market power angle.

Antitrust compliance is a growing focus in state attorney general offices, leading to a push to focus on local actions in conjunction with and independent of federal enforcement of similar conduct. Several attorneys general mentioned the growth of their offices over the past decade, and both California and Washington have expanded their operations to include an in-house economist to assist their antitrust investigation efforts.

New DOJ Whistleblower Pilot Program

In March 2024, the DOJ announced a new pilot program to pay whistleblower rewards for individuals who report corporate misconduct. Like other whistleblower programs, if an individual helps to identify corporate misconduct to DOJ, the individual could receive a portion of the amount forfeited by the company in connection with an enforcement action.

This program is a response to perceived gaps in existing whistleblower programs and follows new whistleblower pilot programs announced by the U.S. Attorney's Offices for the Southern District of New York and Northern District of California (for more information, see our **client alert**). Under the new pilot program, DOJ is most interested in three core areas: (1) criminal abuses of the U.S. financial system; (2) foreign corruption cases outside the Securities and Exchange Commission ("SEC") jurisdiction; and (3) domestic corruption cases involving corporate payments to government officials. DOJ has not released program details, but further guidance is anticipated later this year.

This new program reinforces the importance for all companies, particularly companies who have greater risk related to the three core areas, to evaluate the effectiveness of their compliance program's internal reporting, investigation and monitoring processes that help to encourage internal reporting and aid in prompt identification and remediation of potential misconduct. For more information, please see our **client alert**.

Litigation Corner

Supreme Court Rules Pure Omissions Not Actionable under Rule 10b-5

On April 12, 2024, the U.S. Supreme Court issued its decision in ***Macquarie Infrastructure Corp. v. Moab Partners, L.P.***, No. 22-1165, 601 U.S. __ (Apr. 12, 2024), in which the Court held that pure omissions are not actionable under SEC Rule 10b-5(b), resolving a circuit split concerning whether private securities fraud claims could be based on an issuer's failure to disclose information required under Item 303 of SEC Regulation S-K. A pure omission occurs when a speaker says nothing in circumstances that do not give any particular meaning to that silence. In contrast, a half-truth is a representation that omits critical qualifying information. For more information, please see our **client alert**.

Supreme Court Delivers a Victory for Whistleblowers in Retaliation Claims

In ***Murray v. UBS Securities, LLC***, 601 U.S. __ (2024), the U.S. Supreme Court, by a unanimous decision, found that proof of "retaliatory intent" is not required for whistleblower retaliation claims under the Sarbanes-Oxley Act of 2002, 18 U.S.C. § 1514A ("SOX").

The plaintiff in *Murray*, a research strategist working for UBS Securities, LLC ("UBS"), alleged that he was pressured to "skew" his market reports in violation of SEC regulations requiring him to certify that his reports were independent and reflected his own views. He claimed that he reported this conduct to his supervisor, and shortly thereafter, his employment was terminated. The plaintiff filed a SOX lawsuit claiming that his discharge was in retaliation for reporting violations of SEC regulations. The case went to trial, and the jury found in favor of the plaintiff, finding UBS had failed to prove that it would have fired the plaintiff even if he had not engaged in protected activity. On appeal, the Second Circuit reversed, holding that the words "discriminate . . . because of" in Section 1514A(a) required a showing of "retaliatory intent" and the trial court erred by not instructing the jury on the plaintiff's burden to prove retaliatory intent.

Under SOX, no public company "may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee" for reporting what they reasonably believe to be instances of criminal fraud or securities law violations.[12] Whistleblower retaliation claims under SOX are subject to a burden-shifting framework. Under this framework, a plaintiff bears the burden to prove that the protected whistleblowing activity "was a contributing factor in the unfavorable personnel action alleged in the complaint."[13]

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12 Sarbanes-Oxley Act of 2002, 18 U.S.C. § 1514A.

13 49 U.S.C. § 42121(b)(2)(B)(i).

If the plaintiff succeeds in doing so, the burden shifts to the employer to show "by clear and convincing evidence" that it "would have taken the same unfavorable personnel action in the absence of the [protected activity]."[14]

In its unanimous 9-0 decision, the Supreme Court reversed. The Court's reasoning was two-fold. First, focusing on the statutory text, the Court noted that Section 1514A(a) does not reference or include a "retaliatory intent" requirement, and the phrase "discriminate" in the statute means simply "differential treatment," which does not require retaliatory intent or animus. Second, the Court held that the burden-shifting framework does not require evidence of retaliatory intent, and that Congress' intent was to require whistleblowers to show only that their protected activity was a "contributing factor" to an adverse employment action.[15]

Key Takeaway: The Court's opinion lowers the bar for plaintiffs asserting claims of whistleblower retaliation under SOX, as plaintiffs do not need to prove retaliatory intent. While *Murray* directly applies to employees covered by SOX, the Court's interpretation of SOX could be extended to statutes with similar language. Employers defending whistleblower claims should take steps to demonstrate that they would have taken the same action regardless of protected conduct.

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14 49 U.S.C. § 42121(b)(2)(B)(ii).

15 *Murray v. UBS Securities, LLC*, 601 U.S. __ (2024).

About Paul Hastings

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