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M&A, Activism and Corporate Governance

QUARTERLY REVIEW

Introduction

The *M&A, Activism and Corporate Governance Quarterly Review* is Mayer Brown's quarterly publication designed to keep you current on key legal developments involving mergers and acquisitions, shareholder activism and corporate governance matters.

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Antitrust M&A: How Will 2023's Turbulence Affect Dealmakers in the Coming Year?

By: William H. Stallings and Lauren E. Knudson

It was a momentous (and tumultuous) year for the Biden Administration's antitrust M&A agenda, with increased litigation to block deals resulting in both high-profile wins and painful losses, issuance of new Merger Guidelines that re-calibrate the government's position on how to analyze deals, and a proposal to fundamentally restructure the information parties must provide to comply with the up-front Hart-Scott-Rodino ("HSR") pre-merger notification requirements.

These actions furthered the aggressive antitrust enforcement agenda that the Biden Administration has asserted from the beginning of its tenure. Less than six months after taking office, President Biden issued his "Executive Order on Promoting Competition in the American Economy" (July 9, 2021, the "EO"), establishing a "whole-of-government effort" to address competition concerns and direct federal agencies to commit to stronger and more vigorous enforcement of the federal antitrust laws.[1] The EO expressed an expansive view of the importance of antitrust, opining that perceived "excessive market concentration threatens basic economic liberties, democratic accountability, and the welfare of workers, farmers, small businesses, startups, and consumers."

The M&A-related efforts of the Federal Trade Commission and the Department of Justice (together, "the Agencies") demonstrated a firm adherence to the EO's mandate. Indeed, FTC Chair Lina Khan recently emphasized that "policing unlawful mergers is our front line of defense against harmful corporate consolidation."[2]

The extent of the Administration's impact on dealmaking, however, is subject to debate. The Administration asserts that its efforts in blocking deals (regardless of wins vs. losses) resulted in a chilling effect—with the head of the Antitrust Division stating, "Simply put—most anticompetitive deals are no longer getting out of the boardroom."[3] Others, pointing to the government's mixed record in court, argue that more extensive antitrust reviews (and possible litigation) are simply costs that must be factored into the overall deal analysis and that any slowdown in deal activity is the result of economic factors, not fear of antitrust enforcement.

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[1] *Executive Order on Promoting Competition in the American Economy*, WHITE HOUSE (July 9, 2021) https://www.whitehouse.gov/briefing-room/presidential-actions/2021/07/09/executive-order-on-promoting-competition-in-the-american-economy/

[2] *Federal Trade Commission and Justice Department Release 2023 Merger Guidelines* FED. TRADE COMM'N (Dec. 18, 2023), https://www.ftc.gov/news-events/news/press-releases/2023/12/federal-trade-commission-justice-department-release-2023-merger-guidelines

[3] Jonathan Kanter, *Assistant Attorney General Jonathan Kanter Delivers Opening Remarks at the Second Annual Spring Enforcers Summit* (March 27, 2023), https://www.justice.gov/opa/speech/assistant-attorney-general-jonathan-kanter-delivers-opening-remarks-second-annual-spring.

That debate will not be resolved given that each deal rises and falls on its own merits and circumstances. Nevertheless, dealmakers should take note of the following key events and trends from 2023 that will continue to affect antitrust reviews of deals in the coming year.

A. Revised Merger Guidelines

On December 18, the Agencies jointly issued their 2023 Merger Guidelines.[4] The document describes the factors the Agencies consider when reviewing mergers and acquisitions. It follows a long practice of the Agencies issuing such guidance, with versions dating back to the 1980s.

The 2023 Guidelines constitute 51 dense, single-spaced pages covering myriad legal and economic theories of harm. While extensive, the key takeaways for dealmakers to consider include:

1. Lower thresholds for a "presumption" of harm. The government can establish a presumption of harm by showing that a transaction will lead to undue concentration in the market. The 2023 Guidelines lower the HHI-based threshold[5] for the Agencies to presume a deal is anticompetitive.[6] While this change will ensnare more transactions, dealmakers should know that these presumptions are not determinative:

- A presumption is only as good as the market on which it is based. The definition of the relevant market is, of course, critical to determine market shares.
- A presumption is just a presumption; it does not mean that a deal is illegal. The merging parties can rebut the presumption with evidence showing why the merger is unlikely to harm competition.

Importantly, courts apply the presumption-based burden-shifting framework flexibly so that, in practice, the commercial realities drive the result based on analysis of the entirety of marketplace facts, not formulaic presumptions.

2. Vertical mergers. The 2023 Guidelines are the first set of Agency merger guidelines that address both horizontal (direct competitor) and vertical (different levels of supply chain) deals in the same document. The Administration has been clear about wanting to challenge more vertical transactions in order to advance the law in this area, and we expect the Agencies to continue to closely examine deals that raise vertical concerns.

3. Labor markets. Courts and enforcers have long recognized that businesses compete not only for "downstream" sales to customers but also for "upstream" purchases of inputs. A centerpiece of the Administration's antitrust push has been to emphasize that antitrust laws protect labor. The 2023 Guidelines have an entire section focused on assessing when a merger may reduce competition for workers, creators, suppliers or other providers. This is an area, though, that is not well developed in the caselaw. Accordingly, the Agencies will surely be looking to test (and develop) labor-related theories in future merger reviews.

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[4] *2023 Merger Guidelines*, DEP'T OF JUST. AND FED. TRADE COMM'N, (Dec. 18, 2023), https://www.justice.gov/atr/2023-merger-guidelines.

[5] The HHI is the Herfindahl-Hirschman Index of market concentration, which consists of the sum of the squares of the market shares of the competitors in the relevant market. The change in the HHI measures the impact of a merger in terms of the shares of the merging competitors.

[6] The Agencies now assert that a transaction should be presumed harmful if (1) the post-merger market-wide HHI is greater than 1,800 and the change in HHI from the transaction is greater than 100 points, or (2) the merged firm's market share is greater than 30% and the change in HHI is greater than 100. *2023 Guidelines* at 6.

4. "Context" of acquisitions: The 2023 Guidelines emphasize the need to look at the broader "context" of a merger instead of simply examining the effects of just the deal under review. The Agencies will consider patterns of serial acquisitions ("roll-ups") or acquisitions by a dominant firm of potential future competitors. In such situations, the Agencies state that they will consider the collective or cumulative effect of the pattern of acquisitions. But it remains to be seen where the line will be drawn when a specific deal does not in isolation raise a competition concern but might be part of a pattern.

5. Rebuttal evidence/efficiencies. The 2023 Guidelines discuss certain types of rebuttal evidence that parties can employ to show that a merger does not threaten a substantial lessening of competition, including "failing firm," ease of entry/repositioning, and procompetitive efficiencies. The Agencies stress that, while they recognize these defenses, they will place a high burden on the merging parties to substantiate any such claims. We expect the Agencies to continue to push back on efficiency arguments (but courts may be more sympathetic).

The above is just the tip of the iceberg, with the 2023 Guidelines further providing the Agencies' views on topics such as mergers that:

- eliminate potential entrants;
- entrench or extend a dominant position;
- involve multi-sided platforms or cluster markets; and
- involve partial ownership/minority interests (which is of particular relevance for private equity investors that acquire interests in competing companies through different funds).

In short, antitrust counsel will need to address the theories raised in the 2023 Guidelines as part of the Agency merger-review process.

B. Increased Litigation

The courts, though, will remain the ultimate arbiter of whether a deal violates the law. The US antitrust agencies cannot on their own force companies to abandon or change a merger. The Biden Administration has been aggressive in challenging deals in court, spanning deals in industries such as airlines, agriculture, healthcare, pharma, tech, book publishing, and consumer products and services.

The 2023 litigation track record, though, has been mixed. The courts dealt some significant losses to the Agencies. For example, the U.S. Court of Appeals for the Third Circuit squarely rejected the DOJ's appeal of its unsuccessful challenge to the US Sugar/Imperial Sugar merger. The loss was a particular blow to the Agencies in that the District Court and the Third Circuit credited the trial testimony of a US Department of Agriculture economist, whose views aligned with the merging parties' positions. This result raised questions about the effectiveness of EO's "whole of government" approach to addressing concentration. Other notable government litigation losses include high-profile challenges to the Meta/Within and Microsoft/Activision transactions.

But, the government had major victories as well. The DOJ had a decisive win to block a joint venture between American Airlines and JetBlue Airways. The district court agreed with the government's position that the JV had the effect of anticompetitively reducing competition between the two airlines, much like the impact that a merger would have. As of the date of this article, that decision is on appeal. The FTC had a joyful end-of-the year win with the U.S. Court of Appeals for the Fifth Circuit upholding the FTC's views that

a vertical deal combining Illumina and Grail could cause anticompetitive effects. Although the Fifth Circuit sent the case back to the FTC for further proceedings after determining that the Agency used the wrong legal standard at the rebuttal stage of the analysis, the case is effectively over as Illumina announced that it would unwind the deal given the Fifth Circuit's decision. Also in December, the FTC obtained a preliminary injunction to prevent IQVIA Holdings Inc. from acquiring Propel Media, Inc., and two other transactions—John Muir's takeover of San Ramon Regional Medical Center from Tenet Healthcare, and Sanofi's acquisition of Maze Therapeutics' Pompe disease drug—were abandoned following FTC challenges.

It is difficult to draw substantive conclusions from these litigation wins and losses, as each case is decided on its own merits by individual judges. That being said, a clear takeaway is that the Biden Administration is not afraid to litigate. So, parties to deals in 2024 will continue to need to account for the possibility of litigation against the government.

C. The Rise of Settlements?

Not all deals that raise competition issues result in litigation. Indeed, only very few litigated cases are filed each year. Traditionally, parties resolved competition concerns raised during antitrust reviews by entering into negotiated settlements with the government. The typical remedy involved the public filing of a consent decree that would require the merging parties to divest overlapping assets or a line of business as a condition to closing the overall merger. (Remedies could also include other provisions designed to address the specific competitive concerns at issue.) The public documents would explain the Agency rationale for insisting on a remedy and contain provisions to ensure that the remedy was effectuated.

The Biden Administration—particularly officials at the Department of Justice—signaled early on that they considered blocking a deal outright preferable to negotiating remedies.[7] The number of consent decrees that the Agencies entered into with merging parties dwindled to near zero.

Courts, though, sent a message throughout 2023 that traditional remedies continue to have value in antitrust cases, as judges endorsed remedies that parties offered directly to the court (sometimes called "litigating the fix") and some courts encouraged the government to settle merger cases by agreeing to divestitures. For example, in Assa Abloy/Spectrum, the DOJ agreed to a divesture only after the court on the record pressed the parties to settle. Additionally, courts endorsed remedies offered by parties in both United Health/Change and Microsoft/Activision. That message appears to be resonating, as the FTC has settled two litigated merger challenges—ICE/Blacknight (divestiture) and Amgen/Horizon (commitment not to engage in certain conduct)—with remedies that are similar to the types of remedies that prior administrations had used. These traditionalist-style remedies could signal a less confrontational approach to antitrust review going forward.

Moreover, a new phenomenon appears to be occurring at the DOJ: the rise of so-called "secret settlements." In a December 2023 joint report to Congress, the Antitrust Division described how its "enforcement efforts" directly impacted mergers, including six transactions in which "the parties changed

[7] "I am concerned that merger remedies short of blocking a transaction too often miss the mark. Complex settlements, whether behavioral or structural, suffer from significant deficiencies. Therefore, in my view, when the division concludes that a merger is likely to lessen competition, in most situations we should seek a simple injunction to block the transaction. It is the surest way to preserve competition." Jonathan Kanter, *Assistant Attorney General Jonathan Kanter of the Antitrust Division Delivers Remarks to the New York State Bar Association Antitrust Section* (Jan. 24, 2022), https://www.justice.gov/opa/speech/assistant-attorney-general-jonathan-kanter-antitrust-division-delivers-remarks-new-york.

the structure of their transaction such that the Division chose not to bring an enforcement action at that time."[8] The Division did not identify the matters, the competitive concerns that were raised, or how the remedy addressed those concerns. Nevertheless, the process seems similar to traditional remedies, just without the public process. Parties should consider such an approach in future transactions when the circumstances warrant it.

D. The Proposed Changes to Antitrust Pre-Merger Notification Rules

The Administration is also finalizing proposed revisions to the HSR pre-merger notification filing requirements. Assuming the final rule matches the notice of proposed rulemaking issued in June 2023, the revisions will fundamentally transform the HSR process. Parties to every HSR-reportable transaction will be required up front to provide detailed narratives about their deals, extensive amounts of documents and information (including about employees), and reams of data.

The proposed rule would apply to all "reportable" transactions—those that exceed the statutory threshold for "size of transaction" (which threshold is $111.4 million as of the date of this article, but increases on an annual basis) and other tests—regardless of whether the deals actually raise any competition concerns.

In essence, the revisions will convert the US system from an objective "notice" filing protocol to a more subjective framework, which will require parties to provide up-front disclosures.

The new requirements are far-reaching. (For a detailed discussion of all the requirements, see our Legal Update, "FTC's Proposed HSR Changes Will Complicate Merger Filings".) Several aspects are particularly important for US dealmakers to appreciate, including that parties to all reportable deals will have to provide:

- details about the structure of the transaction, its business rationale, and the entities involved in it;
- narrative descriptions of the markets in which the parties operate and potential effects of the deal;
- a vastly expanded set of deal-related documents, as well as ordinary-course strategic plans and reports; and
- information that screens for labor market issues by classifying employees based on certain job categories and geographic location and details on workplace safety violations.

The proposed rules have attracted significant attention, including a protest to Congressional leaders from the US Chamber of Commerce on behalf of over 30 business groups.[9] The FTC has not provided a timeline for issuance of a revised, final rule. If the final rule tracks the proposal, the changes will require significant additional work, with the FTC predicting that conformity to the proposed rules would result in anywhere from approximately 12 to 222 additional hours per filing. Many practitioners believe that the time required to comply will be much greater.

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[8] *Hart-Scott-Rodino Annual Report Fiscal Year 2022,* FED. TRADE COMM'N AND DEPT. OF JUST. (Dec. 21, 2023) at 3, https://www.ftc.gov/system/files/ftc_gov/pdf/FY2022HSRReport.pdf .

[9] *Coalition Letter on the Hart-Scott-Rodino (HSR) Act Standards*, U.S. CHAMBER OF COMMERCE (NOV. 14, 2023) https://www.uschamber.com/finance/antitrust/coalition-letter-on-hart-scott-rodino-hsr-act-standards

The Impact on Dealmakers

The above trends will continue to make the antitrust review process challenging in 2024. It will be incumbent on deal teams to think through how the current regulatory environment impacts their transactions and take appropriate steps to address (and streamline data collection processes) and, where possible, minimize the risk.

The Administration's antitrust enforcement efforts have led parties to anticipate longer merger review timelines, more frequent second requests, and a higher likelihood that litigation against the government will be needed in order to get deals closed. The proposed HSR revisions, if implemented, will further complicate deal timelines for the merger review process.

As a result, the negotiation of deal terms addressing antitrust risk take on added importance. Such terms include:

- longer outside dates;
- reverse termination fees;
- use of ticking fees and other creative tools to lessen sell-side risk;
- negotiating remedies into the acquisition agreement; and
- efforts covenant (although "hell or high water" provisions are rare).

For a detailed discussion on how these terms are used and scale with antitrust risk, see our Legal Update, "M&A Lawyers Adapt to New Era of Antitrust Enforcement: How Contractual Provisions Are Evolving".

The antitrust impact, while important to assess, does not have to be determinative of whether deals move forward, as the vast majority of transactions are still getting to the finish line even in this period of aggressive antitrust enforcement.

2023 Activism Recap: Universal Proxy Rule Predictions Fell Flat; Director Nomination Rejections on the Rise

By: Camila Panama and Alexander Dussault

2023 marks the first full year in which the universal proxy rules have been in effect. As most know by now, a key change brought about by the rules is the required use of the universal proxy card in a contested director election—which enables stockholders to vote for their preferred combination of directors, including by mixing and matching among the company and dissident nominees, regardless of which side solicited their vote. Many practitioners predicted that the implementation of the universal proxy rules would have a substantial impact, resulting in increased US activist activity, decreased spending by dissidents on proxy contests, and larger slates of director nominees, among other changes. However, year-end numbers show that such predictions generally missed the mark—by most metrics, there were few notable year-over-year changes. Despite this, there is one key development that emerged in 2023 that merits attention: companies rejected dissident director nomination notices for non-compliance with advance notice bylaws at record rates. This has caused an increasing number of dissidents to challenge such rejections in court. Below, we recap the 2023 numbers and provide key takeaways in light of court guidance on advance notice bylaw provisions and nomination notice rejections.

2023 Recap:[10] Predictions on Impact of Universal Proxy Rules Largely Fell Flat

Significant Increase in Activist Activity? **No.**	2023 saw 60 US activist campaigns where the dissident sought board representation, compared to 61 campaigns in 2022. While these levels are higher compared to 2020 and 2021—which saw 15 and 23, respectively—the prediction that 2023 would be a much more active year than 2022 proved to be incorrect.
More Proxy Contests Going to a Stockholder Vote? **No.**	Out of the 60 US activist campaigns where a dissident sought board representation in 2023, 14 campaigns (~23%) went to a proxy contest and all the way to a stockholder vote, which is the same rate as in 2022.

[10] Data provided by *Deal Point Data* for US proxy contests where the dissident sought board representation and announced at SEC reporting companies based on annual meeting date year, excluding proxy contests at regulated funds (e.g., close-end funds), business development companies and foreign private issuers.

Larger Slates of Dissident Director Nominees? **No.**	The proportion of US proxy contests seeking minority board representation, including single-seat nominations (out of all US proxy contests seeking board representation), was 80% in both 2023 and 2022. Some had predicted that the universal proxy rules would encourage dissidents to put up larger slates of director nominees; however, that was not the case.
Dissidents Spending Less on Campaigns? **No.**	Contrary to many predictions, the universal proxy rules generally have not reduced the amount of money activists spend on their campaigns. Out of 26 US proxy contests in 2023 where costs were disclosed, activists reported an average estimated cost of $2.5 million and median estimated cost of $1 million, as compared to an estimated average cost of $1.16 million and median estimated cost of $1 million among the 24 US proxy contests in 2022 where costs were disclosed.
Significant Impact on Settlements? **No, but There Were Marginal Impacts.**	There was an uptick in the number of US activist campaigns that resulted in public settlements (42% in 2023 compared to 34% in 2022) and in the number of US proxy contests that settled prior to the dissident filing their preliminary proxy statement (68% in 2023 compared to 57% in 2022). This could indicate a trend of more campaigns resulting in a settlement, and settling earlier on, prior to dissidents spending on preliminary proxy filings—we will see if these rates increase further in 2024.
Dissidents Winning More Board Seats? **No.**	Of the US campaigns that resulted in a public settlement, dissidents won board seats at about the same rate—84% of settlements in 2023 resulted in the dissident gaining board representation, as compared to 86% in 2022.

Director Nomination Notice Rejections: On the Rise and Being Challenged

In 2023, 10% of dissident director nomination notices were rejected by US companies. This is a five-fold increase as compared to 2022's 2% rejection rate. This change is rooted in the fact that an overwhelming number of companies amended their bylaws in the wake of the universal proxy rules—over the course of 2022 and 2023, over 1,800 companies filed bylaw amendments, and a majority of those amendments included revisions or additions to advance notice bylaw provisions.[11] Examples of such amendments include expanding the scope of disclosing parties, granting the company an express right to reject a nomination notice that does not include all information required by the universal proxy rules, company bylaws and any specified questionnaires, and requiring the nominating stockholder to make detailed representations, including with respect to the 67% solicitation threshold required by the universal proxy rules.

Companies have increasingly focused on advance notice bylaws in recent years—in *Deal Point Data*'s study tracking takeover defense tools[12] implemented by S&P 1500 and Russell 3000 companies, changes to add

[11] *Deal Point Data.*
[12] For illustration, examples of other types of takeover defense tools tracked in the study include board classification, supermajority vote requirements and rights to call special meetings.

or modify advance notice disclosure or eligibility requirements represented approximately 46% of all defense changes implemented by such companies in 2023. Whereas, in this same study in 2018, such changes to advance notice bylaws represented only 10% of the defense tools implemented. Now that more companies have revised their advance notice bylaws, they are also more focused on scrutinizing nomination notices for compliance with those provisions and are less open to waiving non-compliance.

This increased rejection rate, however, has prompted dissidents to fight back in court. In 2023, there were at least five instances[13] where dissidents asserted in court that a company's advance notice bylaws were overreaching or rejection of the dissident's director nomination notice was invalid. Two of these instances, Paragon Technologies, Inc.'s ("Paragon") challenge of its nomination notice rejection by the Ocean Power Technologies, Inc. ("Ocean Power") board and Ted Kellner and Todd Deutsch's (together, "Kellner & Deutsch") challenge of their nomination notice rejection by the AIM ImmunoTech Inc. ("AIM") board, landed in the Delaware Court of Chancery (the "Court"). The Court's remarks in these cases can offer valuable insights for companies with respect to making valid rejections of a stockholder nomination notice and considering amendments to bylaws in the context of the universal proxy rules, including:

Key Takeaways:	
Apply Bylaw Requirements Equitably and Avoid Subjectivity	The Court stated in *AIM* that bylaws that "are applied inequitably" will be struck down and that certain of AIM's bylaws were "ripe for subjective interpretation by the Board" and therefore overreaching. In *Ocean Power*, the Court stated that "if a board could call a nomination notice deficient simply because it disagreed with opinions voiced by the nominating stockholder, rejection would be a foregone conclusion" and noted that, irrespective of any good intentions in ensuring that notices are accurate, dismissal of a notice based on perceived inaccuracy of opinion statements may be preclusive.
Limitations on Stockholder Voting Power Must Be Reasonable and Proportional to a Legitimate Corporate Purpose	The Court in *AIM* placed limits on the company's advance notice bylaw disclosure requirements, stating that broad sweeping information hooks can be disproportional to the company's objective of obtaining transparency from a nominating stockholder when they potentially trigger disclosure requirements that become "overbroad" and "unworkable." The Court in *Ocean Power* suggested that information hooks can also be too narrow and applied in a preclusive fashion. There, the company's advance notice bylaws required nominating stockholders to disclose any barriers nominees would have to obtaining security clearances from the U.S. government. By contrast, however, incumbent directors never made such a disclosure, and further, the company had no government-related contracts or apparent business reason for requesting such disclosure. The Court questioned the intention of Ocean Power's

[13] (1) Kellner v. AIM ImmunoTech Inc., No. 2023 0879-LWW, 2023 WL 9002424 (Del. Ch. Dec. 28. 2023); (2) Paragon Techs., Inc. v. Cryan, No. 2023-1013-LWW, 2023 WL 8269200 (Del. Ch. Nov. 30, 2023); (3) BT Brands, Inc. v. Noble Roman's Inc., No. 123CV01352JRSMJD, 2023 WL 5095605 (S.D. Ind. Aug. 9, 2023); (4) Driver Opportunity Partners I, LP v. Ameriserv Fin., Inc., No. 3:22-CV-00237-SLH, 2023 WL 4711158 (W.D. Pa. July 24, 2023); (5) Lifeway Foods v. Edward Smolyansky, 2023-L-003702.

	board in amending the bylaws to include this disclosure as the amendment did not occur until after Paragon launched its campaign at the company and the board had reason to believe that the nominees would indeed have barriers to disclose.
Omission of Required Disclosure is Not Necessarily Grounds for Valid Rejection	The Court stated in *AIM* that it will examine whether a rejection of a nomination notice is fair by assessing whether any of the missing information is something directors and stockholders would justifiably want to know. The Court indicated that there could be instances where a nomination notice omits required disclosure and is therefore not compliant with the bylaws, but such omission might *not* be a valid basis for rejection if directors and stockholders would not justifiably want to know such omitted information.
Depending on Timing, Companies Might Have to Provide a Complete List of Deficiencies and an Opportunity to Remedy	The Court noted in *AIM* that the dissident's night-of nomination notice submission left no chance for the dissident to remedy any deficiencies pertaining to omitted information that a sensible director or stockholder would reasonably want to know. This suggests that if a dissident submits a non-compliant nomination notice with ample time prior to the nomination deadline, the Court might expect the company to identify such deficiencies to the dissident and provide them with the opportunity to re-submit rather than rejecting the nomination notice outright. This view is further supported by the Court's remarks in *Ocean Power*, wherein the dissident submitted a non-compliant nomination notice three weeks prior to the nomination deadline. There, the company continuously declined to provide the dissident with a complete list of deficiencies, which the Court indicated was akin to moving the goalposts and could be the board's way of "sifting through the notice to dig up deficiencies," including ones the Court considered to be "nitpicky."

While it turned out that the universal proxy rules did not have the significant impact that many predicted, 2023 made clear that more companies are leaning on their advance notice bylaws as a defense tool, and are more often rejecting director nomination notices for non-compliance. We expect this to continue throughout 2024, and also expect dissidents to continue challenging the rejections and advance notice bylaw provisions in court. It will be critical for boards to stay current on court rulings regarding what types of disclosure requirements and rejections are considered "going too far" in connection with shareholder nomination notices, and whether any further amendments to bylaws would be prudent for companies to make.

Corporate Governance Spotlight: Considerations for Protecting Valuable AI-Related Assets

By: Brian W. Nolan, Richard M. Assmus and Nan Zhang

In 2023, the world-wide value of intangible assets (e.g., contractual rights and intellectual property (IP), such as patents, copyrights, and proprietary technology) reached USD57.3 trillion, surpassing pre-pandemic levels and representing an 8% increase from 2022.[14] [15] The United States was responsible for USD836 billion of this year-over-year increase.[16] Major industry sectors—from pharmaceuticals to telecommunications—have intangible asset valuations that exceed the trillion dollar threshold.[17]

IP-heavy industries are increasingly turning to artificial intelligence (AI) to assist in the research and development of new products and services. For example, many innovative pharmaceutical companies are seeking to gain a competitive advantage by integrating AI into the laboratory development loop. [18] As AI technology advances, it will increasingly drive corporate valuations of intangibles—potentially impacting trillions of dollars in corporate value. With such meaningful value at stake, it is important that board members and their advisors are up-to-date on the latest legal developments regarding protection of AI-related assets and ways to help mitigate risk of loss of value.

Uncertainties Exist with Respect to the Appropriate IP Strategy for Protecting AI and Its Output

Companies today are well acquainted with the use of patents and copyrights to protect their IP. These tools have historically afforded a company the ability to assess the scope of its IP protection as well as competitors' patents and copyrights in order to understand potential barriers and vulnerabilities. Moreover, familiarity with patent and copyright protection has allowed companies to analyze their IP portfolio to determine the value such assets contribute to the company. The use of AI, however, complicates this landscape. There are uncertainties regarding obtaining patent and copyright protection on the components of an AI model and its output. This disrupts a company's ability to understand the value of its AI-related assets and may lead more companies to consider relying upon other tools such as trade-secrets and contractual provisions to protect AI models and their output—which come with their own sets of draw-backs. Below, we describe the main avenues for protection of AI-related assets and key considerations for each.

Patents

A patent—a public document that includes a description of the invention and claims that define the scope of the patent's protection—offers an excellent mechanism for creating value from a company's intellectual property. The increased issuance of patents related to AI shows that patents will remain a key mechanism

[14] Brand Finance Global Intangible Finance Tracker 2023, at 16.
[15] *Id.* at 10.
[16] *Id.* at 22.
[17] *Id*. at 19.
[18] Andrew Dunn, *Q&A: Aviv Regev talks three years at Genentech, future of AI in biotech*, at 2-4, Endpoints News (Dec. 11, 2023).

for protecting the value associated with AI inventions.[19] There are, however, several issues that companies should consider when deciding whether a patent is the best vehicle to protect an AI model and its outputs. In the United States, uncertainty exists as to whether AI software, models, or platforms can qualify as patent-eligible subject matter.[20] Should an applicant overcome the patent-eligible subject matter issue, uncertainties related to how an AI model is operating and will operate in the future may present issues for an applicant in describing and claiming the AI model. Should an applicant overcome these obstacles, the "black box" nature of a competitor's AI model may present issues in assessing potential infringement by that competitor's AI model, because it may be difficult to compare the patent claims to the competitor's AI model to assess potential infringement.

The AI output or application is likely to avoid many of the patent hurdles often confronted by a patent application directed to an AI model, but it will have its own patent-related issues. Under the existing laws of several countries—including the United States and throughout Europe—AI cannot be listed as an inventor on a patent.[21] If no human contributed to the invention, then a patent application is not viable unless these countries change their laws. It is unknown how these countries will treat applications that include inventive contributions from both humans and AI. Additional uncertainty exists as to how various countries will determine whether an invention generated by AI can show it was non-obvious. When addressing non-obviousness, the United States Patent and Trademark Office (USPTO) considers whether someone would be motivated to combine existing knowledge and would have a reasonable expectation that the combination would achieve the patented invention. This test is, in part, dictated by the finite capabilities of humans. The USPTO may need to rethink the obviousness standard, however, if AI can consider all knowledge and can predict the results of combining parts of that knowledge.[22] These uncertainties present issues in how a company can assess the value of its IP portfolio and a competitor's portfolio.

Copyrights

AI creates issues with copyrights too. The United States Copyright Office and courts in the United States have held that AI cannot be an author, rejecting, for example, contentions that the human prompting of the AI constitutes authorship.[23] To the extent that aspects of an expression of an idea are attributable to AI, a company cannot protect those aspects of the work. Copyright issues also arise with the training of an AI model. To train a generative AI model, the model needs access to massive amounts of data. Some of this data may include copyrighted material, such as images or literary works. As of the date of this article, there is a host of pending litigations throughout the world alleging that the training of various generative AI models using copyrighted training data infringes those copyrights. It will take several years for the courts across various jurisdictions to resolve the arguments related to copyright infringement and the potential fair use of copyrighted material to train AI models.

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[19] In 2017, the United States Patent and Trademark Office issued 3,267 AI-related patents. That number increased to 18,753 in 2021. Rose Acoraci Zeck, *Analysis: Patents Forecast Widespread Reach of AI Tech in 2023*, Bloomberg Law (Nov. 13, 2022).
[20] 2019 Revised Patent Subject Matter Eligibility Guidance, Federal Register (Jan. 7, 2019).
[21] The following countries are among those that explicitly denied inventorship to AI: the United States (*Thaler v. Vidal,* 43 F.4th 1207 (Fed. Cir. 2022)); the United Kingdom (*Thaler v Comptroller-General of Patents, Designs and Trademarks* [2023] UKSC 49); South Korea (Seoul Administrative Court [Seoul Admin. Ct.], 2022GuHap89524, May 12, 2023); Australia (*Thaler v Commissioner of Patents* [2021] FCA 879.); and the members of the European Patent Office (register publication with grounds for denial of a patent listing the inventor as an AI system).
[22] President Biden's October 30, 2023 Executive Order on the Safe, Secure, and Trustworthy Development and Use of Artificial Intelligence directs the USPTO to issue guidance that addresses the interaction of AI and IP by July 26, 2024. *See* Section 5.2(c) of Exec. Order No. 14110, 88 F.R. 75191 (2023). This guidance will likely address issues that the use of AI presents with the obviousness assessment.
[23] *Thaler v. Perlmutter,* No. 22-CV-01564-BAH (D.D.C. Aug. 18, 2023).

Trade Secrets

Considering the ambiguities surrounding the legal protection of AI under current patent and copyright laws, companies may resort to trade secrets and contracts to define their rights and generate value. Trade secrets—intellectual property rights on confidential information by virtue of that information being commercially valuable because it is a secret, known only to a limited group of persons and for which the holder takes reasonable steps to keep confidential—avoid the hurdles presented in obtaining and enforcing a patent. However, having a trade secret with respect to an AI model would not prevent competition from independently developed or reverse-engineered AI models. To the extent that an AI model is public and a competitor can understand how it operates, trade secret protection may not provide much value. Considering the obligation to maintain secrecy to ensure the existence of trade secret protection, a company would have difficulty explaining the value that trade secrets provide the company—this might make it more difficult for the public and potential partners to understand the value of the company's intangible assets.

Contractual Provisions

Contractual provisions offer the opportunity for companies to define the ownership and use rights that each has in the various components of the AI model and in the output from the AI model, along with each party's obligations should infringement allegations arise. It is key for collaborators to address ownership, use rights, and indemnification responsibilities in such arrangement. But doing so only defines the relationship between the parties to the contract and does not offer protections against non-parties. Considering the benefits and drawbacks of the above IP protection mechanisms, it is imperative for a company to develop a strategy for how it will approach protection of its AI models and their outputs.

A Key to Navigating These Developments: Have an IP and AI Policy

There is not a one-size-fits-all approach to addressing IP issues that arise with respect to AI. Each situation will require thought as to the tailored approach appropriate for the product, the marketplace, and the targeted end user. Given that the various strategies to protect AI-related intangible assets each come with pros and cons, IP-heavy companies using AI would be well-served by board members ensuring that corporate leaders have weighed the various approaches and have in place a thoughtful protocol for considering the IP protection that can best protect the company's AI and monetize its efforts.

A key approach to AI protection is implementing a robust AI policy identifying IP considerations associated with AI and outlining general preferences for the protection schemes. An appropriate AI policy should address a company's approach to protecting its AI model, output, and procedures. The strategy to protect AI should address the various components of AI, including the hardware that implements the AI, the AI algorithm and model, and the output or application of the AI. New AI hardware and AI applications or outputs likely can meet the requirements for patent protection. A company may best protect its AI algorithm and model through trade secrets. The policy should explain the importance of taking certain steps so that a company will be in a position to protect its AI irrespective of the strategy it seeks to implement.

In order to ensure the ability to patent AI inventions, company policy should require the company to track the human involvement with the AI. This would include the persons responsible for the initial ideas as to the form and goals for the AI, developing the hardware for the AI, selecting the architecture of the AI, developing the algorithm, writing the source code, selecting the data to train, validate, and test the model, generating the prompts, interpreting the output of the AI, and using that output. Tracking human involvement will make it easier for a company to harvest potential inventions, identify persons that should

be listed as inventors, and ensure that it has appropriate agreements that assign the rights from the individuals to the company.

To maintain AI as a trade secret, a company should establish that it has implemented reasonable procedures to maintain the information as a secret and develop evidence that shows the information derives independent economic value from not being generally well known. The AI policy should address confidentiality issues (including which employees may access information), place restrictions on third-party access, and require employees and third parties that have access to the AI to execute agreements in which they acknowledge the obligation to maintain the secrecy of the AI information.

The policy may address acceptable tools to use in generating the AI. For example, certain coding tools may use open source code that requires disclosure of modified code or other licensing obligations. If these tools are used, a company may unknowingly be encumbering its code with third-party rights or obligations. By exploring the obligations associated with these tools, a company can identify tools that will not result in unacceptable encumbrance and ensure that its employees avoid those tools.

The policy should require tracking of the origin of the data used to train, validate, and test the AI model. As evident from the numerous lawsuits filed by copyright owners, the potential for liability exists if data is used without obtaining rights to use that data.[24] As with coding tools, a company should identify sources of data that are acceptable to use with its AI models. The company should track what data is used with each version of its AI models so that it can delineate the rights and obligations associated with each version.

The policy should also establish practices that seek to avoid infringement of third-party IP. The procedures related to identifying acceptable coding tools and data sources will assist in avoiding infringement of third-party IP. The policy should establish a mechanism by which a company will respond to notices that allege a violation of a third-party IP right. The policy may also identify the situations under which it will conduct an IP landscape assessment. This assessment should allow the company to identify potential hurdles to the use of its AI model presented by third-party IP. It should also allow the company to identify whitespace where third-party IP does not exist. The company may exploit this whitespace by obtaining its own IP in that space.

The policy may address how a company will approach licensing third-party rights or licensing its AI. The strategy through which a company extracts value from its AI may dictate the approach it takes. An AI platform company will monetize its AI through third-party use of its AI models. It would be helpful to provide insight to employees concerning the general parameters under which it will allow access to the AI models and the parties' rights in the model, data, and outputs. It should also consider what responsibility a party will maintain should an allegation of infringement of third-party IP arise. Other companies may monetize AI by improving internal processes or development of new products. Those companies will likely not engage in licensing of their AI models, as the companies' exclusive right to use the AI model drives the value proposition.

These are key IP issues that a policy should address to provide clarity to the employees responsible for implementing a company's AI strategy, but it is not an exhaustive list. Each industry and AI use case will present unique IP issues that a company must consider separate from these issues. It would be best for the company to address in its AI policy the IP issues unique to its industry or AI use case.

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[24] Isaiah Poritz, *OpenAI Faces Existential Threat in New York Times Copyright Suit*, Bloomberg Law (Dec. 29, 2023).

Recent Developments in Delaware Officer Exculpation Charter Amendments

By: Andrew Noreuil, Andrew J. Stanger, Dustin Cooper and Blair Christian

Key Takeaways:

- Delaware courts have held that officer exculpation amendments do not require a separate class vote. For corporations with multiple classes of stock, this provides certainty to those that have already adopted such amendments and a clear path for corporations that plan to propose them.
- The vast majority of public company proposals to adopt officer exculpation amendments have been successful; however, only a minority of Delaware S&P 500 companies have made such proposals.
- Proxy advisor guidance on officer exculpation amendments remains unchanged for 2024, with both ISS and Glass Lewis voting on a case-by-case basis. So far, negative recommendations do not seem to have had a noticeable impact on the passage of proposals.

As noted in our previous Legal Update, the August 2022 amendments to Section 102(b)(7) of the Delaware General Corporation Law (DGCL) permits a Delaware corporation to include an officer exculpation provision in its certificate of incorporation, providing officers protection similar to that previously only afforded to directors. Specifically, the provision allows corporations to eliminate or limit personal liability for monetary damages for breaches of the duty of care by certain senior officers of the corporation. Exculpation of officers is not permitted for breaches of the duty of loyalty, acts or omissions not in good faith or that involve intentional misconduct, knowing violations of law, or transactions where the officer receives an improper personal benefit, or claims brought by or in the right of the corporation (derivative claims).

In order to provide for officer exculpation, a corporation must include an officer exculpation provision in its certificate of incorporation. For existing corporations, amending the certificate of incorporation to provide for officer exculpation requires board and stockholder approval. Below we discuss recent developments affecting corporations that are seeking to adopt these amendments.

No Separate Class Vote for Officer Exculpation Amendments

The Delaware Supreme Court in *In re Fox Corporation/Snap Inc.*[25] affirmed that certificate of incorporation amendments to adopt an officer exculpation provision generally do not require a separate class vote of the stockholders. This holding will allow Delaware corporations with multiple classes of stockholders to more easily adopt officer exculpation provisions and other amendments that do not affect rights specific to a class of stock.

Each of Fox Corporation and Snap Inc. had classes of voting and non-voting common stock, and both corporations approved officer exculpation amendments without a separate class vote. The non-voting

[25] *In re Fox Corporation/Snap Inc. Section 242 Litigation*, C.A. Nos. 2022-1007, 2022-1032 (January 17, 2024, as revised January 25, 2024).

stockholders of both Fox and Snap filed class action complaints, claiming that they were entitled to vote on the amendments separately as a class under DGCL Section 242(b)(2), which requires a class vote if an amendment would "alter or change the powers, preferences, or special rights of the shares of such class so as to affect them adversely." The stockholders argued that "powers" should be interpreted to refer to fundamental powers of stock ownership, including the ability to sue officers for duty of care violations. They reasoned that the officer exculpation amendment would limit the power of non-voting classes of stock to sue officers and therefore should require a separate class vote under Section 242(b)(2). The Court of Chancery acknowledged the plaintiffs' "plain-meaning argument," but ultimately rejected their analysis of the DGCL and related cases, granting summary judgment in favor of Fox and Snap.

On appeal, the Supreme Court affirmed the Court of Chancery's ruling. It noted that although the terms "powers," "preferences," and "special rights" are not defined, an examination of the relevant DGCL provisions together shows that Section 242(b)(2) is intended as a safeguard to protect the powers, preferences and special rights of stock that are authorized by the DGCL to be expressed in a corporation's charter and is not a broad grant of the right to vote on any amendment affecting any attribute of stock ownership. In other words, "the ability to sue directors or officers for duty of care violations is an attribute of the Companies' stock, but not a power, preference, or a special right of the [non-voting] common stock."

The court held that a charter amendment exculpating corporate officers for breaches of their duty of care does not require a separate class vote. For corporations with multiple classes of stock, the Court's decision removes uncertainty about the validity of officer exculpation amendments that already have been adopted and offers a clear path for corporations that plan to propose such amendments.

Stockholder Approval of Officer Exculpation Amendments

Delaware public companies began seeking stockholder approval for officer exculpation charter amendments soon after the DGCL was amended in August 2022. Tracking data available from *Deal Point Data* ("DPD") report that, as of the end of January 2024, 271 Delaware public companies included in any of the NASDAQ 100, Fortune 500, S&P 1500 and Russell 3000 indices have held stockholder votes to approve officer exculpation amendments (215 doing so during the April-July 2023 annual meeting season), with 85% of such proposals being approved.[26]

Of these 271 companies, 56% were small-cap companies (under $2 billion market cap), 29% were mid-cap companies ($2-10 billion market cap), and 15% were large-cap companies (over $10 billion market cap). Ninety-four percent of the proposals by mid- and large-cap companies passed, while 77% of proposals by small-cap companies passed.

The DPD data reported that for the proposals that passed, an average of 81% of the outstanding voting shares were present at the stockholders meeting, while for the proposals that failed, the average was only 54%. Because a passing vote typically requires approval of a majority of the total voting shares outstanding (or a supermajority threshold, if required under a corporation's certificate of incorporation), stockholder turnout at the meeting can prove to be an important factor. Average stockholder turnout appears to have been somewhat stronger among mid-and large-cap companies (84% of outstanding voting shares present at the meeting) compared to small-cap companies (70%).

According to the DPD data, for all proposals (whether they passed or failed), an average of 88% of shares present at the meeting voted "for" the proposal. Even where the proposals failed, an average of 83% of the shares present at the meeting voted "for" the proposal; however, as noted, such support can still be

26 All data in this section is taken or derived from Deal Point Data at https://www.dealpointdata.com. Broker non-votes are excluded from calculations.

insufficient for approval of the amendment if the corporation's charter required a supermajority threshold for approval or stockholder turnout was low.

Per the DPD data, among the 323 Delaware corporations in the S&P 500 index, only 29 have sought approval of officer exculpation amendments, with 28 of them having been successful.[27] The one corporation for which the amendment did not pass obtained approval from 64% of its voting shares outstanding, but was still short of the 2/3 majority required under its charter.[28] Finally, of the 23 Delaware dual-class companies in the S&P 500 index, only Fox Corporation has sought stockholder approval for an officer exculpation amendment.[29]

Proxy Advisor Guidance

With respect to voting on officer exculpation amendments, Institutional Shareholder Services (ISS) and Glass Lewis have left their 2023 proxy voting guidelines unchanged for 2024. Both firms state that they will continue to evaluate such proposals on a case-by-case basis.

Specifically, ISS will consider, among other factors, the stated rationale for the proposed change and whether the amendment would eliminate an officer's liability for monetary damages for violating the duty of care.[30] In over 80% of the 271 proposals mentioned above, ISS has recommended that stockholders vote "for" the proposal.[31] For the proposals that ISS recommended voting "against," over 90% of the proposals passed notwithstanding ISS's recommendation. From anecdotal evidence, ISS is more likely to recommend voting against an officer exculpation proposal when the corporation's governance structure limits accountability to stockholders (such as through the presence of controlling stockholders, classified boards, lack of independent directors, a record of poor board attendance, and restrictions on proxy access). In such circumstances, ISS contends that stockholders should be allowed to hold officers accountable through litigation.

Likewise, Glass Lewis will generally recommend voting against officer exculpation amendments that eliminate monetary liability for breaches of the duty of care, unless the board provides a "compelling rationale" and the provisions are "reasonable."[32] Based on anecdotal information, Glass Lewis typically recommends against officer exculpation amendments, but such recommendations seem to have had a limited effect given the overall high rate of passage of these proposals.

Although it remains to be seen what continuing impact ISS and Glass Lewis will have on stockholder voting on officer exculpation amendments, particularly as more Delaware corporations make proposals to amend their certificates of incorporation to include officer exculpation, it appears thus far that their guidance and ultimate voting recommendations have not resulted in a significant headwind to obtaining stockholder approval of such proposals.

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27 The companies successfully obtaining approval are Align Technology, Inc., APA Corporation, Arthur J. Gallagher & Co., Caesars Entertainment, Inc., CDW Corporation, CF Industries Holdings, Inc., The Cigna Group, Crown Castle Inc., DaVita Inc., Devon Energy Corporation, Diamondback Energy, Inc., eBay Inc., Edwards Lifesciences Corporation, Entergy Corporation, Fortinet, Inc., Fox Corporation, General Dynamics Corporation, Globe Life Inc., Halliburton Company, Hormel Foods Corporation, Jacobs Solutions Inc., Kinder Morgan, Inc., Loews Corporation, Monster Beverage Corporation, Roper Technologies, Inc., RTX Corporation, Skyworks Solutions, Inc., and Viatris Inc.
28 Paycom Software, Inc., Current Report on Form 8-K (May 1, 2023).
29 Fox Corporation, Current Report on Form 8-K (November 3, 2022).
30 ISS Proxy Voting Guidelines, effective February 1, 2024.
31 Based on information provided by Georgeson.
32 Glass Lewis 2024 Benchmark Policy Guidelines, effective January 1, 2024.

Conclusions

The outlook for Delaware corporations interested in adopting officer exculpation amendments appears to be favorable. Delaware corporations that have proposed such amendments have generally experienced high passage rates and sufficient stockholder support to overcome negative recommendations from proxy advisors. Although few S&P 500/large-cap companies have proposed officer exculpation charter amendments, we expect that the results obtained by companies that have been early adopters of officer exculpation will encourage more companies to propose such amendments in the coming proxy season. Likewise, the Delaware Supreme Court's clarification that no separate class vote is required on such proposals, should encourage more dual-class corporations to adopt officer exculpation amendments.

A Proactive Approach to AI Legal Frameworks is Critical for Success

By: Dominique Shelton Leipzig, Cybersecurity & Privacy Partner, Leader, Global Data Innovation team, and author of Trust. Responsible AI, Innovation and Data Leadership

The use and capabilities of artificial intelligence ("AI") have tremendous promise, but with such significant potential up-side comes myriad risks. AI models can "hallucinate" (i.e., invent inaccurate facts) and "drift" (i.e., deviate from the model's original design and intended purpose), which could lead to biases, inaccurate results and potentially harmful outcomes. A key to harnessing the potential value of AI while managing its risks is to develop and implement thoughtful processes and protocols to govern the company's approach to AI.

Governments in 96 countries across six continents have put out draft legislation and regulatory frameworks aimed at making the use of AI safe. While many jurisdictions are still working through final rules and regulations, on December 9, 2023, European Parliament negotiators and the Council presidency agreed on the final version of what is claimed to be the world's first-ever comprehensive legal framework on AI: the European Union Artificial Intelligence Act (the "EU AI Act"), which, upon obtaining final approval from the EU members states, is expected to go into effect in 2026.

The EU AI Act, like much of the proposed legislation across the globe, categorizes different types of AI into different categories, with "high risk" AI requiring more stringent monitoring and governance than "limited risk" AI, and unacceptably high-risk AI being prohibited altogether. To be well-positioned to comply with legislation and more adequately manage AI-related risks, companies should review their current processes and protocols governing the use of AI.

How to Think About AI Governance: The Colors of a Traffic Light

Compliance with the various AI legal frameworks will require that companies risk-rank their AI use cases. Risk-ranking within the legal frameworks can be thought of as a traffic light—prohibitively risky use cases (red light), low- or minimal-risk use cases (green light) and high risk use cases (yellow light). Below provides a high-level overview of an approach to an AI governance framework based on early drafts of proposed AI legislation around the world, which is described in more detail in the recently published book, "*Trust: Responsible AI, Innovation, Privacy and Data Leadership*", written by the author of this article. Categorizing the company's AI use cases into these three categories could serve as the foundation of a company's AI governance policy.

Red Light (Prohibited AI): There are 17 specific cases, such as voting surveillance or continuous public monitoring, that are strictly off-limits due to their threat to democratic values and privacy. Governments and regulators are already drawing clear lines in the sand.

Green Light (Low Risk): Certain AI use cases have safely navigated the ethical landscape for years and pose minimal risk of bias or safety concerns. This category generally includes use cases such as chatbots and AI used for customer service, product recommendations, and video games.

Yellow Light (High Risk): Most AI use cases fall into this category. This includes applications ranging from HR and finance to manufacturing and surveillance. For AI use cases in this category, companies are well-served by using caution and implementing thoughtful AI governance protocols.

Navigating the Yellow Light:

- **Use High-Integrity Data**: Fueling the AI model with accurate, high-quality, relevant data with verifiable ownership is the bedrock of responsible AI.
- **Test the Model Continually**: Pre- and post-deployment testing of AI models for bias and accuracy is crucial to ensure safety, appropriate privacy and confidentiality, and compliance. Do not wait for a crisis to test AI models. Recall that even the most sophisticated AI models can "drift"—catch it early.
- **Document Technical Aspects of Data**: Ensure that there is real-time logging and meta data. This is critical so that in the event of an issue with AI outputs, for example, the technical data can be reviewed by humans to pinpoint the moment the AI began to drift and which outputs were tainted by the drifting.
- **Include Human Oversight**: AI governance cannot be self-executed by AI systems. Humans must be involved in the quality control process to ensure that output is operating as expected and is consistent with the company's expectations. In the event that the AI model drifts, a human will need to review the technical documentation, including records of the logging and meta data, to diagnose the issue and get the model back on track.
- **Implement Fail-Safes**: Define clear stopping points. There are instances when an AI model continuously deviates, producing tainted output. If deviations cannot reliably be corrected on an ongoing basis, it could be in the company's best interest to cease use of the particular AI model.

With AI-related regulatory frameworks and draft legislation proposed across the globe, it is critical that companies conduct self evaluations regarding their approach to AI controls. The "traffic light" risk-ranking approach outlined above provides a high-level overview of how companies can better prepare for and anticipate what will be required of them, in light of forthcoming AI-related laws and regulations. Given the speed at which AI can evolve—for better and for worse—it behooves companies to take a proactive approach when it comes to AI processes and protocols.

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