The times for PE and VC transactions are a-changin': 2024 challenges in employment and AI

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The first article in this two-part series ("The times for private equity and venture capital transactions are a-changin': 2024 challenges," Reuters, Dec. 19, 2023, https://bit.ly/3SGg1wt) explored the impact of the Corporate Transparency Act's new reporting requirements and increased antitrust enforcement by the Federal Trade Commission (FTC) and U.S. Department of Justice on private equity (PE) and venture capital (VC) funds. Read on for more key items that should be on the radar of PE and VC funds and their portfolio companies for 2024 and beyond, including changes in the law relating to enforceability of restrictive covenants and legal issues surrounding artificial intelligence.

Employee restrictive covenants get their own restrictions

In January, the FTC issued a proposal (https://bit.ly/3RtkP6F) that would ban substantially all noncompetition agreements for employees. The FTC received an onslaught of comments on the draft rules and is expected to vote on a final version of the proposal in spring 2024, with likely courtroom challenges to follow. Earlier this year, the FTC also issued complaints (https://bit.ly/485FQLZ) against three employers alleging they violated antitrust laws in the manner in which they utilized employee noncompetition agreements.

These efforts are in addition to the FTC's position against no-poaching agreements between corporate entities seeking to restrict mobility of employees among competitors. The National Labor Relations Board's general counsel has also indicated her position that noncompetition agreements may unlawfully interfere with employee rights under the National Labor Relations Act.

These developments are significant for the VC and PE industry since many of the companies backed by PE and VC investors are dependent on their intellectual property and proprietary business models and have routinely used noncompetition agreements as a method to protect their business from competition.

In light of these developments, these companies and their PE and VC investors need to consider other avenues for controlling access to highly sensitive information, including strengthening their confidentiality and trade secret protections and utilizing more traditional methods for intellectual property protection such as copyrights and patents. PE and VC investors will want to adjust their diligence procedures for review of such restrictions and implementation of appropriate controls and protections to ensure they preserve the goodwill and value of the businesses in which they invest.

In addition, over the last several years, we have seen a proliferation of states adopting laws restricting the use of noncompetition agreements for lower-wage or other specified categories of workers, or imposing other requirements such as advance notice or significant additional consideration. It is also no longer a given that noncompetition agreements will be more easily enforced in the context of an M&A transaction or that a court will correct an overly broad covenant rather than refusing to enforce it completely as evidenced by state court decisions striking down M&A-related noncompetition agreements deemed overbroad in scope.

VC and PE funds that either use AI in their operations or invest in companies that are developing or utilizing AI tools must do a thorough review of all such use of AI, with a particular focus on the data used for training AI tools to confirm compliance with applicable laws.

PE and VC firms and their portfolio companies should remain mindful of these evolving restrictions. It is imperative to consider the current state of federal and state law when drafting noncompetition and non-solicitation restrictions, including in the context of investment and acquisition documents in M&A deals. Tax advisers should also be consulted in connection with the allocation of transaction consideration to deal-related noncompetition restrictions.

Use of artificial intelligence raising numerous legal issues

While artificial intelligence (AI) can be a highly useful tool to create efficiencies and quickly sort and analyze data at speeds far in excess of anything that could be accomplished by a person, AI is also

creating legal havoc. It has raised numerous legal issues across the spectrum, and the law is rapidly trying to catch up to protect individuals, workers, innovators, data owners, artists, entertainers, and brand owners, among others.

PE and VC funds investing in or acquiring companies building AI tools or using AI in their business models or operations will need to do increased due diligence to keep apprised of issues resulting from the ever-evolving legal landscape in terms of compliance and governance practices and controls. These funds must ensure that companies in which they hold, or intend to acquire, an interest are implementing adequate controls and policies so as to protect the value of their assets.

It remains vital that PE and VC funds utilizing AI tools in decision-making do not simply replicate the existing system.

On Oct. 30, President Biden announced an executive order (https://bit.ly/49rDjN2) that takes a wide-ranging approach to analyzing and addressing the concerns raised by the use of AI, and that applies to companies that develop or use AI or AI-driven products or services and to consumers of those services. The order will impose new U.S. Department of Commerce reporting requirements for private companies that use high-powered AI algorithms and computing clusters in areas that could impact national security, which may include a broad range of tasks such as AI systems that are learning to deceive humans to evade their control.

Unsurprisingly, the order also looks at the intellectual property issues inherent in the use of AI — especially generative AI — that have been the subject of much discussion and consternation over the last year or so. These issues, most recently illustrated by the Writers Guild of America and SAG-AFTRA strikes, have impacted artwork, entertainment, content creation and brand protection. The order includes express requirements for the Under Secretary of Commerce for Intellectual Property and the director of the U.S. Patent and Trademark Office to provide guidance regarding patent and copyright protection available to AI-related works, including those that have been created with contributions from generative AI.

As these are evolving areas of law, VC and PE funds that either use AI in their operations or invest in companies that are developing or utilizing AI tools must do a thorough review of all such use of AI, with a particular focus on the data used for training AI tools to confirm compliance with applicable laws. Funds should exercise diligence and oversight of these areas going forward to ensure that neither such funds nor the companies in which they invest are violating third-party rights and have unfettered ownership of their assets developed through the use of AI.

Firms should consider increased diligence efforts, including engaging counsel and consultants with a deep understanding of these issues to help navigate these novel issues and the ever-changing legal regulatory and litigation landscape.

VC and PE firms should work with their counsel to review and revise the documentation they use when investing in or acquiring new entities as many of these are outdated and need to address the changing legal landscape by modifying the representations and warranties and covenants of their investment documentation to fully address the above issues.

As part of their diligence review, buyers will need to satisfy themselves that sellers have all licenses and permissions required to utilize such AI technology in the way it is currently being used by the business and will adopt adequate policies and procedures to ensure ongoing compliance with the changing laws and protections for third-party rights. This is particularly important if AI technology is being used to generate new intellectual property for the target company.

For example, if a target company is using AI tools to generate new software code, a buyer will need to be certain that: (a) the code being developed is owned by the target company and (b) the code being generated is not existing (and protected) intellectual property that the AI tool has simply repurposed. The law regarding intellectual property ownership of AI-generated content is still evolving, and VC and PE firms need to stay on top of new developments as they unfold.

Finally, the use of AI tools in PE and VC investment decision-making is a double-sided coin that funds need to approach with caution. Potentially, AI could revolutionize the way funds identify potential investment opportunities, with the potential for faster, more accurate analysis. Currently, funds rely on human analysis to identify potential acquisition targets, and this process is invariably fraught with human error and potential bias.

However, it remains vital that PE and VC funds utilizing AI tools in decision-making do not simply replicate the existing system. "Algorithmic bias" may occur if algorithms used by funds to analyze potential investment opportunities are erroneously trained to replicate the same inherent human biases present in the current system. PE and VC funds that utilize these tools need to ensure that the algorithms underpinning any such analysis are trained and audited using unbiased data and that there is always a human element to the review process.

Moving forward

These are just some of the legal and compliance issues that should be top-of-mind in 2024 for VC and PE investors and their portfolio companies. There are many other issues that will need to be considered such as evolving environmental, social, and governance (ESG) standards; the increased adoption of state (and potentially federal) privacy laws such as the Utah Consumer Privacy Act that went into effect Dec. 31, 2023, and Delaware's adoption of its Personal Data Privacy Act in September 2023; and other laws that try to address new and innovative technologies, especially in the digital asset, cryptocurrency, biotech, and healthtech spaces.

All of the above will require a change in the level and scope of due diligence and reexamining the documentation used in investments, as well as more vigilance in oversight by PE and VC fund designees on boards of directors of portfolio companies.

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