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Emerging Businesses and Venture Capital in 2024: 10 Hot Topics for Founders, Investors, and Executives of Emerging Companies

Article By:

Thomas S. Brennan

Amal U. Dave

Emily B. Lewis

Evgeny Magidenko

Adam Diederich

Dan Jasnow

2023 was a pivotal year for the emerging companies, creating new categories of winners and losers across the board. Emerging companies incorporating artificial intelligence or that have clear line of sight to positive cash flows gained significant traction. On the other hand, emerging companies in certain sectors such as packaged goods faced a tight financing market and increased regulations, squeezing margins and, in some cases, driving underfunded companies out of the market.

Early indications are that 2024 will be equally transformative, with new capital standing by to supercharge innovative concepts and products, new technologies providing opportunities for a new wave of entrepreneurs, and new laws and regulations further changing the relationship between emerging companies and their customers, employees, and investors.

Here are 10 hot topics that founders, investors, and executives leading emerging companies should monitor as the year develops.

1. Preparing for an Improved Financing and M&A Environment in Q3 and Q4

Throughout 2023, emerging companies continued to deal with a tight venture capital market, raising interest rates, valuation challenges, and struggling exit markets. With interest rates expected to decline in the second half of the year and a stronger economic outlook in 2024 as the economy emerges from an expected soft landing, we expect the financing and mergers and acquisitions (M&A) environment for emerging companies to improve relative to a difficult 2023. Investors and banks should be more willing to deploy capital and will be looking intensely at emerging companies with steady cash flow streams, especially recurring revenue, and proven concepts or products. Emerging company executives looking to raise capital or pursue exit strategies have a good window in Q1 and Q2 to prepare for such a financing or M&A transaction in what promises to be an improved Q3 and Q4.

2. Alternative Funding Strategies

Of course, until we see at least one or two rounds of rate decreases and an improved fundraising market, investors will likely remain extremely picky, investing only in proven concepts or current "fan favorites" like artificial intelligence (AI). The conventional wisdom is that later stage and growth companies without line of sight to profitability will remain shut out of funding opportunities until rates come down. For emerging companies facing this dilemma, the directive from investors and social media start-up gurus has been to "tighten the belt," eliminating any unnecessary business functions, and preserve capital to avoid having to raise capital in the current funding market.

This may be reasonable advice, but such strategies can cause companies to turn into a "death spiral" as cutbacks on non-core functions (*e.g.*, marketing, staffing, etc.) lead to declines in revenue and productivity, which necessitate further cuts. Accordingly, founders may find it necessary to explore alternative sources of financing. Alternative financing may come from key suppliers (which may be able to invest in cash or in kind), key customers, and/or trade groups and other nonprofits whose mission aligns with the company's products or services. While this sort of alternative funding isn't guaranteed and may not fit within a standard start-up funding framework, it may provide a crucial lifeline for companies that might not otherwise be able to attract investment in this highly selective environment.

3. Dealing with Down Rounds

The number of down round financings has increased over 2023, with Q3 and Q4 of 2023 experiencing some of the highest counts in the past decade according to third-party sources, like Pitchbook, tracking such metrics. While the second half of 2024 may help to improve valuations for emerging companies, founders faced with immediate capital needs, or founders that have deferred going to market in 2022 and 2023, may have to navigate the added complexity of a down round financing. Deal terms in down round financing may come with higher multiples on liquidation preferences, participating preferred, cumulative dividends, and warrant coverage. Founders will need to navigate these deal structures and the potential for added dilution to founders and common stockholders. Additionally, down round financings may also present certain conflicts among the various parties. Founders and non-employee directors will need to consult with outside counsel versed in these deal structures to help boards navigate these financings.

4. Reporting Requirements Under the CTA

The Corporate Transparency Act (CTA) requires entities organized or doing business in the United States that don't qualify for a specific exemption to disclose their "beneficial owners" and provide certain other information to the Financial Crimes Enforcement Network (FinCEN), a bureau of the US Department of the Treasury. Entities formed on or after January 1, will need to provide such information to FinCEN within 90 days of forming such entity (starting in 2025, the reporting obligation must be satisfied within 30 days). Entities formed prior to January 1, must disclose the information no later than January 1, 2025.

Emerging companies, especially those with complicated organizational structures, should start evaluating their reporting obligations early to avoid an end-of-the-year rush to file. While certain exemptions are available (*e.g.,* companies with more than 20 full-time employees, $5 million in US-sourced gross revenue, and a physical presence at a US office are exempt, along with *wholly owned* or *wholly controlled* subsidiaries of most categories of companies exempt from the CTA), many emerging companies are unlikely to meet these requirements and may need information from their investors in order to comply. Overall, early planning is essential to avoid unnecessary stress and distraction.

5. AI Revolution

2023 was a transformative year for AI, particularly the sub-set of AI technologies known as generative AI (GenAI). Companies across industries adopted the use of AI for a variety of uses including sales forecasting, supply chain and logistics, marketing, and customer engagement. These developments promise to allow companies to tailor products and services to customer preference and to improve efficiency at all stages.

Several ongoing lawsuits are challenging a core assumption of generative AI developers: that the use of third-party copyrighted works to train GenAI tools constitutes “fair use” under the US Copyright Act. If this assumption is incorrect, developers could face copyright infringement damages, and commercial users of GenAI tools could face claims of vicarious or contributory copyright infringement.

Courts and regulators have largely declined to extend copyright protection to works created by GenAI. Before utilizing GenAI tools, companies must carefully consider best practices to establish IP protection and avoid loss of rights. Investor due diligence should also include questions about the use of GenAI in the creation of valuable IP.

As venture capital and emerging businesses look to expand their use of or investments in AI technologies in 2024, there are important legal considerations to keep in mind:

1. Whether existing contracts and website terms of use need to be updated to reflect AI-related uses and services;
2. Whether use of AI tools to track employees and make employment decisions could expose them to liability under fair wage and hour laws and equal opportunity laws; and
3. Whether new and more assertive federal and state regulation of AI tools will significantly increase the costs of doing business or frustrate certain desired use cases.

6. Wage and Hour Claims

Employers, especially in California, continue to face class and representative actions under the California Labor Code and similar statutes in other states. Common claims include unpaid overtime and minimum wages, failure to provide meal and rest periods, untimely wage payments, technical paystub violations, and unreimbursed business expenses. These cases, typically class action suits, often seek to involve all employees within the state, exerting immense pressure on companies to settle, regardless of the lawsuit's merit. To avoid such claims, emerging companies should take preventive measures such as conducting wage-and-hour audits for legal compliance and implementing employee arbitration programs.

7. Web and Social Media Management

On the heels of its updates to the influential Endorsement Guides, the Federal Trade Commission (FTC) has proposed rules on the use of consumer reviews and testimonials that will deal with web and social media issues such as fake customer reviews, review hijacking (*i.e.*, repurposing previously provided customer reviews to endorse separate products or services), buying positive or negative consumer reviews, insider reviews, suppression of reviews, and misuse of indicators of social media influence.

What's more, plaintiffs' lawyers are getting increasingly active in this space, bringing class action claims against companies that use deceptive practices to attract or retain consumers for their products and services. Companies also face an increasingly significant threat of mass arbitration. In response to individual arbitration provisions in website terms of use, plaintiffs' lawyers have begun filing (or begun threatening to file) hundreds or even thousands of individual arbitrations, resulting in overwhelming upfront arbitration fees for the company, which can significantly exceed the cost of litigating in court.

With the added legal risks posed by these developments (in addition to the reputational risks already posed by web and social media activities), it is important that consumer-facing emerging companies develop and follow policies that ensure web and social media compliance, while carefully tailoring the terms of use governing their digital assets in order maximize protection while minimizing risk.

8. Managing Non-Competes

The states and the federal government remain heavily focused on non-compete provisions. While New York Governor Kathy Hochul vetoed a measure that would have effectively banned non-competes in New York, many states continue to threaten broad restrictions. Further, failure to comply with limitations (*i.e.*, including an offending non-compete in an employment agreement) does not merely invalidate the provision or employment contract. Rather, it can result in monetary penalties for the offending company in certain jurisdictions.

Buyers and investors in emerging companies outside of California with valuable proprietary information may have heavily relied on non-competes to protect acquired proprietary information. However, with recent legislative trends eroding non-compete protections, more careful consideration should be paid to other tools available to protect proprietary information, such as trade secret protection and confidentiality agreements. Buyers and investors should also conduct thorough diligence on emerging company trade secrets to ensure that they have been adequately protected.

Additionally, emerging companies, especially those in California, would be well-served to review their employment agreements and policies to ensure compliance with state and federal rules surrounding non-competes. Beginning February 14, 2024, California will require employers to send written notices to employees (via mail and email) that void non-competes.

9. Estate Planning

Founders and investors, including those in emerging companies, have a unique opportunity until December 31, 2025, to transfer up to $13,610,000 ($27,220,000 for a married couple) during their lifetimes or at death without incurring federal estate or gift tax. In 2026, these exemption amounts will be cut in half, adjusted for inflation. With transfers in excess of the exemption amount subject to federal tax at a rate of 40% (in addition to state taxes in some circumstances), acting before December 2025 can result in nearly an $11 million tax savings for a married couple.

Additionally, founders and investors of emerging companies looking at a transaction in the near term should start considering making any estate transfers as soon as possible. Making transfers well in advance of a transaction may help mitigate gift/estate tax exposure when transferring equity to a trust or other estate planning vehicle.

It is also crucial to note that transferring wealth in trust rather than outright provides flexibility and creditor protection, and assets transferred need not be liquid, but instead can include closely held business interests. The transferor can dictate many of the terms of the gift — in some cases in perpetuity. Finally, trusts can be structured to remain outside the reach of creditors under most circumstances.

10. Ransomware

The presence of ransomware attacks rose in 2023, affecting as many as two-thirds of all organizations. Such attacks can encrypt sensitive data, including trade secrets and personal data, forcing companies to pay hefty ransoms for decryption keys or to prevent data exposure. Companies considering ransom payment should be aware of US Office of Foreign Assets Control (OFAC) sanctions restrictions.

Ransomware attacks can disrupt business operations for weeks, necessitating swift legal action. From notifying insurance carriers to coordinating with response forensics and crisis communications firms, companies must review numerous policies and agreements. Companies also face contractual obligations to notify business partners and navigate over 50 state data breach laws with tight notice deadlines.

Ransomware attacks and other data breaches can lead to liability from regulatory investigations, litigation, and commercial contract indemnity provisions. An updated data security program to prevent attacks and tested incident response plan to deal with any attacks are crucial.

Companies should also be aware of the rapidly evolving regulations. In 2023, the US Securities and Exchange Commission (SEC) mandated annual disclosure of material cybersecurity incidents and risk management strategies, the California Privacy Protection Agency initiated a rulemaking on detailed cybersecurity audit regulations, and the FTC updated data breach notification requirements for non-bank financial institutions.

Daniel J. McQueen, Thorne Maginnis, Linda M. Jackson, Matthew F. Prewitt, and D. Reed Freeman Jr. contributed to this article.

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