The M&A LAWYER

February 2023 ▪ Volume 27 ▪ Issue 2

FTC PROPOSES BAN ON WORKER NON-COMPETE AGREEMENTS WITH LIMITED M&A EXCEPTION

By Peter Julian, Craig Waldman, Andrew Levine, and Kristin Berger Parker

Craig Waldman is co-leader of Jones Day's global Antitrust & Competition Law Practice and is based in the firm's Washington, D.C. office. Andy Levine co-leads Jones Day's Corporate Practice and is based in the New York office. Peter Julian and Kristin Berger Parker are partners based in the firm's San Francisco and Minneapolis offices, respectively. Contact: cwaldman@jonesday.com or amlevine@jonesday.com or pjulian@jonesday.com or kparker@jonesday.com.

Consistent with a trend of increased antitrust scrutiny in labor markets, in early January 2023 the Federal Trade Commission proposed an unprecedented rule banning non-compete clauses in employment agreements, a day after announcing three challenges and simultaneous settlements to employer/employee non-compete agreements in *Prudential*, *O-I*, and *Ardagh*.

The proposed rule and its retroactive effect also have significant implications for current, future, and even past M&A deals that utilize non-competes to ensure that value of the target business is protected for a reasonable period of time.

1. The Proposed Rule Would Ban Most Non-Competes

The FTC's proposed non-compete rule, if implemented, would ban almost all employer/employee non-compete clauses nationwide, superseding state laws that are less restrictive than the FTC rule. Under the proposed rule, an employer would violate FTC Act § 5's prohibition on "unfair methods of competition" if it:

- **enters** or attempts to enter into a prohibited non-compete clause with an employee;
- **maintains** or does not rescind an existing prohibited non-compete clause; or
- **represents** that an employee is subject to a non-compete without a good-faith belief that the non-compete is lawful.

Once adopted, the non-compete rule would require employers, within 180 days of the final rule's publication, to inform each employee who is subject to a prohibited non-compete that the employer has rescinded the non-compete.

As drafted, the non-compete rule would apply to almost all employers and workers. The broad definition of "worker" covers both em-

IN THIS ISSUE:

FTC Proposes Ban on Worker Non-Compete Agreements with Limited M&A Exception 1

Claims That SPAC Directors, Sponsor Breached Fiduciary Duties Survive Motion to Dismiss 6

New Law Exempts M&A Brokers from SEC Registration 9

Delaware Court of Chancery Grants Plaintiff Attorney's Fees Award Under Corporate Benefit Doctrine for Demand to SPAC Board Leading to Adjusted Voting Structure in Connection with Merger 12

Key Developments in Delaware Law 14

From the Editor 23

THOMSON REUTERS®

42986049

saddle the unlucky first company to have its fee award set by the Court with fees that exceed the benefit that company received."

ENDNOTES:

[1]No. 2022-0132-MTZ (Del. Ch. Dec. 27, 2022).

KEY DEVELOPMENTS IN DELAWARE LAW

By Gail Weinstein, Philip Richter, Steven Epstein, Steven J. Steinman, Scott B. Luftglass, and Peter L. Simmons

Gail Weinstein is senior counsel, and Philip Richter, Steven Epstein, Steven Steinman, Scott Luftglass, and Peter Simmons are partners, in the New York office of Fried, Frank, Harris, Shriver & Jacobson LLP. Contact: gail.weinstein@friedfrank.com or philip.richter@friedfrank.com or steven.epstein@friedfrank.com or steven.steinman@friedfrank.com or scott.luftglass@friedfrank.com or peter.simmons@friedfrank.com.

While there were no dramatic, transformational changes in Delaware law in 2022, the courts reaffirmed, and in some cases expanded, important recent trends. We discuss the key developments below.

Sponsor Liability. Sponsors generally are protected from liability for actions by their portfolio companies so long as the corporate formalities between them are observed such that it is the portfolio company's board and management (and not the sponsor) that is making the decisions for the company. Usual sponsor activity in connection with monitoring and assisting portfolio companies should not lead to liability for the sponsor; however, a sponsor or its principals (even if having no formal role as a director, officer or employee of the portfolio company) face potential liability for the portfolio company's actions, as an "acting" (or *de facto*) manager, if they are deemed to have "materially participated" in the management of the company either generally or with respect to the challenged transaction. This past year, in *P3 Health,* the Court of Chancery held that one of the principals of a PE sponsor (who had no formal role at the portfolio company at issue) may have personal liability for his role in connection with the company's de-SPAC merger in light of his "material participation" with respect to the de-SPAC. The decision serves as a reminder that a sponsor—even (indeed, particularly) when it is the controller of a portfolio company—generally should act with respect to the company *through* its board nominees, equity ownership, and any contractual rights, and should not assert that it is "in charge" of the company or any of the company's transactions.

Director Liability. The Court of Chancery, in *Garfield v. Allen*, expanded potential personal liability of directors by adopting a new theory of director fiduciary liability based on a board's failure to address problems that come to its attention through litigation demand letters. The court adopted this new theory "with trepidation," noting that it is "novel," "lack[s] precedent," and potentially could be used by plaintiffs to inequitable ends (including by "manufacturing a claim against directors by acting as a whistleblower and then suing because the directors did not respond to the whistle"). Accordingly, boards should review their existing processes to ensure that they appropriately consider issues raised in litigation demands the company receives.

Activists—and Other "Short Term" Investors. The Court of Chancery, in *Goldstein v. Denner*, took the expansive view that activists, and other "repeat players" who are "short-term" investors, and the directors appointed by them, may have an *inherent* disabling conflict of interest in a company's sale process—at least when acting in accordance with a "usual playbook" of forcing a near-term sale-of-the-company. The court described such investors as having an inherently divergent interest from the other stockholders given their short-term investment horizon, based on which they may well favor a near-term sale of the company at an inopportune time (even if only based on a desire to "redeploy" their capital to other investments). The

© 2023 Thomson Reuters

court described director-designees of such investors as inherently conflicted given the likelihood that they are grateful for their board seats and their likely expectation of "future benefits" in the form of board seats at the investor's other portfolio companies. We note that the decision may be limited to the context where, as was the case in *Goldstein*, the short-term investor is leading the sale process and has a usual pattern of forcing near-term sales at inopportune times. Moreover, in *Goldstein*, there were additional, egregious alleged actions by the activist director that suggested a lack of loyalty to the company.

Officer Liability. The trend of increased prevalence of fiduciary claims against corporate officers has continued. Further, in *P3 Health*, the court expanded potential liability for officers of Delaware LLCs. The court, applying a new interpretation of the Delaware LLC Act's consent-to-jurisdiction provision, held that the provision extends not only to the "President" of an LLC (as the court had established in prior cases), but extends to any person with a "senior role" at an LLC. The court also indicated that, at the pleading stage of litigation, the court would not find a lack of jurisdiction under the Act based on officers' contentions that, while they held an executive officer title, they in fact did not have a senior role as they did not function consistently with the title. Such a conclusion would require a facts-based inquiry at trial, the court held. Based on *P3 Health*, LLC officers with "C-suite"-type titles should expect more claims against them challenging actions they took as an officer.

Controller Conflicts Based on Desire for Liquidity. The Court of Chancery, in *Goldstein v. Denner*, amplified its erosion in recent years of the *Synthes* doctrine. The *Synthes* doctrine held that a controller had a disabling conflict in a company's sale process if it wished to sell the company to obtain liquidity, but only if the desire for liquidity was based on an "exigent need" for "immediate cash," such that the controller could be expected to have been amenable to accepting even a "fire-sale" price for the company. The court has stepped back the *Synthes* doctrine in several cases over the past few years—and in *Goldstein*, appears to have extended that retreat, stating flatly that a controller may have a disabling conflict in a sale process even if the desire for liquidity is based merely on its wanting to "redeploy" its capital to a different investment. Based on *Goldstein*, controllers may now face a heightened risk of being deemed to be conflicted with respect to a sale of the company.

Who Is a Controller? Delaware decisions continue to emphasize that controller status depends on a facts-intensive analysis of all relevant factors. The Court of Chancery has continued to find in some cases that a less-than-majority stockholder (or even a non-stockholder) may have been a *de facto* controller. Notably, in several recent cases, in finding a pleading-stage inference of controller status, the court has focused on allegations that the alleged controller held itself out as having control and/or that others generally viewed it as having control. The court has also mentioned as a relevant factor in several cases that company board meetings were held at the offices of the alleged controller.

Last year's key decisions include *MPM Holdings*, where the court held at the pleading stage that a 41% stockholder may have been a controller (with the company having the "look and feel" of a portfolio company), and *Blue v. Fireman*, where the court held at the pleading stage that a non-stockholder creditor (who had a proxy to vote 83% of the company's voting power) was a controller.

MFW. The Delaware courts have continued to reconfirm broad applicability of the *MFW* framework to transactions involving conflicted controllers (beyond the squeeze-out merger context of the *MFW* decision itself). Last year, in *City Pension Fund v. The Trade Desk*, the Court of Chancery applied *MFW* to a board's adoption of a stockholder-approved charter amendment that extended the sunset of the company's dual-class share structure (which effectively extended the control held by the company's co-founder/CEO/chairman);

© 2023 Thomson Reuters

and, in *Match Group* (*IAC*), applied *MFW* to a multi-step reverse spinoff initiated by the company's controller (who also would control the spun-off company). In both cases, the court found that, notwithstanding flaws in the sale process, the *MFW* prerequisites to business judgment review were satisfied—and the cases were dismissed at the pleading stage. *MFW* also was applied in a traditional conflicted controller M&A context, in *Smart Local v. BridgeBio Pharma* (where the court rejected arguments that a controller's refusal to sell into a competing offer higher than its own affected the special committee such that the *MFW* prerequisites were unsatisfied).

Director Independence. Delaware decisions continue to reflect the significant, negative impacts (particularly in the context of related-party deals) from judicial findings that one or more purportedly independent directors may not have been independent. Continuing themes in these decisions are that the standard is low at the pleading stage (reasonable conceivability) for a finding of non-independence; that director compensation and business and personal ties (in each case unless unusually extensive) are not sufficient to establish non-independence; and that the court's analysis of independence typically will involve a wide-ranging, facts-specific, "holistic" inquiry. Of note, the Court of Chancery, in *Goldstein v. Denner*, suggested that directors appointed by activists or other "short-term" investors who are "repeat players" may inherently be non-independent in a sale process (see the discussion above under "Activists and Other 'Short-Term' Investors"); and, in *BGC Partners*, the court found that an outside director may not have been independent based on his unusually lavish and emotional praise for the company's controller.

Entire Fairness. The Court of Chancery continues to emphasize that it is difficult to satisfy the entire fairness standard (the most onerous standard of review) and that the standard requires a "unitary" analysis as to whether both the price and process were fair. However, in two important cases last year, *Tesla Motors* (*SolarCity*) and *BGC Partners*, the court amplified its recent trend suggesting that fairness of price may be the predominant consideration in an entire fairness analysis. In both of these cases, the court held that the entire fairness standard was satisfied notwithstanding that the sale processes were flawed—indeed, the court stressed that a "perfect" process is neither possible nor necessary to satisfy entire fairness. Also of note, in *Cellular Telephone Partnership*, the court held that entire fairness was not satisfied although the price paid to the minority unitholders was based on a valuation by a major, national valuation firm. Importantly, the firm had been selected by the company's conflicted controller and the court viewed the firm's analysis as seriously flawed.

SPACs. The Court of Chancery's docket has been increasingly occupied with challenges to de-SPAC mergers. With the court's first decision to address fiduciary duties in the context of SPACs, *Amo v. MultiPlan*, the court surprised practitioners by holding that de-SPAC mergers generally will be subject to entire fairness review based on conflicts of interest (between the SPAC's fiduciaries and the public stockholders) that are inherent in the SPAC structure. Practitioners generally had viewed the disclosure to stockholders of such conflicts in the SPAC's prospectus for its initial public offering as sufficient protection in that respect. Moreover, they had viewed the SPAC stockholders' right, under the typical SPAC structure, to redeem their shares (once an acquisition target has been identified and before the de-SPAC closes) as providing SPAC stockholders with strong protection that would significantly mitigate fiduciary duty risk for SPAC sponsors and directors in connection with de-SPACs. Accordingly, they viewed SPAC sponsors and directors as not analogous to controllers and directors in the non-SPAC context where stockholders can be dragged along in a conflicted merger to which they are opposed and who therefore need the protection of entire fairness review.

We note that development of the law in the context of SPACs is in its earliest stages. We expect that the

© 2023 Thomson Reuters

law may well evolve such that entire fairness will be applicable only when the disclosure was inadequate such that the stockholders' redemption right was impaired. In the meantime, based on *MultiPlan*, it appears that many challenges to de-SPACs will not be resolved at the pleading stage; and, given that entire fairness may apply, SPAC sponsors and directors should seek to avoid actions or circumstances that could raise fairness concerns.

Limited Liability Entity Conflicted-Controller Transactions. The Delaware Supreme Court, in an opinion with potentially wide and significant impact, reversed the Court of Chancery's decision in *Boardwalk Pipeline v. Bandera* (*Loews*). The Court of Chancery had awarded damages of almost $700 million to the public unitholders of a master limited partnership based on "opportunistic and manipulative" conduct by the general partner. The Supreme Court did not overturn the lower court's factual findings as to the general partner's conduct generally, but nonetheless held that there had been no breach of the partnership agreement, which disclaimed fiduciary duties of the general partner.

Boardwalk highlights the typically very limited rights of minority investors in alternative entities; and indicates that, even in the context of public investors and findings of serious misconduct by a controller, the court is likely to interpret narrowly any limited rights that are provided for when (as is usual) the parties' agreement generally disclaims fiduciary duties. The decision may broadly affect how provisions permitting conflicted transactions subject to receipt of a legal opinion are drafted and implemented. As the Supreme Court found in this case that the controller acted reasonably in accepting and relying on the opinion based on its having obtained a second opinion (which was not challenged), from a different law firm, as to whether it was reasonable to rely on the first opinion, the decision may lead controllers (and others) who receive opinions that may be potentially problematic in some respect to seek a second opinion as to the reasonableness of accepting and relying on the first opinion. The decision may make it generally more difficult for minority investors to challenge conflicted transactions by controllers of limited liability entities—especially, for example, in the private fund context, where investors typically are more sophisticated and have greater negotiating leverage than the public unitholders involved in *Boardwalk* and thus are likely to be viewed by the courts as entitled to even less protection.

Boardwalk highlights that sponsors of non-corporate entities should seek to ensure that the entity's organizational documents include an effective disclaimer of fiduciary duties and that the absence (or limitation, as the case may be) of fiduciary duties is fully disclosed. Potential investors, depending on their negotiating leverage, may wish to seek to provide specific protections; and should ensure, before they invest, that they fully understand the effects of any waiver or limitation of fiduciary duties.

Proxy Contests. The Court of Chancery, in *Totta v. CCSB Financial,* held that a board's adoption of a new interpretation of a charter provision imposing a stockholder voting limitation was impermissible in the face of a proxy contest, notwithstanding that the charter stated that the board's good faith decisions in interpreting the provision would be "conclusive and binding." The court emphasized that a corporate charter provision cannot foreclose the court from applying equitable principles when reviewing board actions; and more broadly, that, in contrast to agreements governing non-corporate entities, corporate charter provisions cannot displace directors' fiduciary duties. Applying enhanced scrutiny review under *Blasius* in light of the proxy contest context, the court found that adoption and application of the new interpretation was inequitable. The decision echoes other recent Delaware decisions that, in various contexts, have limited the effectiveness of grants of broad interpretive authority to a board.

Caremark. As reinforced in *Caremark* cases over the years, while management should manage corporate risk on a day-to-day basis, it is part of the *board's*

© 2023 Thomson Reuters

mandate to oversee and monitor the key risks the company faces. Risk management should be made a general corporate priority; the board should, or should designate committees to, identify and monitor key risks on an ongoing basis (including new and emerging risks); and the board's oversight and monitoring efforts should be documented (in board minutes, for example, or other corporate records). Under *Caremark* and its progeny, directors will have personal liability for a failure of board oversight only if there is a "sustained or systematic failure. . .—such as an utter failure to attempt to assure a reasonable information and reporting system exists" or "consciously ignor[ing] red flags" that indicated risk vulnerabilities.

Traditionally, *Caremark* claims for failure of board oversight were regularly dismissed at the pleading stage of litigation, with the court commenting consistently that these claims are among the most difficult on which a plaintiff could hope to succeed. In a series of cases starting in 2019, however, plaintiffs were successful in having *Caremark* claims not dismissed at the pleading stage. Plaintiffs' success in this series of cases was driven by particularized complaints made possible by Section 220 books and records investigations; and, importantly, these cases involved alleged factual contexts that were particularly egregious. Last year, however, in both *City of Detroit Police v. Hamrock* (*NiSource*) and *Contr. Indst. Laborers v. Bingle* (*SolarWinds*), and last year in *Sorenson* (*Marriott*), the Court of Chancery dismissed *Caremark* claims at the pleading stage. In *NiSource*, the claims were brought following a fatal explosion, allegedly following a longstanding pattern of non-compliance by the company with relevant regulatory requirements. The court dismissed the claims, notwithstanding an alleged company history of non-compliance with relevant regulatory requirements, on the grounds that the company had specifically charged a board committee with responsibility to address the key risks the company faced—and therefore had not "utterly failed" to establish some system of oversight.

In *SolarWinds* and *Marriott*, the claims were brought following massive public leaking of private information of the company's customers due to cyberhacking of the company's systems. The court dismissed the claims in both cases—notwithstanding its view that cybersecurity was a "mission-critical" risk for the company and that the company's oversight system of that risk as "subpar"—on the grounds that board committees had been charged with overseeing cybersecurity risk. These most recent cases again emphasize that directors generally face a very low risk of personal liability for a failure of oversight so long as the board implemented any (even a flawed) system of oversight for the company's "mission-critical" risks. At the same time, the previous cases serve as a reminder that there is a real risk of liability for a failure of board oversight.

In another notable development, the court, in *Lebanon Cty. Employees' Rtrmt. Fund v. Collis* (*AmerisourceBergen*), in a case of first impression, created an extensive framework for judicial evaluation of a defense in *Caremark* cases that the claims were not timely brought. The court reviewed in detail the challenges in such an evaluation, including how to determine when the claim accrued given allegations that the board ignored red flags of various types and levels of severity over a long period of time. The court held in this case (again, in the context of a particularly egregious alleged factual context) that the claims were timely made and the court rejected dismissal of the case on the basis of nontimeliness. Notably, the court considered the various alleged incidents of ignoring red flags on a "separate accrual" basis, with each giving rise to its own, separate limitations period.

Board Minutes. The Court of Chancery's decisions continue to highlight that negative consequences may flow from silence in board minutes with respect to sale process developments, or from descriptions in board minutes that are inconsistent with the company's public disclosures. The decisions, last year including *Goldstein v. Denner* and *Hightower v. SharpSpring*, underscore that boards should weigh the benefits and disadvantages of preparation of more (rather than less)

© 2023 Thomson Reuters

comprehensive board minutes to establish a record of the care taken by the board. In all cases, boards should carefully compare the company's draft public disclosure to descriptions of the same events in board minutes (and other books and records, potentially including contemporaneous emails) to ensure consistency.

Disclosure. Continuing trends in Delaware disclosure decisions include: (i) a partial swinging back of the pendulum on deference to stockholder-approved transactions—from what had been almost-automatic dismissal of cases under *Corwin* and *MFW*, to now a more intense judicial evaluation of the applicability of these defense tools, in many cases based on whether the disclosure was sufficient for a fully informed vote; (ii) expanded use by plaintiffs of Section 220 books and records investigations to support claims of inadequate disclosure; (iii) amplification of a board's oversight duty with respect to disclosure; (iv) increased targeting of disclosure claims against corporate officers; and (v) judicial acceptance of aiding and abetting liability of buyers for materially flawed target company disclosure.

On the federal securities litigation front, in *Menora v. Frutarom*, the U.S. Court of Appeals for the Second Circuit established a new, bright-line test that limits standing to bring Rule 10b-5 claims to plaintiffs who "bought or sold shares" of the company *about which the alleged misstatements were made*. We note that, as claims for a target's premerger statements about itself generally cannot be brought against the acquiror, investors in an acquiror may now be left without a route to making federal disclosure claims relating to a target's pre-merger misstatements, even when they affected the acquiror's stock price.

Discovery of Emails. The Court of Chancery has continued to grant access, both in Section 220 actions and other litigation, to "informal" board materials, sometimes including directors' and officers' personal emails and other communications, particularly where the formal board materials do not address the subject at issue or the plaintiff has made particularized allegations with respect to the existence of relevant communications. It bears repeated and strong emphasis that emails and other informal communications may be discoverable, are often outcome-determinative of a litigation, and should be drafted and approached with the same care as formal corporate communications. Directors and officers should be advised accordingly when onboarded and then on an ongoing periodic basis. Outside advisors also should be vigilant in seeking to ensure their own appropriate drafting and treatment of emails. The *Twitter v. Musk* litigation discovery rulings last year highlight that the extent (if any) to which the court will grant access to emails will depend on the specific facts and circumstances of the case.

Section 220. Plaintiffs have continued the trend in recent years of obtaining information through Section 220 investigations to enable them to frame more particularized complaints, which has resulted in more cases surviving the pleading stage of litigation than in the past (particularly in the contexts of *Corwin*, *MFW* and *Caremark* cases). The court generally has continued: to permit access under DGCL Section 220 to investigate potential wrongdoing so long as there is any reasonable basis for suspecting it; more frequently to grant access not only to formal board materials but also to informal materials in some circumstances (see "Discovery of Emails" above); and to encourage corporations not to employ overly aggressive litigation strategies in seeking not to produce appropriately requested books and records.

In decisions last year, the court established that reliable hearsay evidence can be used to demonstrate a "proper purpose" for a Section 220 demand (*NVIDIA*); that resolution of inconsistencies in a company's public disclosures is a proper purpose for a Section 220 demand (*Hightower v. SharpSpring*); and that confidentiality of Section 220 documents will not be granted based on generic concerns about competitors' use of the information (*Rivest v. Hauppauge Digital*). Also of note, in a few litigations not brought under Section 220 (*Wei v. Zoox* and *Lordstown*), the court has granted ac-

© 2023 Thomson Reuters

cess to information based on what would have been available in a Section 220 action even though the stockholder-plaintiffs did not have standing to bring a Section 220 action.

Appraisal. Appraisal risk for deals continues to be greatly reduced—with the Court of Chancery regularly relying on deal-price-less-synergies in cases involving arm's-length mergers, even when the sale process was flawed (so long as not seriously flawed). Of note, however, the court, for the first time, in *BCIM v. HFF*, made a significant adjustment to a fair value determination on the basis of changes that occurred in the target company between signing (when the deal price was set) and closing (as of when, under Delaware law, appraised fair value is to be determined). *BCIM* thus suggests that the appraisal risk is potentially higher in deals involving longer periods of time between signing and closing. (We note that the court also made an adjustment for signing-to-closing changes in last year's *Regal Entertainment* decision, but in that case the adjustment was minimal.) Importantly, while the adjustment to fair value in *BCIM* was based on extraordinary outperformance by the target company during the period pending closing, which was expected to endure, changes in financial results not reflecting a change in fundamental, long-term value generally would not lead the court to make an adjustment.

Other notable appraisal decisions were *Ramcell*—which provides a reminder that in appropriate cases the court still may rely on a discounted cash flow ("DCF") analysis to determine appraised fair value (and that, when it does, the result may significantly exceed the deal price); and *Zoox*—in which the court limited the appraisal petitioners' discovery to what they could have obtained under a Section 220 demand (in light of the court's conclusion that their actual purpose in bringing the appraisal action was to investigate possible wrongdoing rather than to obtain an appraisal of their shares, and that they were bringing the appraisal action after they lost Section 220 standing due to the respondent's rushing the closing).

Advance Notice Director Nominations. State-of-the-art advance notice director nomination requirements now require more detailed information from the nominator than in the past. The Court of Chancery's decisions continue to emphasize that a stockholder's nomination notice must comply precisely with the company's advance notice requirements. The court established last year in *Lee Enterprises* that enhanced scrutiny judicial review will apply to a board's decision to reject even a plainly non-compliant nomination notice—but, at the same time, the court indicated that directors should meet that standard so long as they acted reasonably. The decision serves as a reminder that a board must act in good faith and equitably when deciding to reject a nomination notice, even when the notice is noncompliant with the bylaw, is submitted outside a takeover context, and/or involves nominations for a minority of board seats.

Non-Competes. Non-competes in connection with the sale of a business face greater judicial and regulatory scrutiny that in the past. Importantly, the Court of Chancery, in *Kodiak*, and the FTC, in its *ARKO/GPM* action, took the view that non-competes agreed in the context of the sale of a business could extend only so far as protecting the goodwill of the business *that was acquired*, and not the goodwill of the buyer's other businesses. Moreover, the court has indicated a strong reluctance to "blue-pencil" non-competes to make them compliant; and, instead, has invalidated them in whole if overbroad. M&A parties should carefully consider the scope and duration of non-competes (and related nonsolicitation and confidentiality restrictions) in the context of the specific facts and circumstances of the transaction at issue. As illustrated in *Kodiak* and *ARKO*, overbroad restrictions could result in the buyer being left with no such protection at all and/or even (as occurred in *ARKO*) the invalidation of its other, similar, already-existing agreements. Moreover, in the first week of January 2023, the FTC proposed rules that would ban non-compete agreements in connection with employment.

Sandbagging. The Court of Chancery, in *Arwood v.*

© 2023 Thomson Reuters

AW Site Services, clarified that Delaware is ("or should be") a "pro-sandbagging" jurisdiction. In other words, unless the parties provide otherwise in their agreement, a buyer that sandbags a seller is still entitled to indemnification for breach of the seller's representations and warranties.

The court also clarified that the sandbagging doctrine is implicated only if the buyer actually knew of the falsity of representations and warranties (even if a failure to know was based on the buyer's own carelessness). We note that the majority of M&A agreements are silent with respect to sandbagging. Following *Arwood*, a seller wishing to avoid being sandbagged should include an explicit anti-sandbagging provision (stating that the buyer cannot recover indemnification for breaches of representations and warranties to the extent that it knew or should have known that they were not true).

Ordinary Course Covenants. Last year, the Court of Chancery decided the third major case—*Level 4 Yoga v. CorePower Yoga*—in which a buyer claimed that a target's responses to the COVID-19 pandemic, pending closing, constituted a breach of the target's covenant in the merger agreement to operate, pending closing, only in the ordinary course of business. In the earlier two cases, *AB Stable* (2020) and *Snow Phipps* (2021), the court had established that (i) an ordinary course covenant does not permit operation in what would be the ordinary course in light of the occurrence of an extraordinary event (in these cases, the pandemic) pending closing; and (ii) where the covenant to operate in the ordinary course of business is qualified by the phrase "*consistent with past practice*," the court will look only to the operations of the company itself and not to other companies' operations to determine what is ordinary course.

In *AB Stable*, the court found that the target's responses constituted a breach of its covenant and the buyer was not obligated to close; in *Snow Phipps*, the court found that the target's responses did not breach the covenant (as they were *de minimis* and consistent with the company's actions in previous periods of low consumer demand for its products) and the buyer was obligated to close. In *Yoga Level 4*, the court found that the target, which owned and operated yoga studios, did not breach its covenant to operate in the ordinary course consistent with past practice when it closed all of its yoga studios in response to the pandemic. The holding was based on unique features of the buyer-target relationship (as franchisor-franchisee), as well as the unusual structure of the merger agreement (which contained no closing conditions or termination rights).

These decisions underscore that ordinary course covenant breach claims will be determined based on the precise drafting of the covenant and the specific facts and circumstances of the case. We would advise that merger parties consider carefully whether (and how much) flexibility should be built into an ordinary course covenant for a target to respond to extraordinary events that may occur between signing and closing. A target may find reliance on the buyer's obligation not to unreasonably withhold consent to non-ordinary course actions insufficient given the potential that a buyer may later decide (based on the occurrence of an extraordinary event or otherwise) that it does not want to close.

MAEs. The Court of Chancery, in *Yoga Level 4 v. CorePower Yoga*, continued its invariable trend (with the sole exception of its 2018 *Akorn* decision) of finding that an extraordinary event that occurred between signing and closing of a merger agreement (in this case, the COVID-19 pandemic) did not constitute a "material adverse effect" (or "material adverse change") that excused the buyer from closing. Although the parties' definition of "MAE," unusually, did not specify any exclusions (such as for pandemics, natural disasters, or calamities), the court held that the pandemic's impact did not have the "durational significance" required for it to constitute an MAE. The court emphasized that, at the time the buyer sought to terminate the agreement, the parties expected the closure of the company's studios to last only a matter of a few weeks. We would note that merger agreement parties should keep in mind

© 2023 Thomson Reuters

that an MAE is whatever the parties define it as—and there may be circumstances under which a buyer and target would consider it appropriate to specify a lower or different standard than the court otherwise would apply with respect to what level of impact and/or durational significance would be required for an event to constitute an MAE. Also of note, the court stated in *Yoga Level 4* that the "durational significance" component of the MAE analysis was particularly important in this case because the strategic buyer was pursuing the acquisition as part of "a long-term strategy." We would advise that private equity buyers, if they have not drafted an MAE definition to specify a durational significance standard, should argue in a judicial proceeding that the court ought to apply a lower standard than unusual in the context of acquisitions by private equity buyers given their typically shorter investment horizons.

Cyber-Risk in Payment of Merger Consideration. A decision with potentially increasing relevance, *Sorenson Impact Foundation. v. Continental Stock Transfer Trust*, involved cyber-hacking that re-directed payment of merger consideration from certain actual target company stockholders to the hackers. The Court of Chancery held that the buyer may not have fulfilled its obligations to the target stockholders merely by complying with the merger agreement provision requiring it to transfer the merger consideration to the paying agent. At the pleading stage, the court found it reasonably conceivable that the merger agreement could be interpreted to have required that the buyer ensure that the merger consideration was received by the stockholders. The case highlights that M&A transactions present significant opportunities for cyber criminals; and that M&A participants should carefully plan to avoid possible hacking, should be prepared to respond appropriately if hacking occurs, and should consider specifically addressing in their agreements the potential liability issues in the event that hacking (or other improper diversion of merger consideration) occurs.

In addition, a buyer, target and paying agent (as well as legal counsel) all should pay attention to red flags that letters of transmittal may be suspect and should seek to ensure appropriate resolution of any irregularities (including by following precisely any instructions relating thereto in the parties' agreements).

Contract Interpretation. The Court of Chancery continues to see an increase in contract interpretation cases. Drafters of merger and other commercial agreements should keep in mind the court's decisions interpreting commonly used words and phrases—including, last year, its interpretation of "consent to [and] not object to" (*Manti v. Carlyle*); "void" (*XRI Invstmt. v. Holifield*); "subject to" (*ITG Brands v. Reynolds American*); and "and" (*Weinberg v. Waystar*). Also, the court reaffirmed its view that standards of efforts set forth in M&A agreements all indicate essentially the same level of obligations (*Menn v. ConMed*).

Agreements to Agree. The Delaware Supreme Court, reversing the Court of Chancery's decision in *Cox Communications v. T-Mobile US*, held that an agreement to enter into an agreement on terms to be negotiated in the future was binding only in the sense that it required that the parties negotiate in good faith (and did not require that they actually "make a deal"). The decision underscores the need to address clearly and precisely the extent to which a preliminary agreement (or agreement to agree) is intended to be binding or only to commit the parties to negotiate open issues.

© 2023 Thomson Reuters

FROM THE EDITOR

Two Deals Stay on Course (for Now)

As this issue went to press, a U.S. District Court judge declined the Federal Trade Commission's request for a preliminary injunction to block Meta, Facebook's owner, from buying virtual reality software designer Within. While the FTC said it would not appeal, it may still pursue the case with an internal FTC administrative law judge at a later date.

In July 2022, the FTC sued Meta in federal court to temporarily block the deal, then in the following month sued to fully block Meta/Within in its in-house court. The case is considered to be a test of FTC chair Lina Khan's aim to expand antitrust law boundaries to go after perceived monopolistic actions of the tech giants (see also the FTC's attempt to block Microsoft/Activision). To that end, the FTC employed a relatively rare argument that Meta's Within acquisition would hinder future competition in a still-undeveloped market.

Though details of the Meta case were sealed, reportedly Meta argued that its acquisition would create a platform welcome to all virtual reality apps, including those developed independently, and that the acquisition was a small part of its overall strategy to expand its reach in the virtual reality universe.

Also in January, the Washington State Supreme Court declined to review a case brought by the state attorney general seeking to prevent grocery retailer Albertsons from paying shareholders a $4 billion dividend. The case was an early attempt—likely far from the last—by regulators to delay and likely block the process of a proposed $24.6 billion merger between Albertsons and Kroger.

The deal, whose regulatory approval may require the sale or spinoff of hundreds of grocery stores, has been assailed by consumer advocates (who claim the merger could raise prices), unions (which claim it will result in layoffs) and smaller competitors (who claim the mega-grocer will dominate market sectors and have a chilling effect on competition).

If the Albertsons/Kroger deal closes, it will be an exit at long last for the private equity firm Cerberus, which has been trying to cash out its Albertsons holdings for years. A proposed reverse merger with Rite Aid in 2018 failed when Rite Aid's shareholders opposed it; an early 2022 potential purchase of Albertsons by an unnamed grocery store chain also withered on the vine.

Chris O'Leary

Managing Editor

© 2023 Thomson Reuters

EDITORIAL BOARD

CHAIRMAN:

PAUL T. SCHNELL
Skadden, Arps, Slate, Meagher & Flom LLP
New York, NY

MANAGING EDITOR:

CHRIS O'LEARY

BOARD OF EDITORS:

SCOTT A. BARSHAY
Paul, Weiss, Rifkind, Wharton & Garrison LLP
New York, NY

BERNARD S. BLACK
Northwestern University School of Law
Evanston, IL

DENNIS J. BLOCK
Greenberg Traurig
New York, NY

ANDREW E. BOGEN
Gibson, Dunn & Crutcher LLP
Los Angeles, CA

GEORGE A. CASEY
Shearman & Sterling LLP
New York, NY

H. RODGIN COHEN
Sullivan & Cromwell
New York, NY

CATHERINE J. DARGAN
Covington & Burling LLP
Washington, DC

STEPHEN I. GLOVER
Gibson, Dunn & Crutcher LLP
Washington, DC

EDWARD D. HERLIHY
Wachtell, Lipton, Rosen & Katz
New York, NY

PETER D. LYONS
Freshfields Bruckhaus Deringer LLP
New York, NY

DIDIER MARTIN
Bredin Prat
Paris, France

FRANCISCO ANTUNES MACIEL MUSSNICH
Barbosa, Mussnich & Aragão Advogados,
Rio de Janeiro, Brasil

MARIO A. PONCE
Simpson Thacher & Bartlett LLP
New York, NY

PHILLIP A. PROGER
Jones Day
Washington, DC

PHILIP RICHTER
Fried Frank Harris Shriver & Jacobson
New York, NY

MICHAEL S. RINGLER
Skadden, Arps, Slate, Meagher & Flom LLP
Palo Alto, CA

EVAN ROSEN
Davis Polk & Wardwell LLP
New York, NY

JEFFREY J. ROSEN
Debevoise & Plimpton LLP
New York, NY

FAIZA J. SAEED
Cravath, Swaine & Moore LLP
New York, NY

PAUL SHIM
Cleary Gottlieb Steen & Hamilton LLP
New York, NY

ECKART WILCKE
Hogan Lovells
Frankfurt, Germany

GREGORY P. WILLIAMS
Richards, Layton & Finger
Wilmington, DE

© 2023 Thomson Reuters