

Pre-Closing Covenants: Operating in the Ordinary Course of Business

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Introduction

“A company can seize extra-ordinary opportunities only if it is very good at the ordinary operations.”
 — Marcel Telles

In casual conversation, we often toss around the phrase “in the ordinary course of business” as if we generally know what that phrase means. As the quote cited above highlights and past litigation has shown, operations that one person views as extraordinary may be viewed by another as merely “ordinary course.” In the context of an M&A transaction, this debate can have very serious consequences for the parties involved.

This note summarizes (i) the salient features of a customary covenant by the target to conduct its business in the ordinary course of business (an “ordinary course covenant”) during the period between signing and closing (such interim period, the “pre-closing period”) in merger agreements and other acquisition agreements, such as asset or stock purchase agreements (“acquisition agreements”) that are structured so that the closing of the transaction is deferred; and (ii) the effect of certain Delaware court decisions on the drafting and interpretation of such ordinary course covenants.

This note also examines market trends concerning the use of ordinary course covenants in acquisition agreements, as reported in the American Bar Association’s 2019 Private Deal Point Study (the “ABA Study”).

Background

Acquisition agreements that contemplate pre-closing periods usually include a covenant made by the target company that it will conduct its business in the ordinary course of business during the pre-closing period.

The purpose of this ordinary course covenant is to help ensure that the buyer receives the business in substantially the same condition as it was in when the acquisition agreement was entered into by the parties (which, presumably, was when due diligence was completed by the buyer and it calculated the final value of the target business).

Table of Contents

- Pre-Closing Covenants: Operating in the Ordinary Course of Business 1
- CFIUS 2020: Five Things to Know about Filings and CFIUS Risk 5
- FTC Targets M&A Agreements in Continued Campaign Against Noncompete and No-Poach Clauses 6
- Delaware Supreme Court Examines Director Liability for Acquisitions 9
- FTC and DOJ Announce New Draft Vertical Merger Guidelines 11

Such a covenant is also intended to disincentivize the target's owners and management from engaging in opportunistic or self-serving conduct during the pre-closing period given that the assets of the business may no longer be owned by those parties once the closing occurs.

The most important remedy associated with the breach of an ordinary course covenant often resides in the closing conditions and termination sections of an acquisition agreement. In deferred closing acquisitions, a common condition to closing is that all pre-closing covenants, including any ordinary course covenant, are performed and complied with by the target in all material respects prior to or as of the closing (the "covenant compliance condition").

A failure by the target to satisfy the covenant compliance condition gives the buyer a right to refuse to close the transaction or terminate the acquisition agreement if that option, subject to any cure rights of the target, is provided for in the termination section of the acquisition agreement. As a result, if the target fails to conduct its business in the ordinary course in all material respects during the pre-closing period, the buyer, to the extent that it is aware of such conduct, has the right to walk away from the deal prior to the scheduled closing.¹

Common Features of an Ordinary Course Covenant

Generally. An example of a standard ordinary course covenant found in an acquisition agreement is set forth below:

"From the date hereof until the Closing, [except as otherwise provided in this Agreement] or consented to in writing by Buyer (which consent shall not be unreasonably withheld or delayed),² Seller [and each of its [Significant] Subsidiaries] shall [use best efforts/reasonable efforts/commercially reasonable efforts to] conduct the Business [in all material respects] in the ordinary course of business [consistent with past practice]."

This affirmative covenant is nearly universal in acquisition agreements and is not typically controversial or extensively negotiated by the parties. According to the acquisition agreements reviewed in the ABA Study for the period of 2018–2019, such agreements included covenants to operate in the ordinary course 97% of the time.

To make compliance with such a covenant less burdensome, however, the target may push back on the scope of the covenant by carving out insignificant subsidiaries from its application or insisting that it apply to the target and its subsidiaries as a whole rather than on an individual basis. Further, there are certain features of this ubiquitous covenant that may be subject to dispute or create a trap for an unwary drafter, such as the clauses bracketed in the sample language above, each of which is discussed in turn below.

"Consistent with Past Practice" Standard. The requirement that the target conduct its business in the ordinary course of business may be qualified by the statement that such conduct is "consistent with past practice" of the target. Recently, the Delaware Court of Chancery issued an opinion in *Akorn, Inc. v. Fresenius Kabi AG*, C.A. No. 2018-0300- JTL, that is relevant to this type of qualifying language.

The Chancery Court found that Akorn, the target company in the dispute, breached its covenant to use commercially reasonable efforts to carry on its business in all material respects in the ordinary course of business, thereby enabling Fresenius to terminate the parties' acquisition agreement due to a failure of the covenant compliance condition. The acquisition agreement at issue did not require that Akorn's conduct be consistent with its past practice or otherwise define what conduct would constitute the "ordinary course of business."

¹ Although the following issue is outside of the scope of this article and therefore will not be addressed in more detail, if the buyer elects to close the transaction notwithstanding its knowledge of the target's breach of the ordinary course covenant, the buyer's potential post-closing remedies available to it under the acquisition agreement depend upon several factors.

These include, without limitation, any permissible updates to the disclosure schedules made by the target prior to the closing, any negotiated carve-out to the target's bring-down certificate for the breach of the ordinary course covenant, and the survival period of pre-closing covenants for purposes of indemnification.

² The ABA Study indicates that buyers were precluded from unreasonably withholding their consent in 57% of acquisition agreements reviewed in 2019, while 43% of agreements permitted the buyer to do so.

When making its finding, the Chancery Court used an objective standard and compared Akorn's conduct during the pre-closing period to the operations of other specialty generic drug companies in the industry, rather than to Akorn's own conduct prior to the pre-closing period. It is unsurprising that the Chancery Court used an objective standard in the absence of language in the acquisition agreement requiring that the target's conduct in the ordinary course be consistent with its own past practice.

If the qualifier had been present, and Akorn was able to demonstrate that its conduct (although problematic from an industry perspective), was consistent with its own past practice, the court may have found that Fresenius was not justified in terminating the acquisition agreement for failure of the covenant compliance condition.

A takeaway from the Akorn case is that if a target company operates in a manner that is inconsistent with or below reasonable industry standards and the ordinary course covenant is not qualified by "consistent with past practice," the target could be deemed in violation of the ordinary course covenant (even if such operation was consistent with its own past practice).

Unlike other features of the ordinary course covenant that are either target-favorable or buyer-favorable, the benefit of a past practice standard is largely dependent on the circumstances of the transaction and the interests of each party. If the target engaged in what may be viewed as unusual conduct in the past relative to peer companies in its industry, then using a past practice standard may provide the target with more latitude to operate without running afoul of the ordinary course covenant and triggering a termination right of the buyer.

On the other hand, if the target is interested in engaging in conduct that it did not typically perform prior to the signing date of the acquisition agreement (because, for example, its business is changing rapidly or it is experiencing problems that it never dealt with in the past), then the more vague standard of operating in the ordinary course of business without qualification may be preferable.

If the buyer has acquired a strong understanding of the target's historical operations and is comfortable with this operating behavior, then a consistent with past practice standard may provide the buyer with more certainty than an objective industry-wide standard. The results of the ABA Study for the period of 2018–2019 seems to bear this out as 85% of acquisition agreements reviewed included this qualifying language.

Materiality Qualifier. Like other representations, warranties and covenants in an acquisition agreement, ordinary course covenants may be subject to materiality qualifiers, such as 'the [target] shall conduct its business in the ordinary course of business "in all material respects."' Given that the covenant compliance condition requiring that all pre-closing covenants are performed and complied with by the target is also qualified by materiality, the provisions, when read together, could lead to an unfortunate situation for a buyer in which there is a double-materiality qualifier with respect to the closing condition.

Buyers should be vigilant concerning this issue and, if necessary, confirm that any "materiality scrape" provision in the covenant compliance condition applies to any materiality qualifier contained in the ordinary course covenant. The ABA Study did not include data on the use of materiality qualifiers in ordinary course covenants until the 2019 version, which indicated that only 4 of 117 acquisition agreements reviewed were qualified by "in all material respects." As one would suspect, materiality qualifiers are infrequently used in ordinary course covenants given that a typical covenant compliance condition is already qualified by materiality.

Efforts Clause. Parties to an acquisition agreement can use "efforts" clauses to qualify one party's absolute obligation to perform a specified act. An absolute obligation to operate in the ordinary course may be inappropriate when events or third-party actions outside of the target's control interfere with its ability to perform the covenant.

Typically, operating the business in the ordinary course would seem to be an activity that falls squarely within the control of the target and its management, but one could certainly envision scenarios in which specific events or third parties' actions hinder or prevent the target from operating in the ordinary course. A buyer might argue that a target can reasonably be tasked with an absolute requirement to take its own actions in the ordinary course, but the determination of when a target's actions comply with such a position may be difficult to prove in practice.

A variety of “efforts” terms are used in acquisition agreements, with three commonly used terms being “best efforts,” “reasonable efforts” and “commercially reasonable efforts.” Practitioners and other parties may believe that there is a hierarchy among these terms concerning the amount of effort involved, but courts have not necessarily taken this view.

In particular, the Court of Chancery in *Akorn* noted that case law in Delaware has interpreted “commercially reasonable,” “reasonable best” and “best” similarly.³ The Court of Chancery held that these different standards simply required Akorn to “take all reasonable steps” to maintain operations in the ordinary course of business.⁴ The Akorn court referred to the Delaware Supreme Court’s decision in *Williams Cos. v. Energy Transfer Equity, L.P.*, 159 A.3d 264 (Del. 2017), as precedent for not substantially distinguishing between the different types of efforts clauses and instead employing the “all reasonable steps” standard. Also, the Delaware Chancery Court in *Cooper Tire & Rubber Company v. Apollo (Mauritius) Holdings Pvt. Ltd.*, 2014 WL 5654305 (Del. Ch. Oct. 31, 2014), seemed to partially rely on the fact that the ordinary course covenant at issue was unqualified by an efforts clause when it ruled that Cooper breached an ordinary course covenant.

With the above considerations in mind, the primary importance of an efforts clause in an ordinary course covenant seems to be its inclusion at all rather than the type of standard selected by the parties. Even without including an efforts clause, it seems that some implicit limitations based upon notions of reasonableness, practicality and feasibility would be implemented by a Delaware court (absent express language in the acquisition agreement to the contrary) when determining whether or not a target complied with an ordinary course covenant. Perhaps that is why the number of acquisition agreements that are qualified by some type of efforts standard reviewed in the ABA Study for the period of 2018–2019 remains relatively low at 19%.

“Except as otherwise provided in this Agreement.” A final drafting point to consider when negotiating an ordinary course covenant is how the inclusion of the phrase “except as otherwise provided in this Agreement” within the covenant may cause other provisions in an acquisition agreement to interact with the covenant, inadvertently or otherwise.

For example, in *Cooper Tire*, Cooper, as target, argued that the parties expressly agreed, as set forth in the definition of “material adverse effect,” that effects resulting from certain events were carved-out from the material adverse effect’s application (thereby shifting the risk of such effects and events to the buyer) and, by virtue of the inclusion of the phrase “except as otherwise provided in this Agreement” in the ordinary course covenant, such carve-outs also applied to the ordinary course covenant.

Otherwise, Cooper argued, the same actions by Cooper that would not constitute a material adverse effect would constitute a violation of the ordinary course covenant (and thereby lead to an illogical result in which the same remedy of termination would be available to the buyer as if a material adverse effect had occurred).

However, the court disagreed, pointing to the portion of the definition of material adverse effect that deemed events “that would reasonably be expected to prevent or materially delay or impair the ability of [Cooper] to perform its obligations under this Agreement or to consummate the Transaction” to also constitute a material adverse effect (commonly referred to as an “impairments clause”).⁵

Because this impairments clause was not subject to the carve-outs applicable to the rest of the definition of material adverse effect, “the logical operation of the . . . definition of Material Adverse Effect [on the ordinary course covenant] shifts the risk of any carve out event to [buyer], unless that event prevented Cooper from complying with its obligations under the [acquisition agreement, including the ordinary course covenant]; [in which case], the parties agreed not to excuse Cooper for any such breach.”⁶

Cooper could not comply with its obligations under the ordinary course covenant of the acquisition agreement, so its breach could not be excused. According to the ABA Study, 47% of the acquisition agreements reviewed in 2018–2019 included a carve-out for “as provided in the agreement,” while only 18% of the acquisition agreements contained no carve-outs at all.

³ *Akorn*, C.A. No. 2018-0300-JTL at 214-215.

⁴ *Id.* at 215.

⁵ *Cooper Tire*, WL 5654305 at 19.

⁶ *Id.*

In light of the *Cooper* decision, buyers should focus on the impairments clause in the definition of material adverse effect to confirm that the standard carve-outs to such definition do not apply to the impairments clause (and by virtue thereof, to the ordinary course covenant), and more importantly, to the covenant compliance condition. Other provisions, such as force majeure, should also be carefully scrutinized given the drastic consequences to the parties if a court reads an implicit exception into the ordinary course covenant. Reciprocally, targets should try to include the carve-outs described above in the impairments clause and, as a result, to the ordinary course covenant and covenant compliance condition, to the extent applicable.

Takeaways

Carefully consider the target entities that are subject to the ordinary course covenant (e.g., significant subsidiaries or affiliates) and whether or not to use a past practice standard, a materiality qualifier or an efforts clause.

With respect to the use of a past practice standard, consider the circumstances of the parties and whether an objective or target-specific standard would be more beneficial.

Buyers should push back on any materiality qualifier in an ordinary course covenant or, at a minimum, include a materiality scrape provision in the covenant compliance condition to avoid any unintended double-materiality qualifications.

The importance of an efforts clause in an ordinary course covenant seems to be its inclusion rather than the type of standard selected by the parties. If the parties do not intend that “any reasonableness” requirement be read into the chosen standard, then such expectation should be stated explicitly in the acquisition agreement.

Consider how other provisions in the acquisition agreement interact with the ordinary course covenant. For example, do the carve-outs to the definition of material adverse effect inadvertently create additional exceptions to the requirement that the target operate its business in the ordinary course? A target should consider the use of other carve-outs to the requirement that it operate in the ordinary course, if applicable.

CFIUS 2020: Five Things to Know About Filings and CFIUS Risk

By Joshua Gruenspecht and Stephen Heifetz, Partners, and Melissa Mannino, Of Counsel, of Wilson Sonsini Goodrich & Rosati

On February 13, 2020, new rules went into effect at the Committee on Foreign Investment in the U.S. (CFIUS); investors and businesses should know the following about those rules:

1. For any investment (even a small minority investment) or acquisition by a “foreign person” involving, directly or indirectly, a “U.S. business,” parties should understand CFIUS considerations as early as possible.
 - A U.S. business is any business—foreign or domestic—that maintains U.S. operations.
 - A foreign person is any foreign individual, foreign entity, or foreign government, and anyone controlled by a foreign person; this may include a U.S. fund if its GPs or LPs are foreign and have certain rights.
2. Control transactions and certain investments into “TID businesses” create CFIUS risk that often should be addressed with risk allocation language and, sometimes, by making a filing to CFIUS.
 - A TID business is a U.S. business involved with:
 - Critical **T**echnologies (defined by reference to many U.S. government lists); or
 - Critical **I**nfrastructure (defined by reference to many U.S. government lists); or
 - Sensitive personal **D**ata (most genetic testing data; also several other kinds of data if the business either markets to the U.S. government or has or intends to have records on 1M+ individuals).

- Foreign investment in a TID business implicates CFIUS if any of these “triggering rights” are present:
 - A board or observer seat, or nomination rights; or
 - Access to material non-public technical information; or
 - Involvement in decision-making regarding sensitive aspects of company operations.
 - “Control” may be found if there is a 10%+ voting stake or significant veto authority over any U.S. business.
 - If no foreign person gets control or triggering rights, then CFIUS should not be implicated.
3. CFIUS risk will be exacerbated, and filing may be required, if the U.S. business is involved with critical technologies or a foreign government has a substantial interest in the investor.
 - Critical technology businesses are a subset of TID businesses; critical technologies are defined by reference to U.S. government lists, primarily export controls.
 - Foreign government “substantial interest” exists if the investor will acquire a 25% or greater stake (direct or indirect) in a TID business and the foreign government has a 49% or greater stake (direct or indirect) in the investor (or, in the case of a fund, a 49% stake in the GP or equivalent).
 4. Because CFIUS may review any transaction over which it has jurisdiction (*i.e.*, any control transaction and any investment with a triggering right in a TID business), mandatory filing factors are not the only ones that can exacerbate CFIUS risk.
 - CFIUS rules fulfill a legislative mandate to review investments in TID businesses more carefully; investments into such businesses now present higher risk.
 - CFIUS risk also can be exacerbated by, *e.g.*, other sensitive activities of a U.S. business, whether or not categorized as a TID business, or an investor linked to a country of concern to CFIUS.
 5. Filing with CFIUS might be sensible in order to obtain a safe harbor against post-closing adverse action by CFIUS, even when mandatory filing factors are not present.
 - Recent public CFIUS-compelled divestitures have occurred in un-filed cases where sensitive issues caused CFIUS to intervene; cases involving penalties for failure to make a mandatory filing have not yet emerged.
 - For transactions not subject to mandatory filing requirements, CFIUS enforcement practices will be a significant factor guiding assessments of risks from not making a filing; these enforcement practices may take months or years to ascertain.

FTC Targets M&A Agreements in Continued Campaign Against Noncompete and No-Poach Clauses

By James W. Lowe, Partner, and Amanda Norton, Associate, of Sidley Austin LLP

In the span of five months, the U.S. Federal Trade Commission (FTC) brought two cases alleging that noncompete and no-poach clauses contained in acquisition agreements violated antitrust laws. In September 2019, the FTC filed a complaint challenging an allegedly unreasonable noncompete clause in an underlying acquisition agreement,¹ and in January 2020, the FTC filed a complaint alleging that two merging parties substantially lessened competition by entering into a series of unlawful noncompetes and no-poach agreements pursuant to the parties’ underlying transactions.²

¹ Complaint, In the Matter of NEXUS Gas Transmission LLC, et al., FTC File No. 191-0068 (Sept. 13, 2019), available at <https://www.ftc.gov> (hereinafter Nexus/Generation Pipeline Complnt.). The FTC ultimately settled with the parties and allowed the underlying transaction to proceed, subject to the removal of the noncompete clause and certain other conditions. See Decision, In the Matter of NEXUS Gas Transmission LLC, et al., FTC File No. 191-0068 (Dec. 13, 2019), available at <https://www.ftc.gov>.

² Complaint, In the Matter of Axon Enterprise, Inc. and Safariland, LLC, FTC File No. 181-0162 (Jan. 3, 2020), available at https://www.ftc.gov/system/files/documents/cases/d09389_administrative_part_iii_public_redacted.pdf (hereinafter Axon/Safariland Complnt.). The FTC’s complaint also challenges the consummated acquisition itself. The matter remains pending.

These complaints follow modifications to reporting instructions under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (HSR Act) that now require filers to submit to the antitrust agencies all noncompete agreements between the parties when notifying a reportable transaction.³

Viewed along with the changed HSR Act reporting obligations, the FTC's recent challenges⁴ show that acquisition agreements have become increasingly fertile grounds for antitrust authorities to focus their broader efforts⁵ against unreasonable noncompete, no-poach and similar agreements.

Noncompete, No-Poach and Nonsolicitation Agreements in the Transaction Context: What Are They, and When Are They a No-No?

Noncompete, no-poach and nonsolicitation agreements can arise under a variety of circumstances, but one of the most frequent backdrops for these agreements is corporate transactions. In transaction documents, these agreements often take the form of either a clause in an underlying acquisition agreement or a standalone agreement that is ancillary to the main transaction agreement.

A noncompete typically restricts the seller's ability to compete with the purchaser⁶ in a defined economic activity for a set period of time after closing.⁷ A no-poach or nonsolicitation agreement, by contrast, typically restricts one party's ability to hire or solicit certain employees of its counterparty.

Though these agreements can serve to protect legitimate business interests, they also can serve as restraints on the ability of the restricted party to compete in the market for either certain products or services (in the case of a noncompete) or employees (in the case of a no-poach or nonsolicitation agreement). Accordingly, they are subject to antitrust scrutiny.

Antitrust authorities and courts recognize that many such agreements are lawful when they are reasonably ancillary or necessary to achieve an otherwise legitimate business interest such as a merger, joint venture or other collaboration. But it falls to the parties to the agreement to show that (i) their interest is legitimate, (ii) the restrictive provision is sufficiently ancillary to achieve it and (iii) the provision is narrowly tailored in duration and geographic scope to be successful. The FTC's recent complaints provide guidance as to what authorities view as acceptable noncompete and no-poach agreements in the context of a transaction.

³ Bruce Hoffman, "All" means All: Submit side agreements with an HSR filing, Competition Matters Blog (Dec. 20, 2017 3:08 PM), <https://www.ftc.gov/news-events/blogs/competition-matters/2017/12/all-means-all-submit-side-agreements-hsr-filing>; see also Premerger Notification; Reporting and Waiting Period Requirements, 81 Fed. Reg. 60258 (Sept. 1, 2016).

⁴ The FTC has challenged noncompete agreements pursuant to transactions in the past. See, e.g., Complaint, In the Matter of Oltrin Solutions, LLC; JCI Jones Chemicals, Inc.; Olin Corp.; and Trinity Manufacturing, Inc., FTC File No. 111-0078 (Mar. 7, 2013), available at <https://www.ftc.gov/sites/default/files/documents/cases/2013/03/130308oltrincmpt.pdf>.

⁵ For several years, the Department of Justice (DOJ) has been making headlines in its pursuit of illegal no-poach agreements, which are agreements between or among employers not to compete for talent or employees. The DOJ has made clear that naked no-poach agreements may be considered per se illegal and subject to criminal prosecution. See, e.g., United States v. Knorr-Bremse AG, No. 1:18-cv00747-CKK, 2018 U.S. Dist. LEXIS 142125 (D.D.C. July 11, 2018) (DOJ challenged naked no-poach agreements as per se illegal in a civil action); Statement of Interest of the United States of America, Seaman v. Duke Univ., No. 1:15-CV-462 (M.D.N.C. Mar. 7, 2019) (No. 325) (DOJ intervened in private litigation to reiterate its position that naked no-poach agreements are per se illegal); Barry Nigro, Deputy Assistant Att'y Gen., Antitrust Div., U.S. Dep't of Justice, Keynote Remarks at the ABA's Antitrust in Healthcare Conference: A Prescription for Competition (May 17, 2018) ("We are investigating other potential criminal antitrust violations in this industry, including . . . no-poach agreements restricting competition for employees. We believe it is important that we use our criminal enforcement authority to police th[is] market[.]."), www.justice.gov/opa/speech/deputy-assistantattorney-general-barry-nigro-delivers-keynote-remarks-american-bar.

The FTC recently held a daylong workshop evaluating the effects of noncompete clauses on labor market participants and examining whether the FTC should address potential harm caused by these clauses through its rulemaking, law enforcement or advocacy authority. See Non-Competes in the Workplace: Examining Antitrust and Consumer Protection Issues (Jan. 9, 2020), <https://www.ftc.gov/news-events/events-calendar/non-competes-workplace-examining-antitrust-consumer-protectionissues>. It is likely the FTC will release a report on the workshop later this year.

At the state level, authorities have been targeting illegal no-poach agreements between franchisors and franchisees. See, e.g., Settlement Agreement Between the States of Massachusetts, California, Illinois, Iowa, Maryland, Minnesota, New Jersey, New York, North Carolina, Oregon, and Pennsylvania and Arby's Restaurant Group, Inc. In addition, Attorneys General in at least two states have stated that under certain circumstances, no-poach agreements can be per se unlawful. See Complaint for Civil Penalties, Injunction, & Other Relief Under the Washington State Consumer Protection Act, RCW 19.86, State v. Jersey Mike's Franchise Sys., Inc., No. 18-2-25822-7-SEA at ¶¶ 65-66 (King Cty. Super. Ct. Oct. 18, 2018) (Washington Attorney General); Max Fillion & Joshua Sisco, Franchise No-Poach Agreements Likely per se Antitrust Violations in California, State Official Says, MLEX (Mar. 28, 2019) (California Attorney General).

⁶ In limited instances, the purchaser may be prohibited from competing with the seller if the seller continues to operate other lines of business that are not being sold as part of the transaction.

⁷ Noncompetes can also arise pursuant to agreements between a manufacturer and distributor, licensor and licensee, or among parties to a joint venture. See, e.g., *Polk Bros., Inc. v. Forest City Enters., Inc.*, 776 F.2d 185 (7th Cir. 1985). These noncompetes are also subject to antitrust scrutiny, but this note does not address their treatment in detail.

Recent FTC Challenges to Noncompete and No-Poach Clauses in Acquisition Agreements

In September 2019, the FTC filed a complaint alleging that the acquisition of Generation Pipeline LLC (Generation Pipeline) by NEXUS Gas Transmission LLC (Nexus) would harm competition due to a noncompete clause that the parties included in their underlying acquisition agreement.⁸

The noncompete clause restricted North Coast Gas Transmission LLC (NCGT), one of the minority owners of Generation Pipeline, from competing with Nexus to provide natural gas transportation services within a restricted area encompassing three Ohio counties for three years following closing.⁹ According to the complaint, Generation Pipeline and NCGT were two of few competitive options for certain customers within the restricted area, and the noncompete would eliminate that competition.¹⁰

On January 3, 2020, the FTC filed an administrative complaint challenging the consummated acquisition of VieVu, LLC (VieVu), by Axon Enterprise, Inc. (Axon),¹¹ as well as certain noncompete clauses contained within the parties' transaction documents. In connection with their transaction, the parties entered into a series of noncompete, customer nonsolicitation and employee nonsolicitation agreements.

The noncompetes included provisions that prohibited VieVu's owner, Safariland, LLC (Safariland), from competing (i) for various products and services that Axon supplies, some of which the FTC alleged to have no relation to the business being sold as part of the transaction, and (ii) for Axon's customers.¹² In addition, Axon and Safariland agreed not to hire or solicit each other's employees.¹³ These agreements each lasted 10 or more years and, in some cases, were worldwide in scope.¹⁴

In both of these complaints, the FTC cast similar allegations to characterize the illegal aspects of the noncompete clauses:¹⁵

- The noncompetes were “not reasonably limited in scope to protect a legitimate business interest,” and “[a] mere general desire to be free from competition is not a legitimate business interest.”
- The noncompetes did not protect “any intellectual property, goodwill, or customer relationship necessary to protect” the purchaser's investment.
- Even if a legitimate interest existed, in Nexus/Generation Pipeline, the geographic scope of the noncompete was “broader than reasonably necessary” because “it prevent[ed] NCGT from competing for any opportunity in the restricted area, even for opportunities that were unforeseen at the time of the Transaction,” and, in Axon/Safariland, the noncompetes, all of which were 10 or more years, were “longer than reasonably necessary.”¹⁶

Notably, in both matters, the clauses at issue were ancillary to underlying business transactions. According to the FTC, however, they were not reasonably related to protecting the acquirer's investment. In Nexus/Generation Pipeline, the FTC alleged that the noncompete affected the operations of a pipeline that was not related to the pipeline being sold in the underlying transaction aside from the fact that its owner held a minority stake in the entity that was purchased.¹⁷

In Axon/Safariland, the FTC alleged that the noncompetes extended to products that were unrelated to the products involved in the underlying transaction and products that the seller had not yet developed.¹⁸ Additionally, the clauses at issue in both matters contained limitations on their duration and geographic

⁸ See Nexus/Generation Pipeline Complt. at ¶ 14.

⁹ See *Id.* at ¶ 7.

¹⁰ See *Id.* at ¶ 12.

¹¹ The FTC alleged that the merger reduced competition in the sale of body-worn cameras used primarily by law enforcement and the military. See Axon/Safariland Complt. at ¶ 2.

¹² See Axon/Safariland Complt. at ¶¶ 44-48.

¹³ See *Id.* at ¶¶ 49-51.

¹⁴ See *Id.* at ¶¶ 44-51.

¹⁵ Future references to noncompetes also encompass the no-poach and nonsolicitation clauses in the Axon/Safariland complaint.

¹⁶ Compare Axon/Safariland Complt. at ¶ 53 with Nexus/Generation Pipeline Complt. at ¶ 15.

¹⁷ See Nexus/Generation Pipeline Complt. at ¶ 6.

¹⁸ See Axon/Safariland Complt. at ¶¶ 12, 44, 46.

scope, but the FTC reviewed those limitations in light of market conditions and determined they were broader than reasonably necessary.

No bright-line rules emerge from these enforcement actions regarding noncompetes in the context of transaction documents. To the contrary, they indicate that agency assessment of these provisions in acquisition agreements is both thorough and highly fact-specific.

Practice Tips

Companies considering the use of a noncompete, no-poach or clause with similar effect—whether in connection with a transaction or otherwise—should consult with antitrust counsel to ensure the clause is consistent with both federal and state antitrust laws. Acceptable clauses will be closely related to the purpose of the underlying acquisition agreement and limited in scope and duration.

To arrive at a clause that is reasonable, companies should consider why they need the contemplated protection and how they can tailor the clause to achieve that end. Companies should be prepared to justify to authorities both the rationale for the agreement itself as well as its duration and scope. In addition, their contemporaneous business records should reflect those motivations because, as evidenced by the FTC's recent challenges in this area, the specific facts and circumstances surrounding these clauses will be the ultimate arbiters of enforceability.

Delaware Supreme Court Examines Director Liability for Acquisitions

By Steve Quinlivan, Partner of Stinson LLP

In *McElrath v. Kalanick et al*, No. 181, 2019 (Del. Jan. 13, 2020), the Delaware Supreme Court examined the liability of directors of Uber for an acquisition. The case arose out of Uber's acquisition of Ottomotto LLC. Otto was founded by Anthony Levandowski, a former employee of "Waymo."

Waymo is a subsidiary of Google, and is engaged in developing selfdriving technology. Uber sought to jumpstart its own efforts to develop self-driving vehicles by acquiring Otto. Uber executives began efforts to recruit Levandowski in June 2015, when he still worked for Google.

During the "recruitment period," Travis Kalanick, Uber's founder, personally exchanged text messages with Levandowski. Levandowski left Google and hired over a dozen former Google employees at Otto. Weeks later, Uber and Otto signed a term sheet for Uber to acquire Otto.

After signing the term sheet, Uber and its outside counsel hired Stroz Friedberg, LLC, a computer forensic investigation firm, to conduct an independent investigation into whether Otto employees took with them Google's proprietary information or might breach nonsolicitation, noncompete or fiduciary obligations if they moved from Google to Otto.

The merger agreement included unusual indemnification provisions. For instance, Otto would not indemnify Uber post-closing for Otto's breaches of representations and warranties. Also, certain Otto employees, including Levandowski, would have limited indemnification rights for pre-signing misconduct disclosed during the Stroz investigation, but not for undisclosed pre-signing or any post-signing misconduct.

The Derivative Claim

After Uber acquired Otto, a Google employee noticed that Otto was using what appeared to be Google technology. Google sued Otto and Uber for intellectual property infringement, and Uber ultimately settled

for \$245 million. The plaintiff commenced litigation, purportedly on behalf of Uber, against Kalanick, the directors who approved the transaction, and others, and sought damages arising from the Otto acquisition. The defendants challenged the plaintiff's failure to first make a demand on the board of directors before pursuing litigation on Uber's behalf. This required the Court to examine whether a majority of the board was disinterested because it had no real threat of personal liability due to Uber's exculpatory charter provision. Given the protection from due care violations because of the exculpatory charter provision, the plaintiff must plead with particularity that the directors "acted with scienter, meaning 'they had actual or constructive knowledge that their conduct was legally improper.'"

In other words, directors are liable for "subjective bad faith" when their conduct is motivated "by an actual intent to do harm," or when there is an "intentional dereliction of duty, a conscious disregard for one's responsibilities." According to the Court, pleading bad faith is a difficult task and requires "that a director acted inconsistent with his fiduciary duties and, most importantly, that the director knew he was so acting." Gross negligence, without more, is insufficient to get out from under an exculpated breach of the duty of care.

Plaintiff's Allegations of Bad Faith

First, the plaintiff argued that, because Kalanick as CEO was the one who brought the transaction to the board and was involved with diligence, the directors should have been wise enough not to rely on someone with a reputation as a law breaker. As an example, the plaintiff pointed to one of Kalanick's prior businesses, Scour, which offered music and film releases. Scour was eventually shut down for copyright violations and sued for \$250 billion.

Second, the plaintiff argued that the allegedly unusual indemnification clauses in the merger agreement put the board on notice that Kalanick wanted to steal Google's proprietary information. The agreement indemnified certain Otto employees for pre-signing misconduct disclosed during the Stroz investigation, but prevented Uber from seeking indemnification from Levandowski for violating noncompete and infringement claims.

And, as the plaintiff alleged, Uber hired Stroz to investigate whether Otto employees stole Google's intellectual property, but the board approved the transaction without personally reviewing the preliminary or final Stroz reports. The plaintiff argued that, viewed holistically, these facts entitle him to a reasonable inference that the board's failure to inquire or inform themselves about the scope of potential legal and financial risk faced by Uber in connection with the Otto transaction amounted to bad faith.

The Court Rejects Plaintiff's Allegations of Bad Faith

The Court rejected the Plaintiff's arguments. The complaint alleged that Uber's directors heard a presentation that summarized the transaction, reviewed the risk of litigation with Google, generally discussed due diligence, asked questions and participated in a discussion. The inference from these allegations shows a functioning board that did more than rubberstamp the transaction presented by Uber's CEO.

The Court noted there is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties. It is not enough to allege that the directors should have been better informed as this is a due care violation exculpated by the corporation's charter provision.

The Court noted Kalanick might have a background that would lead a reasonable board member to dig deeper into representations he made about the transaction, but there were no allegations that Kalanick had a history of lying to the board.

The Court noted the indemnification provisions were unusual but those provisions were clearly explained to the board. The indemnification provisions did provide some protection for Uber—Uber would not have to indemnify Levandowski and others for conduct that was not disclosed to Uber before closing.

The allegations as pleaded did not support a reasonable inference that the directors knew the transaction was nothing more than a vehicle to steal Google's proprietary information. Instead, the reasonable inference is the board should have done more, not that it acted in bad faith. Thus, the unusual indemnification provisions approved by the board did not lead to any inference other than the board approved a flawed transaction.

FTC and DOJ Announce New Draft Vertical Merger Guidelines

By Sara Razi, Peter Guryan, Andrew Lacy and Abram Ellis, Partners, and John Goheen, Associate, of Simpson Thacher & Bartlett LLP

For the first time in nearly four decades, the Federal Trade Commission and the Department of Justice's Antitrust Division, the federal agencies tasked with enforcing United States antitrust laws, have issued updated draft guidelines for evaluating vertical mergers—*i.e.*, mergers of companies operating at different stages of the supply chain.

These new draft guidelines come at a time of heightened debate over vertical mergers and in the wake of the government's unsuccessful challenge of the Time Warner/AT&T merger. The draft guidelines seek to provide insight and greater transparency into how the agencies approach vertical merger analysis and enforcement. Further, although they evidence increased interest in vertical mergers, the draft guidelines largely reflect how the agencies have been reviewing vertical mergers in recent years.

The draft guidelines have been released to the public and are open to comment for 30 days. As discussed further below, two FTC Commissioners issued statements criticizing the guidelines as drafted to be insufficient.

The draft guidelines provide an overview of the methodology that the agencies will follow and identify circumstances in which vertical mergers may result in anticompetitive harm.

Anticompetitive Effects

In evaluating these effects, the agencies will consider a wide variety of evidence, including market share, contractual relationships in the industry, the observed effects of similar mergers, and whether a merging party currently serves as a market disruptor. The draft guidelines identify the following ways in which a vertical merger might harm competition:

- *Unilateral Effects*: The draft guidelines recognize that vertical mergers may cause anticompetitive unilateral effects, such as raising a rival's costs or providing access to a competitor's sensitive information.
 - Raising rival's costs refers to situations where the merged, vertically integrated firm can profitably foreclose rivals in a relevant market by charging more for (or refusing to sell) a vertically-connected product. For example, firm A might sell input materials to firms B and C. But after a vertical merger between A and B, the merged firm might refuse to sell materials to C, raising C's costs and diverting sales from C to the merged firm.
 - A merged firm might also gain access to a rival's sensitive business information, which the draft guidelines explain might cause rivals to "see less competitive value in taking procompetitive actions." For example, a rival might choose to buy inputs from a more expensive or lower quality supplier in order to avoid giving the merged firm the rival's sensitive commercial information.
- *Coordinated Effects*: The draft guidelines also warn that a vertical merger may encourage or facilitate anticompetitive coordinated action. The integrated firm may use power in a relevant market to harm a maverick firm's ability to disrupt established rivals. Alternatively, integrated firms may gain access to information that will allow them to more easily coordinate with rivals. The risk of collusion may be undermined by a realignment of incentives, such as the elimination of double marginalization, discussed below.

Procompetitive Effects and Elimination of Double Marginalization

The draft guidelines recognize certain ways that vertical mergers can help consumers. Accordingly, the draft guidelines identify circumstances where the agencies are unlikely to challenge a vertical merger:

- *Elimination of Double Marginalization*: As stated in the draft guidelines, agencies will not challenge mergers where the net effect of eliminating double marginalization is large enough that the merger is unlikely to be anticompetitive. Double marginalization occurs when the upstream and

downstream firms with market power set prices higher than a single integrated firm with market power would. Merging these firms aligns incentives in a way that can increase output and decrease prices, benefiting both the combined firm and consumers. Regulators will consider the net effects by examining the compatibility of technology between firms, existing incentives to reduce double marginalization, and predicted pricing incentives.

- *Efficiencies*: Mergers can help create beneficial efficiencies for consumers. Efficiencies may include combining complementary economic functions, reducing contracting costs, and streamlining production, inventory management and distribution. Additionally, vertically integrated firms may create new valuable products that unintegrated ones cannot. The agencies will evaluate vertical merger efficiencies using the same approach as the Horizontal Merger Guidelines, and will not challenge a vertical merger where the scale of efficiencies suggests that the merger is unlikely to be anticompetitive.

Safe Harbor and the Absence of Any Presumptions

Notably, the draft guidelines advise that the agencies are unlikely to challenge mergers where the parties have less than 20% market share in both the relevant and related product markets. However, unlike the Horizontal Merger Guidelines, the draft guidelines do not establish any presumptions for anticompetitive harm.

Comments From Agency Officials

The FTC's two Democratic commissioners, Rohit Chopra and Kelly Slaughter, separately abstained from the vote on the draft guidelines and issued statements, advocating for even more government scrutiny of vertical integration.

Commissioner Slaughter took issue with the safe harbor provision, noting that "creating a market-share based threshold for enforcement may be an imperfect proxy for assessing whether a vertical merger poses competitive concerns." Commissioner Chopra argued that the draft guidelines do not reflect lessons learned from decades of enforcement actions and "perpetuate an overdependence on theoretical models."

FTC Commissioner and Republican appointee Christine Wilson issued a concurring statement acknowledging that open questions remain and inviting feedback on a number of issues. In particular, she asked how the guidelines should treat the elimination of double marginalization, noting that economic literature "recognizes both its significant benefits and the many reasons that these benefits may not be achieved."

Commissioner Wilson also raised the question of whether a safe harbor provision was appropriate altogether, and if so, whether the 20 percent threshold in the draft guidelines was correct. Finally, her statement asked how the guidelines should define relevant and related markets, and what size of anticompetitive effects should be considered de minimis.

Takeaways

The issuance of the guidelines, which are still subject to comment and further revision, provide insight into how the agencies plan to evaluate and enforce vertical mergers. While they reflect the agencies' heightened interest in vertical mergers, it is uncertain whether they will result in more enforcement actions. Nevertheless, the draft guidelines are an important step in assisting the business community and counsel contemplating and considering potential transactions.

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