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DOJ SEEKS RARE $3.5M "GUN JUMPING" PENALTY AGAINST LEGENDS HOSPITALITY FOR PRE-CLOSING CONDUCT IN CONNECTION WITH ACQUISITION OF ASM GLOBAL

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On August 5, 2024, the United States Department of Justice ("DOJ") filed a rare[1] gun jumping[2] civil lawsuit and proposed settlement in the United States District Court for the Southern District of New York against Legends Hospitality Parent Holdings, LLC ("Legends")—a global sports and entertainment venue services company partially owned by the New York Yankees and the Dallas Cowboys—in connection with Legends' consummated $2.325 billion acquisition of ASM Global, Inc. ("ASM")—a venue services company focused on venue management. According to the complaint, Legends violated the premerger notification and waiting period requirements of the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended ("HSR Act") by exercising operational control over aspects of ASM during the HSR Act waiting period. This is the first such gun jumping action brought by the U.S. antitrust agencies since 2017[3] and is a reminder that the antitrust agencies are on the lookout for, and do bring, standalone HSR Act enforcement actions even when the agencies do not raise antitrust concerns with the underlying merits of the transaction.

HSR Act and "Gun Jumping" Legal Framework

The HSR Act requires companies to notify the Antitrust Division of the DOJ and Federal Trade Commission ("FTC") of acquisitions of assets or voting securities that meet certain size thresholds where no exemption applies.[4] When a transaction requires reporting under the HSR Act, the parties must observe a statutory waiting period (normally 30 calendar days)[5] before closing.[6] This allows the DOJ and FTC to analyze the potential competitive effects and determine whether further investigation is warranted before the parties close. During the waiting period, neither party can exercise "beneficial ownership"[7] (*e.g.*, operational or financial control or bearing

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the risk of loss or benefit of gain) of the other's equity or assets.

Failure to abide by the HSR Act waiting period requirements is one example of a "gun jumping" violation.[8] Relatedly, anticompetitive conduct (*e.g.*, improper information exchanges or coordination between competitors) among merging parties can also be prosecuted under Section 1 of the Sherman Act[9] as an unreasonable restraint of trade or Section 5 of the FTC Act[10] as an unfair method of competition until closing—unlike violations of the HSR Act, which end with the expiration or termination of the waiting period. However, gun jumping violations are most often brought under the HSR Act.[11]

Gun jumping enforcement actions can lead to both injunctive relief and civil penalties against both the acquirer and target, with the civil penalties reaching up to $51,744 per day (currently).[12] Injunctive relief may seek to prevent the specific or similar conduct causing the violation in the future, require the parties to maintain an antitrust compliance program, and/or agree to an antitrust agency-approved compliance officer. Disgorgement of illegally obtained profits stemming from the violation may also be required.[13]

Parties should also remember that many ex-U.S. jurisdictions have similar gun jumping frameworks, including at the European Union level.[14]

Conduct by Legends

On November 3, 2023, Legends agreed to acquire ASM for $2.325 billion and filed its required HSR Act form on November 6, 2023. Accordingly, Legends was subject to the premerger notification requirements of the HSR Act, including the obligation to continue to operate as a separate and independent entity from ASM during the applicable waiting period, which expired May 29, 2024, following an extension by the issuance of a Second Request[15] by the DOJ on January 8, 2024.

According to the DOJ's Complaint,[16] Legends allegedly engaged in illegal gun jumping by obtaining beneficial ownership of ASM's business before the HSR waiting period had expired or been terminated.[17] Specifically, the Complaint alleges:

- In May 2023, Legends won the right to manage an arena in California when ASM's management lease expired, having competed with ASM for the business. However, during the HSR waiting period, Legends determined that ASM would continue to service the contract, which included (i) signing an agreement in December 2023 requiring ASM to book third-party events at the arena and (ii) requiring ASM to provide venue management services for the arena beginning in April 2024, thereby making key decisions on behalf of ASM before the waiting period had expired.

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- Legends sought to discuss competitive bidding strategies with ASM. In August 2023 (while Legends and ASM were in discussions around the transaction, but before the HSR filing), Legends sought to prevent both it and ASM from making competing bids for the same management contract relating to an entertainment complex in North Carolina. Similarly, in May 2023, after transaction discussions began, Legends and ASM sought to coordinate and jointly bid for a contract related to a new university arena that they had previously planned to bid for separately. This happened again in 2024 regarding a different university arena contract.
- The parties exchanged competitively sensitive information to construct the joint bids described above.[18]

Proposed Settlement

Although some of the conduct described in the Complaint occurred pre-signing, interestingly, the DOJ's proposed settlement limited the alleged HSR Act violation period to post-signing conduct, specifically, from December 7, 2023 (when Legends signed the agreement requiring ASM to book third-party events at the arena) to May 29, 2024 (when the HSR waiting period was terminated)—175 days in total.[19] To settle this alleged violation, Legends agreed to a $3.5 million civil penalty, which amounted to approximately $20,000 per day or just under 40% of the maximum statutory penalty. The settlement will also require Legends to, among other things, refrain from certain conduct, appoint an Antitrust Compliance Officer, implement an antitrust training and compliance program, and submit regular compliance reports to DOJ. If the court adopts the proposed settlement (as is expected), it will resolve the lawsuit.

Three Key Takeaways

Closely review the potential antitrust implications of interim operating covenants and ensure that integration planning does not result in implementation before the expiration of the applicable waiting period or closing. Although gun jumping enforcement actions are rare, this case underscores the importance of adhering to premerger notification and waiting period requirements under the HSR Act, regardless of whether the underlying transaction may raise other antitrust concerns. While there are legitimate business reasons for parties to engage in certain forms of pre-closing coordination (*e.g.*, such as pre- and post-signing due diligence and transition planning, as well as developing a clearance strategy), implementation before the expiration of the applicable waiting period or closing should not occur. Setting appropriate parameters, thresholds, and qualifications in interim operating covenants and managing integration planning with the assistance of counsel, for example, help mitigate gun jumping risks by ensuring that a target can operate in the ordinary course of business between signing and closing.

Both acquirers and sellers can be liable for civil penalties under the HSR Act. Even though the DOJ sought reduced civil penalties (as well as other injunctive relief) only from the acquirer, Legends,[20] the antitrust agencies can and have sought civil penalties against both parties in prior gun jumping violation matters, including one matter where the parties ultimately abandoned the transaction.[21] As this case itself is an example of, HSR Act enforcement actions can and do occur where agencies have not taken issue with the underlying transaction.

Have a plan for managing competitively sensitive information. Similarly, despite the fact that the DOJ only alleged an HSR Act violation, the alleged conduct, especially conduct involving the sharing of competitively sensitive information that influenced bidding strategies, could have potentially resulted in allegations of a Sherman Act Section 1 violation. If the FTC rather than the DOJ had investigated the matter, it is also theoretically possible that the conduct described in the complaint could have raised FTC Act Section 5 violations. Parties should have a plan for managing the exchange of competitively sensitive information pre-closing, such as using clean team agreements.

ENDNOTES:

[1]Eleven gun jumping cases have been brought since

1991: *U.S. v. Atlantic Richfield Co.*, 1991-1 Trade Cas. (CCH) ¶ 69318, 1991 WL 290711 (D.D.C. 1991), *United States v. Atl. Richfield Co. and U.F. Genetics, Inc.*, No. 91-3267, 1991 WL 11670716 (D.D.C. Jan. 27, 1992), *U.S. v. Titan Wheel Intern., Inc.*, 1996-1 Trade Cas. (CCH) ¶ 71406, 1996 WL 351143 (D.D.C. 1996), *U.S. v. Input/Output, Inc.*, 1999-1 Trade Cas. (CCH) ¶ 72528, 1999 WL 1425404 (D.D.C. 1999), *U.S. v. Computer Associates Intern., Inc.*, 2002-2 Trade Cas. (CCH) ¶ 73883, 2002 WL 31961456 (D.D.C. 2002), *U.S. v. Gemstar-TV Guide Intern., Inc.*, 2003-2 Trade Cas. (CCH) ¶ 74082, 2003 WL 21799949 (D.D.C. 2003), *United States v. QUALCOMM Inc.*, No. 1:06-cv-00672-PLF, 2006 WL 1316934 (D.D.C. Apr. 19, 2006), *United States v. Flakeboard America Limited*, 2015 WL 12656838 (N.D. Cal. 2015), *United States v. Duke Energy Corporation*, 2017-1 Trade Cas. (CCH) ¶ 79963, 2017 WL 2819875 (D.D.C. 2017), and *United States v. Legends Hospitality Parent Holdings, LLC*, No. 1:24-cv-5927 (S.D.N.Y. Aug. 5, 2024).

[2]"Gun jumping" relates to the unlawful transfer of beneficial ownership of the target's assets or equity prior to the expiration or termination of the HSR Act waiting period (or in other jurisdictions, prior to the relevant antitrust authority approval or waiting period expiration or termination). Gun jumping is sometimes categorized into two types of violation—procedural and substantive. Procedural gun jumping can occur when parties fail to submit an HSR Act filing in connection with a reportable transaction (*e.g.*, an acquirer was unaware of its HSR Act filing obligations), and substantive gun jumping can occur when an acquirer is aware of the HSR Act filing obligation but nevertheless takes actions to acquire beneficial ownership of the target's business (*e.g.*, coordinating on competitive activities, directing the target's ordinary course business, etc.). In this article, references to gun jumping solely refer to substantive gun jumping.

[3]*United States v. Duke Energy Corporation*, 2017-1 Trade Cas. (CCH) ¶ 79963, 2017 WL 2819875 (D.D.C. 2017). As noted in endnote 2, for purposes of this article, alleged violations of procedural failures to file HSR Act notifications are excluded as gun jumping precedents.

[4]*See* our previous client alert: *2024 Increases to HSR Thresholds, Filing Fees, HSR Penalties and Interlocking Directorate Thresholds* (Update with March 6, 2024 Effective Date for HSR Thresholds), A&O Shearman (Feb. 5, 2024) (https://www.aoshearman.com/en/insights/2024-increases-to-hsr-thresholds-filing-fees-hsr-penalties-and-interlocking-directorate-thresholds). Section 7A of the Clayton Act specifies that certain acquisitions must be reported to the DOJ and the FTC in advance of their consummation.

[5]The HSR waiting period is typically 30 calendar days after both parties have filed their respective notifications unless earlier terminated or otherwise extended by the issuance of a request for additional information or documentary material (a "Second Request"). If the waiting period would expire on a Saturday, Sunday, or legal public holiday (as defined in 5 U.S.C.A. § 6103(a)), the waiting period is extended to 11:59 p.m. Eastern Time of the next regular business day. In the case of an all-cash tender offer or a bankruptcy transaction subject to 11 U.S.C.A. § 363(b), the waiting period is 15 calendar days unless earlier terminated or otherwise extended.

[6]15 U.S.C.A. § 18a (a) and (b).

[7]16 C.F.R. § 801.1(c).

[8]As mentioned above, gun jumping can also include procedural violations such as failures to file HSR for reportable transactions.

[9]Penalties for such violations can carry both civil and criminal (of up to $100 million for a corporation and $1 million for an individual, along with up to 10 years in prison). The maximum fine may be increased to twice the amount the conspirators gained from the illegal acts or twice the money lost by the victims of the crime, if either of those amounts is over $100 million.

[10]Section 5 authorizes the FTC to issue cease-and-desist orders to enjoin unfair methods of competition. The FTC may issue an order after finding liability at the conclusion of an administrative hearing or as a consent order settling the charges. Section 13(b) of the FTC Act also authorizes the FTC to seek preliminary or permanent injunctive relief for violations of the FTC Act in federal district court (15 U.S.C.A. § 53(b)). The FTC can obtain monetary relief or civil penalties in limited circumstances, such as for violations of cease and desist orders.

[11]Only three of the 11 cases brought since 1991 have involved an alleged violation of Section 1 of the Sherman Act. *U.S. v. Gemstar-TV Guide Intern., Inc.*, 2003-2 Trade Cas. (CCH) ¶ 74082, 2003 WL 21799949 (D.D.C. 2003), *U.S. v. Computer Associates Intern., Inc.*, 2002-2 Trade Cas. (CCH) ¶ 73883, 2002 WL 31961456 (D.D.C. 2002), and *United States v. Flakeboard America Limited*, 2015 WL 12656838 (N.D. Cal. 2015), which settled the Section 1 claims by the acquirer agreeing to disgorge $1.15 million in profits, among other things. There were no separate Section 1 penalties in either *Gemstar* or *Computer Associates*.

[12]15 U.S.C.A. § 18a(g)(1), Bipartisan Budget Act of 2015, Pub. L. No. 114-74, 129 Stat. 584 § 701 (further amending the Federal Civil Penalties Inflation Adjustment Act of 1990), and FTC Rule 1.98, 16 C.F.R. § 1.98, 89 Fed. Reg. 1445 (Jan. 10, 2024).

[13]We are only aware of only one instance since 2010 where disgorgement was required; in *United States v.*

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Flakeboard America Limited, 2015 WL 12656838 (N.D. Cal. 2015). The DOJ pursued a gun jumping complaint and settlement despite parties abandoning the transaction.

[14]*See* Article 7(1) of the EU Merger Regulation. For example, *see* our previous client alert: *Record EU gun-jumping penalty contributes to surge in merger control fines*, A&O Shearman (Feb. 28, 2024), https://www.aoshearman.com/en/insights/global-trends-in-merger-control-enforcement/record-eu-gun-jumping-penalty-contributes-to-surge-in-merger-control-fines.

[15]A Second Request tolls the agency's statutory time limit to complete its review of a transaction reported under the HSR Act until 30 days after each party (or 10 days after the acquirer has in the case of an all cash tender offer or both the acquirer and acquired persons in an 11 U.S.C.A. § 363 bankruptcy) has certified that it has substantially complied with the Second Request. 15 U.S.C.A. § 18a(e) and 16 C.F.R. § 803.20.

[16]*See* DOJ Complaint, *United States, v. Legends Hospitality Parent Holdings, LLC*, No. 1:24-cv-5927 (S.D.N.Y. Aug. 5, 2024), https://files.lbr.cloud/public/2024-08/127135930935.pdf?VersionId=i_MOEQ02wQidiBlxJdh6jrEzfO6CPmo1.

[17]*Id.* at 22.

[18]For example, "[w]hile constructing their joint bid, Legends and ASM exchanged competitively sensitive information surrounding the arena development project." *Id.* at 18. DOJ defined "competitively sensitive information" as "any non-public information of Defendant or any Competitor, including information relating to negotiating positions, tactics, or strategy; pricing or pricing strategies; Bids or Bidding strategies; intentions to Bid or not to Bid; decisions to Bid; whether a Bid was or was not submitted; and costs, revenues, profits, or margins." *See* DOJ United States' [Proposed] Final Judgment at [F].

[19]*Id.* at 23.

[20]Based on the alleged violation period of 175 days, the maximum civil penalties the DOJ could have sought were $9,055,200 from each of the parties.

[21]*United States v. Flakeboard America Limited*, 2015 WL 12656838 (N.D. Cal. 2015) where the acquirer paid $1.15 million in illegal profits obtained from illegal premerger coordination in addition to injunctive relief and a civil penalty for the Section 1 violation. The DOJ pursued a complaint and settlement despite parties abandoning the transaction.

EARNOUT DECISION UNDERSCORES BUYER'S POST-CLOSING OBLIGATIONS ARE VERY LIMITED EXCEPT AS SPECIFICALLY SET FORTH IN PARTIES' AGREEMENT—*FORTIS V. MEDTRONIC*

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In *Fortis v. Medtronic Minimed*,[1] the Delaware Court of Chancery, at the pleading stage of litigation, dismissed claims against Medtronic Minimed, Inc. for, allegedly, having purposefully defeated a $100 million earnout payment (the "Milestone Payment"). The Merger Agreement, pursuant to which Medtronic had acquired Companion, Inc. for over $300 million, required that, post-closing, Medtronic not take action *with the primary purpose* of defeating the earnout.

Key Points

- **The decision reinforces that, under Delaware law, except as expressly set forth in the parties' agreement, a buyer has very limited obligations**

to take action to support achievement of an earnout. Unless the parties' agreement provides otherwise, Delaware law generally requires only that a buyer not take action with the specific purpose of defeating an earnout. The Court held that the standard in the Merger Agreement in this case imposed an even narrower obligation—with Medtronic permitted to take actions motivated by defeating the earnout so long as some other purpose was "more central" to Medtronic's decision.

- **The decision thus highlights the need for particular care in drafting a buyer's post-closing obligations with respect to an earnout.** While the standard in this case may have been intended to parrot the general Delaware law standard, including the word "primary" rendered it significantly narrower. Further, parties should also consider carefully whether to include in their agreement, in respect of an earnout, business-contextualized covenants, listing specific actions that must or may, or that cannot, be taken by the buyer (or by the seller) post-closing.

- **The factual context was unusual.** The case was unusual in that the Merger Agreement set forth what the Court called an "exceptionally buyer-friendly standard" for the buyer's post-closing obligations with respect to the earnout; and in that, notwithstanding that the standard depended on the buyer's "primary purpose" for its actions, in the Court's view the Plaintiff did not plead allegations relating to Medtronic's purpose in taking the actions that led to the earnout milestone not being met. We note that the Court recently has been more often finding in favor of sellers claiming entitlement to earnout claims than was the case historically. Importantly, however, in each case, the Court has focused on the specific agreement language and the overall circumstances—which generally makes it difficult to predict the outcome of earnout cases.

Background

Medtronic operated a "Diabetes Unit" for its parent company. Prior to the Medtronic-Companion merger (the "Merger"), Companion had developed two "smart insulin pen" products (InPen and InCap). On July 24, 2020, the Merger Agreement was executed. The Merger Agreement provided for Medtronic to pay the Milestone Payment if Medtronic sold at least 85,000 smart insulin pens for an average price of at least $400 each during any four consecutive quarters during the eight full quarters following the closing (the "Milestone Period"). The Merger closed on September 19, 2020. The post-closing sales did not meet the milestone threshold, and Medtronic did not pay the Milestone Payment. The Plaintiff (Fortis Advisors, LLC, in its capacity as Stockholders' Representative for the former Companion stockholders) brought suit. At the pleading stage, Judge Meghan A. Adams (sitting by designation as a Vice Chancellor) granted Medtronic's motion to dismiss the claim relating to the earnout. Separately, she declined to dismiss an unrelated claim seeking the release to former Companion stockholders of certain funds held in escrow.

Discussion

The Merger Agreement earnout provision. Section 2.11(f) of the Merger Agreement stated that: Medtronic will develop and sell the Milestone Products "in accordance with its own business judgment and in its . . . sole discretion"; Medtronic will not rely on any conversations or writings the parties may have engaged in before signing; and Medtronic will not have "any liability whatsoever" for any claim arising out of or relating to "any decisions or actions affecting whether or not or the extent to which the Milestone Consideration becomes payable." Most relevant to the case, this language was qualified by the following: "Notwithstanding the foregoing, until the end of the Milestone Period, Buyer shall not take any action intended for the primary purpose of frustrating the payment of Milestone Consideration hereunder."

The Plaintiff claimed that Medtronic's actions, and failures to act, had the primary purpose of defeating the earnout. Both parties acknowledged that Section 2.11(f) of the Merger Agreement "immunized Medtronic from any milestone-related claims aside from a claim that Medtronic acted for the primary purpose of frustrat-

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ing [achievement of the Milestone Payment].” The Plaintiff asserted that Medtronic acted with the primary purpose of defeating achievement of the Milestone Payment by:

- Requiring the legacy Companion salespeople to sign non-compete agreements that temporarily precluded subsequent employment in “the diabetes field,” which led to an exodus of the top salespeople—although, allegedly, prior to closing, Medtronic had stated that such agreements would be limited in scope to “the field of smart insulin pens”;
- Not replacing the legacy Companion salespeople who resigned;
- Not incentivizing Medtronic’s own salespeople to sell InPens until spring 2021 (although the Milestone Period began in November 2020);
- Even once Medtronic incentivized its own sales team to sell InPens, not offering powerful enough incentives to them (and in any event they did not have enough experience with InPens);
- Deferring commencement of a $12 million marketing program, that had been discussed pre-closing and that would have supported sales of the InPen during the Milestone Period—and instead instituting the marketing program the month after the Milestone Period expired; and
- Refusing to pursue InCap “clearance and sales . . . under the guise of Medtronic’s belief that insurers would not cover InCaps often enough to make pursuing InCap sales worthwhile”—while, in Fortis’s view, it was reasonable to assume that the InCap product would have been covered more than 50% of the time given Companion’s pre-closing ability to obtain coverage for InCaps.

The Court held that, under the Merger Agreement, Medtronic could act in ways intended to defeat the Milestone Payment so long as defeating it was not the primary purpose. The Court noted that Medtronic did not covenant to use best efforts, commercially reasonable efforts, or even good faith efforts to achieve the Milestone Payment. Rather, it had “secured for itself sole discretion to take actions that [it] knew would frustrate the [Milestone Payment], so long as the action had some other primary purpose.” And, in an arm’s-length transaction, “Fortis freely assented to that arrangement.” Therefore, even though, for example, the expected marketing program was instituted just *after* the Milestone Period ended, and the Court found it reasonable to infer therefrom that Medtronic “was content to let the [Milestone Payment condition] go unmet,” it was not inferable, the Court held, that Medtronic’s primary purpose in deferring the marketing program was to defeat the earnout. The Court stressed that “Medtronic had no contractual duty to make any effort to achieve the [earnout]”; its “only obligation was to refrain from actions primarily aimed at frustrating the [earnout].” (The Court noted that it was “not aware of any Delaware precedent applying such a buyer-friendly contingent payment scheme,” and that the parties had cited none.)

The Court drew a distinction between Medtronic *acting to defeat* the earnout and *failing to act to help meet* the earnout. The Court noted that Section 2.11(f) only “expressly proscribe[d] affirmative acts.” The Plaintiff, the Court observed, fashioned Medtronic’s alleged *failures to act* as affirmative actions—for example, alleging that Medtronic *deferred* the introduction of new salespeople, *deferred* the marketing program, and *refused to pursue* InCap clearance and sales. Notwithstanding that “artful wording,” the Court stated, given that the Merger Agreement only expressly proscribed affirmative acts, the relevance of failures to take action was “at best, questionable.”

The Court found the Plaintiff pled no facts as to Medtronic’s purpose in taking the actions the Plaintiff complained of. That failure took on “outsized importance in light of the atypical deference Section 2.11(f) [gave] to Medtronic,” the Court stated. The Court acknowledged that a plaintiff might not be able to offer *direct* evidence of a buyer’s primary purpose, but here, the Court stressed, the Plaintiff had not offered even

"circumstantial evidence of an action's purpose aside from conjecture based only upon the action itself." The Court wrote: "[I]t is not as if Section 2.11(f)'s requirements made it impossible to sufficiently plead a breach of Section 2.11(f) absent direct evidence of Medtronic's purpose. Fortis simply did not do so."

The Court offered examples of the kinds of *circumstantial* evidence that might support an inference of a primary purpose to defeat an earnout. The Court stated that Medtronic's actions—such as requiring non-compete agreements and not providing compelling sales incentives—might have been "more suspect" if these policies had applied only to the legacy Companion business, as that "would tend to suggest that [the] actions had more to do with frustrating the [earnout] than another business purpose." But, the Court stated, the Plaintiff did not allege that Medtronic treated the legacy Companion products differently than any other Medtronic assets. Also, the Court stated that the timing of Medtronic's actions "could help raise an inference of a primarily improper purpose"—if, for example, the non-compete agreements had been "abruptly forced" on the legacy Companion employees or the reduction in sales incentives for InPens had been imposed only when Medtronic had gotten close to achieving the earnout. But, the Court stated, the Plaintiff's allegations reflected instead that "Medtronic largely maintained the status quo throughout the Milestone Period" (with the only exception being the request for non-compete agreements, which Medtronic made shortly after acquiring Companion and before the Milestone Period began). Indeed, the Court noted, the only mid-Milestone Period change Fortis alleged was that Medtronic started incentivizing the sale of InPens about one-quarter of the way through the Milestone Period. With respect to Medtronic's starting the marketing program just after the end of the Milestone Period, the Court emphasized that Medtronic had no contractual duty to make *any* effort to achieve the First Milestone—it could have, but it did not, negotiate for required marketing investments during the Milestone Period, the Court noted.

Practice Points

- ***Define the business deal relating to post-closing obligations to support an earnout.*** Where the parties are silent as to the buyer's post-closing obligations relating to supporting achievement of an earnout, the buyer's obligations under Delaware law is likely to be quite limited. Where the parties address such obligations in their agreement, they should consider including provisions that are highly tailored to the specific company, business, industry, products, and circumstances at issue. The general standard for a buyer's commitments post-closing can vary widely and should be well-defined. For example, in addition to defining the general standard, as well as any specific actions of kinds of actions that the buyer must, can, or must not take, a buyer may wish to provide that any action it takes that has a plausible business reason will be deemed not to have been taken with an intent to frustrate the earnout.

- ***Tailor post-closing obligations to the particular context.*** These should not be boilerplate or standardized provisions, but, with input from the business people who know the company best, contextualized for the specific situation. Such provisions should cover, for example, the aspects of the post-closing operations that are the most critical to the acquired business' operations or to the achievement of the earnout, or those areas that may be most subject to manipulation or dispute. If the parties have discussed post-closing plans, or particular actions that would have to be taken to maximize the potential of achievement of the earnout, the seller should keep in mind that those actions may not have to be taken unless a commitment to take them is set forth in the agreement.

- ***Consider, and specify, whether the post-closing actions the buyer can take relate to the acquired business only or to the buyer's entire business.*** Actions taken that relate to the acquired business only may be more suspect in terms of a motivation

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to defeat the earnout. A buyer also should be sensitive to the timing of actions it takes that may negatively impact achievement of an earnout. Actions that are taken "abruptly" or just as the earnout is getting close to being achieved may be more suspect in terms of a motivation to defeat the earnout.

- ***A buyer should maintain a record of the business reasons for actions it takes during the earnout period that may negatively affect the earnout.*** The Delaware courts have tended not to view actions as having been taken for the purpose of frustrating payment of an earnout if: (i) there was any basis for the actions to be viewed as legitimate business decisions and for the sellers' complaint to be viewed simply as a dispute concerning business strategy, and/or (ii) there were countervailing factors indicating other efforts by the buyer to support the relevant business (for example, the investment of funds in the business, hiring of additional sales people for it, and so forth). Accordingly, buyers should maintain a record of the business reasons for their post-closing actions that may negatively affect achievement of an earnout, as well as a record of the actions they take that support achievement of the earnout.

- ***A seller may want to specify rights that it will have post-closing to support achievement of the earnout.*** This may be advisable particularly where the seller will remain involved in the business post-closing. A key consideration would be the extent to which notice to or control by the buyer would be required with respect to actions the seller is permitted to take.

- ***Keep in mind that the law of other states varies.*** The law in some states, for example, imposes an implied obligation on the buyer to take "reasonable efforts" to achieve an earnout, at least in the absence of an express disclaimer to the contrary.

- ***Consider an alternative dispute resolution mechanism.*** Given the prevalence of earnout disputes, parties should consider providing for an alternative dispute resolution mechanism, such as arbitration.[2]

ENDNOTES:

[1] *Fortis Advisors LLC v. Medtronic Minimed, Inc.*, 2024 WL 3580827 (Del. Ch. 2024).

[2] *See also* our recent Briefing, *Earnouts Update 2023* (https://corpgov.law.harvard.edu/2023/11/29/earnouts-update-2023/).

MODEL LEGISLATION JUMPS ON "BABY HSR ACT" BANDWAGON, SHOWING THE WAY FOR INCREASED STATE-LEVEL MERGER REVIEW

By Bruce McCulloch, Justin Stewart-Teitelbaum, Meytal McCoy, Charles Ramsey and Katie Kissinger

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On July 24, 2024, with the support of the American Bar Association ("ABA") Antitrust Section, the Uniform Law Commission ("ULC") approved (by a wide majority) model legislation outlining a standardized approach requiring companies to provide filings submitted to the Federal Trade Commission ("FTC") or Antitrust Division of the U.S. Department of Justice ("DOJ") pursuant to the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended ("the HSR Act," or "HSR Filings") to state Attorneys General ("State AGs") and permitting State AGs to share HSR Filings with each other. The model legislation's passage reflects the growing trend among states (currently at around 14) to have their own

"baby HSR Acts." The "Uniform Antitrust Pre-Merger Notification Act," if enacted by each state, likely will add to transacting parties' regulatory compliance burdens. It will also likely lead to increased scrutiny by State AGs who could have divergent enforcement priorities from the FTC and DOJ.

Key Take-Aways

- The model legislation requires parties to submit their HSR Filings to a State AG if (1) a filing entity is principally located in a state or (2) a filing entity's parent has sufficient sales in a state. The creation of a new state-level filing obligation would add another compliance element to be monitored to avoid a potential liability for failure to notify.
- States may be encouraged or incentivized to pass legislation with provisions that go beyond the template language of the model, with, for example, waiting periods or filing fee requirements.
- Giving State AGs up-front access to HSR Filings opens the door to more state-level review, particularly for those transactions that have an outsized local impact and/or that may not otherwise have attracted the attention of either the FTC or DOJ.

Model Legislation Functions Similarly to the HSR Act, Minus the Filing Fee, Waiting Period, and Strong Confidentiality Protections

The ULC model legislation[1] requires an entity to submit an electronic copy of a HSR Filing, including all documentary attachments, with a State AG, in one of two scenarios:

- **Scenario 1:** The entity's principal place of business is the state; or
- **Scenario 2:** The entity has annual net sales in the state equal to at least 20% of the dollar value of the HSR Filing threshold when the HSR Filing is submitted. Given that the HSR Filing threshold is currently only $119.5 million, an entity needs to have only $23.9 million in annual net sales in a state to trip this threshold, which may not be that hard to meet depending on the entity.

If Scenario 1 occurs, an entity is automatically required to file with the relevant State AG. However, for Scenario 2, the entity must file only on request of the State AG, and no later than seven days after receipt of such request. If an entity fails to submit the required filing, the State AG may seek a civil penalty of up to $10,000 per day for every day the entity is in violation. The model legislation does not include a provision for a filing fee or a pre-closing waiting period.

Importantly, while the model legislation prohibits the State AG from making public the HSR Filing or the transaction discussed therein, a State AG would be permitted to share information with the FTC, DOJ, or another State AG that has enacted the same model statute (or one with similar confidentiality protections). This contrasts with the strong confidentiality protections afforded by the federal HSR Act, which prohibits the FTC and DOJ from disclosing any information relating to a HSR Filing absent consent from the parties in all but a few narrow circumstances. The model legislation permits a State AG to disclose a HSR Filing to another State AG (so long as that state has enacted the model statute or a substantially similar one) and at least two business days' notice was given to the entity that submitted the HSR Filing.

States Are Free to Deviate from the Model Legislation, Including on Waiting Periods and Filing Fees

The model legislation is "intended . . . [to create] a simple, non-burdensome mechanism for AGs to receive access to HSR [F]ilings at the same time as the federal agencies"[2] to alleviate potential information asymmetries between the federal and state merger review processes. States remain free to enact their own versions of the legislation, which could lead to divergence and undermine the ULC's intent of reducing "costs and uncertainties for the merging parties."[3]

One point of potential deviation for some states could be the lack of a pre-closing waiting period. Many of the "baby HSR Acts" already on the books include at least a

30-day (or longer) waiting period (and at least one, as long as 180 days).[4] States investigating complicated health care transactions, for example, may want longer lead times to ensure they have time to review thoroughly all areas of potential concern, particularly where such states may not have the same resources as the FTC or DOJ.

A second issue on which states might diverge from the model legislation could be the lack of a filing fee. States, such as California, have expressed concern that the model statute will not be "meaningful unless it is coupled with significant additional financial support for enforcement."[5] A recent report on state-level antitrust enforcement by the California Law Revision Commission, an independent state agency, argued that while the federal antitrust authorities receive thousands of filings per year, the cost of review is "defrayed"[6] by filing fees. The fact that the model legislation has no filing fees creates an "unfunded burden"[7] upon a State AG and "may in fact nullify legislative efforts to provide for filing fees"[8] in other contexts.

Conclusion

The model legislation could significantly expand the scope of state-level antitrust review, particularly for those transactions that have a state-level nexus and opens the door for state-level enforcement priorities. For example, California's new law establishing its own merger control notification regime for retail grocery stores and pharmacies opens with finding "that the increasing consolidation of chain retail grocery stores [. . .] and chain retail pharmacies [. . .] impacts the public health of Californians."[9] While a purported aim of the model legislation is to "balance the needs of state enforcers for information with the burdens and risks to filers,"[10] complying with this additional filing obligation may be an added challenge if the final legislation passed in certain states have differing compliance requirements. Monitoring passage of this law at the state level will be key to navigating filing requirements, legal compliance and managing transaction timetables.

ENDNOTES:

[1] https://www.uniformlaws.org/viewdocument/antitrust-pre-merger-notification-a.

[2] https://www.uniformlaws.org/discussion/two-new-uniform-acts-and-amendments-to-acts-approved-at-ulcs-133rd-annual-meeting.

[3] https://www.uniformlaws.org/discussion/two-new-uniform-acts-and-amendments-to-acts-approved-at-ulcs-133rd-annual-meeting.

[4] https://www.oregonlegislature.gov/bills_laws/ors/ors415.html#:~:text=415.500%20Definitions.

[5] http://www.clrc.ca.gov/pub/2024/MM24-35.pdf.

[6] http://www.clrc.ca.gov/pub/2024/MM24-35.pdf.

[7] http://www.clrc.ca.gov/pub/2024/MM24-35.pdf.

[8] http://www.clrc.ca.gov/pub/2024/MM24-35.pdf.

[9] https://legiscan.com/CA/text/AB853/id/2834113.

[10] https://www.uniformlaws.org/discussion/two-new-uniform-acts-and-amendments-to-acts-approved-at-ulcs-133rd-annual-meeting.

CHANCERY FINDS DEAL PRICE IS THE "LEAST BAD" METHODOLOGY TO APPRAISE FAIR VALUE OF AN EARLY-STAGE COMPANY—*FAIRXCHANGE*

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In *Hyde Park v. FairXchange*,[1] the petitioner sought appraisal by the Court of Chancery of its shares of FairXchange, LLC ("FairX"), a nascent securities exchange that was acquired by Coinbase Global, Inc. Although neither party argued for reliance on the deal price to determine appraised fair value, and the court viewed the sale process as seriously flawed, the court held that reliance on the deal price was the "least bad" methodology to determine appraised fair value of an early-stage company with a plan to disrupt the market and no track record. Vice Chancellor Laster determined fair value to be equal to the deal price—$330 million (equating to $10.42 per share). The petitioner had proposed a valuation of $573 million, based on a DCF analysis; and the respondent had proposed a valuation of not more than $150 million, based on certain market-based factors.

Key Points

The decision highlights the difficulty in determining appraised fair value for this type of early-stage company. The court stressed that, with respect to early-stage companies with plans to disrupt the market and no track record, it is particularly difficult to determine appraised fair value (that is, going concern value of the company on the merger closing date, without taking the merger into consideration). The court concluded there was *no* "persuasive methodology" to determine fair value in this context, where a company in just a few years easily could be either a unicorn worth billions or a company worth zero. The court relied on the deal price, finding it to be the "least bad" methodology under these circumstances.

The court rejected reliance on a DCF analysis. For a DCF analysis to be reliable, the company's projections must be reliable. In the context of this type of early-stage company, FairX's projections—although they had been prepared in the ordinary course and used to support bank and equity financings—were "too speculative" to be reliable, the court held. Notably, the court gave "some weight" to the fact that FairX's stockholders, who were sophisticated investors, approved the merger—meaning, the court stated, that they did not credit the projections. We note that the court's analysis would not apply to other types of early-stage companies—such as, say, pharmaceutical companies that develop new drugs, which also face risks and uncertainty, but operate within an established industry with parallel established markets that demonstrate how drugs are commercialized.

The court largely rejected reliance on the past valuations that supported FairX's financing rounds. The most recent round had failed due to, allegedly, manipulation of the process by a third party; and the prior, completed round was based on information that was already stale. Beyond these particular issues, the court stated more generally that reliance on financing rounds would provide only weak evidence of fair value, given that the negotiations on price and terms are so intertwined that the value of a round only reflects the value of the company "for purposes of investors who are investing under a specific set of terms."

The court relied on the deal price, notwithstanding that the sale process was seriously flawed. The court compared FairX to an ancient coin, rare baseball card, or piece of art—stating that such non-cash generating assets are worth whatever someone is willing pay for them. We would note that, for an early-stage company with a disruptive plan and no track record, the deal price reflects, almost entirely, not going concern value as a stand-alone enterprise, but the target's option value—that is, what the buyer was willing to pay for the chance that a company with no cash generation and no track record may be worth billions in its near-term future. Moreover, in *FairX*, the deal price also was unreliable because the sale process was seriously flawed, with value clearly "left on the table." The court viewed the deal price as the "least bad" methodology for determining fair value in this context, however.

The court may rely on appraisal methodologies other than those advocated by the parties. The court emphasized that, notwithstanding the Delaware Supreme

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Court's decision in *Aruba*,[2] the Delaware appraisal statute and case law make clear that the Court of Chancery has the power to make its own valuation determinations and can rely on methodologies even if not proposed by the parties.

Background

FairX catered to retail investors who wanted to trade commodity futures. It had built "a world-class trading platform," with "fast, reliable and adaptable technology" that could also be used for retail trading in cryptocurrency futures. The company "sought to achieve great things." Like the Robinhood trading platform that had used a disruptive market-maker-pays business model to bring low-cost trading in equity securities to retail users, FairX sought to do the same for futures. From September 2021 to February 2022, large cryptocurrency players sought to become vertically integrated by acquiring early-stage companies that ran exchanges. Although all the targets were in the early stages of development with uncertain futures, the amounts the acquirors were willing to pay for them soared.

During this time, a bidding contest for one of FairX's peers—ErisX—resulted in a $550 million purchase price. After the ErisX sale, the FairX CEO then "desperately wanted a near-term exit of his own." (FairX's CEO had founded ErisX, but left after disputes with the firm's lead investor and so had obtained no benefit from ErisX's sale.) Without board approval, the CEO initiated discussions with Coinbase about its acquiring FairX. Despite having no experience in M&A matters, he then led the process, rejected advice to institute a banker-led process, and discouraged competition in the process.

On January 11, 2022, the parties executed the Merger Agreement, pursuant to which Coinbase agreed to acquire FairX for $330 million ($265 million in Coinbase stock and $65 million in cash). In the Merger Agreement, FairX's CEO and the other selling stockholders (the "Selling Stockholders") agreed to indemnify Coinbase for any post-closing appraisal award that exceeded the merger consideration. The merger closed on February 1, 2022. Between signing and closing, Coinbase's stock price declined, reducing the value of the consideration to $310.4 million. After the closing, two venture capital funds managed by Hyde Park Venture Partners sought appraisal. Pre-merger, Hyde Park owned about 15% of FairX's equity. Hyde Park's partner who served on FairX's board had been removed when he criticized the sale process.

Discussion

As a particular type of early-stage company, FairX was particularly hard to value. The court noted that FairX (i) was "privately held, so it lack[ed] a public market for its shares"—which "eliminate[d] a potentially reliable valuation indicator while also making it difficult to construct valuation ratios to use in a comparable companies or comparable transactions analysis"; (ii) "was still at an early stage in its growth," so it did not yet generate free cash flow; and (iii) "was pursuing a disruptive business model that would likely generate binary results"—that is, "either the Company would succeed brilliantly, or it would go to zero." The court concluded that there was "not a persuasive methodology for arriving at fair value" under these circumstances, but that, "[on] this record, the least bad methodology [was] the deal price."

The court rejected Hyde Park's DCF-based valuation, as the company's projections were "too speculative." The court noted that, as a DCF analysis values a company based on the "expected value of [its] future cash flows, discounted to present value in a manner that accounts for risk," without reliable projections any values generated by the analysis are meaningless. The court wrote: "The difficulty lies in FairX's disruptive business model. No one had ever tried to do what FairX hoped to accomplish for retail futures trading. . .. Management's projections reflected how FairX would perform if everything went according to plan. Projecting results for a new business is inherently speculative. . .. The projections that FairX management created are too speculative to use. They represent FairX's hoped-for reality, not its operative reality." Further, the court noted, although the Hyde Park partner on FairX's board had sent a letter to FairX's stockholders urging them not to support the merger because FairX "could be worth at least $1 billion by the end of 2022,"

the stockholders, who were sophisticated investors, supported the merger "rather than banking on FairX's success." And even the Hyde Park partner "thought it was a coin flip, 50/50, as to whether FairX would make the . . . projections."

The court largely rejected the Selling Stockholders' proposed methodologies.

- **Financing rounds**. The court acknowledged that financing rounds have the advantage of being negotiated transactions. However, the court stated, financing rounds do not begin with negotiation over price and then shift to bargaining over terms. Instead, they involve both at once, "result[ing] in tradeoffs between the price term and non-price terms." Therefore, the value of a financing round is "squishy," as it "reflects the value of the company for purposes of investors who are investing under a specific set of terms." Further, the court found that the evidentiary value of FairX's last financing round (reflecting a pre-money valuation of $150 million) was "weak," as it had been abandoned after, allegedly, the round was manipulated by a third party, causing a potential lead investor to delay its response to the company. The prior financing round, which was completed (reflecting a pre-money valuation of $100 million), was based on information that had become stale, as thereafter FairX "hit multiple milestones," including successful demonstration of its technology, additional broker and market-maker partners, and increased trading volume.

- **Other proposed methodologies**. The court rejected the Selling Stockholders' proposed reliance on: (i) a comparable transaction analysis—finding that the $64 million transaction was not comparable, as the company was not a competitor of FairX, had pursued a non-disruptive business model, used antiquated technology, and had no path to offering crypto products; (ii) Hyde Park's internal valuation of its investment in FairX—$100 million, which represented book value, as was "permitted under accounting rules" but not reflective of going concern value; and (iii) a Rule 409A valuation—$0.59 per share, which was stale and also unreliable because it was obtained for the purpose of valuing options for employees (creating an incentive for a low valuation).

- **Other factors undercutting the Selling Stockholders' arguments**. (i) The court viewed the Selling Stockholders as having "constructed a litigation narrative" after signing the Merger Agreement, when it learned about appraisal proceedings for the first time at a meeting with Delaware counsel. After the meeting, management revised its earlier, optimistic projections; and created an "Outline of [FairX's] Operative Reality Today," laying out "a narrative . . . to portray the sale to Coinbase as the only option for a company with zero prospects and virtually no chance of success." (ii) The Selling Stockholders did not offer "a specific assessment of fair value," but offered only that fair value was "no more than ˜$150 million." (iii) The Selling Stockholders' position on valuation "evolved over the course of the case"—with an expert's opinion at the outset that fair value was lower than the value of the merger consideration on the merger closing date ($310.4 million); a pre-trial brief argument that fair value was "about $154 million"; and a post-trial brief argument that fair value was "no more than ˜$150 million."

The court viewed the sale process as seriously flawed. The court stressed that deal price was a "not perfect" methodology under these circumstances, including because the sale process was seriously flawed. The court referred to the sale process as involving "a thirsty and inexperienced CEO negotiating hurriedly from a position of weakness" against Coinbase. FairX's CEO had approached Coinbase about a potential acquisition without board approval; ignored advice from many quarters that the sale process should be led by bankers; committed himself to a deal with Coinbase and discouraged competitive bids (and told Coinbase as much); did not keep the board informed; repeatedly made "rookie mistakes" and "blunders"; and made "soft" requests for a

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higher bid from Coinbase while focusing on negotiations to "optimize his personal payout." The sale process flaws "all fell on FairX's side of the ledger," the court stated. The CEO "left value on the table," resulting in "the deal price in this case operat[ing] as a probable floor, not a ceiling." Nonetheless, given the unreliability of the alternative methodologies, the court found the deal price was the least bad option.

The court rejected making any adjustment to the deal price. The court rejected any deduction of merger synergies from the deal price because, although the Selling Stockholders argued that Coinbase "must have" expected substantial synergies, "no one attempted to quantify them." The court rejected any adjustment to the deal price for a change in value between signing and closing because, although there was a decline in Coinbase's stock price that caused the value of the merger consideration to decrease, "a decline in an acquirer's stock price does not necessarily correspond to a change in the target's value, particularly when the acquirer is comparatively large and the target comparatively small."

The court can make its own appraisal determination if it finds the parties' methodologies unpersuasive. The Delaware Supreme Court had reversed Vice Chancellor Laster's appraisal decision in *Aruba* on the basis that in that case the Vice Chancellor relied on unaffected trading price when both parties had argued only for reliance on the DCF methodology. The Supreme Court stressed in its *Aruba* opinion that, because the unaffected market price methodology had not been proposed by the parties, it had not been "subjected to the crucible of pretrial discovery, expert depositions, cross-expert rebuttal, expert testimony at trial, and cross examination at trial." In *FairX*, Vice Chancellor Laster rejected FairX's argument that the lesson from *Aruba* is that the court cannot rely on any valuation methodology that the parties themselves did not advance. The Vice Chancellor stated that *Aruba* "feels like a decision censuring the trial judge for acting improperly in that specific case," and that there was no indication of any intention by the Supreme Court "to set out a new framework for appraisal cases in which the trial court lacks the power to make its own valuation determination." The Vice Chancellor stressed that Delaware's appraisal statute and case law are clear that the trial court has the burden of determining fair value in appraisal cases—and, "when neither party establishes a value that is persuasive, the court itself must make [the] determination based upon its own analysis."

Practice Points

Early-stage companies, with disruptive plans and no track record, should keep in mind the characteristics the court found rendered certain methodologies unreliable as indicators of fair value in that context.

- *DCF and projections*. If proposing reliance on a DCF analysis, a party should address why the projections are not too speculative to be reliable, notwithstanding the company's lack of a track record and uncertain future. In other words, the party should point to firm anchors to assumptions in the projections. For example, if the company's plans call for creating a new market that does not yet exist, there may be an existing, parallel market that would provide a sufficient underpinning for the projections.

- *Financing rounds*. Failure of a financing round may indicate that the company was not worth the pre-money valuation on which the round was conducted. Where a party argues that a financing round is a reliable indicator of fair value, the party should explain the extent to which negotiations on price took precedence over negotiations on terms; and why the information is not stale (taking into account any milestones achieved after the round).

A company-respondent should avoid the actions the court viewed as undercutting the Selling Stockholders' appraisal arguments.

- Documents should not be created that appear to be made-for-litigation in anticipation of a potential appraisal proceeding—such as revising earlier, optimistic projections without explaining a clear business basis for doing so, and creating documents

that lay out a favorable narrative seemingly unsupported by the facts. Use of highly legal terms (for example, "operative reality") should be avoided in business documents, as they may create the impression that the documents were prepared in anticipation of litigation.

- The court is likely to prefer a "specific assessment" of fair value as compared to a proposed range, floor, or ceiling.
- A party's proposed fair value determination should not "evolve" over the course of the proceeding, or at least, an explanation of any changes over time should be provided.
- A party seeking adjustment of the merger price to exclude synergies arising from the merger (which can be positive or negative), should provide evidence of the expected synergies so that, if the court relies on deal price, it will adjust the deal price accordingly.
- We would note, although the court did not address this, that careful consider consideration should be given to the benefits and disadvantages of removing a director who has criticized the sale process.

Care must be taken not only with formal corporate communications but also informal communications. In *FairX,* the CEO's emails and oral communications provided evidence that he was "apoplectic" after the ErisX sale and "desperate" to benefit from a similar sale of FairX. Also of note, the court noted five separate times in the opinion that, while the CEO did not transmit a key email to the board, he had transmitted it to his spouse. These emails included the CEO's initial indication of price to Coinbase; Coinbase's initial letter of intent; and an exchange with a Coinbase deal team member emphasizing his commitment to a deal with Coinbase. The court also noted that the CEO's spouse drafted a conciliatory email for the CEO to send to one of the other FairX directors who had expressed concerns about the process.

The court often exposes sale process flaws in detail—even when not directly relevant to the court's analysis or holdings. We have noted the court's trend in recent years to call out sale process flaws and name names. In *FairX*, the sale process flaws were not central to the court's analysis or result (indeed, they cut *against* reliance on the sale process). Nonetheless, over 32 pages of the 62-page opinion, the court described the sale process flaws in detail.

Merger agreement provisions. A buyer may wish to consider negotiating to obtain (as Coinbase did in *FairX*) a right to be indemnified in the event an appraisal award exceeds the deal price (possibly subject to a cap). Similarly, a seller might wish to seek entitlement to indemnification if an appraisal award is less than the deal price. Such provisions can offer an alternative to an appraisal condition in allocating appraisal risk.

ENDNOTES:

[1]*Hyde Park Venture Partners Fund III, L.P. v. FairXchange, LLC*, 2024 WL 3579932 (Del. Ch. 2024).

[2]*Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.*, 210 A.3d 128 (Del. 2019).

DELAWARE COURT OF CHANCERY HOLDS CHARTERS CANNOT INCORPORATE PRIVATE AGREEMENTS BY REFERENCE

By Andre G. Bouchard, Jaren Janghorbani, Kyle T. Seifried, Cullen L. Sinclair, Megan Spelman, Laura C. Turano, Frances F. Mi, and Jason S. Tyler

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Recently in *Seavitt v. N-able, Inc.*,[1] the Delaware Court of Chancery (in an opinion by Vice Chancellor Laster) held that the charter of a Delaware corporation cannot incorporate by reference the substantive terms of a stockholders or other private agreement. According to the court, allowing parties to do so "introduces the DNA of a purely private agreement into a foundational and public document." Further, because parties could amend such agreements without a stockholder vote, and thereby automatically change the charter's substantive terms, allowing private agreements' incorporation into a charter would deprive stockholders of their statutory right to vote on charter amendments under the Delaware General Corporation Law ("DGCL").

The above holding arose in the context of an opinion that invalidated governance rights in a stockholders agreement in accordance with *W. Palm Beach Firefighters' Pension Fund v. Moelis & Co.*[2] and *Wagner v. BRP Grp., Inc*.[3] As acknowledged by the court, the analysis resulting in the invalidation of the stockholders agreement provisions will not apply once the 2024 amendments to the DGCL[4] go into effect on August 1, 2024. However, the 2024 DGCL amendments will not affect the court's holding that incorporation by reference of the terms of a private agreement into a charter is invalid. Though the *Seavitt* opinion remains subject to appeal, parties drafting charter provisions should consider this case carefully, including whether to minimize references to external documents, to ensure all desired charter terms are given their intended effects.

Background

In anticipation of N-able's spin-off from SolarWinds Corporation, the company amended its charter and bylaws and entered into a stockholders agreement granting various governance rights to certain lead investors. Many of these governance provisions were similar to those addressed in the *Moelis* and *BRP* decisions with a key distinction—certain provisions of N-able's charter and bylaws contained language stating that the provision is "subject to" the lead investors' rights under the stockholders agreement. An N-able stockholder brought claims challenging the facial validity of the rights granted to the lead investors in the stockholders agreement.

Analysis

The court evaluated the plaintiff's claims on the basis adopted in *Moelis* and *BRP* and concluded that the bulk of the challenged stockholders agreement provisions were facially invalid because they improperly restricted the board's duty to manage the business and affairs of the corporation under DGCL Section 141. Importantly, the court acknowledged that this analysis will not apply once the DGCL is amended, effective August 1, 2024,[5] to add a new Section 122(18) that authorizes stockholders agreements like those at issue in *Seavitt*, *Moelis* and *BRP*.

Because certain provisions of the N-able charter expressly provided that they were "subject to" the terms of the stockholders agreement, the court's analysis involved an additional layer beyond *Moelis* and *BRP*, namely whether a charter may incorporate by reference the substantive terms of a private agreement (thereby elevating such provisions to the status of charter terms rather than mere contractual obligations). More specifically, though Section 102(d) of the DGCL permits charter provisions to be "made dependent upon facts ascertainable" outside the charter, the *Seavitt* court held that substantive terms of a private party document are not "facts" within the meaning of the DGCL and their incorporation by reference in a charter is prohibited.

We highlight the following key points from the court's reasoning for this holding:

- **"*Facts* ascertainable" are not "*provisions* ascertainable."** The court reasoned that Section 102(d)'s reference to "facts" ascertainable outside a charter does not include outside "provisions" or other incorporation by reference of a broad, substantive nature. According to the court, "facts ascertainable" refers to specific inputs and are not a vehicle for introducing substantive provisions. According to the court, the examples of "facts"

given in the statute (*i.e.*, "the occurrence of any event" or "a determination or action by any person or body") supported its conclusion. While the court distinguished and took no issue with references to private agreements for limited facts (*e.g.*, the identity of parties or whether there has been a breach of the agreement) or references to laws and regulations (*e.g.*, the definition of "affiliate" in the U.S. Securities and Exchange Act of 1934), a Delaware corporation cannot simply create substantive charter terms through an external, private document.

- **Public unavailability of private agreements.** The DGCL requires charters to be publicly filed, but not a private agreement. The court reasoned that the public nature of charters makes basic information about the corporation available to both investors and third parties, but incorporating provisions by reference to non-public documents frustrates that statutory purpose. Furthermore, while federal securities laws might require public companies to file their governance agreements, that fact does not affect the interpretation of the DGCL applicable to all Delaware corporations.

- **Circumvention of stockholder vote on charter amendments.** The court observed that DGCL Section 242 requires both board and stockholder approval of charter amendments, whereas incorporation by reference of private party agreement provisions permits the contracting parties to amend their agreement on their own and thereby amend the charter automatically. According to the court, this would circumvent Section 242, thereby depriving stockholders of their voting rights.

As noted above, though the *Seavitt* opinion remains subject to appeal, parties drafting charter provisions should consider it carefully to ensure that desired substantive terms receive their intended effects, such as by minimizing references to external private agreements and including substantive provisions in the charter itself to the extent feasible in the circumstances.

ENDNOTES:

[1]*Seavitt v. N-Able, Inc.*, 2024 WL 3534476 (Del. Ch. 2024) (https://courts.delaware.gov/Opinions/Download.aspx?id=367070).

[2]*W. Palm Beach Firefighters' Pension Fund v. Moelis & Co.* (https://courts.delaware.gov/Opinions/Download.aspx?id=360460).

[3]*Wagner v. BRP Inc.* (https://courts.delaware.gov/Opinions/Download.aspx?id=364510).

[4]*See* https://legis.delaware.gov/json/BillDetail/GeneratePdfDocument?legislationId=141480&legislationTypeld=1&docTypeld=2&legislationName=SB313. *See also*: https://www.paulweiss.com/media/3984934/delaware_general_assembly_approves_2024_amendments_to_general_corporation_law.pdf.

[5]Note that though the 2024 amendments to the DGCL apply retroactively, they will not apply to or affect any civil action or proceeding completed or pending on or before August 1.

THE EC ISSUES GUIDANCE ON ASSESSING MARKET DISTORTIONS UNDER THE FOREIGN SUBSIDIES REGULATION

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The Situation: The European Commission ("EC") has released its first guidance on assessing market distortions under the Foreign Subsidies Regulation ("FSR").

The Result: The Commission Staff Working Document offers some initial guidance and clarifications on the interpretation of the distortion of the internal market and the application of the balancing test.

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Looking Ahead: Important questions of interpretation and application of central concepts remain open. The EC and the European courts will further elaborate on these initial clarifications through case practice and case law. The EC has committed to publish guidelines on the application of specific provisions of the FSR by January 12, 2026.

The FSR came into force just over a year ago, on July 12, 2023. The EC has received numerous notifications and initiated several in-depth and *ex officio* investigations. However, many aspects of the EC's substantive assessment on the distortion of the internal market remain unclear. On July 26, 2024, the EC published a Commission Staff Working Document ("CSWD"), offering initial clarifications on some aspects of the substantive assessment under the FSR.

Structure of the Distortion of the Internal Market Test

The CSWD confirms that the FSR's "distortion in the internal market" assessment is a two-step assessment. First, there must be a link between the foreign subsidy and the economic activity on the internal market and, second, the foreign subsidy must actually or potentially negatively affect competition in the internal market.

According to the CSWD, the EC must assess under Article 4 FSR whether a foreign subsidy distorts the internal market based on several indicators provided in Article 4 (1) FSR (detailed below). Consequently, the EC is required to analyze the impact of foreign subsidies on competition. This is different from EU State aid law, where the EC presumes a distortion of competition whenever a beneficiary receives a selective financial advantage from an EU Member State on a competitive market.

Indicators for distortion in the internal market and "most likely to distort" categories: The CSWD claims that the indicators in Article 4 FSR are neither mandatory nor exhaustive, and it is within the EC's discretion to determine which indicators to apply in evaluating the distortive effect of a subsidy, therefore potentially giving the EC more discretion, instead of providing more guidance for companies on the application of the FSR.

The CSWD also specifies that for subsidies falling under Article 5, *i.e.*, which are deemed "most likely to distort" competition, the EC does not need to carry out a detailed assessment based on the indicators outlined in Article 4 of the FSR. Essentially, this reverses the burden of proof, so that an undertaking needs to show that foreign subsidies, despite being considered as "most likely to distort" under Article 5, do not actually distort the internal market in the specific circumstances of the case.

Assessment of distortion in the internal market in M&A: According to the CSWD, in relation to M&A, the distortion can be related to the acquisition process itself as well as to the market on which the combined entity is active post-concentration (most likely the target's market(s)), and the EC will consider one or the other or both of these potential distortions. In this respect, the Commission may evaluate whether the subsidies granted prior to the concentration are likely to distort the internal market post-concentration in the merged entity's activities.

Foreign subsidies received by the acquirer are more likely to attract scrutiny and cause distortive effects than those received by the target or seller.

Although the EC will consider the impact on competition in the target's market, the CSWD states that the assessment of concentrations under the FSR differs from the assessment under the EU Merger Regulation and that the outcomes of the two processes might be different.

Assessment of distortion in the internal market in public procurement: The CSWD states that the EC will limit its assessment of distortion in the internal market to the specific public procurement procedure in question.

In order to determine whether a foreign subsidy distorts the internal market, the EC will analyze two conditions: (i) if the tender submitted by the subsidized economic operator is unduly advantageous in relation to the works, supplies, or services concerned; and (ii) if there is a link between the granting of the subsidy and the tender, demonstrating a caused or risked distortion in a public procurement procedure.

The balancing test: According to the FSR, the Commission may balance the negative effects of a foreign subsidy in terms of distortion in the internal market against certain positive effects.

The CSWD indicates that, at this stage, the EC has not yet acquired substantial experience in applying and interpreting this balancing test. Therefore, the guidance is very limited and goes barely beyond a rephrasing of the FSR:

- When conducting the balancing test, the EC must consider the positive effects of foreign subsidies on the development of the subsidized economic activity on the internal market, as well as broader EU policy objectives, such as environmental protection, social standards, or the promotion of R&D.
- Positive effects recognized under EU State aid rules will also be taken into account under the FSR.
- The outcome of the balancing test can only be positive or neutral for the undertaking; it cannot result in the undertaking being worse off as a result of the test.

Three Key Takeaways

1. **Structure of the test**: The FSR's "distortion in the internal market" assessment is a two-step assessment. First, there must be a link between the foreign subsidy and the economic activity on the internal market and, second, the foreign subsidy must actually or potentially negatively affect competition in the internal market.
2. **Application of the test:** Article 4(1) of the FSR does not contain an exhaustive list of indicators for a distortion, which increases uncertainty in the practical application of the test. Where foreign subsidies are deemed "most likely to distort" under Article 5, the burden of proof is reversed and companies need to show that the foreign subsidy is not distortive in their individual case.
3. **Public procurement and M&A**: For public procurement, the EC examines if a subsidized tender is unduly advantageous and linked to the foreign subsidy. In M&A, the EC examines distortions of the acquisition process itself as well as distortions on the market(s) where the combined entity is active post-concentration. The FSR assessment can lead to a different outcome than merger control, although in both cases, the EC may examine distortions on the same market(s).

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FROM THE EDITOR

The Grocery Battle Gets Underway

As this issue went to press at the end of August, the U.S. Federal Trade Commission had opened its case against the proposed $25 billion merger between grocery store retailers Kroger's and Albertsons. This case is considered key to the Biden administration's stated push to lower consumer prices, as the Republican Party is using inflationary grocery prices as a criticism of VP Harris in the ongoing presidential race. It's also likely to be the last chance the Biden/Harris administration has to claim an antitrust victory before November's election.

Eight states and the District of Columbia have sued alongside the FTC, while Washington and Colorado have each filed lawsuits to block the merger, cases scheduled to go to trial after the FTC's. In federal court in Portland, Oregon, FTC lawyers claimed they sought to block the deal in part because it could potentially raise prices for consumers and reduce bargaining power for unionized grocery workers.

In her opening statement on August 26, FTC chief trial counsel Susan Musser told U.S. District Judge Adrienne Nelson that by preventing Kroger from "swallowing" Albertsons, this action "will keep in place the vigorous competition that acts as a check on rising grocery prices and spurs improvements in quality and innovation."

Kroger attorneys said in response that they expect the merger to "immediately" lower prices for Albertsons shoppers, as prices at the latter can run 10% to 12% higher than at Kroger stores, and that the FTC "neither understand[s] the industry nor the parties within it."

Albertsons attorneys said the deal is necessary for the grocery retailers to compete effectively with such rivals as Costco, Amazon, Dollar Tree and Walmart, which at times sell products at prices lower than the grocery store chains can buy them wholesale. If the merger isn't allowed to proceed, "it could mean layoffs. It could include closing stores. It may include exiting certain markets altogether. These are the kind of things that are on the table if the merger does not go through," Albertsons lawyer Enu Mainigi said, as per Reuters.

Kroger has said previously that it intends to sell 579 of the roughly 5,000 stores that it will own upon the merger's completion. Some of the FTC's case will focus on whether the prospective buyer C&S Wholesale Grocers can successfully run these stores.

Judge Nelson was reportedly considering the FTC's request to pause the deal while an in-house judge examines how the deal could impact competition. Given the typical duration of such reviews, a pause would be regarded as a possible death blow for Kroger and Albertson's prospects, as in the past companies have abandoned paused deals rather than wait for the verdict.

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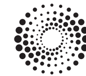

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