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EU COURT CONFIRMS PARENT LIABILITY FOR PRIVATE EQUITY BUYERS

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The European Commission (the "Commission") is well known for very high antitrust fines, including a record fine of €4.34 billion imposed on Google in July 2018. Less well known, at least among M&A lawyers, is the Commission's practice of imposing fines not only on direct infringers but also on their parent companies. European Courts have long upheld this practice, without regard to corporate-law principles of "piercing the veil." The parent liability principle can have significant implications where an antitrust infringer changes control. A seller may be liable for all or a portion of fines imposed for a subsidiary's conduct years after the subsidiary is sold, while the buyer may be fined for infringements by a newly-acquired subsidiary that continue after closing, even before the buyer has had time to integrate the target into its business. These implications may be particularly significant for private equity firms, who are in the business of buying and selling companies with relatively little involvement in their day-to-day management.

In July 2018, the EU General Court issued the first EU level judgement addressing the application of the parent liability principle to a controlling private equity shareholder. In 2014, the Commission fined Prysmian about €105 million for participating in a cartel in power cables between February 1999 and January 2009 and found The Goldman Sachs Group, Inc. jointly and severally liable for about €37 million as a result of its investment in Prysmian.[1] The Goldman group controlled 100% of the voting rights in Prysmian from July 2005 to May 2007, when its shareholding dropped to about 32% as a result of Prysmian's initial public offering (IPO). Nonetheless, the Commission imposed joint and several liability on the Goldman group in respect of both pre- and post-IPO periods, and the General Court upheld that approach.[2]

Although the *Goldman* court's upholding of parental liability for controlling shareholders was not surprising to EU antitrust lawyers, the Court's judgement sheds light on the treatment of private equity investors and the types of conduct that may lead to imposition of liability. This article discusses the *Goldman* judgement and suggests a number of implications for M&A agreements, from both the buyer's and the seller's perspectives.

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Background on Parental Liability for EU Antitrust Violations

Liability for antitrust violations under EU law attaches to an entire "economic unit," not only the company or companies directly involved in the infringement. This approach could imply that all members of a corporate group would be jointly and severally liable for antitrust violations by any group member. In practice, however, the Commission typically imposes fines only on the legal entities directly involved (or their successors in interest) and their ultimate parent companies (though fines may also be imposed on intermediate holding companies).

The EU courts justify the imposition of parental liability on the ground that a subsidiary "does not decide independently upon its own conduct on the market, but carries out, in all material respects, the instructions given to it by the parent company. . ." From a commercial viewpoint, however, the EU courts' approach is at odds with the way corporate groups operate. A parent company does not typically give its subsidiaries "instructions" on day-to-day management decisions (if it did, there could be a piercing-the-veil risk), but this does not mean that subsidiaries are "independent" in the usual sense of the word, since parent companies elect the members of their subsidiaries' boards of directors.

Early EU cases stated that the Commission cannot impute liability to a parent company merely because it is in a position to exercise decisive influence over its subsidiary, but must check whether that influence is actually exercised. However, EU courts now take the view that "the decisive factor is whether the parent company, by reason of the intensity of its influence, ***can*** direct the conduct of its subsidiary" (emphasis added).[3] In the case of a wholly- or nearly wholly-owned subsidiary, control can be presumed. In principle, a parent company can still escape liability by showing that its subsidiary acts "independently," but in practice it is very difficult to rebut the presumption of control. Even in respect of majority-owned subsidiaries significantly below 100%, where the presumption does not apply, the EU courts often require no detailed analysis from the Commission of whether and how parent companies give instructions to subsidiaries.

Whether the parent company was aware of or, *a fortiori*, involved in its subsidiary's illegal activity is irrelevant. In fact, lack of awareness may be culpable in itself. On the other hand, the fact that a parent

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company ordered an internal investigation of possible infringements has been cited as evidence of parental control. In light of the EU courts' broad approach, in the rare cases in which parent companies succeed in overturning Commission fines, these successes tend to be based on the technical defects in the Commission's decisions, rather than the parent's proving that a subsidiary was "independent." In summary, then, it is prudent to assume that a parent company may be found jointly and severally liable for antitrust violations by its subsidiaries and at least some joint ventures.

A number of cases have addressed the implications for parental liability of a change in control over a company found to have infringed EU competition law. A buyer may be held responsible only for the conduct of its subsidiary with effect from its acquisition if the subsidiary continues the infringement. Conversely, the seller is responsible for a subsidiary's conduct only up to the change in control. Thus, a seller and its former subsidiary may be held jointly and severally liable for a portion of the total fine that is attributable to the period during which the seller controlled the former subsidiary, while the buyer and its newly-acquired subsidiary may be jointly and severally liable for the portion attributable to the period after the sale.

The EU statute of limitations for antitrust infringements is five years, but it begins to run for the infringing company only when the violation ends. Since cartels sometimes operate for many years, a fine may be imposed in respect of conduct that occurred many years before. Where the infringing company has been sold, however, the statute of limitations begins to run for the seller from the date of the change of control. Thus, a seller's direct exposure to fines (as opposed to its exposure through warranty and indemnity provisions) is limited to five years after closing.

The *Goldman* Judgement

As a threshold matter, the Court considered Goldman's argument that it should be treated as a purely financial investor to which EU parental liability does not apply under EU case law. The Commission rejected this argument, because Goldman exercised voting rights regarding strategic decisions, such as the appointment of top management and the approval of business and management plans, and the General Court upheld this approach.

During the first period of Goldman's investment in Prysmian, when Goldman controlled 100% of the voting rights attached to Prysmian's shares, the General Court upheld the Commission's application of a presumption that Goldman controlled Prysmian, even though Goldman owned considerably less than 100% of Prysmian's equity following transfers of shares to passive co-investors and management incentive plans. As noted, there is a rebuttable presumption that a parent company holding 100% of the shares of a subsidiary that infringes EU competition law is able to, and does in fact, exercise decisive influence. *Goldman* thus clarifies that the presumption is triggered where a parent company controls 100% of a subsidiary's voting rights, even if its equity ownership falls well below 100% (in this case, as low as 84.4%).

Also as noted, the parent company of an EU antitrust infringer can in theory avoid liability by providing sufficient evidence that the subsidiary acted independently on the market. In the case at hand, however, the Court rejected Goldman's argument that there was a great deal of evidence demonstrating that Prysmian acted independently on the market, without any direction from Goldman.

Instead, the Court upheld the Commission's finding that Goldman did in fact exercise control over Prysmian based on "objective factors": (i) Goldman's power to appoint the members of the various boards of directors of Prysmian; (ii) Goldman's power to call shareholder meetings and to propose the revocation of directors or the entire board; (iii) Goldman's actual level of representation on Prysmian's board; (iv) management powers delegated to Goldman's board representatives; (v) the important role of Goldman's representatives on certain board committees; (vi) Goldman's receipt of regular updates and monthly reports; (vii) measures Goldman took to ensure continuation of decisive control after the IPO date; and (viii) evidence of behaviour "typical of an industrial owner."

Perhaps unsurprisingly, the Court found little difficulty in upholding the Commission's finding that Goldman exercised decisive influence over Prysmian during the period when it controlled 100% of Prysmian's voting rights and appointed all of Prysmian's board members, who then delegated significant management powers to individual board members. More surprising is the Court's treatment of the post-IPO period, when Goldman held only about 32% of Prysmian's votes. The Court found that the fact that the post-IPO board was appointed before the IPO and that Goldman caused Prysmian to adopt a slate system for the nomination and appointment of new boards supported the Commission's conclusion that Goldman maintained control with a smaller shareholding. It was irrelevant, according to the Court, that the Prysmian board had a majority of independent directors for securities law purposes, because the board's own assessment of independence "could not call into question" the Commission's finding that a majority of directors had unspecified "links" to Goldman.

The General Court further examined the Commission's reliance on Goldman's role in certain Prysmian board committees—the strategic committee, compensation committee and internal control committee. The Court upheld the Commission's reliance on Goldman representatives' majority position on the strategic committee, even though the strategic committee had no veto or even voting rights in relation to board decisions, but found that the Commission could not rely on Goldman representatives' participation in the compensation and internal control committee, because they did not represent a majority on those committees. (Oddly, the General Court did not consider whether the other members had "links" to Goldman for this purpose.)

The General Court noted that Goldman's encouragement of cross-selling between Prysmian and other portfolio companies was "evidence of behaviour typical of an industrial owner," even though Goldman did not give any instructions to establish contacts, much less to enter into contracts, or engage in a systematic practice of cross-selling.

The General Court also agreed with the Commission that Goldman's receipt of regular updates and monthly reports constituted an additional factor illustrating that Goldman was regularly informed of Prysmian's commercial strategy, supporting the existence of an economic unit between them.

In sum, the General Court concluded that "the Commission was entitled to consider, without making any error, that the applicant exercised decisive influence not only before the IPO date but also during the entire period from 29 July 2005 until 28 January 2009." Notably, the Commission was not required to present any evidence that Goldman had any involvement in, or was even aware of, the illegal aspects of Prysmian's commercial policy.

Implications for M&A Agreements

M&A agreements typically contain detailed provisions allocating liabilities through a combination of warranties and rights to indemnification, including the target's compliance with law (including antitrust law). The seller's obligations are commonly subject to thresholds and caps, as well as to procedural requirements regarding how warranty and indemnity claims must be asserted. The EU's imposition of joint and several liability for the parents of subsidiaries engaged in EU antitrust violations has significant implications for M&A agreements, in particular for private equity firms that buy and sell controlling interests in portfolio companies frequently.

Implications From the Seller's Perspective

From a seller's perspective, a number of modifications to traditional M&A agreement clauses may be appropriate to take account of the EU antitrust law issues discussed above. Potentially affected provisions include those relating to (i) the period for which the warranties survive closing, (ii) limitations of liability, and (iii) procedural rights.

As regards the survival period, M&A agreements often limit the seller's obligations to a relatively short period after closing (typically one to three years) but may extend for the entire statute of limitations in the case of a violation of law. Although the EU statute of limitations is five years, this period only begins to run for the infringing company from termination of the violation. If the target continues to participate in a cartel post-closing, therefore, a portfolio company's exposure can be prolonged indefinitely. The seller may want to clarify that its exposure will end no later than five years after closing, the EU statute of limitations for joint and several liability to be imposed on the seller.

The possibility that a private equity seller will be found jointly and severally liable for all or a portion of a fine imposed on a portfolio company may also raise questions about limitations of liability. For example, the seller should ensure that the sale agreement adequately deals with joint and several liability where the buyer may be liable for the target's fine but claim reimbursement for all or part of that fine (or vice versa).

A seller may also want to review the procedures applicable to warranty claims in light of the possibility to obtain reductions of EU fines by cooperating with the Commission. Provisions requiring buyers to notify the seller promptly if a third party asserts a claim may be insufficient to protect the seller's interests if the buyer or portfolio company itself become aware of an infringement and seek to reduce or avoid a fine by "blowing the whistle" or cooperating with the Commission's investigation. Thus, a seller might want to require the buyer or the portfolio company to notify the seller immediately upon becoming aware of facts that could make an internal investigation appropriate and negotiate the right to control such internal investigations, filing of leniency or immunity applications and cooperation with the Commission.

Implications From the Buyer's Perspective

A private equity buyer's concerns about typical M&A agreement provisions largely mirror the seller's. Although a seller may seek to negotiate a limitation to warranty obligations lasting for the entire statute of limitations, a buyer may resist on the basis that the seller should not escape liability for an infringement that began on the seller's watch and of which the buyer may have been completely unaware. A private equity buyer with no prior involvement in the relevant markets and no reason to suspect that a violation is occurring may be better placed to defend this position than an industrial buyer, particularly if other members of an industrial buyer's group are also involved in the cartel.

The buyer may also argue that the seller's warranty obligations should cover not only fines imposed on the target but also fines imposed on the buyer as a result of the target's conduct. Since the buyer will only be exposed to fines in respect of infringements that continued after the buyer acquired control, the seller is likely strongly to resist such an argument. However, the buyer may argue that it should at least be protected against liability resulting from target infringements that continue during a reasonable transition period post-closing so that it has an opportunity to detect and put an end to such behavior. Again, a financial buyer that could not be considered to be "on notice" of the violation may be better placed to defend this position than an industrial buyer whose other subsidiaries may also be involved in the cartel.

Conclusion

The concept of parent liability for subsidiaries' antitrust infringements is well established in EU competition law and has been repeatedly upheld although it flies in the face of the basic corporate law principle of limited liability. The *Goldman* judgement sheds light on how this EU law principles applies in the private equity context, including the following:

(i) private equity buyers who, as is commonly the case, appoint directors to their portfolio companies' boards and otherwise become involved in management decisions are not exempt from liability as purely financial investors;

(ii) where a private equity firm controls all or almost all of the voting rights of a portfolio company, the Commission can presume that it exercises control of the portfolio company even if a significant portion of the portfolio company's equity is held by other, passive investors; and

(iii) a private equity investor may be found to control a portfolio company even with a relatively small minority interest, depending on factors such as its representation on the company's board and board committees, informal links between the firm and independent directors, the detail and frequency of information it receives on the portfolio company's activities, and whether it encourages business connections between portfolio companies.

Again, while a private equity firm can in theory rebut a presumption of control even of a wholly owned portfolio company, it is difficult if not impossible to do so in practice. The absence of evidence that a private equity firm knew of or was involved in a portfolio company's antitrust infringement is not a defense.

The EU's approach to fining groups for antitrust violations has significant implications for private equity M&A agreements. In particular, traditional M&A agreement provisions relating to sellers' warranty obligations and the applicable procedures may not fully address the implications of EU fining law and practice. How fully these implications can or should be addressed will vary from case to case. Where there is no basis to suspect that a target company engaged in any EU antitrust violations, few or no special provisions may be required. Even in these cases, however, the parties may consider simple changes such as setting an outside limit of five years for warranty survival periods based on the EU statute of limitations. Where the target is known or believed to have infringed EU competition law but the Commission has not yet imposed fines, however, the allocation of antitrust liabilities may be an essential element of the transaction's economics and require detailed treatment in the transaction documents.

ENDNOTES:

[1]Case AT.39610: Power cables, Commission decision of 2.4.2014 addressed to ABB AB and others, *available at* http://ec.europa.eu/competition/antitrust/cases/dec_docs/39610/39610_9899_5.pdf.

[2]Case T-419/14, Judgement of the General Court of July 12, 2018—*The Goldman Sachs Group v. Commission*, *available at* http://curia.europa.eu/juris/document/document.jsf;jsessionid=9ea7d0f130dc6720787ba0f3422ab623d82d40b0b098.e34KaxiLc3eQc40LaxqMbN4Pbh0Ne0?text=&docid=205830&pageindex=0&doclang=EN&mode=req&dir=&occ=first&part=1&cid=444536.

[3]Case T-77/08, *The Dow Chemical Company v. Commission*, judgement of February 2, 2012, para. 77, *available at* http://curia.europa.eu/juris/document/document.jsf?text=&docid=119002&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=76367, and Case T-76/08 *EI du Pont de Nemours and Others v. Commission*, judgement of February 2, 2012, para. 62, *available at*, http://curia.europa.eu/juris/document/document.jsf?text=&docid=119007&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=76558.

EARNOUT PERIOD PITFALLS: COVENANT TO OPERATE "CONSISTENT WITH PAST PRACTICES" PRECLUDED EARLY DISMISSAL OF EARNOUT CLAIM (*EDINBURGH*); DELAYED CLOSING LED TO EARNOUT PERIOD STARTING BEFORE CLOSING (*GLIDEPATH*)

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Earnouts, while often used to bridge valuation differences during negotiation of an agreement to sell a company, frequently lead to post-closing disputes. Two Court of Chancery decisions issued earlier this year highlight pitfalls associated with the period during which an earnout is measured (the "Earnout Period"). In *Edinburgh Holdings, Inc. v. Education Affiliates, Inc.*,[1] the court held that the covenant to operate the acquired business "consistent with past practices" during the Earnout Period precluded disposition of the earnout-related dispute at the early pleading stage of litigation. The court stated that the covenant necessitated a facts-intensive analysis of what past practices were and what the practices during the Earnout Period had been. In *Glidepath Limited v. Beumer Corporation*[2] the court rejected the plaintiffs' request for reformation of the acquisition agreement to change the dates of the Earnout Period based on a delay in signing and closing the agreement (which had led to the anomalous result of the Earnout Period commencing before the closing).

Key Points

***Edinburgh* serves as a reminder that, without *specific* covenants relating to operation of the business during the Earnout Period, a covenant to operate in accordance with a general standard (such as "consistent with past practices") may lead to *non-dismissal at the pleading stage* of a claim for breach of an earnout payment obligation.** We note that the inclusion of specific covenants *in addition to* a general standard could provide an answer to, or at a minimum could provide context for, a determination whether an action taken during the Earnout Period was or was not permissible (and thus might permit disposition of such a dispute at the pleading stage). In the case of the *Edinburgh* agreement, the parties had agreed that the buyer would operate the acquired business during the Earnout Period "consistent with past practices" and there were *no* specific covenants relating to operation of the business during the Earnout Period. As discussed below, counsel for both sellers and buyers should carefully consider the benefits of including specific, business-contextualized covenants to govern operation of the business during an Earnout Period. (Of course, even when parties endeavor to include specific covenants, different interpretations and unanticipated events may in any event lead to disputes which the court deems to be unresolvable at the pleading stage.)

These decisions also serve as a reminder of the prevalence of post-closing disputes relating to earnouts. Although earnouts are used frequently to solve valuation disagreements between parties during negotiation of a sale agreement, they commonly lead to post-closing disputes relating to the earnout itself. Thus, parties should seek to structure the purchase agreement to limit the potential for disputes and to incentivize their settlement in the event that they arise. Where the potential amounts involved are not large, parties should consider whether they would be advantaged by settling valuation disagreements upfront (or utilizing an alternative to an earnout) rather than relying on an earnout.

Statistics on earnouts. Earnouts were utilized in about 28% of the private target transactions entered into in 2016 and the first half of 2017, according to the 2017 ABA Private Target Deal Study (which analyzed 139 deals with purchase prices between $30 million and $500 million). This rate is consistent with the rate generally over the past decade, which has ranged from 20- 30% (with a spike to 38% in 2014). With respect to the agreements with earnouts:

- 21% included an express covenant requiring the buyer to run the business consistent with past practice, and 33% expressly permitted the buyer to operate post-closing in its discretion;
- 8% included an express covenant requiring the buyer to seek to maximize the earnout
- 5% included an express acceleration of the earnout payment(s) on a change of control (in recent prior years, 11-27% of agreements with earnouts included this type of acceleration)
- 51% of agreements expressly permitted the buyer to offset indemnity payments against the earnout (in recent prior years, 58-81% of agreements with earnouts expressly permitted offsets); and
- 32% provided for calculation of the earnout based on revenues, 27% based on earnings/EBITDA, and none based on a combination of revenues and earnings.

Edinburgh

Background. In 2013, the American Society of Professional Education, Inc. (the "Seller") sold its proprietary education business (the "Business") to a subsidiary of Educational Affiliates, Inc. (the "Buyer") pursuant to an asset purchase agreement (the "APA"). The APA provided for $6 million to be paid at closing and four contingent annual installment payments based on the Business' revenue. The seller's managers of the Business pre-closing continued on as the management post-closing and, under their new employment agreements, had "significant autonomy in running the [Business]." The APA required that the Business be operated during the Earnout Period "in a reasonable manner and consistent with past practices of [the seller]." The APA provided as follows with respect to calculation of the earnout payments: (i) for each of 2013, 2014 and 2015, the payment will be equal to 50% of the "Pre-Tax Profits" if the "Total Revenue" is less than $13 million and 65% if the Total Revenue is $13 million or more; (ii) at the end of 2016, if $2 million or less has been paid in the aggregate, then an additional amount will be paid so that the aggregate amount paid equals $2 million; and (iii) for 2016, the payment will be equal to 25% of Total Revenue if Total Revenue is $8 million or more.

Total Revenue was $12 million the first year of the contingent payout period and rose each year thereafter, reaching $12.64 million in the final year. The buyer made the first three contingent payments, but refused to make the final payment (of $4.7 million). The seller sued to obtain the final payment. The buyer sought dismissal of the claim on the basis that (among other things), the Business had not been operated by the seller's former management to optimize revenues and, specifically, had not been operated "consistent with past practices" as required under the APA. Vice Chancellor Slights refused to grant the motion to dismiss the breach of contract claim on the basis that the issue whether a business was operated consistent with past practices is facts-intensive and therefore cannot be decided at the pleading stage.

Without more detailed, specific covenants relat-

ing to operation of the business during the Earnout Period, a covenant to operate "consistent with past practices" (or other general standard) may lead to non-dismissal at the pleading stage of a claim for breach of an earnout payment obligation. The court stated that the issue of compliance with a covenant to operate consistent with past practices "is fact intensive." The court wrote: "[T]o answer [the question] dispositively, the Court must consider evidence of [the seller]'s past practices and compare those practices to the practices employed after the [sale] was consummated. Such evidence is not before the court and, in any event, could not be considered on a motion to dismiss." As noted above, the inclusion of specific covenants in addition to the general standard—as is fairly typical—could well lead to a different result by providing an answer, or least context, for a determination whether an action taken during the Earnout Period was or was not permissible.

The court rejected the seller's contention that the implied covenant of good faith applied to the buyer's conduct during the Earnout Period. The court stated that the implied covenant "requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the bargain." Here, the seller contended that the implied covenant required that the buyer could not deprive the seller of the fruits of the bargain by "actively preventing" the Business from making acquisitions requested by the seller that would have grown revenues. (The seller maintained that the buyer prevented these acquisitions because the buyer was "singularly focused" on securing funding from non-government sources—in order to meet a regulatory requirement for this type of educational institution that not more than 90% of revenues be obtained from government funding.) The court ruled that the implied covenant did not apply because the APA expressly covered the subject of the claim by setting forth a standard for operation of the business during the Earnout period—*i.e.*, that the Business was to be operated consistent with past practices. If the contract "expressly addresses a particular matter, an implied covenant claim respecting that matter is duplicative and not viable," the court wrote. In effect, inclusion of the covenant to operate consistent with past practices left no "gap" in the agreement as to what the parties had agreed with respect to operation of the Business (*i.e.*, they had agreed to the general standard of consistency with past practice). However, the content of that general standard as applicable in the particular case was not knowable without fact-finding at trial (*i.e.*, determining what actions would be consistent with past practices and what actions were taken).

Glidepath

Background. The parent of Glidepath Limited (together with Glidepath, the "Sellers") sold 60% of the equity in Glidepath to Beumer Corporation (the "Buyer"). The Acquisition Agreement and an Operating Agreement (the "Agreements") contemplated a period of shared management (albeit with the Buyer in control) for three full years. The consideration consisted of (i) a cash payment at closing of $1 million; (ii) an earnout payment equal to 60% of the net profits generated by Glidepath during the 'Earnout Period,' up to a maximum of $1.56 million; (iii) a distribution equal to 40% of the net profit generated by Glidepath during the Earnout Period, up to a maximum of $1.04 million (*i.e.*, with the earnout payment, the Sellers would receive the benefit of all of the net profit generated by Glidepath during the Earnout Period, subject to the earnout cap); and (iv) a payment of an amount between $400,000 and $2.4 million (depending on Glidepath's net profit during the Earnout Period) in return for the remaining 40% of Glidepath's equity if the Buyer chose to exercise a call at the end of the Earnout Period.

Glidepath did not perform as expected and the Buyer notified the Sellers that, using the Earnout Period provided for in the Agreements, no earnout payment would be payable. The plaintiff-Sellers brought suit, alleging contract and fiduciary duty breaches and seeking reformation of the Agreements. The court requested that the parties address first the reformation claim (as, without reformation, the contract claims would fail and the deadline for bringing a fiduciary claims would have expired).

The Agreements stated that the Earnout Period covered "fiscal years 2014, 2015 and 2016" *(i.e.*, April 1, 2013 through March 31, 2016). When the Agreements were drafted, the parties anticipated that the closing would occur shortly after Glidepath's fiscal year-end of March 31, 2013. For valid business reasons, however, the signing and closing were delayed and did not actually occur until January 2014. The Agreements were dated effective as of January 1, 2014; but the dates for the Earnout Period remained unchanged from the initial draft. The Sellers argued that they believed and the parties intended that the measurement period for the earnout would be three full years from the effective date of the Agreements (*i.e.*, January 1, 2014 through December 31, 2016). They argued for reformation of the Agreements to provide for these dates as the Earnout Period. Vice Chancellor Laster rejected the plaintiffs' request for reformation of the contract.

The court found that the party seeking reformation of the contract did not prove by clear and convincing evidence that the parties had agreed to a different earnout measurement period than the period that was set forth in the final, written agreement. The court reviewed that the party seeking reformation of a contract has the burden of proving, by clear and convincing evidence, that (i) it was mistaken about the contents of the final, written agreement; *and* (ii) its counterparty either (a) was similarly mistaken (so-called "mutual mistake") or (b) knew of the mistake and remained silent so as to take advantage of the error (so-called "unilateral mistake"); *and* (iii) there was a "specific meeting of the minds" regarding a term that was not accurately reflected in the final, written agreement (*i.e.*, that there was an actual agreement between the parties that was not reflected in the final, written agreement). To establish proof by "clear and convincing evidence" requires proving that it is "highly probable, reasonably certain, and free from serious doubt," the court wrote. To prove mutual mistake, the plaintiff must show that both parties were mistaken as to a material portion of the written agreement.

According to the court, the evidence established as follows: (i) The Sellers mistakenly believed that the Agreements would use calendar years to measure the relevant Periods, but did not show that the Buyer was similarly mistaken. The court found credible the Buyer's testimony that the Buyer had assumed that the dates that were set forth in the Agreements would be the applicable dates. The court noted the Buyer's testimony that, in a recent prior acquisition (by the Buyer with a different counterparty), a similar set of circumstances unfolded in terms of a delayed closing, no changing of the dates for the Earnout Period based on the delayed closing, and thus an Earnout Period that commenced prior to closing-with, in that case, no objection from the sellers. (ii) The Buyer ultimately came to understand that the Sellers had made a mistake, but this happened *well after signing* (at which time the Buyer "gained no advantage by remaining silent," the court noted). (iii) While both sides agreed that the original bargain contemplated that the Earnout Period would span three full years after closing, and that understanding assumed that the closing occurred shortly after March 31, 2013, there was no evidence of any meeting of the minds as to how the dates would operate if (as actually occurred) the closing were delayed.

The court also noted as persuasive evidence cutting against the plaintiff-Sellers' position that the issue of use of calendar versus fiscal years for the acquired business post-closing had been specifically discussed between the parties, without those discussions prompting any discussion of whether the fiscal years specified in the Agreements should be changed to calendar years. In addition, the court noted that the Sellers, while "unhappy" when they heard that there would be no earnout payment, did not challenge the conclusion until four months later and only disputed the dates set forth in the Agreements "after [the] dispute arose."

Practice Points on Earnouts

Parties should consider not relying solely on a vague, general standard for operation of the business, but including clear, specific, business-contextualized covenants. As a general matter, parties should not rely solely on a standard such as "consistent with past practices," "in the ordinary course," or "in a reasonable manner," but should include specific covenants tailored to the business and industry at issue and to all reasonably anticipated developments. Parties should consider requiring that the acquired business, to the extent feasible, be operated pursuant to pre-agreed, detailed business plans and budgets that specify the important aspects of operation for the particular business (such as acquisitions, expenses, marketing, R&D, intercompany support services, tax-sharing agreements, etc.)—with such changes as the parties agree to over time. While specificity with respect to the parties' obligations during the Earnout Period can reduce the risk of disputes and/or make settlement more likely, we note that, in any event, a buyer, if it will be running the business post-closing (and depending on other circumstances) may wish to provide instead for a *general* standard, without any specificity, so as to have the maximum flexibility for running the business.

Risks presented when "carryover" employees are involved. If the acquired business is to be managed by former employees of the seller ("carryover employees"), there are potential risks for the buyer, the seller and the carryover employees—particularly if the carryover employees will be providing the information upon which the earnout calculations will be determined and/or will be receiving a significant portion of any earnout payments made. *A buyer should consider* whether provisions should be included to address the risk of potential non-loyalty to the buyer. For example, the buyer could consider providing for a specific right to object to or double-check the information provided, or a process for correction, if it believes that the information provided is fraudulent or inaccurate. A mechanism for ongoing or periodic oversight of compliance with covenants applicable to the running of the business during the Earnout Period also could be considered. Alternatives to an earnout should be considered—such as performance-related employee compensation or bonuses (subject to tax and other considerations); contingent value rights (CVRs); or, where the achievement of specific non-financial milestones are critical, milestone payments tied to those achievements. *A seller and carryover employees should consider* whether provisions should be included to address the risk of the buyer reducing or changing the carryover employees' duties or authority to run the business and/or of the buyer directing the carryover employees to take action that is (potentially) inconsistent with the sale agreement. A seller should also consider generally the possibility of the carryover employees' greater loyalty to the buyer than to the seller going forward.

Disclaimers should be included. In *Edinburgh*, the plaintiff claimed that the seller had made extra-contractual "promises" to achieve revenue growth. Although the court decided that the statements made by the seller were only forecasts and that no binding obligation to grow revenues had been made, the issue was complicated by the fact that there was no express disclaimer in the purchase agreement relating to reliance on extra-contractual statements. Generally, a seller should include an integration clause with an explicit anti-reliance statement by the buyer (*i.e.*, a provision stating that the written agreement is the sole agreement between the parties with respect to the subject matter of the agreement and supersedes any previous agreements, and that the buyer is not relying on any representations made or information provided to it other than as expressly set forth in the agreement). In addition, a buyer should seek to expressly disclaim any obligation to ensure or maximize the earnout payments; conversely, a seller may seek to negotiate to include a provision to the effect that the buyer must conduct its businesses following the closing so as to seek to maximize the earnout payments.

The parties' specific objectives in adopting an earnout should be scrutinized and the appropriateness of an earnout considered. As noted, earnouts often prevent disagreements during the negotiation of the deal price only to result in post-closing disputes over the earnout itself. We note that in some transactions the earnout is utilized to bridge a relatively small valuation gap and the parties may be better served with a compromise upfront rather than risking later litigation (or even arbitration) with respect to the earnout.

A well-crafted earnout provision involves significant challenges in terms of both negotiation and drafting. Earnouts implicate numerous interrelated provisions involving the metrics for the earnout formula, the accounting principles that will be applicable to calculation of the formula, the process for making the earnout determinations, and the seller's rights and the buyer's obligations with respect to the operation of the acquired business during the Earnout Period (including the general level of efforts, and any specific efforts, by the parties that will be required with respect to enabling the business to reach the targets). When an earnout takes the form of "milestone payments," which are payable upon the occurrence of specified events (such as, in pharma deals, regulatory approvals being received for drugs in development), the nature of the trigger events, specificity as to the parameters relating to the trigger events, and the parties' respective obligations (if any) in promoting the occurrence of the trigger events, need to be addressed. In addition, an earnout will create special considerations for the governing law, remedies and many other provisions in the sale agreement. Specific covenants relating to operation of the business during the earnout measurement period should be drafted with a focus on anticipated events or issues that could adversely impact operations, and should include key actions that the parties contemplate will be taken.

Lawyers and business people who understand the specific company and its industry, its business operations, and its accounting practices should work closely together in crafting provisions that are as clear and specific as possible and are contextualized for the specific business at issue. Litigators should review the provisions to ensure clarity and an effective dispute resolution mechanism. Review by tax and employee benefits lawyers is also advisable, as issues relating to the treatment of items such as tax or employee expenses, accruals, rebates, reserves, and so on, often arise and can have a significant dollar impact on an earnout formula. The parties may also want to consider including in their agreement general statements of their mutual intent with respect to the earnout generally (or with respect to specific provisions) in order to help guide resolution of any future dispute. In addition, hypothetical examples of earnout calculations for illustrative purposes should be considered.

A buyer does not have a legal duty to ensure or maximize the earnout—but the buyer cannot purposefully frustrate the earnout. Generally, in Delaware, *except to the extent that the parties expressly provide otherwise in their agreement*, the buyer has no obligation to take or refrain from taking action, and no implied obligation to use any form of best or reasonable efforts, to ensure or maximize an earnout. However, the courts have held that the implied covenant of good faith and fair dealing requires that the buyer not take any affirmative action for the purpose of frustrating the achievement of earnout targets. The courts tend not to view actions as having been taken for the purpose of frustrating payment of an earnout if (i) there is any basis for the actions to be viewed as legitimate business decisions and the sellers' complaint as a dispute concerning business strategy and/or (ii) there are countervailing factors indicating efforts by the buyer that supported the relevant business (such as the investment of funds in the business, the hiring of additional sales people for it, and so forth). Thus, there is a generally high bar to succeeding on a claim that a buyer frustrated an earnout—but, because the factual context is critical, and because earnout provisions often are not sufficiently specific, the result of litigation relating to earnouts has a relatively high degree of uncertainty. (Note that the law of other states varies, with some states, such as California and Massachusetts, imposing an implied obligation that a buyer take "reasonable efforts" to achieve an earnout—at least in the absence of an express disclaimer to the contrary.)

Particularly in light of the prevalence of post-closing earnout-related disputes, the parties should consider including provisions that mitigate the risk of litigation and encourage settlement of disputes. In addition to seeking to avoid disputes through clear and specific drafting (as discussed above), the parties should consider the following possibilities for discouraging litigation and incentivizing settlement of disputes that do arise.

- ***Arbitration.*** The parties should consider providing for arbitration of disputes to be the exclusive method of resolving disputes, with the arbitrator's decision being final and binding on the parties. (We note that, if the agreement provides for arbitration *without* the arbitrator's decision being final and binding, there is a risk that, in future proceedings, a party may be deemed to have waived any issues and considerations not reflected in its initial calculations of the earnout and/or in the initial objections it made to the arbitrator's decision.) Some acquisition agreements limit the scope of arbitrable disputes by requiring that the buyer and the seller prepare and agree on a written description of the accounting issues in dispute and that the arbitrator limit its decisions to those issues, with the arbitrator's decisions based solely on the arguments and theories raised by the parties.
- ***Graduated formula.*** A graduated formula (*i.e.*, a percentage payment on partial satisfaction of performance targets), as opposed to an all-or-nothing structure (*i.e.*, a single payment, triggered only if performance targets are fully met), may avoid an incentive for the buyer to just miss achievement of the target or an incentive for the seller to stretch to just make the target (albeit to the detriment of the business) to the extent that doing so is within the party's control. A graduated formula could also reduce the amount of discrepancy that could be subject to dispute.
- ***Floor or cap.*** The parties could consider including a floor and/or a cap on the earnout payments so as to limit the range of discrepancy that can be subject to dispute.
- ***Fee-shifting.*** The parties may wish to consider including fee-shifting provisions so that the party whose position is rejected (or is only minimally successful) in arbitration or litigation would bear some or all of the other party's expenses.
- ***Specified remedies.*** As it can be difficult to prove that benchmarks would have been achieved but for breaches by the buyer, the seller should consider seeking to specify remedies for breaches of the sale agreement—such as liquidated damages (which, as a stimulus to compliance with the earnout provisions, could be in excess of the aggregate payments that could be earned under the earnout formula); specified adjustments to the metrics of the earnout formula; or payment of all or a specified percentage of the earnout.
- ***Offset rights and carrybacks.*** The parties should

specify whether there will be any right to use the earnout payments as an offset against any required payments under indemnification claims or otherwise. A seller may seek to delay other payments being made until the earnout is finally determined. The parties should consider whether there will be any adjustment with respect to payments made (or missed) in previous installments based on subsequent performance.

Distinguish earnout disputes from other disputes. If a post-closing earnout dispute arises, the sale agreement should be carefully analyzed to distinguish and separate from the earnout dispute any issues that actually give rise to claims of breach of non-earnout-related representations and warranties, fraud, indemnification, or other issues. The agreement also should provide whether the buyer can offset indemnity claims against earnout payments.

The risk associated with the final earnout payment. In a number of cases (including *Edinburgh*), all earnout payments have been made other than the *final* payment due. This not uncommon pattern suggests that *throughout the period* the parties should monitor the performance of the business with respect to the calculation of the earnout and be aware of and try to resolve disputes as they arise.

Selecting dates for the Earnout Period. Determining the optimal length of an Earnout Period will involve, for either party, a balancing of factors. Perhaps most importantly, a longer period will provide a more reliable look into how the business performs, but will also entail a longer period during which there are restrictions on the business, a longer wait for the earnout payment, possibly longer involvement by the seller in managing the business, and an increased potential for the business' performance to be affected by *general* industry or market conditions (or other factors not related to the specific business acquired). At the same time, of course, a longer period may be preferred by a seller to provide sufficient time for the business' value to grow. Thus, the preferred route will depend on the specific factual context. As highlighted in *Glidepath*, dates for the Earnout Period included in a draft agreement should be reconsidered and (if appropriate) revised if the signing and closing date of the agreement extends beyond the date that the parties initially anticipated.[3]

ENDNOTES:

[1]C.A. No. 2017-0500-JRS (Del. Ch. June 6, 2018).

[2]C.A. No. 1220-VCL (Del. Ch. June 4, 2018).

[3]Further practice points relating to specifically tailored earnout terms, and discussion of the major Delaware earnout decisions, are included in our article, *The Enduring Allure and Perennial Pitfalls of Earnouts* (January 2018), https://corpgov.law.harvard.edu/2018/02/10/the-enduring-allure-and-perennial-pitfalls-of-earnouts/.

UK CITES SECURITY REASONS FOR PROPOSED DEAL NOTIFICATION REGIME

By Matt Evans, Leon N. Ferera, William E.H. McDonald, Laura Fraedrich and Chase D. Kaniecki

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The UK government has published a consultation paper on national security and investment which proposes far-reaching rules to enable it to scrutinize and ultimately block deals it believes may give rise to national security concerns where "hostile actors" might use ownership of, or influence over, businesses and assets to harm the United Kingdom. The proposals, which are described in further detail below, will, in many ways, bring the UK foreign direct investment review regime more in line with the Committee on Foreign Investment in the United States ("CFIUS") review process in the United States.

The proposals envisage a voluntary national security notification regime which, in theory, could cover any sector of the economy, although guidance is given as to likely areas of focus. Where deals complete without being notified for national security clearance, the government proposes having a six-month window following completion in which to assert jurisdiction to review the deal.

The proposed regime will cover not just acquisitions of majority shareholdings, voting rights or asset ownership but any deal giving the acquirer "significant influence" over an entity or asset. An acquisition of more than 25% of shares or votes in an entity would be covered, and even a lower shareholding, in particular if accompanied by a veto right over the business plan, could meet the test. No deal will be too small to be exempted from the new regime. The proposed timetable for a national security review seems likely materially to slow the pace at which qualifying deals can be completed, with a proposed review period of up to 21 weeks (105 working days), with further extensions possible.

The proposed changes, if introduced in line with the government's consultation paper, can be expected to introduce additional costs and uncertainty of foreign investment in the United Kingdom. Given the extent of the changes, the period of the consultation and the need for new primary legislation, it is unlikely that the new regime will come into force until well into 2019 at the earliest. Potential acquirers of companies doing business in the United Kingdom which may find themselves in the future subject to this new regime may wish to consider bringing forward their investments so as to avoid its application.

In addition, given the similarities between the proposals and the current CFIUS review process in the United States, parties might, at least initially, consider looking to CFIUS precedent for clues as to how the changes could be implemented from a practical perspective.

Context

The paper emphasizes that the proposals are not intended to deter, or change the United Kingdom's approach to, foreign investment. The paper explains that the proposed new regime is "only related to national security" and is intended to allow the government to take measures where "hostile actors" might use ownership of, or influence over, businesses and assets to harm the United Kingdom. It goes on to state that "foreign investment and an active and competitive economy are key to the UK's growth and development; the UK warmly welcomes the contribution that foreign investment makes and seeks to increase international partnerships in areas such as research and innovation. Only a small number of investment activities, mergers and transactions in the UK economy pose a risk to our national security."

The new approach is not intended to change the UK's openness to foreign investment or its open and dynamic economy. The government will, apparently, continue to strive to increase overseas investment from, and collaboration with, partners across the world. The paper also observes that the United Kingdom is not alone in wanting to implement a regime of this kind and that other countries and international organizations have updated their rules and powers (or are in the process of doing so) to ensure that they can protect their own national security interests. For example, although the United States already has an interagency committee, known as CFIUS, that has the authority to review transactions that could result in control over a U.S. business by a foreign person, new legislation that would significantly change foreign direct investment review in the U.S. by, among other things, expanding the jurisdiction of CFIUS, is expected to become law in the very near future. In addition, the UK proposals and other foreign direct investment related developments in Europe could reignite the discussion on the draft EU Regulation Establishing a Framework for the Screening of Foreign Direct Investments into the European Union. The European Union has identified the investment screening proposal as a legislative priority and aims to adopt the Regulation by the end of the year.

The proposals in the paper are far-reaching in scope, and it remains to be seen how, if and when implemented, they would be put into practice.

Key Questions

Why Is the United Kingdom Doing This?

The United Kingdom believes it needs to update its ability to scrutinise and, if necessary, block deals that may pose a risk to UK national security. It wishes to reform current laws to enable it to protect the country from hostile actors using ownership of or influence over businesses and assets to harm the United Kingdom. It believes its proposed reforms will bring the United Kingdom closer in line with other countries' existing foreign investment regimes, such as the United States.

What Types of Transaction Could Be Caught?

The UK calls relevant transactions "trigger events." Similar to the current CFIUS review regime in the U.S., trigger events will be transactions that grant a party significant influence or control over entities or assets.

This would include:

- acquiring more than 25% of shares or votes in an entity;
- acquiring more than 50% of an asset;
- acquiring further significant influence or control beyond the above thresholds; and
- acquiring the ability to direct the operation of an asset or direct the operations or the strategic direction of an entity.

A trigger event could include a person who acquires a minority shareholding (less than 25%) but who nevertheless is the largest shareholder and/or whose recommendations are likely to be, or are likely almost always to be, followed by other shareholders.

The government envisages that a trigger event could also include a situation in which a foreign state has the right to appoint its representative to a business' board of directors and thereby have the means or opportunity directly or indirectly to shape that entity's operations or strategy. This could be of particular relevance to companies whose significant shareholders include state-owned enterprises.

Which Areas of the Economy Are Affected?

In theory, all areas of the economy could be subject to the proposed new regime. The government has identified certain "core areas" that are most likely to give rise to national security risks. These are:

certain national infrastructure sectors:

- civil nuclear,
- defense,
- communications,
- energy,
- transport;

certain advanced technologies:

- advanced materials and manufacturing science,
- artificial intelligence and machine learning,
- autonomous robotic systems,
- computing hardware,

- cryptographic technology,
- nanotechnologies,
- networking and data communication,
- quantum technology,
- synthetic biology;

critical direct suppliers to the government and emergency services sectors;

and military or dual-use technologies.

The government has made clear that sectors outside these core areas may also fall within the proposed new regime. This will depend on a case by case assessment. In addition to specific sectors of the economy that qualify as national infrastructure sectors, such as finance, chemicals, food, health, space and water, the government has flagged that the acquisition of land in close proximity to a sensitive site may raise national security concerns, as may the acquisition of significant influence over a supplier that indirectly provides goods or services to a core area.

How Does One Notify a Deal?

The government envisages a notification template and the possibility of submitting an online notification. This will be voluntary—it is not proposed that potentially qualifying deals must be notified before they complete. A nominated senior government minister will consider the notification to decide whether to call it in for a national security assessment. The consultation paper is silent as to whether this initial notification and screening process will be made public. We would expect it to be confidential. If the senior minister calls the deal in for a national security assessment, that decision will be publicly announced. The government will then undertake its assessment before deciding either that it will take no further action or that remedies must be imposed. Its final decision will be made public. This is different from the CFIUS review process, pursuant to which, absent a block by the President of the United States, the fact that a transaction was reviewed by CFIUS and its outcome is kept confidential by the U.S. government.

How Long Will the Process Take?

The government recommends submitting voluntary notifications at as early a stage as possible. It proposes an initial screening to decide whether to call the deal in for a national security assessment lasting up to 15 working days, extendable by another 15 working days. If the deal is not called in by the government at the end of that initial screening, then the government has effectively concluded that no national security concerns arise and the parties may close the deal in the knowledge that the government will not intervene. If the deal is called in for a national security assessment, that assessment will last up to 30 working days but can be extended by a further 45 working days. The proposed regime envisages possibilities to stop the clock in response to information requests and for the parties to agree on further extensions. Parties can therefore expect to have to wait between three and six weeks before learning whether the deal will be called in for review and that any review will last a further six to 15 weeks. This is compared to the current CFIUS review process, which recently has been taking between 16 to 24 weeks from start to finish.

What If an Acquirer Decides Not to Notify a Deal?

The government is proposing a voluntary notification regime, meaning that parties will be free to close deals without first seeking national security clearance. If the government becomes aware of a deal that may raise national security considerations and that deal has not closed, the government may call it in for review and may even impose restrictions to prevent closing pending the outcome of the government's review.

If a deal closes without being notified to the government, the government will have up to six months after closing in which to call it in, following which it loses the right to intervene.

What Remedies Can the Government Impose for Deals Raising National Security Concerns?

The government wishes to avoid providing an exhaustive list of remedies it would impose to address concerns it has identified.

Indicative remedies include:

- limiting access to a particular site operated by the acquired entity to certain named individuals;
- permitting only personnel with appropriate security clearances to have access to certain information;
- forcing a new acquirer to retain an acquired entity's existing supply chain for a set period;
- restricting the transfer or sale of intellectual property rights;
- giving government approval rights over the appointment of directors or other key personnel;
- retaining UK staff in key roles at particular sites;
- requiring that the government be given access to information on the company's activities; and
- blocking or unwinding the deal in its entirety.

These are consistent with the measures imposed by CFIUS to mitigate national security concerns associated with a particular transaction within the jurisdiction of CFIUS.

What Sanctions Will the Government Have to Enforce the New Regime?

The proposals envisage civil and criminal penalties for failure to comply with conditions, orders or information-gathering demands during a review process. For each offence, either a civil or a criminal penalty could be imposed, but not both. Under the criminal powers, individuals could be fined or imprisoned for infringements of the new regime. Under civil offences, companies could be fined up to 10% of global turnover and individuals the higher of up to 10% of total income or £500,000.

How Will the New Regime Sit with the Current UK Public Interest Test?

Currently, the government can ask the Competition and Markets Authority ("CMA") to assess on public interest grounds deals raising national security concerns and those deals affecting either the stability of the financial system or media plurality. Under the proposed new regime, the CMA will lose the right to review on public interest grounds deals affecting national security but will retain its powers to review on public interest grounds deals affecting media plurality or the stability of the financial system.

The new regime will replace the recently introduced lower qualifying thresholds for review of deals involving military and dual-use technologies, quantum technologies and computer processing unit-related deals. Those deals that fall within the new national security regime may nevertheless still be reviewed by the CMA on competition grounds.

What Happens Next?

Interested parties had until October 16, 2018 to submit responses to the government's consultation. The government will now consider those responses before concluding on its preferred new regime. It will then draft new legislation which will be debated in, and need approval from, the UK parliament. It seems unlikely that a new national security regime, if approved, would come into force before the second quarter of 2019. It is possible that the new legislation will adopt many of the same concepts included in the pending legislation in the United States, which, as noted above, would significantly change the foreign direct investment regime in the United States.

The views and opinions set forth herein are the personal views or opinions of the authors; they do not necessarily reflect views or opinions of the law firm with which they are associated.

HOW BLOCKCHAIN WILL (EVENTUALLY) TRANSFORM AND DISRUPT M&A AND RELATED TRANSACTIONS

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Blockchain technology is slowly but steadily transforming virtually every industry, with sweeping impacts on the future of business operations and transactions. To stay ahead of the curve, corporate executives and dealmakers and their advisors need a basic understanding of blockchain and its practical applications as well as its political impact on M&A and investment transactions. This understanding includes: (i) which industries are particularly susceptible to disintermediation and what can be done about it; (ii) how blockchain may influence various sectors for the better and what this means for the future; and (iii) the ways in which blockchain is already being harnessed to create disruptive change in the marketplace. Specifically for those involved in M&A and related transactions, blockchain's role and influence on the evaluation of business models, due diligence processes, the structure of transactions, and post-closing transaction issues and corporate integration, is critical.

Blockchain is revolutionizing modern finance, systems of transactions, exchange, and recordkeeping in virtually every industry around the world. This durable, robust, and transparent technology, most well-known for enabling Bitcoin and Ethereum transactions, is poised to transform and disrupt entire industries ranging from accounting, investment management, banking, and finance, to insurance, derivatives, real estate, cybersecurity, benefits, law and health care, to name only a few. By now, most understand that a blockchain and Bitcoin are not the same thing. Blockchain was originally developed by an individual (or many individuals) under the pseudonym Satoshi Nakamoto in 2008, and has been growing in popularity and usefulness ever since.

Think about blockchain as a backbone technology for an advanced version of the internet. Blockchain technology, at its core, is a digital database of information that maintains an ever-growing list of records (known as 'blocks') with timestamps, transaction data, and links to previous blocks; essentially it's a digital ledger system. The blocks are recorded chronologically, and while new information may be added, old information may not be edited, adjusted or changed. Cryptography links the blocks together, ensuring that any change in a previous block would corrupt and invalidate all later blocks. Cryptography links make appending data decentralized, thereby preventing any one entity from controlling the chain whereas the internet, on the other hand, usually contains data stored in a centralized system. "The blockchain is an incorruptible digital ledger of economic transactions that can be programmed to record not just financial transactions but virtually anything of value."[1]

The driving force behind the invention of blockchain was creating a decentralized system capable of expediting transactions and supporting new innovations; however, the creation of the technology led to other unforeseen benefits as well. The most obvious benefit stemming from blockchain is security. From fraud prevention to cybersecurity, the decentralized nature of the distributed ledger allows virtually any industry to enter the market without putting its trust in a central authority. "The beauty of [the blockchain] construct is that the transactions recorded [are] publicly published and verified, such that anyone can view the contents of the [chain] and verify that events that were recorded into it actually took place."[2]

Trust in major institutions has been gradually decreasing over the past decade, stemming from cybersecurity data breaches to questionable institutional policies and practices, and as a result, companies are reexamining how they conduct business with others. As trust plummets, the parties currently responsible for facilitating that trust must increasingly prove their value if they want to avoid being replaced by the distributed ledger.[3] However, it is important to note that even systems supported by blockchain are not immune to security breaches (as was illustrated by the Bitcoin and Ether cybersecurity breaches that cost investors millions). So while blockchain does provide many benefits, and may be the better alternative to past systems, there is still room for improvement and users must ensure they do not overlook any potential security issues.

Blockchain as a Disruptive Technology

Although some may argue blockchain is not a truly disruptive innovation (a process by which a product takes root at the bottom of a market and eventually displaces established competitors, typically through the use of new or innovative technologies), it is surely a disruptive technology. "Blockchain represents a new paradigm for the way information is shared," and, as a result, there will surely be victims of the technology (much like how taxis were the victim of Uber) and the victims are far broader than you may think.[4] If you do not believe you or your industry is susceptible to falling prey to this revolutionary technology, then you may not understand the breadth of blockchain's tentacles.

Let's look at a real life example of how blockchain can transform an industry. Microsoft has a text editing program known as Word. One attorney works on a document then sends that document to another attorney either in the same firm or elsewhere and waits on that attorney to make changes before the originating attorney can work on the document again. Banks use a similar method and it is how they preserve balances. Essentially the bank locks access to the account while it manages the balance. This is an outmoded method for doing legal work and for financial institutions to maintain balances. Google has a program called Google Docs. Google Docs is a real-time collaboration tool which allows multiple users to access and edit a shared spreadsheet simultaneously. Blockchain does the same thing for financial institutions and preserves in perpetuity what has happened in the past.[5] Its transparency helps financial institutions regain the trust they have lost over the past decade. As Vitalik Buterin, the inventor of Ethereum stated, "blockchain solves the problem of manipulation."

Blockchain has the power to "digitize, decentralize, secure and incentivize the validation of transactions."[6] Importantly, the technology is versatile, and while commonly used as a platform for cryptocurrency, its applications within other industries are truly limitless. The above highlights the technology's ability to provide greater security efficiently and at a decreased cost, providing opportunities regardless of industry. One can see why there is so much interest in adopting this technology.

In mergers and acquisitions, blockchain promises to yield several benefits. As any M&A attorney or advisor will attest to, *trust* is the building block of any M&A transaction; without trust, the deal will inevitably fail. As with any transaction, large or small, a prominent point of contention is money—the old saying "money makes the world go round" is undoubtedly true in the world of M&A, and while not the only element to consider, it is most definitely an essential element. Blockchain may help bring trust to an otherwise contentious relationship, reduce costs associated with the deal, more quickly and effectively finalize the agreement, and so much more, thereby eliminating several points of concerns for the parties to the transaction.

Blockchain will impact M&A in a variety of ways in the near (and distant) future. For example, due diligence of the future may include the review of "blockchain" transactions in customer and supply chain payments, distribution channel transactions and even investment transactions on the capitalization table. Target companies may have even raised capital through an "initial coin offering" ("ICO") which will create the need for new due diligence skills and expertise. Blockchain will affect HR due diligence in a variety of ways, including recruitment, compensation, employee records, benefits and bonuses. Blockchain may affect IP due diligence in the ways that intellectual property is developed, owned, registered, licensed, verified, litigated and co-developed, raising a number of key issues and concerns in critical review of the target intangible assets. Blockchain will impact due diligence on issues surrounding a company's financial statements, internal controls, and recordkeeping practices, which may trigger a wide variety of risk management strategies and risk allocation tools which will need to be developed in the future.

As due diligence best practices and processes shift and evolve around blockchain, fintech and cryptocurrency offerings, M&A lawyers and advisers will need to adjust key provisions in the definitive documents. New representation and warranties around these technologies will need to be prepared while other risk management provisions may need to be adjusted given the "trust and verify" functionality that these technologies can provide. New and different approaches to indemnification, holdbacks and baskets for liabilities will need to be developed. Fintech technologies have the potential of reducing certain types of financially-related post-closing disputes but may give rise to *new* categories of post-closing integration challenges, such as a non-blockchain driven company buying a blockchain driven company that deploys cryptocurrencies for payroll and/or customer payments.

Industries Susceptible to Disintermediation: All of Them

Disintermediation, the elimination of the so-called "middle-man," can overtake any industry at any moment in time, forcing the old industry leaders to revise how they conduct business. According to the World Bank, $466 billion in money transfers were made in 2017 to low- and middle-income countries. Those transactions frequently use a middle-man such as a bank, but these intermediaries may no longer be needed with the advent of blockchain.

Before blockchain, someone, like a bank or broker, had to keep track of a transaction by attaching to the bank's systems, but blockchain uses a decentralized ledger stored on thousands of computers to see the balance and in real time make debits or credits to the ledger. As long as the computers agree on the transaction, the data entry is added into the ledger. The impact on banks in the form of lost fees can clearly be seen.

What about the stock market? NASDAQ, NYSE and other exchanges allow for the exchange of securities. Brokerage houses, and companies themselves, maintain a ledger of ownership and record the transaction. Blockchain, however, has already begun transitioning the industry. Recently, the SEC approved Overstock's plan to issue stock using blockchain. Michael Bodson, CEO of the Depository Trust & Clearing Corporation said, "[t]he industry has a once-in-a-generation opportunity to reimagine and modernize its infrastructure to resolve long standing operational challenges."[7]

Disintermediation will affect almost all industries, but those very industries can, and should, embrace the technology. For example, banks will likely need fewer offices and people, and with a decrease in fraud, the cost of credit will come down. Deals may be staffed differently and the role of investment bankers in transactions are likely to be affected by blockchain technology. Deal lawyers are not immune from the effects of blockchain either. What if significant portions of the due diligence is in blockchain? The role of counsel in due diligence will need to adjust accordingly.

Blockchain's Influence on Industry and Impact in the Future

These developments will also impact the valuation of targets and transactions. We can certainly see blockchain causing consolidation in industries particularly susceptible to disintermediation, but what about using the tool itself in an M&A transaction? M&A often occurs to obtain knowledge and technology. Major organizations are acquiring companies that most have never heard of, primarily to acquire IP and at valuations that defy mathematics.

An Estonian startup is using blockchain to actually bring about a marketplace for the sale of companies and their IP. They essentially act as a broker between buyers and sellers, using blockchain to record valuations, bids, and other transactions via "smart contracts." Smart contracts self-execute once all the conditions have been satisfied and move money without an intermediary. The company believes their process will greatly speed up transactions and make them more efficient. IP can be licensed instantaneously using blockchain, yet the marketplace does not have to disclose buyers or sellers until they want to unmask who they are. Negotiations take place in a virtual deal room where results are put into blockchain, which means disputes can be resolved easily just by looking at the ledger. It is almost like someone took all the notes from the negotiation and stored them for later reference.

Buying or selling a car, a more mundane act, first involved a dealership, then people put ads in papers, then they moved to using sites like eBay. Each migration brought efficiency to the market and either lowered costs or possibly increased price due to multiple buyers wanting that car. Now that car, company, IP, music, movie, or anything else, can be digitized in some form and made into blockchain using smart contracts.

Investment bankers are required to complete diligence forms known as "KYC" to ensure they have a strong understanding of their client's investment preferences. It is a time consuming process that gets repeated by each company needing to do it. If there was a shared client database in blockchain, investment banks could use previously validated investors, greatly cutting down by weeks the time to get to market. Goldman Sachs believes the savings in this sector alone, through the use of blockchain, is over $6 billion per year.[8]

Conclusion

M&A is being transformed by blockchain. The largest impact appears in the financial sector, but it won't be long before the technology extends into all industries. There are drawbacks of course; for example, the actual technology can be slowed since it relies on efficient network traffic amongst thousands of computers, and as the technology grows, so will the demand on infrastructure. However, the future is bright for those looking to create trust in acquisitions and increase the speed of execution while greatly lessening disputes. Success in the blockchain arena, regardless of your industry, starts by locating and retaining an advisor with hands-on experience who can assist in guiding you through the nuances of this innovative technology.

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FROM THE EDITOR

Speeding Up the Game: DOJ's Plans to Expedite Merger Reviews

As this issue went to press, the post-season of Major League Baseball was underway, and one topic of conversation in the baseball press is the growing concern that games are on average dragging on far too long, compared with only a few years ago. Similar concerns are being voiced about the merger review process.

At the 2018 Global Antitrust Enforcement Symposium in late September, Assistant Attorney General Makan Delrahim said "there is widespread agreement that significant merger reviews are taking longer to complete. According to one source, in calendar year 2017, significant merger reviews conducted by U.S. antitrust enforcers took an average of 10.8 months to resolve. That's up from an average of 7.1 months in 2013, which is a 65% increase."

Contributing to delays are the greater amount of electronic data to process and maintain, increases in more regulatorily-complex international deals, and "when divestitures are required to protect competition and remedy anticompetitive elements to transactions, we increasingly require upfront buyers that are pre-approved before consent decrees can be filed. That also adds time," he said. So although the Antitrust Division in 2017 only opened an investigation into 2.3% of transactions and issued second requests for less than 1% of them, "that 1%, however, is expensive. It is also resource intensive," he added.

"The government also spends enormous amounts of time and money reviewing mergers that go to a second request. . .every additional minute and dollar spent reviewing the merger is deadweight loss. We have limited resources," Delrahim said. He added that over the past 10 years the Antitrust Division's budget has stayed roughly constant in nominal terms, "which means it has declined in real terms, as salaries and other expenses have risen. A significant part of my job, then, is ensuring that we use those limited resources wisely."

"Delay is a form of uncertainty and risk, and we should seek to remove it from the merger-review process whenever possible," he said. So what can be done? Delrahim listed a series of proposals, including:

Meet with Relevant Parties Earlier. "One improvement that we are making is that the Antitrust Division Front Office will be open to an initial, introductory meeting," he said. "We expect that these meetings will be most productive if the parties include key executives from relevant businesses. We want to understand their deal rationale and any other facts they believe will be important to our analysis."

Publishing a Model Voluntary Request Letter. The Division plans to have a model voluntary request letter on its website to provide merging parties with a list of what information should be presented. "This information is crucial to resolving mergers during the initial waiting period for the simple reason that there are enormous information asymmetries between the parties and the enforcer," Delrahim said. "Parties should be prepared to provide key information within the first few days of their HSR filing, if not before filing, to allow the staff time to confirm critical facts through the parties' document productions and our own independent investigation." So the model voluntary request letter "identifies information we believe will allow us to assess quickly whether there is any potential anticompetitive harm that would require a longer, more in-depth investigation. The sooner we get this information, the sooner we can close investigations that do not raise competitive issues."

Greater Pull-and-Refile Accountability. The Division will also better track what happens when parties pull-and-refile their HSRs. "[We] cannot, of course, resolve all concerns within the initial 30-day waiting period. The parties, rather than face a second request they believe unnecessary, may choose to pull-and-refile their HSRs. Our new system is designed to ensure that we have an investigative plan in place to maximize our use of the additional time."

Publishing Model Timing Agreements. A new model timing agreement that will be available on the Division's website can help prevent negotiations over timing agreements from "taking on a life of their own." This model agreement will encourage an orderly process by which parties comply with the second request and the Division analyzes the transaction and decides whether to clear it, seek remedies, or seek to block it. "The Division gets certainty on timing. . .and the parties get certainty, among other things, on the number of custodians, the number of depositions, and the availability of meetings with the Front Office."

Reforming Timing Agreements. Saying that "we are also cognizant that timing agreements are a deviation from the process that Congress outlined in the HSR Act, which sets a deadline of 30 days for the Division to decide once the parties certify compliance with the second request," Delrahim said the Division will make "changes to the model timing agreement in order to narrow potential areas of disagreement, facilitate more efficient reviews, and bring the process closer in line with the HSR Act."

For example, the Division will now seek documents from "from fewer custodians than we generally have in the past. While every investigation is different, as a general matter we will assume that 20 custodians per party will be sufficient unless the Deputy AAG in charge of the investigation explicitly authorizes more." They also plan to take fewer depositions, generally not more than a dozen. And "we also will strive to make a decision as quickly as possible from the time the parties' certify compliance. We will make a decision in no longer than 60 days—sooner, if possible."

In return, the Division expects to receive documents earlier. "If the parties employ traditional document reviewers, this will mean a more robust rolling production, with the parties producing several tranches of documents roughly evenly spaced over the compliance period. For parties employing technology assisted review, it will mean completing the bulk of the production a certain number of days in advance of certifying full compliance." Data also should be available early, for "frequently, there is no reason that data cannot be produced substantially earlier than production of the main bulk of documents. We will expect to receive early cooperation on identifying relevant data for our economists to analyze. We will further expect production of useable data substantially before the second request compliance date."

And there should be less "privilege log gamesmanship," Delrahim said. "The Division respects the attorney-client privilege and the work product doctrine, but too often we see parties game the process, withholding large numbers of documents as privileged, only to de-privilege and dump many of these documents on us much later in the process, often on the eve of a particular deposition. While some of the de-privileged documents might be close calls, most never should have been withheld in the first place."

More Timely CID Enforcement. "While the merging parties are generally the most important source of information about the competitive significance of a transaction, third parties often possess critical documents and data," he said. So the Antitrust Civil Process Act empowers the Antitrust Division to issue CIDs for relevant materials, "an essential tool to collect third-party documents, data, and testimony." But "as you can imagine. . .third parties rarely greet CIDs with enthusiasm. Compliance is often slow and incomplete. This hampers the Division's ability to analyze the transaction at issue expeditiously." So going forward, the Division will "hold CID-recipients to the deadlines and specifications in the CIDs we issue. When necessary, we will not hesitate to bring CID enforcement actions in federal court to ensure timely and complete compliance."

Goodbye 2011 Remedies Guide. The Division is withdrawing the 2011 Remedies Guide and is currently "taking a close look at our remedies policy. Negotiating remedies to anticompetitive mergers often adds significant time to the merger review, and our commitment to shortening the duration of merger reviews extends to the remedies phase," Delrahim said. "The 2004 Policy Guide to Merger Remedies will be in effect until we release an updated policy."

The Division also plans to release more statistics that will show, on average, how long it takes to review mergers. This data will include average durations of second request investigations and average lengths of time from the opening of a preliminary investigation to the investigation's early termination or closing. "We believe that releasing them periodically going forward will increase our own accountability and give the private bar and the business community greater insight into our process," he said.

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