204 - What Litigators Know About Transactions that M&A Lawyers Should Know Too

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Faculty Biographies

Steven Barley

A Fellow of the American College of Trial Lawyers, Steve Barley is an experienced courtroom lawyer who represents diverse clients in a range of complex civil matters, with an emphasis on complex commercial litigation. He has significant experience in professional malpractice litigation, securities litigation, class action litigation, and litigation involving claims of fraud. Steve has extensive bench and trial experience in courts and before arbitration panels, and has obtained many favorable jury verdicts and arbitration awards for his clients. His cases have been highlighted in several publications, including a case that was cited as one of the "Defense Verdicts of the Year" by the National Law Journal. Steve has been selected by the Chief Judge of the Maryland Court of Special Appeals to serve on the faculty of the Maryland Institute for Continuing Professional Education of Lawyers' nine-day Trial Advocacy Institute.

Prior to joining Hogan & Hartson, Steve was a principal in a large Baltimore based law firm, serving as the chair of the firm's recruitment committee and head of its professional malpractice defense group.

Steve co-founded the University of Maryland's Business Law Society, received American Jurisprudence awards in numerous subjects, including Trial Planning and Advocacy and Legal Writing, and was selected to receive the John S. Strayhorn, Jr. Prize for the student most proficient in evidence. Steve also interned for a semester for The Honorable Paul V. Neimeyer.

Mark Gately

Mark Gatley is well known and experienced in the product liability area. He is presently national product liability counsel for Hogan & Hartsen LLP, a major pharmaceutical company in Baltimore, and has previously served as national product liability counsel for a leading power tool manufacturer and as regional counsel for a medical device manufacturer in a multi-district litigation proceeding.

Mr. Gatley has significant medical and drug-related knowledge from years of handling medical negligence and product liability cases. Mr. Gatley has also handled litigation against the Food and Drug Administration under the Food, Drug and Cosmetic Act.

Mr. Gatley also has substantial complex commercial litigation experience, particularly in the antitrust and securities law area. He has handled and continues to handle a number of significant post closing disputes involving claims growing of large corporate transactions.

Before joining the firm, he had been at a large Baltimore firm for more than 20 years and had spent over a decade as that firm's chair of the litigation department. Prior to that, he served as a law clerk to The Honorable C. Stanley Blair of the U.S. District Court for the District of Maryland.

Samuel Isaacson
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Robert Lavet

Robert Lavet is senior vice president and general counsel of SLM Corporation ("Sallie Mae"), a Fortune 500 Company and the leading provider of education finance. He is responsible for managing all legal affairs for Sallie Mae and its subsidiaries and also has responsibility for the corporate compliance function and loan servicing policy.

Prior to joining Sallie Mae he was an associate in the Washington D.C. law firm, Howrey & Simon, a trial attorney at the United States Department of Justice, and partner in the law firm of Cole Corette & Abrutyn, in Washington, D.C., where he specialized in corporate and securities litigation. Mr. Lavet is currently a member of the Board of Directors of the ACC and previously served as President of ACC's Washington Metropolitan Area Chapter. He is also a member of the board of director's of Mentor's Inc. (A private, nonprofit organization that pairs Washington, D.C. public high school students with trained adult mentors), and a member of the law alumni board of Georgetown University Law Center.

Mr. Lavet graduated from the University of Pennsylvania and received his law degree from Georgetown University Law Center.

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What Litigators Know About Transactions that M&A Lawyers Should Know Too
Session 204

Thomas M. O'Brien

Senior Vice President General Counsel & Secretary

Colfax Corporation

ACC's 2007 Annual Meeting: Enjoying the Ride on the Track to Success

October 29-31, Hyatt Regency Chicago

What do they know that I don't?

- Deal lawyers understand their subject, clients and the underlying business objectives.
- Deal lawyers are expert contractual draftsman.
- Litigators are procedure hounds with only a general knowledge of topical law and couldn't tell the difference between a covenant and a condition if it hit them.
- In house deal guys are **MUCH** smarter than trial lawyers.

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Deal Lawyers

- Emphasize the achievement of acceptable business solutions that both sides want to achieve.
- Their skill is interpersonal, negotiating “win win” solutions, successfully downplaying differences.
- They will rely on ambiguity to work around troublesome contractual issues.

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Litigators

- Emphasis is on protecting the client and preventing the other side from achieving its desired result. Winning .
- Their skill is tactical, procedural, exploiting differences,.
- Use ambiguity as a weapon.

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Complexity

- Merger and Acquisition Documents are very complex documents by nature.
- The negotiation of them is a process of compromise and the draftsmanship suffers from the appearance of specificity.
- In other words the specifics of a compromise creates ambiguity, often welcomed by one of the parties.

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The "It's In There" fallacy

- Client is concerned about a particular issue but doesn't want you to highlight the concern.
- The document is studied and wording is found and adjusted to address the concern
- The Client is told "It's in there."
- Chances are it has created an ambiguity.

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Ambiguity: the lifeblood of litigators

- Although not always required for the admission of extrinsic evidence it certainly helps.
- Extrinsic evidence is used by the Courts to determine what the parties “reasonably intended.”
- Your precisely drafted document is now given to judge, possibly juries and of course to the trial lawyers.
- (NOTE: If it is important it is cheaper to address up front.)

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What Do They Know

- It is in this context where litigation experts understand how a contract will be viewed.
- They understand implicitly the limitations of a busy judge who may never have seen a complex commercial contract let alone understand the language and concepts.
- With a general understanding of the concerns of the client and the spirit of the deal a litigator can better advise on the intersection of warranty, and indemnity.
- They will better understand how a concern will play when being enforced or defended.

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Common reasons for a SALE of a business

- Unrelated to "core" business (i.e. don't understand it).
- Not performing as it should or as expected. (i.e. don't understand it).
- A problem. (i.e. don't understand it).
- Need it for cash (i.e. haven't had time to understand it).
- All downplayed by parties selling the business.

- Experienced trial counsel will help predict how the problems will manifest in the "real" world of trial or arbitration.
- That can afford practical advice on how to protect against a problem or unknown issue that develops after Close.
- Afford practical advice on liability.

WHAT LITIGATORS KNOW ABOUT TRANSACTIONS THAT M&A LAWYERS SHOULD KNOW TOO

ACC'S 2007 ANNUAL MEETING
HYATT REGENCY CHICAGO
OCTOBER 29, 2007

PRESENTERS:
STEVEN BARLEY & MARK GATELY, HOGAN & HARTSON LLP
SAMUEL B. ISAACSON, DLA PIPER US LLP[1]

I. Dispute Resolution Clauses

A. Is Mandatory Arbitration Desirable?

1. Commercial contracts routinely require parties to resolve future disputes through arbitration. By including mandatory arbitration clauses in contracts, deal lawyers hope to achieve a speedier, less burdensome and less costly resolution of any disagreements that may occur after closing. Arbitration, however, is no panacea. Increasingly, commercial arbitration is characterized by extensive discovery, costly expert witnesses and delays. The notion that arbitration will save the client from costly and burdensome litigation is, if not wholly illusory, at least greatly exaggerated. Arbitration also is less predictable than traditional litigation and, because of severe limitations on the right to appeal, can leave the victim of an aberrant or flawed arbitration award without effective means of redress.[2] Deal lawyers therefore should think twice before including a mandatory arbitration clause in their contracts. Moreover, if the decision is made to include a mandatory arbitration clause, deal lawyers should consult with their litigators to determine what arbitration process and procedures best match the parties and the subject matter of the contract.

[1] Mr. Isaacson would like to thank Sonya D. Naar, Partner, and Gillian D. Madsen, Senior Associate, DLA Piper US LLP for their assistance in preparing these materials.

[2] See generally 9 U.S.C. § 10 (arbitration award may be vacated where: (1) award is procured by corruption, fraud or undue means; (2) there is evident partiality or corruption in arbitrators; (3) arbitrator commits misconduct; or (4) arbitrator exceeded his powers.

B. Selection of Forum for Arbitration

1. Mandatory arbitration clauses often require arbitration to be conducted under the auspices of the American Arbitration Association ("AAA"), JAMS, or another arbitral body. These bodies have well-developed rules and procedures, but also charge relatively significant fees for their services. Commercial parties may, in some cases, be better served by arbitration before a private arbitrator who is required by the parties' agreement to apply the procedures of the AAA or some other body. This approach provides for a well-defined process while avoiding the hefty fees charged by established arbitral bodies.

C. Selection of Arbitrator

1. Mandatory arbitration clauses sometimes call for a panel consisting of multiple arbitrators. Multiple arbitrators, of course, are more costly than a single arbitrator. Some litigators also believe that arbitral panels comprised of multiple arbitrators are more likely to enter an award that simply "splits the baby." Deal lawyers therefore should consider whether it is preferable to require the parties to proceed before a single arbitrator. Where the parties cannot agree upon a single arbitrator, the parties may seek judicial assistance.[3]

D. Arbitral Procedures

1. When drafting an arbitration clause, deal lawyers enjoy wide latitude to shape the arbitration process. Among the process issues that should be considered are the following:

a. Location. Do you really want a Fortune 500 client headquartered in California to send its officers and employees to a relatively minor arbitration that will occur in your opponent's "home court" of Trenton, New Jersey? Wouldn't it be preferable to hold the arbitration in a neutral and easily accessible location such as Chicago.

b. Discovery. Parties can tailor their arbitration clauses to provide as little or as much discovery as they choose. Unfortunately, because many arbitration clauses are silent

[3] See, e.g., 9 U.S.C. § 5 (provision of the Federal Arbitration Act allowing federal court to appoint arbitrator); Md. Code Ann., Cts. & Jud. Proc. Art., § 3-211 (similar provision under Maryland law).

on the availability of discovery, disputes often arise over such issues as whether the parties are entitled to depositions. Many arbitrators and arbitration associations will require the parties to exchange documents and witness statements before the arbitration hearing, but will prohibit depositions, even of the parties – a result that may be very uncomfortable in a multi-million dollar dispute. As a practical matter, it is often difficult to obtain the deposition of a non-party in arbitration. Cf. Integrity Insur. Co. v. Amer. Centennial Ins. Co., 885 F. Supp. 69 (S.D.N.Y. 1895) (arbitrator lacked power to compel non-party to attend deposition). Different problems arise when an arbitration clause permits full discovery in accordance with the practice in a particular court; this approach often eliminates the cost savings that can be obtained from arbitration.[4] A sensible middle approach may be to set specific limits on discovery in the arbitration clause itself (e.g., 15 interrogatories per side; 4 depositions, none of which will exceed six hours in length).

c. Injunctive relief. Arbitration clauses sometimes allow the parties to proceed to court when necessary to secure injunctive relief. Creative litigators, however, can almost always find some plausible grounds for seeking injunctive relief and thereby frustrate a party's expectation that its dispute will be resolved by an arbitrator. An alternative approach is to provide the arbitrator with the power to award injunctive relief. Of course, a party may nevertheless need to obtain a court's assistance in enforcing injunctive relief ordered by an arbitrator.

E. Dispute Resolution

1. Many arbitration clauses require parties to first pursue some form of informal dispute resolution. For example, a clause may require the parties' respective CEO's to negotiate in good faith for a stated period of time before either side is permitted to commence litigation and/or arbitration. Such clauses seldom achieve their

[4] See John H. Henn, "Where should you Litigate your Business Dispute? In an Arbitration or through the Courts?" 59 Oct. Disp. Resol. J. 34 (2004) ("There is one exception to the generally lower cost of discovery in arbitration. That is if the parties agree to conduct arbitration under state or federal rules of procedure. This is usually undesirable because most if not all of the benefits of arbitration will be lost.").

goal of avoiding litigation. Further, in cases where a party needs to institute litigation quickly to secure some right (e.g., to protect intellectual property or confidential information), mandatory dispute resolution requirements can create uncertainty and delay.

F. Forum Selection Clauses

1. Both federal and state courts generally enforce forum selection clauses. Deal lawyers, however, must consider jurisdictional realities when drafting such clauses. For example, a clause requiring the parties to litigate in a particular federal district court may be useless if there is no diversity between the parties providing a basis for federal jurisdiction.[5] Similarly, a clause requiring the parties to litigate in a particular state court (e.g., the Delaware Court of Chancery) will be unenforceable if the parties and the subject matter of the contract have no connection to that state.

II. Ambiguity and Parol Evidence

A. Ambiguous Contract Language

1. The existence of ambiguity in a contract has important practical consequences for litigation. Ambiguity, however, can mean different things to drafters, litigators and judges. In many cases, deal lawyers believe that the language they have drafted is clear and that all parties understand how a particular provision should be interpreted. Fortunately for litigators, the passage of time and the occurrence of unanticipated events can lead to very different perceptions as to how a clause should be interpreted.[6]

2. To appreciate why the existence of ambiguity is important for litigation, it is useful to review the principles most courts follow when interpreting contract language. In theory, most jurisdictions adhere to a "plain meaning rule" or "objective theory of contracts"

[5] This problem often arises in matters involving limited partnerships and REITs. Both of these entities are deemed to be a "citizen" of every state in which any of their limited partners or members reside. As a result, it is virtually impossible to obtain federal diversity jurisdiction over such entities. See, e.g., Belle View Apartments v. Realty Refund Trust, 602 F.2d 668 (4th Cir. 1979) (an unincorporated REIT "is to be considered, under § 1332, a citizen of very state of which any of its members if a citizen").

[6] As Justice Holmes once noted, "a word is not a crystal, transparent and unchanged; it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the times in which it is used." Towne v. Eisner, 245 U.S. 418, 425 (1918).

that requires a trial court to enforce the plain language of an agreement as it is written.[7] Where this approach is followed, a court usually will not consider facts outside the four corners of the agreement ("extrinsic evidence") when interpreting a particular contractual provision. In particular, a court will not consider evidence of contractual intent where the unambiguous language of the contract manifests the clear intent of the parties.

3. In practice, the "plain meaning rule" is tempered by the principle that a court will consider a contractual provision in the context of an agreement as a whole rather than in isolation.[8] Moreover, courts sometimes will consider the course of dealing of the parties[9] and custom and usage in the industry[10] when deciding whether or not a contractual clause is ambiguous. In practice, this means that courts often have wide latitude to construe a provision as "ambiguous" even where the language, viewed in isolation, may appear clear.

B. Effect of Ambiguity

1. If a court first determines that contractual language is ambiguous (i.e. reasonably susceptible of more than one possible meaning), it will allow the parties to submit all manner of so-called extrinsic evidence.[11] This means that parties generally can produce any

[7] See generally Margaret N. Kniffen, 5 Corbin on Contracts § 24.6 (Rev. 5th Ed. 1998), see also E. Allen Farnsworth II Farnsworth on Contracts § 7.12 (3d Ed. 2004) (discussing plain meaning rule); cf. Auction & Estate Representatives Inc. v. Ashton, 354 Md. 333, 340, 731 A.2d 441, 445 (1999) (Maryland courts follow the "objective law of contracts" under which a court "must determine from the language of the agreement itself what a reasonable person in the position of the parties would have meant at the time it was effectuated.").

[8] As one federal judge has observed, "[w]ords matter but the words are to be read as elements in a practical working document and not as a crossword puzzle." Fleet Nat'l Bank v. H&D Entertainment, Inc., 96 F.3d 532, 538 (1st Cir. 1996). See also Restatement (Second) of Contracts § 202(2) ("A writing is interpreted as a whole . . .").

[9] "A course of dealing is a sequence of previous conduct between the parties to a particular transaction which is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct." Uniform Commercial Code § 1-205(1).

[10] Trade usage is defined in the Uniform Commercial Code as "any practice or method of dealing having such regularity of observance in a place, vocation or trade as to justify the expectation that it will be observed." Uniform Commercial Code § 1-205(3).

[11] See, e.g., Calomiris v. Woods, 353 Md. 425, 436, 727 A.2d 358, 363 (1999) (ambiguity arises when the language of a contract is reasonably susceptible to more than one meaning);

(footnote continued to next page)

admissible evidence of intent in order to clarify the meaning of an ambiguous provision. Self-serving after-the-fact statements by the lawyers who drafted the transaction seldom are of much persuasive weight. Rather, courts construing a contract are far more likely to be persuaded by contemporaneous correspondence, e-mails between the parties and drafts of the contract. Internal e-mails also can be helpful, but communications exchanged with the other side of the transaction are far more significant to a court.

2. Because multi-million dollar post-acquisition disputes often are decided on the basis of extrinsic evidence of intent, it is important that deal lawyers carefully document the deal and preserve evidence. If the other side's counsel sends you an e-mail reflecting an incorrect interpretation of the parties' intent, a letter or e-mail correcting that misimpression will be far more useful than a phone call. Of course, e-mails are only valuable if they are preserved either in hand or soft copy.

3. Unfortunately, it is a very rare case indeed where there is not some evidence to support each side's interpretation of a disputed contractual provision. As a result, if a court determines that contractual language is ambiguous, it is unlikely that the court or arbitrator will decide the case on a motion to dismiss or motion for summary judgment. Instead, claims involving ambiguous contract provisions often are decided only after an expensive trial or arbitration hearing. It is therefore essential that deal lawyers take all measures possible to eliminate ambiguity.

C. Sources of Ambiguity

1. Deliberate ambiguity. Sometimes, ambiguity in a contract is not accidental. For example, because of pressure to close a deal, lawyers may seek to avoid a dispute over a particular issue by including vague language that allows each side to later argue its particular interpretation. Litigators are very appreciative of deal lawyers who follow this approach, but clients might be better served by a frank resolution pre-closing of a dispute that is likely to far more expensive and intractable in a post-closing environment.

(footnote continued from previous page)
McIntyre v. Guild, Inc., 105 Md. App. 332, 355, 659 A.2d 398, 409 (1995) (if ambiguity exists, court considers extrinsic evidence to determine intent).

2. Conflicting Provisions. Although a provision may appear perfectly clear to the lawyer who drafted it, a court could later find that the clause is ambiguous because of some conflict with another provision of the contract. Great care should be taken to ensure that a contract is free of all internal contradictions.

3. Amendments. Amendments that alter discrete portions of a contract can create ambiguity by failing to address the impact of the amendment on other provisions of the contract.

4. Definitions. It is important to make sure that a defined term works for all its applications within a particular contract. Disputes often arise because a broad and detailed definition of a technical term (e.g. "financial statements") simply does not work in all of the contexts for which it is used in the parties' agreement.

5. Documents Incorporated by Reference. Complex commercial contracts often incorporate other documents by reference. This can lead to ambiguity.

D. Parol Evidence Rule

1. A closely-related and often misunderstood doctrine is the so-called parol evidence rule. Under this rule, a court ordinarily will not consider oral evidence that seeks to vary the terms of the parties' agreement or add new and additional terms.[12] The parol evidence rule, however, is subject to a number of exceptions and qualifications. Most importantly, it does not prevent a court from considering extrinsic evidence when construing an ambiguous contract. Moreover, parol evidence does not preclude the parties from offering evidence of a post-agreement oral modification or amendment of the contract – sometimes even where the parties' agreement expressly prohibits oral modifications. For this reason, deal lawyers and clients must carefully document not only all of their negotiations, but also all post-closing disputes that may arise between the parties.

[12] See generally Margaret N. Kniffen, 5 Corbin on Contracts § 24.11 (Rev. 5th Ed. 1998) (distinguishing parol evidence rule from interpretive principles).

III. Post-Closing Issues

A. Balance Sheet Adjustments

1. Parties to acquisition agreements routinely encounter disputes over post-closing adjustments to balance sheets. Buyers often argue that earnings are overstated or one not being consistently calculated. To help reduce the likelihood of such disputes, deal lawyers should address certain core issues:

a. Accounting methodology. It is not sufficient merely to state that a post-closing balance sheet will be calculated in accordance with GAAP. Such a provision leaves a seller with wide discretion to select among different GAAP-compliant methodologies. Instead, the agreement should clarify the discretion (if any) the seller has to employ different accounting methodologies in the pre-closing and post-closing balance sheets.

b. Non-GAAP Compliant Procedures. Sometimes, a seller's pre-closing balance sheet may use accounting practices that a buyer will later argue are not GAAP compliant. Deal lawyers should consider whether the parties wish to specify particular accounting methods that are either acceptable or required.

B. Earn-outs & Non-financial Milestones

1. Post-closing earn-outs and non-financial milestones also are fertile ground for future litigation. Earn-out clauses should clearly define the ability of the buyer to change either the business operations of the company or its accounting procedures. The parties may wish to agree that post-closing accounting policies will not be changed. Before including such a clause, however, a deal lawyer must first confirm that the buyer does not have future plans (e.g., consolidation of the target with another business unit) that will require changes to accounting practice.

2. Deal lawyers also should be sensitive to issues that can arise with respect to non-financial milestones (e.g., approval of a product by the FDA). Often such milestones may use terms that are not static, but subject to changing interpretations by an administrative agency. All technical terms used for milestones must be clearly defined.

IV. Material Adverse Change Clauses

A. General

1. The "material adverse change" or "material adverse effect" provision is common in agreements governing the sale of a business and various types of financing agreements.

a. In merger agreements and other documents governing the sale of a business, the absence of a material adverse change to the business is often one of the representations and warranties that the seller is required to provide. The buyer in a stock-for-stock merger might also be required to make such a representation. In addition, the absence of a material adverse change in the business is frequently included among the conditions to closing in such agreements.

b. In financing agreements, the absence of a material adverse change is a typical condition to additional borrowing under the agreement.

2. The difficulty with these provisions, especially in the merger context, is in their application.

a. During the period between signing and closing, a purchaser might learn information about the seller's business or prospects that leads it to believe that a material adverse change has occurred. In many instances, however, this question will not be answered definitively until years later, after extensive litigation.

b. What may seem to the purchaser to be new information raising significant doubts about the transaction might later be asserted by the seller to have been among the risks that were accepted by the purchaser when the transaction was agreed to, or to have been the result of either the buyer's own conduct or of broader industry or economic trends that were never the subject of a seller's representation.

B. Common Drafting Decisions

1. Basic sample provision: "'Company Material Adverse Effect' shall mean any change in or effect on the business of Company that, individually or in the aggregate . . . is. . . materially adverse to the business, assets, liability, financial condition or results of operations of Company, taken as a whole . . ."

2. Should you Include a Forward-Looking Element in Material Adverse Change Clauses?

a. The addition of "prospects" to the basic definition can capture anticipated future results, makes the provision more friendly to buyers and can affect the outcome of any dispute about whether a material adverse change has occurred.

(i) Compare Polycast Tech. Corp. v. Uniroyal, Inc., 1988 WL 96586 (S.D.N.Y. Aug. 31, 1988) (denying motion to dismiss in view of shortfall in projections where MAC provision referred to "prospects" of business) with Pachecho v. Cambridge Tech. Partners, 85 F. Supp. 2d 69 (D. Mass. 2000) (denying breach of contract claim where MAC did not refer to "prospects" and shortfall from analysts' estimates was forward-looking).

(ii) Goodman Mfg. Co. L.P. v. Raytheon Co., 1999 WL 681382 (S.D.N.Y. Aug. 31, 1999) (granting motion to dismiss where MAC did not include "prospects" and claimed production delay only affected future production).

(iii) Longwood Elastomers, Inc. v. Aeroquip Corp., 1995 WL 1052245 (W.D. Va. Feb. 24, 1995), aff'd mem., 165 F.3d 18 (4th Cir. 1998) (same).

b. Adding the phrase "is reasonably likely to be" or could reasonably be expected to be" to the standard definition also will bring in a forward-looking element to the provision, but is not as strong as including "prospects."

3. Possible Carve-outs to make in a Material Adverse Change Clause.

a. Effects arising from changes in general economic, regulatory or political conditions or in financial markets;

b. Effects arising from changes, circumstances or conditions affecting the seller's industry in general;

c. Effects arising from the agreement or transactions contemplated hereby [or the announcement of the agreement or those transactions]

d. Other examples include:

(i) changes in stock price;

(ii) failure to meet analysts' earnings estimates; and

(iii) employee attrition resulting from merger announcement and numerous others that were specific to the transactions in question.

4. Thresholds

a. Disagreements about "materiality" can be minimized by including an amount that must be exceeded before the provision is triggered. See, e.g., Great Lakes Chem. Corp. v. Pharmacia Corp., 788 A.2d 544, 557 (Del. Ch. 2001).

b. Nip v. Checkpoint Sys., Inc., 154 S.W.3d 767, 769 (Tex. Ct. App. 2004) (defining "material adverse change" as a change that could "reasonably be expected to adversely affect [the company's financial condition] in an amount equal to or greater than $50,000").

c. Multi-Fineline Electronix, Inc. v. WBL Corp., C.A. No. 2482-N, 2007 Del. Ch. LEXIS 21 (Del. Ch. Feb. 2, 2007) (defining "material adverse change" to be that which decreases the acquired company's assets by more than 10%).

5. Parallelism

a. If the intention is to subject both parties to the same standard, care must be taken to maintain parallel phrasing. See Pacheco v. Cambridge Tech. Partners (Mass.) Inc., 85 F. Supp. 2d 69 (D. Mass. 2000) (only seller had agreed to material adverse change provision that applied to its "prospects").

b. On the other hand, if a lack of parallelism is intended, clarity in drafting is again essential to avoid intensive litigation over the parties' intent. See, e.g., Allegheny Energy, Inc. v. DQE, Inc., 74 F. Supp. 2d 482 (W.D. Pa. 1999)

C. What is a "Material" Adverse Change?

1. In re IBP, Inc. Shareholders Litigation, 789 A.2d 14, 68 (Del. Ch. 2001) (applying New York law) (emphasis added)

a. even where a Material Adverse Effect condition is as broadly written as the one in the Merger Agreement, that provision is best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquiror.

b. The MAE provision in IBP did not refer to the "prospects" of the target but did include circumstances that were "reasonably likely to have" a material effect on the business or results of operations.

c. See also Frontier Oil Corp. v. Holly Corp, C.A. No. 20502, 2005 Del. Ch. LEXIS 57 (Del. Ch. April 29, 2005) (approving standard adopted in IBP as to the definition of a material adverse effect).

2. Courts have rejected the suggestion that "materiality" is based on a GAAP understanding of that term.

a. See Allegheny Energy, Inc. v. DQE, Inc., 74 F. Supp. 2d 482, 517 n.8 (W.D. Pa. 1999) ("GAAP incorporates a particularly low materiality threshold which focuses on whether information might influence any user of the financial statements. Such a test would not comport with the parties' intent that the MAE provision should not provide either party with an easy out.").

b. See also Bear Stearns & Co. v. Jardine Strategic Holdings Ltd., N.Y.L.J., June 13, 1990, p. 22 (similar).

3. Instead, as was the case in IBP, courts tend to engage in a fact-intensive inquiry to determine "the significance of the fact to the essence of the transaction in question . . ." Northern Heel Corp. v. Compo Indus., Inc., 851 F.2d 456, 463 (1st Cir. 1988); see also JPA, Inc. v. USF Processors Trading Corp., No. 3:05-CV-0433-P, 2006 U.S. Dist. LEXIS 10513 (N.D. Tex. March 15, 2006) (litigation that might diminish the value of the acquired company by 10% deemed materially adverse).

D. Contractual Disclaimers and Fraudulent Inducement

1. Closely related to the issue of whether there has been a "material adverse change" in a business after the signing of a purchase agreement are claims that the buyer was fraudulently induced into entering into the purchase agreement by misrepresentations made during the negotiating process.

2. Express disclaimers in purchase agreements are enforceable against sophisticated parties and will bar a claim of fraudulent inducement. See, e.g., Great Lakes Chem. Corp. v. Pharmacia Corp., 788 A.2d 544 (Del. Ch. 2001) (applying Delaware law).

3. In Great Lakes, a chemical business buyer asserted that the seller misrepresented the reason for two downward adjustments to its projections that were made during the course of negotiations. It claimed that, contrary to the seller's assurance that the adjustments were the result of short-term factors, they actually were due to long-term industry trends that materially affected the value of the business being sold.

   The court dismissed the buyer's fraud claim and refused to permit rescission of the purchase agreement based on the specific disclaimer, which provided, with respect to estimates and projections, that:

   > "The Buyer acknowledges that there are uncertainties inherent in attempting to make such estimates, projections and other forecasts and plans, that the Buyer is familiar with such uncertainties, that the Buyer is taking full responsibility for making its own evaluation of the adequacy and accuracy of all estimates, projections and other forecasts and plans so furnished to it . . . and that the Buyer has received no representation or warranty from either Seller with respect to such estimates, projections and other forecasts and plans . . ."

4. In IBP, the Delaware Court of Chancery went one step further, holding that a contractual disclaimer contained in a confidentiality agreement that had been signed by the buyer (Tyson) prior to entering into a merger agreement barred its claims of fraudulent inducement. See IBP, 789 A.2d at 73 (applying New York law).

   In that instance, the confidentiality agreement provided that Tyson could not use any written or oral due diligence materials as the basis for a subsequent lawsuit unless the information was later

made subject to an express representation in the merger agreement. The court concluded that, given this disclaimer, Tyson could not reasonably rely on assurances made by IBP in the negotiating process that were not later embodied in the merger agreement, thereby precluding its claim of fraud. Id.; see also ABRY Partners V, L.P., v. F&W Acquisition LLC, 891 A.2d 1032, 1057 (Del. Ch. 2006) ("[A] party cannot promise in a clear integration clause of a negotiated agreement, that it will not rely on promises and representations outside of the agreement and then shirk its own bargain in favor of a 'but we did rely on those other representations' fraudulent inducement claim."). Note, however, that the ABRY court made clear that a seller may not, by an anti-reliance clause, insulate itself from claims arising from *intentional* misrepresentations.

5. It is important to note that these cases generally concern projections, estimates and similar forward-looking information, which are generally less amenable to claims of fraud than historical data. It is unlikely that a similar result would have obtained in an instance of knowing manipulation of existing financial statements or similar fraud, notwithstanding the existence of contractual disclaimers of reliance on such financial statements.

V. Covenants Not to Compete and Related Restrictive Promises

A. Two Situations Where These Agreements Generally Arise

1. Ancillary to the Sale of a Business

   a. Seller of business has promised not to engage in a similar business in competition with the buyer or agrees to restrict other, related future activities

   b. Buyer of business offers continued employment to seller's employees conditioned on the signing of a non-competition agreement

   c. Buyer of business purchases all of the seller's assets, including all employment agreements, restrictive covenants and other restrictive agreements

2. Employer/Employee Relationship - generally scrutinized with more care than those ancillary to the sale of a business – same general principles will apply - not going to address standards particular to these agreements here

B. Types of Restrictions Available

1. Covenant not to compete in same industry or profession: Generally prohibit an individual from undertaking certain business activities

2. Non-Solicitation Provisions:

   a. Can protect solicitation of customers or employees

   b. Often can substitute for or complement a geographic restriction against engaging in a specific type of business

3. Non-Disclosure: Of trade secrets or other confidential information

C. General Considerations

1. Generally, courts frown upon restrictive covenants and related agreements as improper restraints on trade.

2. However, in connection with the sale of a business, these agreements are viewed more favorably because of the parties' arms length bargaining position. See, e.g., Hess Newmark Owens Wolf, Inc. v. Owens, 415 F.3d 630, 634 (7th Cir. 2005) ("Illinois may be skeptical about covenants executed by salesmen and other employees, but it is quite willing to enforce covenants executed by entrepreneurs in order to form or sell a business. . . . An agreement *ex ante* among the entrepreneurs that these covenants do fit their needs, and that they have received sufficient benefits in exchange for the restraints, is the sort of exchange that any jurisdiction must enforce if it wants to promote the formation and success of new businesses.").

3. In the business sale context, covenants not to compete are considered necessary to assure the buyer that the former owner will not walk away from the sale with the company's customers and/or goodwill, leaving the buyer with an acquisition that turns out to be worth less than the purchaser expected. See, e.g., King v. PA Consulting Group, Inc., 485 F.3d 577, 587-88 (10th Cir. 2007) (Non-compete agreements gave the buyer "critical security in connection with its acquisition. . . . Absent those provisions, [the buyer] would have purchased the intellectual capital of [the acquired company], which included [the key employees who agreed to the non-competes], with no guarantee that the capital would not walk out the door after the merger."); see also Purchasing Assocs., Inc. v. Weitz, 13 N.Y.2d 267, 271-72 (NY. Ct.

App. 1963) (recognizing enforceability of covenants ancillary to the sale of a business).

4. Generally, as a threshold matter, the restriction must be ancillary to a valid contract or transaction and must be supported by adequate consideration

   a. When is the restriction ancillary to the sale of a business?

      (i) Whether the covenant is ancillary to the sale of a business rather than ancillary to an employment agreement is often a question of the parties' intent (Loewen Group Int'l, Inc. v. Haberichter, 912 F. Supp. 388, 393 (N.D. Ill. 1996); Arthur J. Gallagher & Co. v. Youngdahl, 412 F. Supp. 2d 1013, 1017 (D. Minn. 2006) (Covenant deemed ancillary to the sale of an insurance brokerage business where the parties' contractual language indicated "that the parties intended the non-compete . . . to protect the integrity of the sale.").)

         (1) When the promise is ancillary to the sale of a business, courts generally inquire as to whether the covenant was intended to protect the integrity of the sale

         (2) This analysis requires the court to look at issues such as (1) the terms of the sale; (2) whether the covenant was integrated into the sale; and (3) the time the covenant was signed in relation to the sale of the business. Loewen Group, 912 F. Supp. at 393.

         (3) Courts also look to the "bargaining capacity of the covenantor to determine whether he is more like an owner of the business or an employee" and courts consider the "existence of any independent consideration given for the covenant because employment itself is generally the only consideration given for a [non-ancillary covenant]." Palmer & Cay, Inc. v.

Marsh & McLennan Cos., 404 F.3d 1297, 1304 (11th Cir. 2005).

(ii) Covenant in a shareholder's agreement is more analogous to a covenant not to compete ancillary to the sale of a business where the covenant is part of the transaction forming the share-issuing corporation and the parties intend it to be evidence of a good faith attempt to make the corporation successful. Central Water Works Supply, Inc. v. Fisher, 608 N.E.2d 618, 622 (Ill. App. Ct. 4th Dist. 1993).

(iii) Where a corporation's business depends heavily on the goodwill of one or more officers or shareholders, and those individuals promise purchaser they will not compete with the business following a sale, courts generally treat that agreement as ancillary to the sale – see e.g., California Business & Professional Code, § 16601 (need clear indication that parties valued or considered goodwill as a component of the sales price and that transaction involves a sale of a substantial interest in the corporation).

(iv) Similarly, if those same individuals promise the corporation that they will not compete with it following the sale of their stock, courts will treat the promise as ancillary to the sale.

(v) An implied covenant not to compete can arise where there is a voluntary division of partnership assets which results in a sale by which goodwill was transferred. Abrams v. Liss, 762 N.E.2d 862 (Ma. Ct. App. 2002).

(vi) Promises made after a transaction is completed or the relationship ends can be held to be too late to be considered ancillary

b. Adequate consideration

(i) Care should be taken to see that there is a transfer of good will, for a mere sale of other assets will not necessarily suffice as adequate consideration.

(ii) Some courts have found that transfer of goodwill, even if not specifically mentioned, is transferred as an incident to the business. In re Spradlin, 284 B.R. 830 (E.D. Mich. 2002) (applying Michigan law) (non-competition agreement made in connection with the sale of a business does not require an explicit sale or transfer of goodwill to be enforceable especially where such a transfer was implicit; restraint must be reasonable as to time and geographic scope.)

5. Two key tests used to determine whether restrictions are reasonable and enforceable:

a. Whether the agreement protects a legitimate business interest

(i) When the covenant or provision is contained in an agreement governing the sale of a business, courts generally courts will presume that there is a legitimate interest being protected such as preservation of good will

(ii) In such instances, the party seeking to enforce the restriction need only demonstrate that the geographic, temporal and activity restrictions are reasonable. Loewen Group, 912 F. Supp. at 392-93..

b. Whether the agreement's restrictions reasonably are tailored so that they do not impose an undue hardship on the individual or the public. Three areas that are analyzed:

(i) Time period of the restriction

(1) Cannot be longer than is necessary to protect the promisee's legitimate interest

(2) For example, a Colorado court held a 3 year covenant restricting seller of stock from competing within specific product lines and a specific marketing area was enforceable (Logixx Automation, Inc. v.

Lawrence Michels Family Trust, 56 P.3d 1224 (Colo. Ct. App. 2002))

(ii) Geographic limitation of the restriction

(1) Non-solicitation provisions generally do not require a geographic limitation to be enforceable.

(2) However, a Pennsylvania court found that an oral covenant among lawyer shareholders in a law firm, which was unlimited in time or territory, was unenforceable (Capozzi v. Latsha & Capozzi, P.C., 797 A.2d 314 (Pa. Super. Ct. 2002)); see also Health Professionals, Ltd. v. Johnson, 791 N.E.2d 1179, 1180 (Ill. App. Ct. 2003) (a covenant is geographically reasonable if it covers "only that territory to which the good will extends . . . or to which it might reasonably be expected to extend during the existence of the restraint");

(iii) Scope of the activity restriction: generally, the type of activity restricted should be limited to that of the business sold

c. Must look at all three areas in total when determining enforceability

D. Will a Court Blue Pencil the Agreement if A Particular Term or Provision is Found Unenforceable?

1. Blue penciling is a method that allows a court to sustain part of an overly broad covenant or restriction by reducing the scope as to what is reasonable. See, e.g., Vais Arms, Inc. v. Vais, 383 F.3d 287, 295 (5th Cir. 2004) (approving district court's blue-penciling of ancillary non-compete to reduce the scope from international to national).

2. Traditionally, some courts will not save terms if it requires rewriting the agreement, although they will excise terms

a. For example, if the restriction on future employment in a particular industry was ten years, and the length was found to be overbroad, the court would not save the restriction by reducing the restriction to five years.

b. However, it could excise the restriction with the overbroad time period to save other restrictions, such as a customer non-solicitation provision, found to be reasonable.

3. The modern trend is for courts to reduce the scope of the covenant even though the term cannot simply be "blue-penciled" out.

a. This is referred to as the rule of reasonableness.

b. Some jurisdictions, such as Georgia, permit this approach to be used on restrictions ancillary to the sale of a business but not in the employment context. See, e.g., Palmer & Cay, 404 F.3d at 1303 ("Georgia courts apply a low level of scrutiny to agreements ancillary to the sale of a business. . . and they can reform, or 'blue pencil,' any objectionable portions to bring them in conformance with Georgia law.").

E. Are these Agreements Assignable?

1. Covenants not to compete made in connection with the sale of a business generally are held to be assignable on the buyer's resale of the business.

F. Enforcing the Restrictions

1. What is considered a breach of an agreement?

a. Highly dependent on the language used to describe the prohibited activity

b. Some courts have found that merely leasing property or loaning money to others engaged in a competing business is not precluded absent a specific contractual provision to the contrary (See, e.g., Nat'l Propane Corp. v. Miller, 18 P.3d 782 (Colo. App. 2001))

c. Others, however, have held that being actively involved in the financing of a competing business is a breach of a promise against competing (See Riverview Floral v. Watkins, 754 P.2d 1055 (Wash. App. 1988))

2. Some states have held that if there is a failure to make a payment due under a covenant not to compete in the sale of a business or merger context, any obligation under the agreement not to compete is discharged. (See, e.g., In re Teligent, Inc., 268 B.R. 723, 730-31 (Bankr. S.D.N.Y. 2001) (applying Delaware law))

3. Related causes of action to consider if litigation for breach of a restrictive covenant is contemplated – application of particular cause of action depends on facts and circumstances of case and particular governing state law

   a. Breach of fiduciary duty

   b. Tortious interference with contract or prospective business relationship

   c. Misappropriation of Trade Secrets

   d. Breach of implied covenant of good faith and fair dealing

4. Types of relief available in the event of a breach

   a. Compensatory Damages:

      (i) Generally net profit lost as a result of the breach

      (ii) Sometimes can also have disgorgement of profits earned by breaching party as a result of the breach

      (iii) Some courts have held that if the restriction has been violated, payment of any monies owed under the agreement may be suspended (See, e.g., Van Oort Constr. Co. v. Nuckoll's Concrete Serv., Inc., 599 N.W.2d 684, 693 (Iowa 1999))

   b. Liquidate damages: if agreement contains provision permitting recovery

   c. Injunctive Relief:

      (i) Preliminary injunction or temporary restraining order

      (ii) Must meet general standards for obtaining such relief

   d. Attorneys' fees – depends on jurisdiction as to whether fee-shifting provision in a restrictive covenant agreement is enforceable

G. Considerations and Suggestions For Drafting Restrictive Covenants

1. Because standards governing enforcement of restrictions ancillary to the sale of a business are not as stringent as those in the employer/employee context, need to ensure that parties' intent for restrictions to be ancillary to the sale of the business is clearly expressed in the documents.

2. Need to be explicit that there is a transfer of good will which supplies the consideration for the restriction, as the mere sale of assets will not suffice as consideration for the additional restrictions

3. Must be clear that the future restrictions are effective regardless of the reason for termination of employment if covenants are contained in employment agreements

   a. Restriction should provide that it is independent of and not conditioned upon the employer's performance

   b. Make clear that the covenant binds the employee whatever the reason that the employment comes to an end

4. Need to tailor the restriction to meet the needs of the particular situation and confine the proscription to activities that threaten the employer's protectible interests

   a. Courts generally are more tolerant of restrictions designed to protect confidential information such as trade secrets than those designed to protect customer lists and similar information

   b. Covenant must be limited to an area in which the individual may pose a significant threat to the employer's business – courts usually scrutinize this more in the employer/employee context than in the sale of a business context

   c. Time period also must be reasonable, although that varies with each case

      (i) Generally, you should include a provision in the agreement that the time period shall not run

between the first breach of the covenant and the date the relief is granted.

5. Want covenant written in such a way that encourages a court that disapproves of a covenant's breadth nevertheless to enforce as much of the covenant as it finds reasonable

    a. If jurisdiction follows blue pencil rule, covenant should contain a provision permitting offensive portions to be removed or edited out while leaving the rest of the covenant in tact

    b. Even if you are in a jurisdiction that takes a more liberal approach to rewriting covenants, do not want the restriction to be written so broadly as to suggest bad faith, permitting the court to find that the covenant as a whole simply cannot be enforced

6. Include a severability clause that permits a court not only to enforce the contract without any objectionable provision but also to limit the application of any offensive provision to avoid an objectionable result

7. Liquidated damages clauses

    a. Especially important if the time period of the restriction is so short that preliminary or injunctive relief might become moot.

    b. If such a clause is included, should indicate that the liquidated damages are not the exclusive remedy to avoid the contention that such a provision precludes equitable (injunctive) relief or recovery of other damages

8. Consider using other kinds of restraints, such as non-solicitation of customers or restraint on disclosure of confidential information, if those provisions will accomplish goals, because they often are viewed more favorably

9. Other considerations

    a. May want to include specific language whereby the parties consent to the assignment of the agreements or restrictions if the company is sold, is involved in a merger, or changes its name

    b. Choice of law or forum selection clauses

(i) Inquire as to particular state's view of covenants prior to agreeing to particular state's law in a choice of law provision

(ii) If you intend on choosing the law governing these agreements, should know whether the state has a statute specifically governing the enforceability of covenants not to compete prior to drafting to ensure it meets state requirements

(1) DE, IL and NY do not have a general statute

(2) CA (Cal. Bus. & Prof. Code §16601) and FL (Fla. Stat. Ann. § 542.335) do

(3) Many states also have separate statutes governing the enforceability of covenants or restrictions in certain professions (i.e., attorneys, physicians)

(iii) Generally, court is not bound by a choice of law or forum selection clause in these agreements unless the state chosen has some reasonable relation to the parties or the contract

WHAT LITIGATORS KNOW ABOUT TRANSACTIONS THAT M&A LAWYERS SHOULD KNOW TOO

PRESENTERS:

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Dispute Resolution Clauses

- **Mandatory Arbitration Clauses**
  - Is arbitration superior to litigation?
  - Is it necessary to have arbitration conducted by JAMS, the AAA or another organization? Is it preferable for the parties to select a private arbitrator who will conduct the proceeding in accordance with the rules of a recognized arbitral body?
  - Is there any benefit to having more than one arbitrator?
  - How is the arbitrator selected?
  - Location, location, location.
  - Should the arbitration clause specify the limits of discovery?
  - Will the arbitrator have the power to award injunctive relief?

Dispute Resolution Clauses

Informal Dispute Resolution Mechanisms

- Seldom effective
- Creates uncertainty when a party needs prompt relief to protect intellectual property, confidential information or other important rights.

Forum Selection Clauses

- Routinely enforced.
- But . . . the court must have subject matter and personal jurisdiction.

Ambiguous Contracts

- What is ambiguity?
  - When the language of a contract, on its face, is reasonably susceptible of two or more possible interpretations.
  - The existence of ambiguity can have important litigation consequences.
- How is ambiguity determined?
  - In theory, most courts follow a "plain meaning rule."
  - But courts will look at the contract as a whole.
  - They also will sometimes consider the course of dealing of the parties and custom and usage in the industry.
  - In practice, there are many avenues a court can follow to find that seemingly clear language is, in fact, ambiguous

Ambiguous contracts

- Common drafting issues that create ambiguity
  - Deliberate ambiguity
  - Conflicting provisions within a single agreement
  - Broad definitions that don't work in all their applications
  - Other documents incorporated by reference
  - Amendments

Ambiguous Contracts

- **Parol Evidence Rule**
  - Generally prohibits parties from introducing evidence of new or additional terms not contained within the agreement.
  - Because the rule is subject to a number of exceptions, deal lawyers should not assume it will apply.
- **Practical Implications**
  - Intent must be documented
  - Incorrect interpretations must be immediately corrected in writing
  - Files must be maintained

Post-Acquisition Disputes

- **Balance Sheet Adjustments**
  - Frequent source of litigation
  - Does the agreement make clear whether GAAP or past practice controls? Does it leave the seller with substantial discretion to choose among different possible GAAP-compliant practices?
  - Does the agreement address the treatment of historical practices that arguably are not GAAP-compliant?
  - Often an appropriate topic for mandatory arbitration.

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Post-Acquisition Disputes

- **Earn-outs and Non-Financial Milestones**
  - Does the agreement clearly define the accounting practices that will be followed to calculate the Earn-out?
  - Does the buyer have any discretion, for example, to combine the acquired business with another business unit and allocate overhead?
  - Do non-financial milestones have clearly identified benchmarks that are not susceptible to change by a third-party? (E.g., a change in a regulatory agency's definition).

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Material Adverse Change Clauses

- A backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the earning potential of the target in a durationally-significant manner.
- Often found in merger agreements and other documents governing the sale of a business.
- The absence of a material adverse change in the business is frequently included among the conditions to closing.
- Generally disfavored in Delaware if there is not an event that threatens target's overall earnings in a "durationally significant manner" In re IBP, Inc. Shareholders Litigation, 789 A.2d 14, 68 (Del. Ch. 2001)

Application Difficulties

- While seemingly clear on its face, a material adverse change clause can become the subject of extensive post-closing litigation.
- Significant disagreements arise as to whether "new" information that comes to light post-closing was actually an accepted transaction risk.

Sample Provision

"Company Material Adverse Effect" shall mean any change in or effect on the business of Company that, individually or in the aggregate is materially adverse to the business, assets, liability, financial condition or results of operations of Company, taken as a whole.

Include Forward-Looking Element

- The addition of "prospects" to the basic definition can capture anticipated future results.
- Makes the provision more buyer-friendly.

  Example: No material adverse change in the business, operations, properties, financial conditions <u>or prospects</u> of [company being acquired] have occurred since [date].
- Also consider adding the phrase "is reasonably likely to be" or "could reasonably expected to be" to the standard definition in order to incorporate a forward-looking element.

Possible Carve-Outs

- Effects arising from changes in general economic, regulatory or political conditions or in financial markets.
- Effects arising from changes, circumstances or conditions affecting the seller's industry in general.
- Effects arising from the contemplated transaction (or its announcement).
- Changes in stock price.
- Failure to meet analysts' earnings estimates.
- Employee attrition resulting from transaction announcement.

What is Material?

- Consider defining the trigger point at which a change is "material."
- For instance: Define "material adverse change" as
  - a change that could "reasonably be expected to adversely affect the company's financial condition in an amount equal to or greater than $50,000" or
  - A change that "decreases the company's assets by more than 10%."

Contractual Disclaimers and Fraudulent Inducement

- A closely related issue to whether there has been a "material adverse change" is the issue of whether a buyer was fraudulently induced into the transaction by the seller's misrepresentations during the negotiating process.
- Express contractual disclaimers in purchase agreements are often enforced against sophisticated parties to bar claims of fraudulent inducement.
  - As explained by the Delaware Chancery Court, "A party cannot promise . . . that it will not rely on . . . representations outside of the agreement and then shirk its own bargain in favor of a 'but we did rely on those other representations' fraudulent inducement claim."
- Warning: A seller cannot rely upon a disclaimer clause to protect itself from deliberate misrepresentations.

Restrictive Covenants – Two Types

1) Ancillary to the Sale of a Business

– Seller of business has promised not to engage in a similar business in competition with the buyer or agrees to restrict other, related future activities; or

– Buyer of business offers continued employment to seller's employees conditioned on the signing of a non-competition agreement; or

– Buyer of business purchases all of the seller's assets, including all employment agreements, restrictive covenants and other restrictive agreements.

2) Employer/Employee Relationship - generally scrutinized with more care than those ancillary to the sale of a business. (Not the focus of this presentation.)

Typical Categories of Restrictions

Covenant not to compete in same industry or profession: Generally prohibits an individual from undertaking certain business activities.

Non-Solicitation Provisions:

- Can protect solicitation of customers or employees.
- Often can substitute for or complement a geographic restriction against engaging in a specific type of business.

Non-Disclosure Provisions: Of trade secrets or other confidential information.

General Considerations

- Generally, courts frown upon restrictive covenants and related agreements as improper restraints on trade.
- However, in connection with the sale of a business, these agreements are viewed more favorably because of the parties' arms length bargaining position.
- In the business sale context, covenants not to compete are considered necessary to assure the buyer that the former owner will not walk away from the sale with the company's customers and/or goodwill, leaving the buyer with an acquisition that turns out to be worth less than the purchaser expected.

How do courts determine whether a restriction is "ancillary to the sale of a business"?

Was it intended to protect the integrity of the sale?

- The terms of the sale (whether the covenant was integrated into the sale).
- When the covenant was signed in relation to the sale of the business.
- The bargaining capacity of the covenantor – is she more like an owner of the business or more like an employee?
- Whether independent consideration was given for the covenant (employment itself is generally the only consideration given for a non-ancillary covenant).
- Where a corporation's business depends heavily on the goodwill of one or more officers or shareholders, and those individuals promise purchaser they will not compete with the business following a sale, courts generally treat that agreement as ancillary to the sale.

Restriction Must be Reasonable

- The restriction must protect a legitimate business interest (such as preservation of good will). This can be presumed when the restriction is contained in an agreement governing the sale of a business.
- The restriction must be geographically and temporally reasonable, and must not be overbroad in the activities it prohibits.
- Some courts will blue-pencil (modify) a restriction to render it reasonable and enforceable.

Possible Relief in Event of a Breach

Possible remedies in the event of a breach:

- Compensatory damages (generally net profit lost as a result of the breach).
- Disgorgement of profits earned by breaching party as a result of the breach.
- Non-breaching party's obligation to make further payment of monies owed under the purchase agreement may be suspended.
- Liquidated damages – if contractually provided for.
- Injunctive relief.
- Attorneys' fees – if contractually provided for.

Restrictive Covenant Drafting Pointers

- Because the standards governing enforcement of restrictions ancillary to the sale of a business are not as stringent as those in the employer/employee context, it is important to ensure that the parties clearly express their intent that the restrictions are ancillary to the sale.
- Be explicit that the transfer of good will supplies consideration for the restrictions.
- Make clear that the restrictions apply regardless of the reason the employee's employment comes to an end.
- Confine the scope of the restriction to an area in which the individual may pose a significant threat to the employer's business.
- Include a severability clause permitting a court to enforce those provisions that the court does not find objectionable.
- Consider a liquidated damages provision, especially if the time period of the restriction is so short that preliminary or injunctive relief might become moot. But indicate that liquidated damages are not the exclusive remedy – to avoid the contention that such a provision precludes equitable (injunctive) relief or recovery of other damages

Other Provisions to Consider

- Consider using other kinds of restraints, such as non-solicitation of customers or restraint on disclosure of confidential information, if those provisions will accomplish goals, because they often are viewed more favorably.
- If using a forum/choice-of-law clause, investigate whether your chosen state has a statute specifically governing enforceability of restrictive covenants and ensure that your restrictions comply with all applicable law.

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