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DOJ AND FTC RADICALLY REVISE ANTITRUST MERGER GUIDELINES: FAQS FOR BUSINESS

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The Antitrust Division of the Department of Justice and the Federal Trade Commission have published draft new merger guidelines, reflecting the profound change in antitrust enforcement we have seen under the Biden Administration. In this article we address important questions raised by these draft guidelines and at the end of the paper present more details on key provisions of the individual guidelines and their implications.

What Are The Merger Guidelines? Why Are They Important?

Since 1968, the DOJ and FTC have issued and occasionally updated merger guidelines to help businesses understand the agencies' approach to merger enforcement and to provide agency staff and counsel with a framework within which to analyze mergers. The guidelines are not binding law, but courts have treated the guidelines as persuasive, largely because the guidelines, historically, reflected generally accepted legal theories and current economic thinking.

In July, the DOJ and FTC published a draft of new merger guidelines ("Draft Guidelines"). These Draft Guidelines would be the seventh iteration of the horizontal merger guidelines (not counting the separate non-horizontal merger guidelines and vertical merger guidelines), replacing the 2010 horizontal merger guidelines and the 2020 vertical merger

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Private equity firms holding board seats or appointing leadership in multiple portfolio companies should evaluate whether any could be considered "competitors" for Section 8 purposes.

Expect DOJ and FTC to continue to push expanded interpretations of Section 8 that strain precedent and look beyond the individuals themselves who sit on a board of directors and look instead to the companies appointing them and/or whether those directors have affiliations that might trigger antitrust scrutiny.

Other antitrust statutes, particularly Section 1 of the Sherman Act (which prohibits agreements that unreasonably restrain trade), but possibly now Section 5 of the FTC Act, continue to apply even if the interlock is within Section 8 safe harbors. A sound antitrust compliance plan will therefore also establish reasonable procedures to prevent sharing of competitively sensitive information, among other things.

ENDNOTES:

[1]As discussed in a previous Client Alert: https://www.gibsondunn.com/doj-antitrust-division-head-promises-litigation-to-break-up-director-interlocks/.

[2]Michael E. Blaisdell, *Interlocking Mindfulness*, June 26, 2019, *available at*: https://www.ftc.gov/enforcement/competition-matters/2019/06/interlocking-mindfulness.

[3]*Interlocking Mindfulness* (Section 8 "prohibits not only a person from acting as officer or director of two competitors, but also any one **firm** from appointing two different people to sit as its agents as officers or directors of competing companies").

[4]Analysis of Agreement Containing Consent Order to Aid Public Comment, *In the Matter of EQT Corp*., File No. 221-0212, *available at*: https://www.ftc.gov/system/files/ftc_gov/pdf/2210212eqtquantumaapc.pdf.

[5]As discussed in a previous Client Alert: https://www.gibsondunn.com/ftc-announces-broader-vision-of-its-section-5-authority-to-address-unfair-methods-of-competition/.

EARN-OUTS IN CROSS-BORDER M&A: CHOOSE WISELY

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Earn-outs are in: as deal lawyers know well, economic uncertainty and valuation gaps between seller expectations and buyer appetite over recent years have resulted in the increased use of earn-outs in structuring M&A purchase terms.

In this article we briefly consider some of the implications of this rise in popularity of earn-outs for North American cross-border M&A, in particular for buyers considering acquiring Canadian targets. We focus specifically on considerations arising from comparisons of Delaware and Canadian law related to the efforts undertakings often incorporated into earn-out obligations. This is an important consideration for both buyers and sellers. What level of commitment must they meet in executing on the post closing obligations in respect of an earn-out? Where the time period of an earn-out extends over two or three years or an even longer timeframe post closing, the im-

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pact of the choice of efforts standards by both buyer and seller can be further magnified.

The high-level practical takeaway: choose wisely and with appreciation for how different efforts undertakings have been applied by Canadian courts, including in M&A disputes.

Efforts Undertakings in Delaware: A Tendency to Collapse Categories

Unfortunately, courts do not always respect a hierarchy among efforts undertakings in M&A agreements to the same degree that many transactional lawyers do.

In 2010, the ABA Business Law Section M&A Committee cautioned that "[a]lthough practitioners may believe there are differences between the various efforts standards, courts have been inconsistent both in interpreting these clauses and in perceiving distinctions between them."[1]

This advice appears to hold true today, at least in the United States. In its seminal 2018 decision in *Akorn v. Fresenius*, the Delaware Court of Chancery explained that "[c]ommentators who have surveyed the case law find little support for the distinctions that transactional lawyers draw" among such terms as "best efforts," "reasonable best efforts," "reasonable efforts" and "commercially reasonable efforts."[2]

Similarly, in *Channel Medsystems,* the Court of Chancery explained that "[a]lthough the agreement here refers to the use of 'commercially reasonable efforts' while the provision in *Akorn* referred to the use of 'reasonable best efforts,' " Delaware case law contains "little support for distinctions between these two clauses."[3]

In both cases, the Court of Chancery cited the Delaware Supreme Court's overarching instruction that "covenants like the ones involved here," *i.e.*, efforts undertakings in an M&A agreement, "impose obligations to take all reasonable steps to solve problems and consummate the transaction."[4] In that case, *Williams v. Energy Transfer*, the Supreme Court declined to apply different efforts standards to the two different efforts formulations at play, being "reasonable best efforts" and "commercially reasonable efforts."

Efforts Undertakings in Canada: A Relatively Well-Defined Hierarchy

In contrast to Delaware, Canadian courts generally do apply different expectations and requirements to different formulations of efforts undertakings. In fact, a relatively well-defined hierarchy has emerged in Canadian case law.

Best Efforts

At the most onerous end of the spectrum is a "best efforts" undertaking. This is a demanding standard that requires the burdened party take "all reasonable steps to achieve the objective, carrying the process to its logical conclusion and *leaving no stone unturned*."[5] The standard also requires "*doing everything* known to be *usual, necessary and proper* for ensuring the success of the endeavour."[6] Courts recognize limits to this commitment: the burdened party is not required to "sacrifice itself totally to the economic interests of the party to whom the duty is owed," but maintain that the "interest of the other party must predominate."[7]

Reasonable Commercial Efforts

Unlike the "leave no stone unturned" burden imposed by a "best efforts" standard, an undertaking based on a "reasonable commercial ef-

forts" (or "commercially reasonable efforts") standard imports a *cost/benefit* type analysis. As explained in a dispute over the sale of two residential towers:

> The [buyer's] obligation. . . to use all reasonable commercial efforts . . . required them to pursue the matter up to the point where it became commercially unreasonable for them to proceed further. In making that determination, the [buyer] would naturally take into account all information in its possession about the probability of [the regulatory] application succeeding, and would weigh the probability of success against the cost of proceeding further. If the cost of taking further steps became unreasonably high in relation to the probability of success, so that it would not be commercially reasonable to proceed further, then the [buyer] would be justified in stopping at that point.[8]

An important difference between "best efforts" and "reasonable commercial efforts" is therefore that, unlike the former, the latter does not require the burdened party to subordinate its interests to those of its contractual counterparty.[9]

Reasonable Efforts

A third efforts formulation sometimes used in Canada is "reasonable efforts." It has, however, received the least judicial treatment and as a result, its contours cannot be mapped with confidence. Commentators explain that reasonable efforts "denotes a lower standard than 'best efforts.' "[10] But beyond this, guidance is scant. A notable exception is the following instruction given in a dispute arising from the sale of 15 undeveloped building lots:

> "[R]easonableness". . . denotes a *prudent* and *moderate measure* of *sustained diligence* necessary to give business efficacy to the object of the parties' underlying agreement (being, in this case, to effect the purchase and sale of subdivided lots). Alternatively put, it describes the effort that a reasonable person, committed to achieving the objective, would have undertaken.[11]

Hybrid Efforts Standards

Lastly, Canadian courts have given effect to *hybrid* efforts standards that do not adhere to a "best efforts," "reasonable commercial efforts," or "reasonable efforts" formulation. A recent example is the "commercially reasonable best efforts" undertaking made by the buyer of a health provider business. The trial court effectively negated the "best" component by attributing dominance to the "commercially reasonable" component.[12] The court of appeal reversed. It explained that by dismissing the hybrid formulation as a victim of "overdrafting," the trial court had sidestepped its duty to determine "the intent of the parties and the scope of their understanding by looking at the *contract as a whole*, and giving *all of the words* their ordinary grammatical meaning consistent with the *surrounding circumstances*."[13]

Practical Takeaways for Earn-Outs in Cross-Border M&A

As exemplified by *Airborne Health v. Squid Soap*, some Delaware courts have taken a cynical stance with regards to earn-outs:

> In theory, the earn-out solves the disagreement over value by requiring the buyer to pay more only if the business proves that it is worth more. But since value is frequently debateable and the causes of underperformance equally so, an earn-out often converts today's disagreement over price into tomorrow's litigation over the outcome.[14]

It is worth noting that earn-outs have not been

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litigated in Canada to the same extent that they have in Delaware. However, efforts undertakings have been fairly extensively litigated in Canada and as such, can provide some helpful guidance in the drafting of the efforts components of earn-out clauses.

The principal takeaway is that drafting will matter: Canadian courts should be expected to be familiar with the different efforts formulations employed by transacting parties and to seek to give effect to the particular wording chosen.

Second, be mindful that a "best efforts" undertaking is an onerous one. It will attract more demanding obligations than the alternatives. It is best known for its "leave no stone unturned" requirement, and for subordinating the interests of the burdened party to those of the other party.

Third, "reasonable commercial efforts" and "reasonable efforts" are clearly less demanding than "best efforts," but exactly how much so is difficult to gauge with precision. "Reasonable commercial efforts" stands out for its cost/benefit orientation. We would expect a "reasonable efforts" standard to fall somewhere between "best efforts" and "reasonable commercial efforts" as a result of the absence of the "commercial" qualifier, but we are unaware of any Canadian court that has made a definitive ruling or statement on the point.

Fourth, approach the possibility of a hybrid efforts undertaking with caution. The clause will not benefit from the established jurisprudence enjoyed by the more common formulations canvassed above. This could import greater uncertainty and may increase the likelihood of dispute regarding whether the undertaking has been complied with. Courts would be called upon to interpret the contractual intent of the parties engaging a hybrid efforts standard. This may increase the unpredictability of any judicial treatment, as the court will likely consider the earn-out or M&A agreement as a whole, as well as the surrounding factual matrix.

Fifth, appreciate that while efforts undertakings have been fairly extensively litigated in Canada, efforts undertakings in the *particular context* of earn-outs have not. Where efforts undertakings in M&A have been litigated in Canada, this has typically been in the context of interim period covenants. It therefore remains to be seen how efforts undertakings might be approached in the *post-closing context* and where the seller's interest in maximizing its payment under the earn-out and the buyer's interest in running the business may not always pull in the same direction.

Additional Insights from Canadian Courts

Lastly, those instances in which earn-outs have been litigated in Canada provide other valuable insight.

In *Whiteside v Celestica*, for example, the parties disputed whether a particularly lucrative contract landed by the target during the final earn-out period should contribute toward the earn-out calculation. The contract did not fit squarely within the specified criteria and thus, based on a strict reading of the earn-out clause, the trial court held the buyer was justified in excluding it from its final earn-out calculations. However, the court of appeal overturned the decision and key to its reasoning was that, *in calculating earn-out payments under earlier earn-out periods*, the buyer had previously included similar (albeit less lucrative) contracts.[15]

This is a reminder that, while the particular drafting of the earn-out will certainly matter, so too might the buyer's actions post-closing in its interpretation of *how* the earn-out covenants and calculations are applied.

In *Bhatnagar v Cresco Labs,* the issue was whether the buyer had breached its duty of good faith and honest performance in connection with an earn-out. Prior to the sale of the target, the sellers had learned of the potential acquisition of the buyer, and the earn-out provided for an additional payment if this acquisition occurred during the three year earn-out period. The buyer was in fact acquired, but some months after the earn-out period expired. The lower court dismissed the seller's claims that the buyer had undermined the target's efforts toward revenue growth in breach of the buyer's duty of good faith, but found the buyer in breach of its duty of honest performance for failing to correct and update the seller regarding the timeline for the acquisition of the buyer. Notwithstanding that the court of appeal reversed on this point for finding that the buyer was well aware of the revised acquisition timeline,[16] the dispute is an important reminder that, *regardless of the exact efforts standard(s) incorporated into an earn-out*, the buyer will *in any event be bound* by the duties of good faith and honest performance applicable to all contracts in Canada.

ENDNOTES:

[1]ABA Business Law Section Mergers & Acquisitions Committee, *Model Stock Purchase Agreement with Commentary*, 2nd Ed. (American Bar Association, 2010) Vol. 1 at page 213.

[2]*Akorn, Inc. v. Fresenius Kabi AG*, 2018 Del. Ch. LEXIS 325 at *203-204.

[3]*Channel Medsystems, Inc. v. Boston Scientific Corp.*, 2019 Del. Ch. LEXIS 1394 at *95 note 410.

[4]*Williams Cos. v. Energy Transfer Equity*, L.P., 159 A3d 264 (Del. 2017) at *272 (emphasis added). *See also Snow Phipps Group, LLC v. KCake Acquisition, Inc.*, 2021 Del. Ch. LEXIS 84 at *86.

[5]*Atmospheric Diving Systems Inc. v. International Hard Suits Inc.*, 1994 CanLII 16658 (BC SC) at para. 71 (emphasis added).

[6]*Atmospheric Diving Systems Inc. v. International Hard Suits Inc.*, 1994 CanLII 16658 (BC SC) at para. 71 (emphasis added).

[7]*Philo Investments Ltd. v. Toronto Paramedical Management Inc.*, [1996] O.J. No. 733, 61 A.C.W.S. (3d) 686 at para. 82.

[8]*Nelson v. 535945 British Columbia Ltd.*, 2007 WL 3077429 (B.C. S.C. 2007) at para. 38.

[9]*See* G. Hall, *Canadian Contractual Interpretation Law*, 4th Ed. (LexisNexis Canada, 2020) at 9.5.3: "Thus unlike the best efforts standard, which in large measure subordinates a party's own economic interest to that of the contracting counterparty, the commercially reasonable efforts standard allows the party undertaking the effort in question to cease its effort when the economics of doing so, from its own perspective, cease to make sense."

[10]A. Swan, J. Adamski & A. Na, Canadian Contract Law, 4th Ed. (LexisNexis Canada, 2018) at § 8.217.

[11]*1092369 Alberta Ltd. v. Joben Investments Ltd.*, 2013 ABQB 310 (CanLII) at para. 75 (emphasis added).

[12]*See Sutter Hill Management Corporation v. Mpire Capital Corporation*, 2020 BCSC 238 (CanLII).

[13]*Sutter Hill Management Corporation v. Mpire Capital Corporation*, 2022 BCCA 13 (CanLII) at para. 37 (emphasis added).

[14]*Airborne Health v. Squid Soap*, 984 A.2d 126 (Del. Ch. 2009) at *132.

[15]*See Whiteside v. Celestica International*

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Inc., 2014 WL 5840824 (Ont. C.A. 2014), Additional reasons in, 2014 WL 2916036 (Ont. C.A. 2014).

[16]*See Bhatnagar v. Cresco Labs Inc.*, 1111 WL 2061811 (Ont. C.A. 2023).

U.S. MOVES TO NARROWLY LIMIT INVESTMENT IN CHINA

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On August 9, 2023, after more than a year of deliberations, the Biden administration finally released an executive order[1] (the "Order") directing the Department of the Treasury ("Treasury") to create a new regulatory program to prohibit or require notification of outbound U.S. investments to China in certain sensitive sectors.

This new outbound foreign direct investment ("FDI") review program, which complements existing authority to review **inbound** U.S. FDI conducted by the Committee on Foreign Investment in the United States ("CFIUS"), will not go into effect immediately. But the contours of the eventual program can be seen in the Order and in an advance notice of proposed rulemaking ("ANPRM") also issued by Treasury on August 9, 2023.

The program will be narrowly targeted, at least at the outset, with the greatest impact most likely on U.S. private equity and venture capital investments in China.

Restrictions on Outbound Investment

The Order directs Treasury to create an outbound FDI review program that will require reporting on or (in more narrow circumstances) will prohibit investments by U.S. persons involving "covered national security technologies and products," which is defined to include "sensitive technologies and products in the semiconductors and microelectronics, quantum information technologies, and artificial intelligence ("AI") sectors that are critical for the military, intelligence, surveillance, or cyber-enabled capabilities" of China (to include Hong Kong and Macau).

Thus, the outbound FDI review program will complement other efforts by the Biden administration to limit China's ability to develop these categories of sensitive technologies, most notably the October 7, 2022, rule issued by the Department of Commerce imposing additional export controls over these technologies. According to data from the Department of Commerce Bureau of Economic Analysis (BEA),[2] while FDI from China into the United States has decreased by almost 30% since 2019, U.S. FDI into China has increased by almost 20% over the same time period.

According to the Order and ANPRM, U.S. investments in companies developing these technologies in China are "not sufficiently addressed by existing tools" because such investments often provide Chinese companies with intangible benefits such as managerial assis-

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