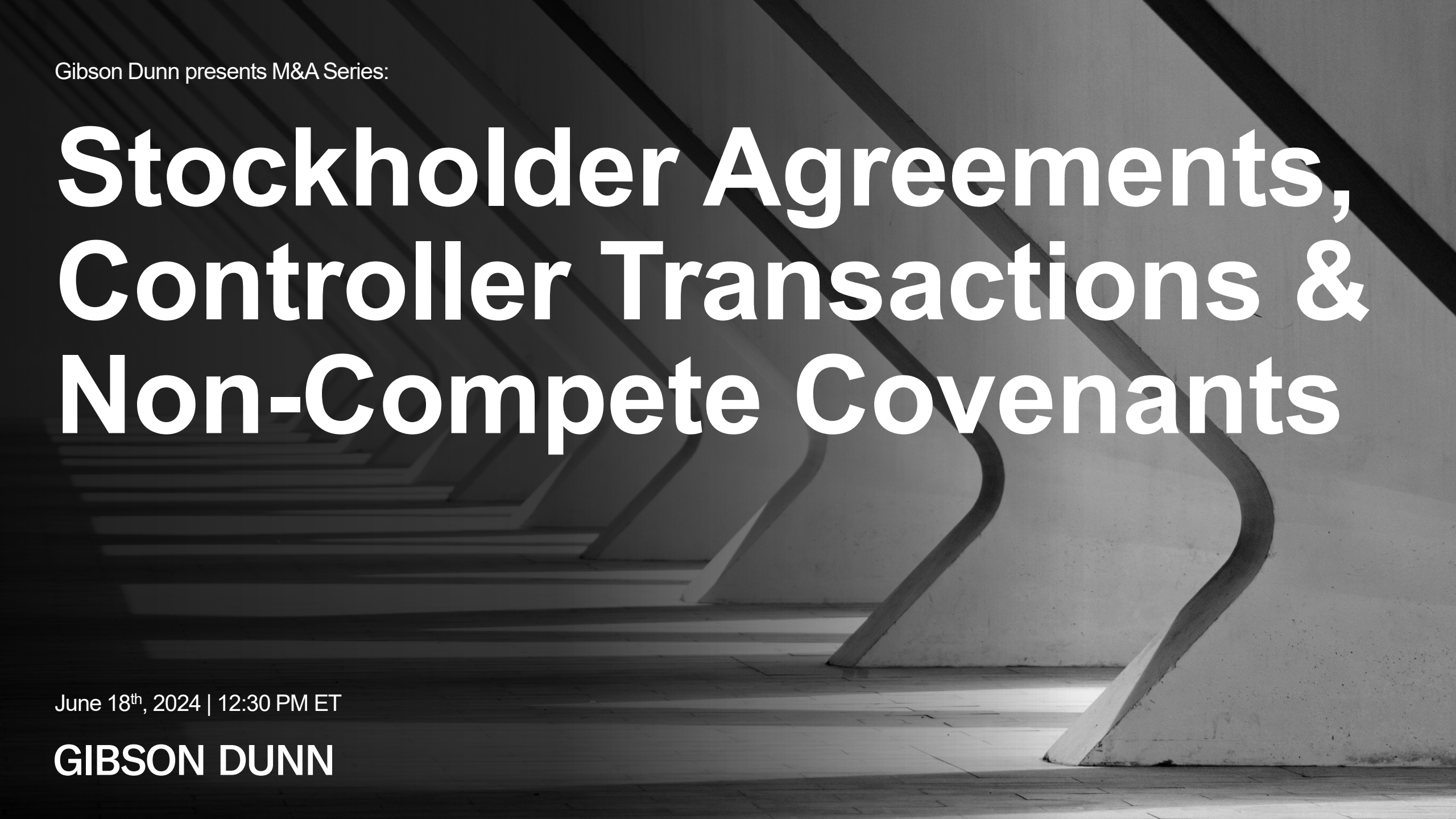

Gibson Dunn presents M&A Series:

Stockholder Agreements, Controller Transactions & Non-Compete Covenants

June 18th, 2024 | 12:30 PM ET

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Today's Panelists

Stephen Glover

Stephen I. Glover is a partner in the Washington, D.C. office of Gibson, Dunn & Crutcher who has served as Co-Chair of the firm's Global Mergers and Acquisitions Practice. Mr. Glover has an extensive practice representing public and private companies in complex mergers and acquisitions, joint ventures, equity and debt offerings and corporate governance matters. His clients include large public corporations, emerging growth companies and middle market companies in a wide range of industries. He also advises private equity firms, individual investors and others. Mr. Glover has been ranked in the top tier of corporate transactions attorneys in Washington, D.C. for the past seventeen years (2005 – 2023) by Chambers USA America's Leading Business Lawyers.

Ed Batts

Ed Batts is a corporate partner in Gibson Dunn's Palo Alto office who counsels technology clients in the semiconductor supply chain; enterprise software and cloud; hardware and devices; 5G and satellite; and large-cap enterprises that engage in many of these sub-verticals at once. Ed focuses on mergers and acquisitions, including cross-border transactions, spin-offs, tender offers, and going private transactions. He also counsels public companies on corporate governance and fiduciary duties, as well as crisis management on cyber-security and internal investigations, activist investor situations, and accounting issues. He has significant experience in equity capital markets and venture capital transactions.

Jamie France

Jamie France is a partner in the Washington, D.C. office of Gibson, Dunn & Crutcher and a member of the firm's Antitrust and Competition Practice Group. Jamie represents clients in antitrust merger and non-merger investigations before the U.S. Federal Trade Commission, U.S. Department of Justice Antitrust Division, state Attorneys General, and international competition authorities, as well as in complex private and government antitrust litigation. She also counsels clients on a range of antitrust merger and conduct matters. Her experience encompasses a broad set of industries, including healthcare, technology, consumer goods, retail, pharmaceuticals, software, gaming, wood products, and chemicals. Jamie has been recognized in the 2024 edition of the Best Lawyers: Ones to Watch® in America for Antitrust Law and Litigation – Antitrust.

Harrison Korn

Harrison A. Korn is of counsel in the Washington, D.C. office of Gibson, Dunn & Crutcher, where he is a member of the firm's corporate department. Harrison advises public and private companies, private equity firms, boards of directors and special committees in a wide variety of complex corporate matters, including mergers and acquisitions, asset sales and other carve-out transactions, leveraged buyouts, spin-offs, joint ventures, strategic investments, equity and debt financing transactions and corporate governance matters, including securities law compliance. Harrison has been recognized in the 2024 edition of Best Lawyers in America: Ones to Watch® for Corporate Law.

Delaware Cases, Stockholder Agreements, and Proposed DGCL Amendments

A Torrent of Unexpected Delaware Cases

Delaware's Busy 6 months

31 Oct 23: "*Crispo*" *Luigi Crispo vs. Elon R. Musk, X Holdings I, Inc. and X Holdings II, Inc.:*

- Chancellor McCormick held that damages for lost premium in mergers not recoverable where third party beneficiaries have been disclaimed, as company is not an agent of stockholders, undermining '*Con Ed*' provisions.

30 Jan 24: *"Tornetta"* *Richard J. Tornetta et al.* v. *Elon Musk et al.:*

Chancellor McCormick invalidated $56b equity grant to Musk, holding:

- Musk as a controlling stockholder triggered the Entire Fairness standard, and the original shareholder vote was defective as the approval materials (a) identified outside directors as independent, and (b) omitted a full description of the interaction between Musk and such directors on terms of the grant; and
- Musk's grant did not meet the Entire Fairness dual prongs of (1) fair process, given relationships between directors and Musk, and (2) fair 'price' because (a) Musk already was a 20%+ stockholder, (b) purported no risk of Musk leaving Tesla and no grant condition on amount of time required at Tesla, (c) grant conditions not deemed ambitious to achieve, and (d) no benchmarking applied.

29 Feb 24: "*Activision*" *Sjunde AP-Fonden v. Activision Blizzard:*

- Chancellor McCormick held that board failed to approve an 'essentially complete version' of a merger agmt because draft lacked (1) parties names, (2) purchase price, (3) disclosure schedule/letter, (4) charter of surviving corporation, and (5) finalized material terms (final term on dividend payments delegated to *ad hoc* board committee).

Moelis and Stockholders' Agreements (Background)

Reconciling Tension Between Contractarianism, Statute, and the Role of the Board.

4 Mar 24: The *Moelis* Decision/Interlocutory Order: *West Palm Beach Firefighters' Pension Fund v. Moelis & Co.* Vice Chancellor Laster.

Section 141(a) of the Delaware General Corporation Law states: *"the business and affairs of every corporation organized … [in Delaware] shall be managed by or under the direction of a board of directors, except as may be otherwise provided … [under the DGCL] or in its certificate of incorporation.*"

- Ken Moelis, founder of the eponymous investment banking firm currently owns approx. 6.5% of NYSE-listed Moelis & Co., but through holding Class B 'high vote' shares with 10 votes per share, has approx. 38.7% of voting rights of the Company.
- The high votes per share for Moelis are contingent on conditions such as Moelis maintaining a minimum stockholding of approx. 4.5m shares and are not transferable.
- One day prior to the Moelis IPO in 2014, Moelis and the company entered into a stockholder agreement, which continues until he no longer holds at least 2.2 m shares in the Company and grants two buckets of rights: Consent ("Veto") Rights and Director Rights.

Moelis and Stockholders' Agreements (The Provisions)

Moelis (cont.).

Consent (or 'veto') rights: Extensive, covering 18 categories, or '*virtually everything the [b]oard can do*': Debt in excess of $20m, equity in excess of 3% of voting rights, any preferred stock, equity or debt commitment ltr above $20m, new business line requiring more than $20m in investment, any shareholder rights plan, removal or appointment of any Section 16 officer, any charter or bylaws amendment, any amendment to the Company's Partnership LP agmt, any Company name change, approval of budget and business plans, paying dividends, a merger or sale or liquidation/wind-up of the Company, material amendment of a material contract, any related party transaction, initiating or settling litigation, and changes to the Company's tax or fiscal year.

Board nomination ('designation') rights: Board size (capped at 11) and size changes prescribed, 50% (scaling down to 25%) of directors must be designees of Moelis, and Company must nominate, recommend for election and "use its reasonable best efforts to cause the election of such designees to the Board." Moelis has right to name any replacement director for his designees, and proportionate representation of Moelis designees on board committees.

Most of *Moelis* deemed facially invalid. What wasn't banned in *Moelis*? Company may agree:

- For Ken Moelis to have right to put forth nominees for a majority of the board;
- To nominate (but not recommend) such nominees; and
- To use reasonable efforts for such nominees to be elected.

Delaware State of Play

In the interim

- *Moelis* decision likely to be appealed to the Delaware Supreme Court.
- On May 2, Microsoft filed for judicial curing/approval in *Activision*.
- Various related cases/alternatives pending: For example, whether having a 'fiduciary out' on consent rights helps thread needle is unclear.

Proposed legislative changes to the DGCL

- On March 23, proposal passed by the Council of the Corporation Law Section of the Delaware State Bar Association.
- On May 23, introduced as S.B. 313. Reported out of Judiciary Cmte on June 11. Ordinary session of Legislature ends June 30. Would become effective August 1. Retroactive, but would not pre-empt pending cases.
- *Crispo*: Lost premium explicitly recoverable under contract, and corporation may appoint a stockholders' representative to seek recovery.
- *Activision*: "Substantially complete" contract (rather than "essentially complete") contract board approval permissible. Also addresses notice requirements.
- *Moelis:* Essentially 'overturns' *Moelis*.

Counterpoints

- May 14 letter from the Council of Institutional Investors urging a pause in "*a legislative rush to judgment*" on *Moelis. "More specifically, for CII and its members, we strongly believe that permitting stockholder agreements to contain the provisions at issue in the Moelis case would disadvantage long-term investors."*
- Provoked a relative firestorm of debate in legal academic circles.

Larger Implications for Choice of Incorporation

Delaware Implications

Delaware known for three principal advantages:

(1) Dedicated business judiciary without jury (Chancery Court);

(2) Well established body of law that has thoughtfully evolved over time to create predictability and thus certainty; and

(3) Ease of 'user interface' with the Delaware Secretary of State.

Exploring Alternatives to Delaware?

- Recent cases call #2 into question. That said, prior nascent efforts to create a similar infrastructure elsewhere, particularly in Nevada, have largely fizzled, notwithstanding recent high profile reincorporation examples (e.g. Neuralink (NV), TripAdvisor (NV), and now Tesla (TX)) and that taxes generally lower outside Delaware.

- More interesting will be how (a) Delaware generally navigates the recent months of uncertainty, and (b) if Texas, as it plans to do, can create a viable alternative with their proposed business courts.

Implications of the Delaware Supreme Court's *Match* Decision

Entire Fairness and *MFW*

The "Entire Fairness" standard of review presumptively applies to transactions with a conflicted controlling stockholder

Entire Fairness Standard:

The standard consists of two inquiries: (a) fair price and (b) fair dealing

- **Fair price** means a price that a reasonable seller, under all of the circumstances, would regard as within a range of fair value.
- **Fair dealing** considers both the process that the board followed and the quality of the result achieved.

If all the *MFW* conditions are satisfied, the standard of review shifts to business judgment

MFW Conditions:

1. The controlling stockholder conditions the transaction on the approval of both a special committee and a majority of the minority stockholders.
2. The special committee is independent.
3. The special committee is empowered to freely select its own advisors and say no definitively.
4. The special committee meets its duty of care in negotiating a fair price.
5. The vote of the minority stockholders is informed.
6. There is no coercion of the minority.

Case Background

- Match Group, Inc. was a publicly traded company controlled by IAC
- Through a reverse spinoff, IAC separated Match and some debt from IAC's other businesses
- The transaction was approved by a special committee of Match and a majority of Match's minority stockholders
- Match's minority stockholders alleged that the transaction was unfair because IAC received benefits at the expense of Match's minority stockholders
- Court of Chancery ruled that although one member of the special committee was not independent, the special committee was not infected, so *MFW* was satisfied and the business judgment standard of review applied

On Appeal, the Delaware Supreme Court Answers Two Questions

- For a transaction with a controlling stockholder that does not involve a freeze-out merger, is satisfaction of all the *MFW* conditions necessary to shift the standard of review to business judgment, or is approval by either an independent special committee or a majority of the minority stockholders sufficient?
- If compliance with *MFW* is required, can the conditions still be satisfied if not all the members of the special committee are independent (but a majority are and the non-independent directors do not dominate the process)?

Delaware Supreme Court Ruling

The Supreme Court held:

- Compliance with all *MFW* conditions is required to shift the standard of review to business judgment in all transactions where conflicted controlling stockholder receives non-ratable benefit (not just squeeze-out mergers)
- If even one director on the special committee is not independent, the *MFW* conditions are not satisfied (even if the director did not dominate the process)

Potential Implications

- Likely increases litigation risk for transactions with controlling stockholders, as it will be harder to succeed on a motion to dismiss
- Continues the trend of *MFW* conditions becoming more difficult to meet; transaction planners may be more likely to not even attempt to meet the conditions
- May lead to smaller special committees with less experienced directors to reduce the risk a director can be attacked for not being independent

Update on the Recently Adopted FTC Rule Banning Non-Compete Agreements

Overview of Final FTC Rule Banning Non-Compete Agreements

In April 2024, the FTC voted along party lines (3-2) to adopt a final rule imposing a near-categorical ban on the use of non-compete agreements nationwide

What does the rule do?

- Prohibits any new non-compete agreements between employers and workers
- Renders existing non-compete agreements with workers unenforceable, subject to narrow exceptions
- Requires employers to provide workers with notice that existing non-compete agreements are no longer enforceable (but does not require previous agreements to be formally rescinded)
- Defines "workers" broadly to encompass persons working as employees, independent contractors, interns, externs, volunteers, and sole proprietors

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The rule marks an abrupt contrast from past treatment of non-competes under the antitrust laws

- Non-compete agreements were previously recognized to have potential procompetitive value and were subject to a reasonableness standard

The rule is set to go into effect on September 4, 2024, but several pending legal challenges to the rule could delay or enjoin that effective date

FTC predicts the rule will impact 30 million workers

FTC Rule Adopts a Functional Definition of a Non-Compete Clause

- The rule defines a non-compete clause as: "a term or condition of employment that prohibits a worker from, penalizes a worker for, or functions to prevent a worker from (1) seeking or accepting work in the U.S. with a different person where such work would begin after the conclusion of the employment that includes the term or condition; or (2) operating a business in the U.S. after the conclusion of the employment that includes the term or condition"
- If other terms or conditions of employment (e.g., non-disclosure agreements, non-solicitation agreements, training repayment provisions) prohibit, penalize, or function to prevent a worker from (1) or (2) above, such terms/conditions are considered "functional non-competes" under this definition

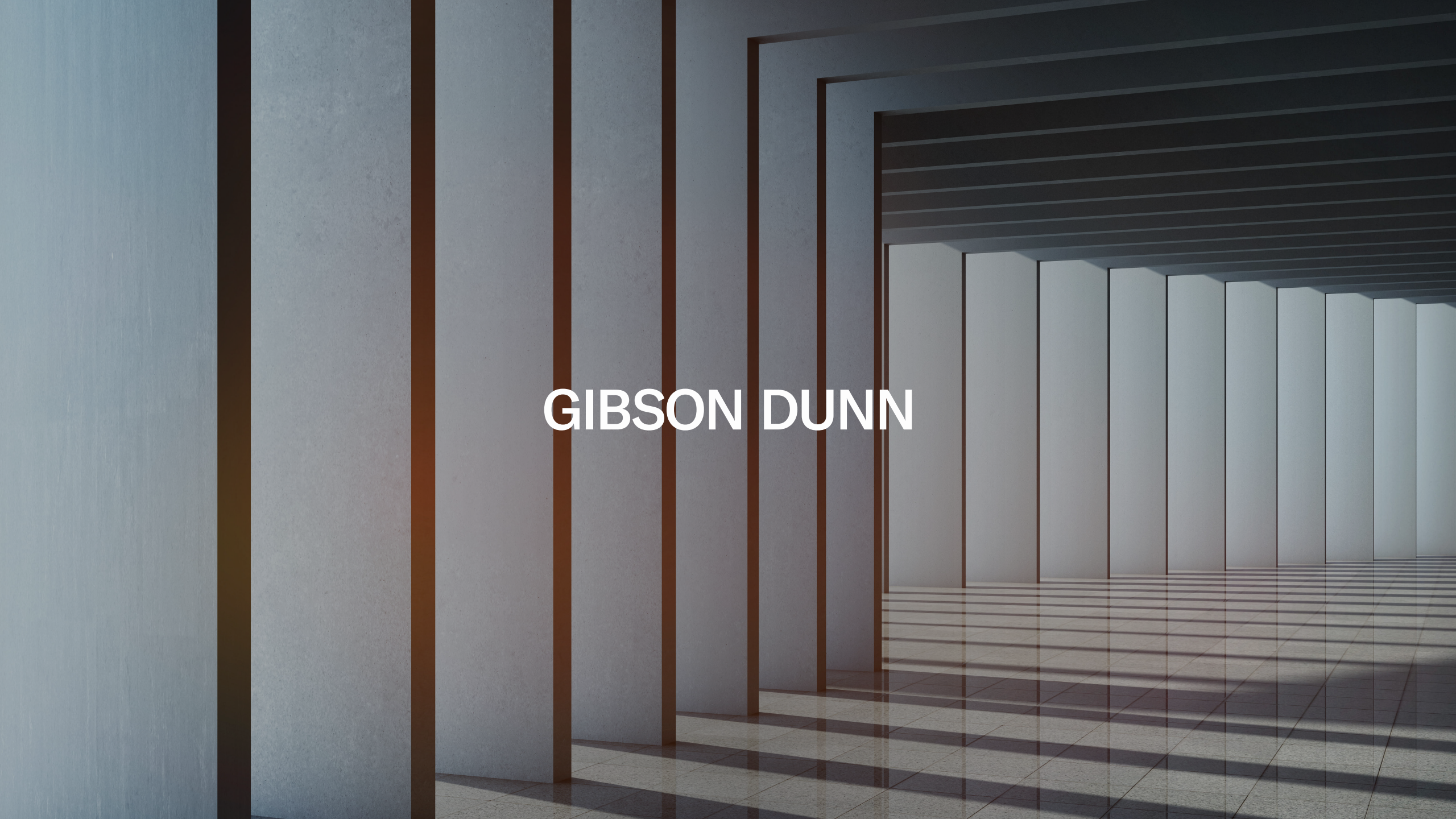
Examples of problematic NDAs that would be considered "functional non-competes":

- An agreement barring a worker from disclosing any information "usable in" or relating to the industry in which they work
- An agreement barring a worker from disclosing any information obtained during their employment, including publicly available information

Narrow Exceptions to FTC Rule

What are the exceptions to the FTC rule?

- The rule does not invalidate existing non-compete agreements with senior executives
  - "Senior executive" defined as a worker who: (1) earns more than $151,164 annually; and (2) is in a "policy-making position"
- The rule does not bar causes of action related to a non-compete that accrued prior to the final rule's effective date
- The rule's general prohibition on non-competes is not applicable to non-competes entered pursuant to the sale of a business
- Enforcing or attempting to enforce a non-compete is not considered an unfair method of competition where an employer has a good faith basis to believe the final rule is inapplicable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