Texas Twists in M&A: The Latest and Greatest

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Moderator:
Samantha Crispin, Baker Botts L.L.P., Dallas, Texas

Panelists:
Byron Egan, Jackson Walker LLP, Dallas, Texas
Robert R. Kibby, Munsch Hardt Kopf & Harr, P.C., Dallas, Texas
Chauncey Lane, Holland & Knight LLP, Dallas, Texas
Mark Solomon, Katten Muchin Rosenman LLP, Dallas, Texas

UT LAW CLE Continuing Legal Education

Agenda

- Divisive Mergers
- Fiduciary Duties
- Express Negligence
- Successor Liability
- Sandbagging
- Non-reliance
- Best Efforts

Texas Twists – Divisive Mergers

- Texas law has since 1989 authorized a corporation, partnership or LLC to effect a "divisive merger" by which a single entity can adopt a plan of merger pursuant to which it divides its assets and liabilities among one or more new or existing entities. Delaware statutes were amended in 2018 and 2019 to authorize LLCs and LPs, respectively, to effect "divisions" which are comparable to divisive mergers, but has thus far not allowed corporations or other entities to effect divisions.

- Delaware lawyers have for years redomiciled Delaware corporations to Texas to effect divisive mergers – called by media a "Texas Two Step." In one case to be discussed later the resulting Texas entities were converted elsewhere after only four few hours – one to Delaware and one to North Carolina to file for bankruptcy there to take advantage of favorable Fourth Circuit bankruptcy precedent.

Texas Twists – Divisive Mergers

Texas

- The Texas divisive merger analysis begins with Texas Business Organizations Code ("TBOC") § 1.002(55) which defines "merger" to mean "(A) the division of a domestic entity into two or more new domestic entities or other organizations or into a surviving domestic entity and one or more new domestic or foreign entities or non-code organizations."

- A divisive merger under the TBOC can involve any combination of corporations, partnerships or LLCs, including professional entities, but all of them would need to be organized under the TBOC or the laws of another state which permits divisive mergers. Among the states that authorize divisive mergers are Arizona, Delaware, Pennsylvania, and Texas.

- The plan of merger for a divisive merger under the TBOC must provide, among other things, the manner and basis for allocating and vesting the assets and liabilities of the parties, making adequate provision for the payment and discharge of each liability or obligation. Additionally, the plan of merger should address contingent assets and contingent liabilities of the parties.

Texas Twists – Divisive Mergers

Texas

- TBOC § 10.008(a)(4) provides that, upon the effectiveness of a merger, "each surviving or new domestic organization to which a liability or obligation is allocated under the plan of merger is the primary obligor for the liability or obligation, and, except as otherwise provided by the plan of merger or by law or contract, no other party to the merger, other than a surviving domestic entity or non-code organization liable or otherwise obligated at the time of the merger, and no other new domestic entity or non-code organization created under the plan of merger is liable for the debt or other obligation. . ." If, however, the plan of merger fails to provide for the allocation or vesting of any particular item of property or any liability of any party to the merger, TBOC § 10.008(b) provides that "the unallocated property is owned in undivided interest by, or the liability or obligation is the joint and several liability and obligation of, each of the surviving and new organizations, pro rata to the total number of surviving and new organizations resulting from the merger."

Texas Twists – Divisive Mergers

Texas

- TBOC § 10.008(a) provides in relevant part that when a merger takes effect, all of the properties of the constituent entities are vested in the surviving entity without "any transfer or assignment having occurred." A literal reading of these TBOC provisions was given by a Texas Court of Appeals in *TXO Prod. Co. v. M.D. Mark*, 999 S.W. 2d 137 (Tex. App. - Houston [14th Dist.] 1999, pet. denied), in holding that a merger is not a "transfer." The Sixth Circuit, in *Cincom Sys., Inc. v. Novelis Corp*., 581 F. 3rd 431 (6th Cir. 2009), held under the similar Ohio statute that in the context of patent licenses or trade secrets, a "transfer" occurs under federal law any time an entity other than the one to which the license was expressly granted gains possession of the license.

- A divisive merger under the TBOC may alter and reduce the pool of assets to which a creditor may look to for repayment. If a claim of a creditor of one entity in a divisive merger is allocated to a different or new entity in the merger, that creditor will generally only be entitled to look to the entity to which its claim is allocated and not to each surviving entity. The creditor, however, will continue to possess all the rights otherwise available to it under law (including fraudulent transfer laws) and contract, including all security interests in the property of the debtor securing the payment of the creditor's claim.

Texas Twists – Divisive Mergers

Texas

- TBOC § 10.901 provides that "[t]his code does not affect, nullify, or repeal . . . any right or rights of creditor[s] under existing laws." Principal among the laws available to protect creditors in mergers with multiple survivors are the Texas Uniform Fraudulent Transfer Act and the United States Bankruptcy Code of 1978. Although the specific standards vary between the UFTA and the Bankruptcy Code, a merger is considered a "transfer" thereunder, notwithstanding that TBOC § 10.008(a)(2)(C) provides that the allocation of assets in a merger occurs "without . . . any transfer or assignment having occurred."

- Under TBOC § 10.901 the allocation of liabilities and obligations in a divisive merger may not "abridge any right or rights of any creditor under existing laws." In *Plastronics Socket Partners, Ltd. v. Don Weon Hwang*, 2022 WL 948 (Fed. Cir. Jan. 12, 2022), the Court of Appeals for the Federal Circuit held that TBOC § 10.901 would not allow a Divisive Merger to avoid obligations under a product royalty agreement by allocating the obligations to pay royalties to a new subsidiary with no operations or significant assets while continuing to sell products itself for resale to others without paying any royalties at any stage. Recent bankruptcy court cases also confirm this interpretation that the Texas divisive merger statute does not relieve companies of obligations under preexisting agreements.

Texas Twists – Divisive Mergers

Delaware

- Delaware statutes allow LLCs and LPs to effect "divisions" which are the same as divisive mergers, but does not allow corporations to divide. DLLCA § 18-217 (effective August 1, 2018) and DRLPA § 17-220 (effective August 1, 2019) enables a Delaware LLC or LP to divide into two or more LLCs or LPs, with the dividing entity either continuing its existence or terminating as part of the division.

- If division not specifically addressed and not prohibited in the entity's governing documents, approval of a Delaware division is required to be in same manner as for a merger or consolidation as set forth in its LLC agreement or partnership agreement.

- If LLC or LP agreement is silent, division must be approved by members/partners who own more than 50% of the then current percentage or other interest in the profits of the dividing entity.

Texas Twists – Divisive Mergers

Delaware

- DRLPA §§ 18-217(1)(2) and 17-220(1)(2) provide that for all purposes of the laws of Delaware, all of the rights, privileges and powers, and all the property, real, personal and mixed, of the dividing company or partnership and all debts due on whatever account to it, as well as all other things and other causes of action belonging to it, shall without further action be allocated to and vested in the applicable division company or partnership in such a manner as basis and with such effect as is specified in the plan of division.

- If debts and liabilities are not allocated by the plan, they shall be the joint and several debts and liabilities of all of the division entities.

- Both Texas and Delaware law expressly provide that the interest in the property of the dividing entity shall not be deemed, as a result of the division, to have been assigned or transferred.

Texas Twists – Divisive Mergers

Taxes

- Divisive mergers may, but typically are not, classified as non-recognition events under the Internal Revenue Code. Each state's tax statute must be considered.

Texas Twists – Divisive Mergers

Effect On Creditors

- A divisive merger/division may alter and reduce the pool of assets to which a creditor may look for repayment of a debt or assets needed to perform a contract, and could result in moving collateral that secures a loan to a new entity that is not credit-worthy without breaching the terms of the credit agreement.

- Under TBOC § 10.901 creditors will continue to possess all other rights otherwise available under law and contract, including all security interests in the property of the debtor securing the payment of the debtor's claim.

- The Delaware statutes provide that if an LLC or LP formed prior to statutory authorization of divisions is party to an agreement that restricts a merger by the entity, then such restrictions will be deemed to also apply to a division of the entity. Any action or proceeding pending against a dividing LLC or LP may be continued against the surviving entity as if the division did not occur and against any resulting entity to which the asset, property, right, series, debt, liability or duty associated with the action was allocated pursuant to the plan of division. Each division company or partnership is jointly and severally liable for any liabilities if a court determines that the division would constitute a fraudulent transfer under applicable law (§§ 18-217(1)(5) and 17-220(1)(5)).

Texas Twists – Divisive Mergers

Bankruptcy Court Cases Involving The "Texas Two Step" – *DBMP LLC*

- *In re DBMP LLC*, Bankruptcy Court described the "Texas Two Step" as "a Divisional Merger followed by a bankruptcy by the new company bearing the old company's asbestos liabilities and in which the debtor seeks Bankruptcy Code relief for the entire enterprise."
  - CertainTeed Corporation was a manufacturer of building products with asbestos liability that converted to a Texas LLC and then used the Texas divisive merger provisions to convert into two Texas LLCs: one with all operations, employees and non-asbestos creditors of the old company and another company with no operations, few assets and 100% of CertainTeed Corporation's asbestos liabilities.
  - On the same day following the division, CertainTeed LLC converted to a Delaware LLC and DBMP converted to a North Carolina LLC. The Court notes that the companies "were Texas entities for less than four hours." The parties also entered into a Funding Agreement where CertainTeed gave DBMP a limited indemnity for asbestos claims and administrative costs.
  - Ninety-one days later, DBMP filed for Chapter 11 bankruptcy protection in North Carolina.

Texas Twists – Divisive Mergers

Bankruptcy Court Cases Involving The "Texas Two Step" – *DBMP LLC*

- The Bankruptcy Court held that while the TBOC permits a company to engage in a divisional merger, it does not permit that company to thereby prejudice its creditors. The TBOC explicitly states that the TBOC merger provisions do not "abridge any right or rights of any creditor under existing laws."

  - The Court cites legislative history and a 1989 law review article by one of the statute's authors for the proposition that despite the "no transfer" language of the TBOC, the allocation of assets in the merger should constitute a transfer and conveyance under the fraudulent transfer statutes and the Bankruptcy Code.

  - Even though the court tells us that a fraudulent transfer claim had not been made (since it needed to be made by DBMP, controlled by CertainTeed), court states "… if a corporation uses a divisional merger to dump its liabilities into a newly created 'bad' company which lacks the ability to pay creditors while its 'good' twin corporation walks away with the enterprise's assets, a fraudulent transfer avoidance action lies." The court was critical of the Funding Agreement because it was not arm's length and relied on management of CertainTeed (also managing DBMP) for its enforcement.

Texas Twists – Divisive Mergers

Bankruptcy Court Cases Involving The "Texas Two Step" – *Johnson & Johnson*

- Divisive merger (i.e., "corporate restructuring") on October 12, 2021. Through a series of transactions, Johnson & Johnson Consumer Inc. ("OldJJCI") became (1) Johnson & Johnson Consumer Inc. ("NewJJCI") and (2) LTL Management, LLC ("Debtor").

  - Old JJCI and New JJCI agreed in funding agreement to provide funding to Debtor (1) for costs and expenses prior to and during bankruptcy, including cost of administering bankruptcy, and (2) to satisfy the debtor's talc-related liabilities via funding a trust, up to the full value of New JJCI in order to make certain that the Debtor has the same, if not greater, ability to fund the costs of defending and resolving present and future talc-related claims.

  - Bankruptcy of new JJCI was filed October 14, 2021 in Western District of North Carolina having a bank account with $6 million, rights to the funding agreement, equity in a North Carolina subsidiary of Old JJCI, BUT is principal place of business was in New Jersey and 92% of talc litigation cases are pending in New Jersey.

Texas Twists – Divisive Mergers

Bankruptcy Court Cases Involving The "Texas Two Step" – *Johnson & Johnson*

- On October 25, 2021, the Bankruptcy Court ruled that Debtor's actions indicate a preference to file bankruptcy in its district, likely due to the Fourth Circuit's dismissal standard and commented: "There are currently five mass tort bankruptcy cases pending in this district, including the four involving the 'Texas Two Step."

- Court held "[t]he Debtor is not just forum shopping; the Debtor is manufacturing forum and creating a venue to file bankruptcy. There is no reason this Court should be the only bankruptcy court to have the opportunity to weigh in on these novel legal issues, especially considering that the 'Texas Two Step' tactic is being employed by national corporations and impacts tens of thousands of present and future claimants across the country."

- While the Texas Two Step drama continues to unfold in courts around the country, the divisive merger remains a valuable tool for entity reorganizations.

Texas Twists – Fiduciary Duties

Fiduciary Duties

- Texas and Delaware courts recognize that directors owe fiduciary duties to the corporation and its shareholders, collectively.

- Fiduciary duties in Texas:
  - Duty of Loyalty (including Duty of Good Faith)
  - Duty of Care
  - Duty of Obedience

- Fiduciary Duties in Delaware:
  - Duty of Loyalty (including the Duty of Good Faith)
  - Duty of Care
  - Note: Delaware courts have established the Duty of Disclosure and the Duty of Oversight, however these duties are not separate fiduciary duties; they are derived from the duties of loyalty and care.

Texas Twists – Fiduciary Duties

Source Of Fiduciary Duties

- The Texas Business Organizations Code ("TBOC") and the Delaware General Corporation Law (the "DGCL") provide statutory guidance with respect to certain internal governance matters (e.g., notice of annual and special meetings, dividends, and voting), however, neither provide statutory guidance with respect to a director's fiduciary duties.

- Courts in Texas and Delaware have been (and continue to be) responsible for shaping the contours and nature of a director's fiduciary duties.

- Texas and Delaware courts each have their own framework for reviewing the actions of directors in the context of a claim of breach of fiduciary duty.
  - Texas courts utilize a "formal vs. informal" fiduciary relationship framework.
  - Delaware courts apply a different level of scrutiny based upon the action at issue (business judgment rule, enhanced scrutiny, or entire fairness standard).
- Note: The internal affairs doctrine (followed in Texas and Delaware) states that the law of the state of organization of an entity governs the fiduciary duties of governing persons of such entity.

Texas Twists – Fiduciary Duties

Business Judgment Rule

- Courts in Texas and Delaware adhere to the “business judgment rule” (under which courts defer to the business judgment of a corporation’s directors with respect to business decisions).

- The business judgment rule is a defense to claims of breach of the duty of care by a director.

- Generally speaking, Texas courts, as compared to Delaware courts, are more inclined to cite the business judgment rule as a shield and defense to claims against a director for breach of the duty of care – thereby affording directors greater protection and deference.

Texas Twists – Fiduciary Duties

Business Judgment Rule

- Delaware Business Judgment Rule

  - The business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), overruled on other grounds by *Brehm v. Eisner*, 746 A.2d 244, 253-54 (Del. 2000). "A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose.'" *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)).

- Texas Business Judgment Rule

  The business judgment rule protects corporate officers and directors from being held liable to the corporation for alleged breach of duties based on actions that are negligent, unwise, inexpedient, or imprudent if the actions were "within the exercise of their discretion and judgment in the development or prosecution of the enterprise in which their interests are involved." *See, e.g., Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707; *Sneed v. Webre*, 465 S.W.3d 169 (Tex. 2015); *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014);

Texas Twists – Fiduciary Duties

Revlon Rule

- In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, the Delaware Supreme Court created (and imposed) an affirmative duty on a corporation's board of directors to seek the highest value reasonably obtainable when the sale of a company becomes inevitable.
- Following the Revlon decision in 1986, the Delaware Supreme Court has continued to outline the requirements of what is now known as the "Revlon Duty."
- Courts will apply enhanced scrutiny involving the sale of a company except where the transaction involves (i) a pure stock-for-stock merger between two non-controlled companies or (ii) the mere relegation of the target's shareholders to a minority position in a post-merger combined company.
- This burden entails more than obtaining a fair price for shareholders. Delaware courts have found a breach of duty even though the transaction price exceeded the value of the corporation determined under the Delaware appraisal statute.
- **No Revlon Duty has been established by Texas courts.**

Texas Twists – Fiduciary Duties

Personal Liability For Breaches Of Fiduciary Duty And Limitations

- Directors can be held personally liable for breach of fiduciary duties.
- Texas and Delaware statutes provide methods for limiting the liability of directors for breach of fiduciary duties:
  - Including liability limiting provisions in its certificate of incorporation/formation (only allows for limiting liability with respect to breaches of the duty of care; cannot limit liability for bad faith or breaches of the duty of loyalty).
  - Renouncing individual business opportunities in its certificate of incorporation/formation or by resolution of the board of directors.
  - Permitting interested director transactions if (i) approved by a disinterested board or committee after disclosure; (ii) approved by the shareholders after disclosure; or (iii) fair to the corporation.

Texas Twists – Fiduciary Duties

Alternative Entities

- Limited liability companies and partnerships are "alternative entities."
- Generally speaking, in Texas and Delaware, the fiduciary duties of managers of limited liability companies are similar to those of corporate directors.
- With respect to partnerships, courts in Texas and Delaware look to the operating agreement and other contractual provisions in evaluating the fiduciary duties owed.
- Texas statutes permit modification and limitation of fiduciary duties in the context of alternative entities (but not elimination).
- Delaware statutes permit modification, limitation, **and elimination** of fiduciary duties in the context of alternative entities (this can be accomplished via express language in limited liability company agreements and partnership agreements).

Texas Twists - Express Negligence

- Public policy: an indemnified party should not be indemnified for its own negligence
- Typical desire of M&A parties: the contract alone should allocate the risk between the parties, who are grown-ups represented by sophisticated counsel
- Therefore, to override the express negligence doctrine in an acquisition agreement, the language must be clear and unambiguous
  - In TX, courts have additionally held that the statement of intent must be conspicuous
  - Note: TBOC Section 8.005(b) negates the express negligence doctrine for D&O indemnification and exculpation provisions in governing documents
- Courts have also applied express negligence doctrine to indemnification claims involving:
  - Strict liability
    - Example: CERCLA liability
  - Intentional misconduct
- Sample language:*
  - …REGARDLESS OF WHETHER ANY PERSON (INCLUDING THE PERSON FROM WHOM INDEMNIFICATION IS SOUGHT) ALLEGES OR PROVES THE SOLE, CONCURRENT, CONTRIBUTORY OR COMPARATIVE NEGLIGENCE OF THE PERSON SEEKING INDEMNIFICATION, OR THE SOLE OR CONCURRENT STRICT LIABILITY IMPOSED ON THE PERSON SEEKING INDEMNIFICATION.

* From Byron Egan

Texas Twists - Successor Liability in Asset Acquisitions

Introduction*

- From 1998 to 2018, number of reported successor liability cases almost tripled to just over 750/year
- Third parties aren't bound by the Purchase Agreement choice of governing law
- Successor liability can be imposed by statute
- Successor liability can be imposed under common law
- Bottom line: in an asset purchase, the parties can't "solve" successor liability problem merely through careful drafting

* Primary source material: Memo dated 1/12/19 to Judicial Interpretations Working Group of M&A Committee of Business Law Section of ABA

Texas Twists – Successor Liability in Asset Acquisitions

Assumption of Specific Liabilities in Special Situations: "Long-Tail Claims" and Statutory Successor Liability

- Taxes
  - Federal taxes for members of seller's affiliated group
  - State taxes - see, e.g., Section 111.020 of TX Tax Code and 34 TX Administrative Code Section 3.7

- Products liability
  - CA common law product line exception - if buyer continues seller's product line
  - Post-sale failure to warn of defects in predecessor's products, if evidence of continuation of relationship between buyer and seller's customers

- Environmental
  - Successor liability under CERCLA if "substantial continuity" standard satisfied

Texas Twists – Successor Liability in Asset Acquisitions

Assumption of Specific Liabilities in Special Situations: "Long-Tail Claims" and Statutory Successor Liability

- Employee-related claims
  - Discrimination
  - FLSA
  - Union / CBA obligations
  - WARN - buyers have been held to have duty to notify seller's employees buyer does not hire
  - FCPA
  - COBRA
  - ERISA plans
- Data breaches
- Bulk Sales Laws
  - Bulk sales laws repealed by most states, with the exception of CA and MD
- Health and safety
- Healthcare
- Construction

Texas Twists – Successor Liability in Asset Acquisitions

General Assumption of Liabilities

- Express or implied assumption
- De Facto Merger Doctrine
- Mere Continuation Doctrine
- Fraud Exception

Texas Twists – Successor Liability in Asset Acquisitions

Express or Implied Assumption

- Can mostly solve through careful drafting and structure, including:
  - List of liabilities being assumed ("Assumed Liabilities")
  - Liabilities not expressly assumed are left behind
  - Laundry list of exemplary Excluded Liabilities
  - Special indemnity covering Excluded Liabilities, coupled with escrow or holdback

- Implied assumption may happen when buyer undertakes to perform liabilities it did not expressly assume (e.g., warranty claims)

Texas Twists - Successor Liability in Asset Acquisitions

Common Law Theory of De Facto Merger

- Factors considered:
  - Continuity of:
    - Physical location
    - Management and other personnel
    - Assets and general business operations
    - Ownership
      - Complete identity of ownership not required
  - Seller's ordinary course liabilities assumed
  - Whether buyer holds itself out as being a continuation of seller
  - Seller dissolves shortly after the sale
- TX statute overrides: TBOC Section 10.254
- DE courts rarely apply the doctrine without evidence of fraud
  - NY and CA courts apply it more often
- That said, how can you be sure TX or DE law applies to a situation involving someone who isn't a party to your APA?

Texas Twists – Successor Liability in Asset Acquisitions

Common Law Theory of Mere Continuation

- Similar to de facto merger doctrine, but the analysis focuses on whether allowing a party to escape liability is tantamount to a fraud upon the creditors

- Substantial identity of stockholders, directors, management is key factor

Texas Twists - Successor Liability in Asset Acquisitions

Fraud Exception

- Fraudulent transfer - state statutes, federal bankruptcy laws
  - Under these laws constructive fraud may suffice to set aside the transaction

- Especially a risk with M&A involving distressed or highly leveraged businesses
  - Sleeper/scary director liability issue is posed by the Nine West LBO case (SDNY)

Texas Twists - Successor Liability in Asset Acquisitions

How Do You Reduce Risk?

- Use a separate acquisition sub as buyer
- Require Seller to remain in existence until statute of limitations runs (typically 3-6 years)
  - If that's not possible, consider escrowing portion of sale proceeds and requiring seller to undergo expedited statutory termination process (available in TX) designed to draw creditors out of the woodwork
  - Also consider seller cash balance maintenance requirement
- Choice of law: TX, DE, or another jurisdiction favorable to buyer
  - But, as noted above, won't necessarily bind third parties
- Extended survival period for reps and warranties on long tail/statutory liabilities
- Use reps and warranties insurance with beefed up reps and warranties for long tail liabilities to enhance coverage
  - That said, insurance companies are no dummies, and policy exclusions will apply
- Special indemnities
- Escrows/holdbacks/offset rights
- Watch your words - ask for all deal related announcements to be reviewed and approved by counsel

Texas Twists - Successor Liability in Asset Acquisitions

How Do You Reduce Risk? (continued)

- Lease real estate instead of buying it if potential environmental or property-related liabilities
- Insurance
  - Consider special insurance such as:
    - Environmental insurance
    - Patent infringement insurance
    - Tax insurance
    - Litigation insurance
  - Require seller to purchase tail coverage / extended reporting period on claims-made policies, such as D&O, EPLI, fiduciary liability, cyber liability and, if possible and advisable, product liability insurance.
  - Add buyer as additional insured on seller's occurrence-based policies
- Taxes:
  - Certificate of no tax due / tax clearance certificate
  - Tax lien searches
  - CPA review of past tax returns

Texas Twists - Successor Liability in Asset Acquisitions

How Do You Reduce Risk? (continued)

- Due diligence
  - Insurance due diligence
    - Insurance loss runs
    - Review policy retentions, limits, and exclusions
    - Add buyer as additional insured on seller’s occurrence-based policies
  - Beef up reps and warranties regarding “long tail” matters
  - Litigation searches
  - Phase I
  - ERISA Plan review and analysis of any withdrawal liability
  - Property condition report

- If seller insolvency is a risk, then consider a fairness opinion

Texas Twists – Sandbagging

Overview

- Purchaser "sandbags" Seller when Purchaser knows a representation or warranty made by Seller in the purchase agreement is untrue, Purchaser closes the deal anyway, and then Purchaser brings a post-closing indemnity claim against Seller.

- Default Rule (in the absence of express contractual language):

  - Historical view: In order to recover, Purchaser must have relied on the breached warranty when Purchaser decided to close the deal. Purchaser did not rely because Purchaser knew the warranty was false.

  - Modern view: Representations and warranties are part of the bargained-for benefit of Purchaser under the agreement. Purchaser's right to sandbag is captured in the purchase price and Purchaser can recover damages for breach of contract.

See Charles K. Whitehead, Sandbagging: Default Rules and Acquisition Agreements, 36 Del. J. Corp. L. 1081, 1081-1085 (2011).

Texas Twists – Sandbagging

Contracting Around the Default Rule

- Purchaser and Seller can include express contractual provisions in the purchase agreement to circumvent states' default rules and either allow or prohibit sandbagging.

- Pro-Sandbagging Provision:
  - The representations, warranties and covenants of the indemnifying party, and the indemnified party's right to indemnification with respect thereto, will not be affected or deemed waived by reason of any investigation made by or on behalf of the indemnified party (including by any of its representatives) or by reason of the fact that the indemnified party or any of its representatives knew or should have known that any such representation, warranty or covenant is, was or might be inaccurate or unfulfilled, as applicable.

- Anti-Sandbagging Provision:
  - Seller shall not be liable under this agreement for any damages, claims, losses, or liabilities suffered, sustained, paid or incurred by the indemnified purchaser party or any its affiliates after closing that result from any inaccuracy in or breach of any representation or warranty in this agreement if the indemnified purchaser party seeking indemnification for such damages, claims, losses, or liabilities had knowledge of such inaccuracy or breach at the time of closing.

Texas Twists – Sandbagging

Delaware and Texas law

- Both Delaware and Texas courts enforce express contractual provisions governing pro- or anti-sandbagging, honoring the parties' freedom of contract

- Delaware and Texas courts generally have different default rules when a purchase agreement is silent on sandbagging:

  - Delaware: In a recent decision, the Delaware Court of Chancery stated Delaware is "affectionately known as a 'sandbagging' state. A pro-sandbagging regime ensures that reps and warranties serve their risk allocation function. Arwood v. AW Site Services, LLC, 2022 WL 705841 (Del. Ch. 2022), reargument granted, 2022 WL 973441 (Del. Ch. 2022).

  - Texas: Texas courts generally take the historical view of sandbagging, holding that Purchaser must prove reliance on a breached warranty and that Purchaser cannot rely on a representation it knows to be untrue.

See https://www.shearman.com/-/media/files/perspectives/2020/02/corporate-counsel-newsletter---shearman-article---cuellar---winter-2020-issue.pdf

Texas Twists – Sandbagging

Trends

- Pro-sandbagging provisions in purchase agreements have been declining over time. According to the ABA's 2021 Private Target Mergers & Acquisitions Deal Points Study, 29% of deals included pro-sandbagging provisions, down from its 50% peak in 2006.

- Anti-sandbagging provisions have always been uncommon. In 2021 they were found in 3% of deals, down from their 10% peak in 2012.

- A large majority of deals remain silent on sandbagging, conceding to states' default rules. 68% of deals in 2021 included neither a pro- or anti-sandbagging provision.

See 2021 ABA Private Target Mergers & Acquisitions Deal Points Study, M&A Market Trends Subcommittee of the Mergers & Acquisitions Committee, part of the Business Law Section of the American Bar Association

Texas Twists – Non-Reliance Provisions

Overview

- Non-reliance provisions are included in purchase agreements in an attempt to preclude Purchaser's reliance on information provided or statements made outside of the four corners of the agreement. Precluding Purchaser's reliance is key to defeating claims of fraud.

- Non-reliance provisions are necessary, from Seller's perspective, given the volume of information provided and statements made in the course of negotiations and the M&A due diligence process.

- Non-reliance provisions typically include Seller's disclaimer of any reps or warranties other than those made in the purchase agreement, a statement that Seller will not be liable for information provided or withheld in due diligence (other than for breaches of the reps or warranties included in the agreement), and a statement that Purchaser agrees it has not relied on any reps or warranties other than those provided in the agreement.

- Purchasers may try to include a carve-out for fraud in the agreement's non-reliance provision. However, courts have found express disclaimers of reliance to defeat carve-outs for fraud.

See Victor L. Hou, Jared Gerber and Roger A. Cooper, 3 N.Y.Prac., Com. Litig. In New York State Courts §12:57 (5th ed.)
See Timothy R. Donovan and Jodi A. Samala, 3 Successful Partnering Between Inside and Outside Counsel §41:44.

Texas Twists – Non-Reliance Provisions

Delaware and Texas Law

- Both Delaware and Texas courts will generally enforce non-reliance provisions found in M&A purchase agreements.
- Delaware
  - For a non-reliance provision to accomplish Seller's goals under Delaware law, the provision must include a statement by Purchaser agreeing that it has not relied on statements outside of the purchase agreement or statements made other than those contained in the reps and warranties within the purchase agreement.
  - (i) Seller's statement that it makes no reps or warranties outside of the purchase agreement (ii) a statement that Purchaser conducted its own investigation into the acquired business, (iii) a standard integration clause and (iv) a general disclaimer by Purchaser that Seller has not made any reps or warranties outside of the agreement will all likely be insufficient, absent Purchaser's express statement of non-reliance.
- Texas
  - Like Delaware, Texas law also requires an express statement of non-reliance by Purchaser.
  - Unlike Delaware, Texas courts more closely examine the circumstances around the negotiation of the non-reliance provision, including the sophistication of the parties, whether the party expressing non-reliance was represented by counsel, whether the parties were bargaining at arms' length and whether the non-reliance provision was negotiated or included as boilerplate.

See Victor L. Hou, Jared Gerber and Roger A. Cooper, 3 N.Y.Prac., Com. Litig. In New York State Courts §12:57 (5th ed.)
See Schlumberger Technology Corporation v. Swanson, 959 S.W.2d 171 (Tex. 1997).
See Forest Oil Corporation v. McAllen et al, 268 S.W.3d 51 (Tex. 2008)

Texas Twists – Non-Reliance Provisions

Trends

- According to the ABA's 2021 Private Target Mergers & Acquisitions Deal Points Study, in 2021, 72% of deals included express Purchaser non-reliance provisions. The prevalence of these provisions has steadily increased over the years.

- In 2021, 35% of such deals also included a fraud carve-out to the non-reliance provision, despite the fact that they may be ineffective.

Texas Twists – Best Efforts Clauses

Texas

- In Texas, a "best efforts" commitment, without any goal or guideline against which to measure the commitment, is not enforceable
- The goal or guideline does not need to be a black-line metric, but some level of guidance must be provided

Delaware

- Delaware courts generally do not distinguish between varying degrees of hierarchy in "efforts" standards
  - **Although deal practitioners have some sense of the hierarchy among efforts clauses, courts applying the standards have struggled to discern daylight between them. This court, for example, has interpreted "best efforts" obligations as on par with "commercially reasonable efforts."**

    Menn v. ConMed Corp 2022 WL 2387802 (Del. Ch. June 30, 2022)

Takeaways

- Draft with specificity to define what efforts are expected on the part of a party
- If it is expected that a party will do whatever is necessary to achieve an objective, such as obtaining regulatory approval or a third party consent, be specific and use a "hell or high water" provision

Samantha Crispin

2001 Ross Avenue, Suite 900, Dallas Texas 75201

Direct: 214.953.6497

samantha.crispin@bakerbotts.com

Samantha Crispin is a seasoned M&A lawyer with over 20 years of experience helping publicly traded and privately held corporate clients and private equity funds in complex M&A, capital markets and strategic business transactions. Samantha is firmwide Chair of the Corporate Department and serves on the firm's Executive Committee.

Her clients include the media, technology, infrastructure and construction products, and energy tech industries. Strategic and private equity buyers and sellers rely on Samantha's counsel for M&A transactions, including corporate reorganizations, spin-offs and split-offs, joint ventures, strategic alliances, and opportunistic, distressed and/or bankruptcy-related acquisitions and dispositions. She also advises in public offerings, PIPEs and other capital raising transactions.

Samantha serves on the boards of directors of the Boys and Girls Clubs of Greater Dallas and the North Texas Business Council for the Arts. She is a Leader with and serves on the executive committee of the Center for Women in Law and previously served as the firmwide chair of the Baker Botts Global Women’s Forum and as a member of the firm’s Diversity, Equity & Inclusion Committee. She is ranked by Chambers USA and has been named one of the “Best Lawyers in America” by Best Lawyers since 2016. She has also been recognized as one of “The Most Powerful Business Leaders in Dallas-Fort Worth” by D CEO’s D 500, was named one of the “Top Women in Dealmaking” by the Deal in 2021 & 2022 and a “Top 21 in 21 Women In Tech” by KAYO Conference Series and was the recipient of the Outstanding Woman Lawyer Award in 2020 by the Dallas Women Lawyers Association.

Byron F. Egan

2323 Ross Avenue, Suite 600, Dallas, Texas 75201

Direct: 214.953.5727

began@jw.com

Byron F. Egan is a partner of *Jackson Walker LLP* in Dallas and is engaged in a corporate, partnership, securities, mergers and acquisitions (M&A), and financing practice and has extensive experience in business entity formation and governance matters, M&A, and financing transactions. In addition to handling transactions, he advises boards of directors and their audit, compensation, and special committees with respect to fiduciary duty and other corporate governance issues, the Sarbanes-Oxley Act, special investigation, and other issues.

Mr. Egan is Senior Vice Chair and Chair of the Executive Council of the M&A Committee of the American Bar Association and served as Co-Chair of its Model Asset Purchase Agreement Task Force. He has been Chair of the Texas Business Law Foundation, the Business Law Section of the State Bar of Texas and that section's Corporation Law Committee. On behalf of these groups, he has been instrumental in the drafting and enactment of many Texas business entity and other statutes.

For more than 25 years, Mr. Egan has been listed in "The Best Lawyers in America" under corporate, M&A, or securities law. Mr. Egan has been recognized as one of the top corporate and M&A lawyers in Texas by a number of publications and is a four-time winner of the Burton Award for distinguished legal writing. Mr. Egan writes and speaks about the areas in which his law practice is focused, and is a frequent author and lecturer. He authored the treatise "EGAN ON ENTITIES: Corporations, Partnerships and Limited Liability Companies in Texas" (3rd Ed. 2020) which addresses the formation, governance and sale of business entities, including an analysis of the fiduciary duties of their governing persons in a variety of situations.

Robert Kibby

500 N. Akard, Suite 3800, Dallas, Texas 75201

Direct: 214.855.7504

rkibby@munsch.com

Rob is a shareholder in Munsch Hardt Kopf & Harr, P.C. He heads the firm's Corporate Securities group and has over 30 years of experience counseling publicly and privately held companies in a wide spectrum of M&A and other corporate transactions.

He has broad industry experience, having worked closely with operating companies, investment funds, and family offices focused on businesses in the following areas: technology, software, health care, energy services, manufacturing, distribution, retailing, restaurant, real estate, consulting, and financial and insurance services.

Rob earned his J.D. from the Southern Methodist University Dedman School of Law, where he served as Senior Comments Editor of the *Journal of Air Law and Commerce*. He has a BBA in Accounting from Baylor University, having graduated with honors.

He has served in a leadership role in several industry organizations, including the M&A Section of the Dallas Bar Association, as past President, the DFW Chapter of the Association for Corporate Growth (*ACG*), as past President, the Corporate Counsel Section of the Dallas Bar Association, as past Chairman, and the DFW Chapter of the Society of Corporate Secretaries and Governance Professionals, as past President.

Among other awards, Rob has been recognized by *Chambers USA* and was named by *D CEO* magazine and *ACG* as the Dallas Attorney Dealmaker of the Year in 2021.

Chauncey Lane

1722 Routh Street, Suite 1500, Dallas, Texas 75201

Direct: 214.969.1278

chauncey.lane@hklaw.com

Chauncey is regularly called on to advise clients on their most significant transactions, including stock and asset acquisitions, going private transactions, leveraged buyouts, carve-outs, platform acquisitions, add-on acquisitions and recapitalizations. Chauncey regularly leverages his transactional skills and knowledge to advise clients on cross-border transactions in Europe and South Asia, among other international jurisdictions. A thought leader on mergers and acquisitions, Chauncey is an active member of the American Bar Association's Business Law Section where he currently serves as the Executive Editor for Mergers and Acquisitions for the Section's *Business Law Today* publication, a member of the Section's Content Board and a member of the Section's Mergers and Acquisitions Committee where he now leads the effort to explore the intersection of ESG and mergers and acquisitions.

In addition to his mergers and acquisitions practice, Chauncey serves as an adviser to venture capital funds and other alternative financing vehicles, where he regularly leads significant investment transactions into emerging growth companies and strategic partnerships. Often serving as outside general counsel and trusted business adviser to his fund clients, Chauncey has a breadth of knowledge on the many issues that investors and venture-backed operating companies regularly face.

Mark S. Solomon

2121 North Pearl Street, Suite 1100, Dallas, TX 75201-2591

Direct: 214.765.3605

mark.solomon@katten.com

When private equity firms and business owners need an attorney who can command the respect of a room and cut through roadblocks to achieve their goals, they call on Mark Solomon. Mark, managing partner of Katten's Dallas office, immerses himself in his client's businesses, treats their problems as his own and leads transactions to the finish line. His clients are his partners and his familiarity with his client's goals and operations keeps him one step ahead of the competition.

Mark and his team don't need a learning curve, which gives his clients an advantage in the fast-paced world of M&A. Clients rely on him to negotiate effectively to get optimal pricing and terms, and they appreciate his personal touch on matters large and small. He also handles securities and corporate finance work for businesses of all sizes, including public companies.

As managing partner of Katten's Dallas office and former national managing partner and CEO of an AmLaw 100 firm, Mark is a business lawyer who understands the needs of his clients. He has been on both sides of the table and understands the unique business environment of North Texas, while representing clients with operations all over the world. His personal relationships with leaders throughout the community give him further insights into relevant business forces in the region and beyond.