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Insights Into Corporate Governance, M&A and Securities Law

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Secondary Fraud Claims Against a Non-Party to M&A Deal Allowed to Proceed Under Delaware Law

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On June 27, 2024, in *Matrix Parent, Inc., et al. v. Audax Management Company, et al.*, the Delaware Superior Court denied Audax's motion to dismiss, allowing to proceed H.I.G. Capital's fraud claims in connection with its March 2022 purchase of a majority stake in Mobileum, Inc. from a holding company controlled by Audax.

H.I.G. contends that a 2021 Confidential Information Memorandum (CIM) provided by seller's banker and other diligence materials fraudulently misstated certain financial metrics and projections, including EBITDA, revenue and bookings and that such misstatements induced H.I.G. to enter into the stock purchase agreement (SPA) and acquire Mobileum. H.I.G. alleged that under Audax's "guidance, Mobileum: (1) improperly accelerated its revenue recognition by acting as if it had performed more work than it had; (2) covered up its improper revenue acceleration by creating, but not sending, invoices for work that had not been done; and (3) recorded "sham" bookings from artificial entities, knowing that the bookings would not lead to revenue."

As part of its motion to dismiss, Audax noted that, as is customary, the SPA (a) disclaimed reliance on any representations outside of the SPA, including the CIM and other due diligence materials, (b) included an integration clause stating that the SPA acts as the final agreement between the parties, superseding prior agreements and (c) included provisions limiting the liability of and enforcement against persons who are not parties to the SPA.

While recognizing that the alleged fraudulent misstatements first arose as part of the projections presented in the CIM and that in the SPA H.I.G. disclaimed reliance on statements in the CIM, the Court found that H.I.G.'s fraud claims were based "solely on the falsity of express contractual representations." H.I.G. alleged that Audax perpetuated a fraud and breached at least seven representations in the SPA, including relating to (a) financial statements, (b) maintenance of books and records, (c) absence of changes, (d) accuracy of tax returns, (e) compliance with laws and (f) the bona fide nature of accounts receivable. Noting that its role at the present stage was "not to distill the representations that can support a viable fraud claim from those that cannot," the Court found that H.I.G. "raised a fair inference that the SPA contained false representations." Therefore, the Court stated that it had no reason to assess the first two SPA provisions cited by Audax, as they were not in dispute: (i) that H.I.G. disclaimed reliance on extra-contractual representations and (ii) that the SPA supersedes all prior agreements.

As to H.I.G.'s agreement not to bring claims against Audax, as an affiliate of the buyer entity, and other non-parties, although the SPA prohibited H.I.G. from bringing against Audax even secondary fraud claims for aiding and abetting fraud and civil conspiracy, the Court found "that under Delaware law, the terms of a fraudulently procured contract cannot exempt from liability entities that were knowingly complicit in the fraud, including entities that aided, abetted, or conspired to commit such fraud."

As will be relevant as the case proceeds, under the SPA, "fraud" was defined as follows:

"intentional and knowing common law fraud under Delaware law in the representations and warranties set forth in this Agreement, any Contribution Agreement and the certificates delivered pursuant to Section 2.02(f)(i) and Section 2.03(d)(i). A claim for Fraud may only be made against the Party committing such

Fraud. “Fraud” does not include equitable fraud, constructive fraud, promissory fraud, unfair dealings fraud, unjust enrichment, or any torts (including fraud) or other claim based on negligence or recklessness (including based on constructive knowledge or negligent misrepresentation) or any other equitable claim.”

Recognizing that the SPA requires actual and not constructive fraud, the Court found that H.I.G. met the heightened pleading standard imposed by Delaware Superior Court Civil Rule 9(b) for fraud claims, namely that H.I.G. has plead with particularity “the time, place, and contents of the false representations; the facts misrepresented; the identity of the person(s) making the representation; and what that person(s) gained from making the misrepresentation.”

The Court did not disagree with Audax’s contention that H.I.G. will have to prove scienter at trial, *i.e.*, that Audax committed actual, intentional fraud but distinguished this from the “position to know” standard applicable for pleading purposes. As was espoused in *Iotex Communications, Inc. v. Defries*, a central element of a fraud allegation is that the defendant was in a position to know of the fraud, namely that the defendant “knew as a fact (and failed to disclose) something about the state of mind of [an affiliate] and others during the period of negotiation of the Agreements.”

Although H.I.G.’s fraud claims against Audax have been allowed to proceed by the Court, the outcome of the litigation, or whether the parties will ultimately settle the dispute, remains to be seen.

Audax, which retained a minority stake in Mobileum through a limited partnership agreement with H.I.G., countersued claiming essentially that H.I.G. mismanaged Mobileum after the sale and “ran what was a high-performing business into the ground.”

The outcome of the trial – *i.e.*, whether or not Audax conspired to perpetrate fraud – will be highly dependent on the facts and evidence presented. At this stage of the litigation, the Court held H.I.G. sufficiently pled facts that, if true, could lead to the conclusion that Audax controlled Mobileum and conspired to perpetrate a fraud against H.I.G.

Of note, the decision highlights the Court’s unwillingness to allow parties to “contract-around” Delaware law in order to limit recourse against non-parties to an agreement, at least in so far as such parties commit actual fraud.

U.S. Treasury Proposes Regulation of U.S. Outbound Investments


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On June 21, 2024, the U.S. Department of Treasury ("Treasury") issued a notice of proposed rulemaking ("Proposed Rule") that would regulate certain U.S. transactions with persons of a country of concern involved in the semiconductor and microelectronics, quantum information technology and artificial intelligence (AI) sectors, as authorized by Executive Order 14105 ("EO 14105"). The Proposed Rule maintains the two-tiered regulatory framework announced in the advance notice of proposed rulemaking released in August 2023 that would prohibit entirely some transactions and require notification to the Department of the Treasury for others. Given its scope, the Proposed Rule has the potential to impact U.S. investors, including investment funds, in their investment decisions and approach to deal diligence generally.

Scope of the Proposed Rule

The Proposed Rule would only apply to outbound investment transactions that meet certain criteria. The jurisdiction is scoped based on (1) the involvement of a U.S. person in the transaction, (2) the nature of the transaction undertaken and (3) the characteristics of the target. Implicated transactions are those by "U.S. persons" where the target is a "covered foreign person" – a person of a country of concern (*i.e.*, the People's Republic of China or PRC, including the Special Administrative Regions of Hong Kong and Macau) that a U.S. person knows or intends will be engaged in a "covered activity."

1. "U.S. person" includes U.S. citizens and permanent residents, entities organized under U.S. law and any person otherwise present in the United States. Certain obligations under the Proposed Rule would also extend to the activities of foreign entities controlled by U.S. persons.

2. A "covered transaction" includes various types of transactions (equity acquisitions, convertible debt financing, greenfield investments, formation of joint ventures, limited partnership investments and others) and also requires that the U.S. person know (or should know) or intend that the transaction involves a "covered foreign person."

3. A "covered foreign person" is scoped by both the characteristics of the person *and* the activities of such person.
    - A person of a country of concern is a PRC citizen or resident or entity organized under the laws of, headquartered in, or with its principal place of business in the PRC, or any entity controlled by the foregoing person or entity.

- "Covered activities" establish the connection to the national security-related technologies and products that were identified in EO 14105 as the rationale for the outbound investment regulations. Covered activities are those related to the certain *activities* with respect to certain *technologies or products* (*e.*, developing, installing, selling, or producing any supercomputer meeting certain specifications). The Proposed Rule sets out these activities, technologies and products by grouping them into distinct categories that scope the "prohibited" and "notifiable" transactions under the two-tiered approach.

Notified and Prohibited Transactions

Prohibited transactions are covered transactions that involve covered foreign persons engaging in activities with respect to technologies and products that pose a "particularly acute" national security threat. The Proposed Rule sets forth a list of activities that would be prohibited, including those related to semiconductors, quantum computing and related sectors. One example given in the Proposed Rule is a covered transaction in which the covered foreign person "develops" any AI system that is designed to be exclusively used for military end use or government intelligence or mass surveillance.

Notifiable transactions by definition do not overlap with prohibited transactions and are scoped by covered foreign persons engaging in activities with respect to technologies and products that may contribute to the threat to the national security. For example, if the covered foreign person "develops" any AI system (that does not fall under the scope of the activities, technologies and products described in the definition of prohibited transactions) designed to be used for any government intelligence or mass-surveillance end use or military end use. Notifiable transactions would require notification to the Department of the Treasury no later than thirty days after completion.

Takeaways

The Proposed Rule outlines a regulatory system that will likely require many U.S. investors and other market participants to expand their diligence activities to include evaluating transactions for outbound investment restrictions. True to the policy outlined in EO 14105, while very narrowly tailored by a target's operating sector (the activities, technologies and products described above), the proposed regime is very broadly structured to capture numerous types of transactions where U.S. persons transact with PRC persons engaged in those narrowly scoped activities.

The Proposed Rule's knowledge requirement for a transaction to be a "covered transaction" will likely be impactful, particularly because knowledge not only means actual knowledge but also "an awareness of a high probability of a fact or circumstance's existence or future occurrence" and "reason to know of a fact or circumstance's existence." As the Proposed Rule explains, the deemed knowledge requirement is meant to incentivize proper diligence: "If a U.S. person failed to conduct a reasonable and diligent inquiry at the time of a transaction and undertook the transaction where a particular fact or circumstance indicative of a covered transaction was present, the Department of the Treasury may find in the course of determining compliance with the proposed rule that the U.S. person had reason to know of such fact or circumstance…"

The public comment period for the proposed rule ends August 4, 2024. EO 14105 was published amid increasing interest in Congress in regulating U.S. outbound investment.[1] Interest likely remains high in this space, and the implementation of the final rules with respect to outbound investment could be impacted by additional actions by the legislature or one or more administrations.

[1] *See*, *e.g.*, Outbound Investment Transparency Act of 2023, S. 2678, 118th Cong. (2023); 2021 National Critical Capabilities Defense Act, S. 1854, 117th Cong. (2021) (later incorporated into America COMPETES, passed by the House in February 2022, which was targeted at bolstering competition with China. H.R. 4521, 117th Cong. (2022)).

District Court Issues Limited Preliminary Injunction in First Challenge to FTC Rule Prohibiting Use and Enforcement of Non-Compete Clauses

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The United States District Court for the Northern District of Texas (Dallas Division) has issued a preliminary injunction in favor of a plaintiff challenging the Federal Trade Commission's (the "FTC" or the "Commission") adoption and enforcement of a final rule prohibiting the use or enforcement of non-compete clauses in most employment agreements (the "Rule").[1]

Businesses that rely on non-competes and wish to continue to rely on non-competes may not, however, take much immediate comfort from the preliminary injunction decision in *Ryan LLC v. Federal Trade Commission* because it is limited to enforcement of the Rule against the plaintiffs. The court can revisit this decision when it issues its merit decision, but at present the FTC is not substantially hindered in its future enforcement of the ban on non-compete clauses. Additionally, both the FTC and the Department of Justice can challenge specific non-compete clauses or a general practice of entering into or enforcing non-compete clauses as anticompetitive. The FTC has recently challenged the use of non-compete clauses as an unfair method of competition.[2]

Thus, employers considering enforcement of non-compete clauses, and employers and employees considering entering into non-compete clauses, should continue to consider alternative agreements that are consistent with the purpose of non-compete clauses but that do not run afoul of the Rule (or, more generally, the antitrust laws). The court indicated it would rule on the merits of Ryan's challenge to the Commission's issuance of the Rule no later than August 30.

Ryan's Challenge to the Rule

In *Ryan LLC v. Federal Trade Commission*, the plaintiff, a tax services and software provider (joined by plaintiff-intervenors[3]), argued that: (i) the FTC did not have the statutory authority to promulgate the Rule; (ii) the Rule was the product of an unconstitutional exercise of power by the FTC; and (iii) the FTC's promulgation of the Rule was arbitrary and capricious. Ryan requested, in part, that the district court stay the effective date of the Rule – presently scheduled as September 4 – and preliminarily enjoin the FTC from enforcing the Rule. The court granted the plaintiff's request for a preliminary injunction but limited it to enjoining enforcement of the Rule only against the plaintiff and plaintiff-intervenors.

District Court Considers Ryan's Likelihood of Success on the Merits

In deciding whether Ryan's request for a preliminary injunction should be granted, the court considered Ryan's likelihood of success on the merits; thus, the opinion provides substantial guidance on the court's likely final adjudication of plaintiff's complaint. In issuing the Rule, the FTC relied on its authority under Section 5 of the FTC Act to declare conduct an unfair method of competition and on a broad reading of Section 6(g) of the FTC Act, that, according to the FTC, allowed it to issue rules prohibiting unfair methods of competition.[4] Section 6(g) gives the FTC authority to issue rules, but the agency and plaintiffs differed on whether that authority supported the issuance of rules that have a substantive effect (such as a prohibition on conduct defined as an unfair method of competition) or is limited to rules that support the agency's adjudicative and administrative functions (such as investigatory or ministerial rules). The court rejected the FTC's reading and application of Section 6(g).

According to the court "Section 5 creates a comprehensive scheme to prevent unfair methods of competition"[5] while "Section 6 gives the FTC the power to make

rules and regulations for the purpose of carrying out the provisions of [the FTC Act]"[6] and "enumerates additional powers that generally aid in the administration of th[e] adjudication-focused scheme [of the FTC Act]."[7] In analyzing the text, structure and history of the FTC Act, the court concluded that while "the FTC has some authority to promulgate rules to preclude unfair methods of competition" it "lacks the authority to create substantive rules."[8] The FTC's reliance on Section 6(g) was misplaced because it is merely a "housekeeping statute" authorizing "rules of agency organization, procedure, or practice as opposed to substantive rules."[9]

The court:

[C]oncludes the text and structure of the FTC Act reveal the FTC lacks substantive rulemaking authority with respect to unfair methods of competition, under Section 6(g). Thus, when considering the text, Section 6(g) specifically, the Court concludes the Commission has exceeded its statutory authority in promulgating the Non-Compete Rule, and thus Plaintiffs are likely to succeed on the merits.[10]

The court reached this conclusion, in part, by noting that Congress, where it wishes to grant substantive rule-making authority, prescribes sanctions for violations of an agency's rules. Here, Section 6(g), according to the court, "contains no penalty provision – which indicates a lack of substantive force" – in contrast to the penalty provisions associated with an adjudication finding a violation of Section 5's prohibition of unfair methods of competition.[11]

The court also found "a substantial likelihood the Rule is arbitrary and capricious because it is unreasonably overbroad without a reasonable explanation."[12] According to the court, the Rule "imposes a one-size-fits-all approach … which fail[ed] to establish a rational connection between the facts found and the choice made."[13] The failure to target "specific, harmful non-competes render[ed] the Rule arbitrary and capricious."[14]

Limited Scope of the Preliminary Injunction

While the court granted Ryan's request for a stay, its review of 5th Circuit precedent suggested it was not appropriate to issue a nationwide injunction against enforcement of the Rule. The court identified several reasons for not issuing a nationwide injunction: (i) failure of the plaintiffs to explain why such an injunction was needed at the preliminary stage; (ii) recent 5th Circuit case law supported limiting injunctive relief to the parties before the court (citing *Braidwood Management Inc. v. Becerra*, No. 23-10326, 2024 WL 307934 (5th Cir. Jun. 21, 2024)); (iii) the plaintiffs were not a governmental entity; and (iv) the failure of plaintiff-intervenors to provide evidence of "associational standing" of their members."[15] The court can revisit this decision in its ruling on the merits of Ryan's challenge to the Rule.

Other Challenges to the Rule

Ryan is only one of three challenges to the Rule. In *ATS Tree Services* and *Properties of the Villages*, other private entities are challenging the Rule.[16] The multiple challenges to the Rule create the possibility of different rulings on the merits of the statutory and constitutional challenges to the Rule. This also creates a strong likelihood of appellate court review, and continued uncertainty, especially if the FTC has the right to, and moves to, enforce the Rule in some jurisdictions and not others. The court in *ATS Tree Services* has indicated it will issue a ruling on ATS's request for a preliminary injunction no later than July 23.[17] The court in *Properties of the Villages* has not announced a timeline for a decision.

A version of this article was originally produced as a Clients & Friends Memo here.

1 Memorandum Opinion and Order, *Ryan LLC v. Federal Trade Commission*, Case 3:24-cv-00986-E, U.S. Dist. Court, N.D., Tex. (Dallas Div.) (Jul. 3, 2024) (hereinafter, the "Memorandum Opinion"); Preliminary Injunction, *Ryan LLC v. Federal Trade*

Commission, Case 3:24-cv-00986-E, U.S. Dist. Court, N.D., Tex. (Dallas Div.) (Jul. 3, 2024); Complaint, *Ryan LLC v. Federal Trade Commission*, Case 3:24-cv-00986-E, U.S. Dist. Court, N.D., Tex. (Dallas Div.) (Apr. 23, 2024). We previously identified the scope and effective date of the FTC's Rule. *See* Bilal Sayyed and Peter Bariso, Cadwalader Clients & Friends Memo, FTC Adopts Broad Ban on the Use of Non-Compete Clauses in Employment Agreements (Apr. 24, 2024). The Commission's Rule is set forth at 16 C.F.R. § 910 *et seq*.

2 *See*, *e.g.*, In the Matter of O-I Glass, Inc., FTC File No. 211-0182 (Feb. 21, 2023); In the Matter of Ardagh Group S.A., FTC File No. 211-0182 (Feb. 21, 2023); In the Matter of Prudential Security, Inc., FTC File No 221-0026 (Feb. 23, 2023); In the Matter of Anchor Glass Container Corp., FTC File No. 211-0182 (May 18, 2023).

3 The Chamber of Commerce (USA), Business Roundtable, Texas Association of Business and the Longview Chamber of Commerce joined the lawsuit as plaintiff-intervenors and argued similarly that the FTC had exceeded its authority in advancing the Rule.

4 *See* 15 U.S.C. §§ 45, 46.

5 Memorandum Opinion at 13.

6 *Id*.

7 *Id*.

8 *Id*. at 15.

9 *Id*.

10 *Id*. at 19.

11 *Id*. at 15-16.

12 *Id*. at 21.

13 *Id*. at 21.

14 *Id*. at 22. The court also found that a preliminary injunction was in the public interest because it would "maintain[] the status quo and prevent[] the substantial economic impact of the Rule, while simultaneously inflicting no harm on the FTC." Id at 28.

15 Id. at 28-32.

16 *See* Complaint, *ATS Tree Services, LLC v. FTC*, No. 2:24-cv-1743 (E.D. Penn.) (Apr. 25, 2024) and Complaint, *Properties of the Villages v. FTC*, No. 5:24-cv-00316-JSM-PRL (M.D. Florida) (Ocala Division) (Jun. 21, 2024).

17 Order, *ATS Tree Services, LLC v. FTC*, No. 2:24-cv-1743 (E.D. Penn.) (May 21, 2024).