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BUSINESS LAW UPDATE

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BUSINESS PERSPECTIVES

All Change, Again

By Frank D. Chaiken, Practice Group Leader, Corporate Transactions & Securities

Having worked at this profession for many years, it is interesting to see topics and issues rise and fall with the times. I have written before in this column about change (see "The More Things Change … ," *Business Law Update*, Spring 2018). Once again, *plus ça change (plus c'est la même chose)*, and there's nothing new under the sun.

As I was beginning my practice of law (I suppose someday I will perfect it), the Reagan era was coming to an end. In that era and even before, the federal government had taken strong actions to energize the economy and business, weakening unions, relaxing antitrust rules and deregulating core industries such as transportation, telecommunications, banking and finance, among others. In fact, the byword then was that antitrust was "dead" as a viable area of law practice.

In its boundless and adaptable enthusiasm, business responded. There were of course many other influences at work, not least the explosive innovation and growth of technologies and new business models. Some would argue that the change in government policy, most notably the relaxation of restrictions on banking, finance and telecommunications, opened the door for those world-changing developments, giving rise to powerful businesses in technology, finance and other industries, and corresponding personal fortunes.

For more details on any of the topics covered in this *Business Law Update*, please contact the authors via the links at the end of each article or David R. Valz, editor-in-chief. For information on our Corporate Transactions & Securities practice, please contact Frank D. Chaiken, practice group leader.

Fast forward to 2023. The Federal Trade Commission is cracking down on what some would consider to be technology industry monopolies. Unions are in the ascendant. Restrictive covenants in employment, long under attack at the state level in important regions of the country, now may be on the chopping block at the federal level. The pendulum certainly seems to have swung. Reports of the demise of antitrust law seem to have been somewhat exaggerated.

We have seen this before. Notably in his book *Outliers*, which I highly recommend, author Malcolm Gladwell mentions a list of the 75 wealthiest people in history, including kings, emperors and pharaohs, among bankers and other businesspeople. The list includes 14 Americans who were active in business in the 1860s and 1870s as leaders in industry and finance. These gifted individuals had the good fortune to live in a time of tremendous economic expansion and relatively relaxed regulation. Students of history may trace the developments in government regulations such as the antitrust laws beginning in the late 19th and early 20th centuries, the Pure Food and Drug Act of 1906 and the financial services regulations of the 1930s and later, among many others, to this earlier legacy of unbridled business enthusiasm.

Such a list today would include some of the titans of technology who are now in the government's crosshairs. So, are we poised for a similar swing of the pendulum toward stricter government regulation of business, in response to the last 30 or 40 years of economic development, as suggested by the current trend? It remains to be seen whether the political consensus will be there to sustain it.

Either way, as noted in my earlier column, the one constant in life and business is change itself. We as your lawyers are here to help you stay on top of the moving landscape of law and regulation. I hope you will find our latest edition of the *Business Law Update* to be enjoyable and useful. Feel free to contact me, or any of us at Thompson Hine, with your comments, questions and suggestions for future topics you would like us to cover in these pages.

Stay safe,

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Frank Chaiken leads the firm's highly regarded Corporate Transactions & Securities practice, which comprises more than 100 professionals who represent clients of all sizes across virtually every industry. If you have questions or would like to share your thoughts, please contact Frank at 312.998.4249 or Frank.Chaiken@ThompsonHine.com.

MERGERS & ACQUISITIONS

Creative Solutions for Buyers as Non-Compete Bans Increasingly Affect M&A Deals

By Courtney Flowers, Emma Off and Betsy Thacker*

You may have heard murmurs about significant new prohibitions on non-compete covenants ("non-competes") and might be concerned about how these developments could threaten your current, past and future deals. In the M&A context, buyers often rely on non-competes as part of a broader strategy to retain the value of the businesses they are purchasing. If any of the target company's executives, salespeople, owners, developers of IP or others who hold important client relationships or trade secrets can easily leave and compete against the target company, the buyer immediately loses some of the assets and value they just purchased. On the other side, sellers might worry about not receiving the anticipated or desired price for their businesses if they feel they cannot adequately assure buyers that they will receive the full benefit of the transaction.

While these are legitimate concerns, particularly in jurisdictions that have enacted near-total bans on non-competes, here we summarize current and proposed restrictions (and applicable exceptions) and, most importantly, introduce potential workarounds that may preserve value and deter unethical or bad-faith competition.

Current Restrictions

State-Level:

California, North Dakota, Oklahoma and Minnesota have all banned non-competes, with narrow exceptions for the sale of a business. New York will soon follow. Similar to the National Labor Relations Board (NLRB) and Federal Trade Commission (FTC) actions described below, even with exceptions for seller non-competes, there are potential key employees who may not legally enter into non-competes due to these prohibitions. Most states limit employers to some degree so that non-competes will not be used in anti-competitive ways or to restrict the free movement of low-paid employees. Employers are already familiar with these restrictions, which don't typically interfere with M&A activity.

National Labor Relations Act (the "Act"):

This year, the general counsel of the NLRB published a memo stating that non-competes violate the Act. This finding may impact a business being purchased if that company has relied on non-competes to preserve the value of its IP or customer relationships, but the Act excludes managers and supervisors (as defined in the Act or NLRB case law) from this prohibition and would therefore not directly interfere with non-competes a buyer might want to enter into with executives of a seller company. The restrictions could, however, be a potential roadblock if a company's value resides in a few key people who are not managers or supervisors (e.g., small biotech companies that rely on a few scientists or companies that have a few major customers kept happy by deep relationships with key salespeople).

Congressional Activity and FTC Enforcement and Rule Proposal:

At the federal level, lawmakers and rulemakers have been busy proposing increased restrictions on non-competes including a number of proposed bills to enact near-total bans. More pressingly, the FTC has stepped up enforcement actions and proposed a ban on most non-competes. Some experts speculate that the ban will be more narrowly tailored than the initial iteration and that it will likely be challenged, but this all remains uncertain. The FTC's proposed rule is essentially a complete ban but includes a narrow carve-out for acquisitions where buyers may enter into a noncompete with a seller who holds at least 25% of the equity of the target company. As currently written, this carve-out would prohibit non-competes with minority owners who hold less than 25% of the target, non-owner salespeople, executives, IP developers, and others who might be considered key employees to potential buyers.

The comment period on the FTC's proposed rule has ended and the publication of a revised rule or other response to public comment is expected by spring of 2024.

Workarounds

Ultimately, in situations where non-competes are illegal but the potential consequences of seller- or key employee-competition would damage the business to be purchased, buyers have to preserve value by building relationships and structuring the deal to encourage loyalty and commitment. As a buyer, you can work with your legal counsel to consider either structural deal changes or specific types of agreements or tools to protect your investment. Some of these may be considered positive incentives (i.e., carrots) while others introduce negative consequences for competition (i.e., sticks), such as the following:

- **Employment Agreements** may provide employees with a sense of security that is sometimes lacking during the upheaval of an acquisition. Existing agreements can also be amended as a closing condition to extend terms and build in useful provisions that are narrowly tailored to be enforceable and effective.
- **Restricted Stock** or performance share awards can be granted with forfeiture provisions that may persuade employees to stick around and reap the benefits of long-term loyalty with the company.
- **Consulting Agreements** for key people for whom an employment relationship may not be ideal (consider founders or executives) but who may enjoy a continued connection to the business and some consideration for less formal services to the company post-acquisition.
- **Transition Services Agreements** that are thoroughly negotiated and highly detailed can lead to a deep knowledge and relationship transfer to the buyer's team, which might lessen concerns about competition in many industries.
- **Earn-outs** and other contingent models of consideration rely on performance metrics to determine the full value of the enterprise post-closing. Sellers are less likely to compete or otherwise make decisions that could harm the business if a significant portion of the consideration for the deal will be paid only if the business meets negotiated financial targets or extended post-closing timeframes. If a business model is particularly vulnerable to the potential competition of sellers without a non-compete, you could consider a longer than typical earn-out period while you build systems to mitigate this vulnerability.
- **Trade Secrets Protection Programs** should be in place, but if not, you can work with the seller pre-closing to begin building robust programs that include training and appropriate physical and cybersecurity measures. The Defend Trade Secrets Act may be an important avenue to federal enforcement in the event of trade secrets disclosure.
- **Intellectual Property Assignments and Registration** are essential for protecting the business and its assets, even if you cannot retain key employees or prevent them from competing. Requiring sellers to have all employees assign inventions to the company and ensure that all IP is properly registered in all necessary jurisdictions is among the most critical ways to protect your investment as a buyer. You may not be able to prevent a former employee from opening their own shop, but you can seek an injunction if they use the acquired company's IP.
- **Extra-Contractual Relationship Building and Social Sanctions** refer to operating outside of contracts and the legal system and instead building relationships and reputations that strengthen a business and lead to compliance with norms in an industry. The professionals in the business you are acquiring are vulnerable to reputational consequences if they behave in unethical ways. Many studies show that, particularly in certain types of industries, there are tight networks of influential actors. If you are not already submersed in the culture of the industry, deepening your connections and building relationships can be a highly effective strategy to ward off some of the concerns that lead contracting parties to enter into non-competes in the first place.

Though M&A practitioners have come to rely on non-competes as a first line of defense to protect acquired businesses from unethical competition from sellers or sellers' key employees, as new policies make these restrictive covenants less available, buyers can work with their legal teams to tailor creative solutions to best protect their investments.

If you have any questions, please contact Courtney Flowers or Emma Off.

** Betsy Thacker (Case Western Reserve University School of Law, '24) contributed significantly to this article as a Thompson Hine summer associate; she is not admitted to the practice of law.*

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So, You're Thinking About Buying an ESOP? Initial Considerations When Acquiring an ESOP-owned Corporation

By Kelsey Mehaffie

According to the National Center for Employee Ownership, there are currently over 6,000 ESOPs.[1] Although the total number of ESOPs has remained relatively steady from year to year, there are around 250 new ESOPs formed each year.[2] Those numbers suggest that ownership of ESOPs is being transitioned to third parties at a similar rate to the formation of new ESOPs. ESOPs are not particular to any specific industry, but over half of ESOPs are in the professional services, manufacturing, and construction industries.[3] If your company is thinking about acquiring an ESOP-owned company, below are some initial matters to consider.

What is an ESOP?

An employee stock ownership plan (ESOP) is a company-paid retirement benefit that invests primarily in stock of the employer. An ESOP can only hold corporate stock, so an ESOP-owned company must be a corporation (as opposed to an LLC, for example).[4] You might hear ESOP-owned corporations referred to as "employee owned"; however, the actual shareholder of an ESOP-owned corporation is the ESOP Trust, which holds the shares of the corporation on behalf of the plan participants. ESOPs are regulated by the Internal Revenue Service and the Department of Labor.

What are the differences in the deal process when acquiring an ESOP?

As an initial matter, there will be several more parties involved in an ESOP transaction than a traditional M&A deal. Rather than dealing with an individual seller or small group of sellers, the shareholder of the ESOP-owned company is the ESOP Trust, which has a trustee. The trustee could be an individual or an institution with a committee of professionals that will consider the transaction. The trustee will have its own support staff and engage its own legal counsel and valuation firm to evaluate the potential transaction.

Prior to closing the transaction, the trustee must determine that: (1) the consideration is not less than fair market value (as such term is used in determining "adequate consideration" under Section 3(18) of ERISA); and (2) the terms and conditions of the transaction, taken as a whole, are fair to the ESOP from a financial point of view.[5] In connection with this determination, the trustee's valuation firm must conduct its own financial due diligence, prepare a valuation, and deliver a fairness opinion at closing. The valuation firm will take into account the waterfall of payments (and will consider deductions to the deal proceeds such as transaction bonuses, contingent payments, and escrows) in determining whether the transaction is fair.

As further described below, the ESOP will be wound down following closing and the plan assets will be distributed to plan participants. That means that traditional indemnification structures with caps, baskets, escrows, holdbacks, etc. are less often included in ESOP acquisitions. Instead, many buyers obtain a representation and warranty insurance policy in order to bridge the gap between the lack of recourse against the ESOP Trust that is in the process of wind down and the potential for post-closing claims.

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[1] "Employee Ownership by the Numbers," National Center for Employee Ownership, February 2023
[2] *Id.*
[3] *Id.*
[4] 26 U.S. Code § 409(l)(1).
[5] 29 U.S.C.§ 1106(a)(1)(A) and (D) prohibit an ESOP from acquiring stock of the plan sponsor from a "party in interest" unless the transaction qualifies under the exemption provided for in 29 U.S.C. § 1108(e). This exemption is allowed for employer stock if and only if the purchase is for "adequate consideration," which in the case of assets for which there is no generally recognized market as "the fair market value of the asset as determined in good faith by the trustee or named fiduciary." 29 U.S.C. § 1002(18)(B). *See also*, 29 C.F.R. § 2550.408(e). This standard is typically met by delivery of an adequate consideration and fairness opinion from a qualified appraiser pertaining to the transaction. Even though a third-party acquisition is not a "party in interest" transaction, trustees typically require such opinions as a demonstration that the transaction is prudent under ERISA.

What are the differences in deal structure when acquiring an ESOP?

Most forms of transaction that would require a shareholder vote under state law (such as a merger or a sale of substantially all the assets of the company) require a pass-through vote of plan participants.[6] In order to conduct this pass-through vote, the company must deliver a disclosure statement to the participants that includes a summary of the deal and a solicitation of their direction to the trustee to vote for or against the transaction. Due to the administrative burden of preparing, printing, and mailing the participant statement and tabulating votes, most ESOP-owned companies would prefer a stock deal (which would not require a shareholder vote under state law) to an asset deal (which would require a shareholder vote under state law).

What different information or documents should be requested and reviewed in diligence of an ESOP-owned corporation?

Buyers should get comfortable in their diligence review with compliance of the ESOP at formation and ongoing compliance thereafter. As a starting point, buyers should request the closing binder from the original sale of shares to the ESOP, not only to track capitalization history, but also for some key documents that are entered into very frequently in connection with a sale of shares to an ESOP: promissory notes and warrants issued to the sellers as deal consideration, loans from the company to the ESOP and third-party lenders to finance the transaction, stock appreciation rights plans, and phantom stock plans. All of these documents need to be considered in the waterfall, funds flow, and payoffs.

Because ESOP-owned companies are more heavily regulated, additional due diligence requests should be included around Department of Labor and Internal Revenue Service investigations or litigation. Also, ongoing compliance diligence should be conducted through requests for the most recent favorable determination letter; the plan, trust, summary plan description, and all amendments; forms 5500; compliance testing; non-discrimination testing; and annual valuation reports.

What are the differences in conditions to closing and post-closing covenants?

As mentioned above, the ESOP will be wound down shortly following the closing. As a condition to closing, the ESOP-owned company should be required to start this process by amending its plan to freeze contributions and stop accepting new participants. As a post-closing covenant, buyer and seller will agree to cooperate in terminating the ESOP, filing a final form 5500, and obtaining a favorable determination letter. A percentage of the deal proceeds will be distributed to participants promptly after closing, but some funds will be held back to pay the expenses of the wind down, which can take up to 18 months to complete. A final distribution will be made once escrows are released, contingent payments are settled, and expenses of the wind down are paid.

ESOP-owned corporations also have agreements in place with the ESOP trustee to provide for indemnification against claims or suits brought against the trustee in connection with their service on behalf of the corporation. These liabilities can be insured against by the corporation with an errors and omissions policy that provides coverage for the directors, officers and service providers of the corporation, but a tail policy must be purchased at the time of a transaction to provide for this coverage following the closing.

Are there employee relations and retention considerations?

The deal proceeds in the acquisition of an ESOP-owned corporation will be distributed to the plan participants in proportion to their plan accounts. Employees who have had a long tenure with the company may have racked up significant ESOP account balances and will receive a large portion of cash in the wind-down process. If participants take the cash, they will be subject to ordinary income tax and may be subject to early pension distribution penalties.[7] Because of that, many buyers focus efforts on educating their new employees (i.e., the plan

[6] 26 U.S. Code § 409(e)(3).
[7] 26 U.S. Code § 72(q)(1).

participants) to roll over plan balances into a 401(k) or IRA.

Human resources should be engaged early to review benefits packages from a retention perspective. If the buyer does not sponsor an ESOP of its own, employees will notice a reduction in their total benefits package unless compensation is otherwise increased. Human resources should also understand transaction bonuses to be granted to key employees early on in the process so that retention packages can be planned accordingly. Some consideration should also be given to post-transaction retention and engagement of employees, some of whom will receive ESOP distributions significant enough to allow the employees to retire sooner than they otherwise may have.

The above are only the initial, high-level questions to consider in the acquisition of an ESOP-owned corporation. If your company is thinking about acquiring an ESOP-owned corporation, hiring advisors, including lawyers, who have deep experience in acquisitions involving ESOPs is key.

Please see our website for more information about our ESOP services. If you have any questions, please contact Kelsey Mehaffie.

SECURITIES QUARTERLY UPDATE

Check out the latest editions of *Securities Quarterly Update*, our newsletter that provides updates and guidance on securities regulatory and compliance issues.

- In the summer edition, we look at SEC rulemaking, certain enforcement activity, recent ESG regulatory activity, and developments impacting quarterly and other SEC reports.
- The fall edition covers the SEC's recent rulemaking, certain enforcement activity, the latest ESG regulatory activity, some Nasdaq rule changes, recent developments impacting quarterly and other SEC reports, and certain regulatory developments that could be of interest to audit committees.

ARTIFICIAL INTELLIGENCE

Questions to Ask Your Law Firms About Their Use of Artificial Intelligence

By William T. Garcia, Chief Practice Innovation Officer; Matthew D. Coatney, Chief Information Officer; and Julie D. Honor, Counsel

Even the most casual observer of current news appreciates the projected use of artificial intelligence or "AI" to improve service delivery across a variety of industries. Artificial intelligence techniques such as natural language processing, machine learning, and deep learning have been commercially available for several years and are incorporated into some of the more widely adopted software applications (for example, Lex Machina which analyzes court dockets to predict case timing and judges' penchants).

The more recent maelstrom involves the use of a species of AI called generative AI (GAI). GAI is a subset of deep learning (a sophisticated sub-field of machine learning) that, based on a user "prompt" (i.e., query or request), creates new images, computer code, video, audio, or natural language based on enormous amounts of data analyzed to train the algorithm. GAI is designed to generate content – it is not an editor, not an analytic tool (yet), and not a web browser. It doesn't necessarily operate in "real time": it may be basing its work off ingested materials that are years old. Failure to understand this limited functionality (which concededly GAI performs brilliantly) is the genesis of much of the criticism and concern about the use of these applications.

Clients need to understand the technology being utilized to support their representation and seek competent legal advice on the issues that might arise. When considering a law firm's use of AI, it's essential for clients to ask relevant questions. Remember, the goal is to gain a clear understanding of how the law firm incorporates AI, ensuring that it is used responsibly, ethically, and in the best interests of the client.

Here's a list of a few of the questions that a client might ask about the use of AI and GAI. For these purposes, "AI" includes but is not limited to GAI.

Firm's Use of AI

- Does the law firm utilize AI in its legal practice? If so, in which specific areas of law? Are there differences from practice area to practice area in how the AI is being used?
- Does the firm have a clearly defined policy for restricting the use of AI in specific cases or overall if necessary?
- How does the firm monitor compliance by its attorneys of AI and GAI use in accordance with the firm's policy?
- What is the firm's policy on use of personal accounts created in generative AI tools by firm attorneys?
- If the client already has an AI policy in place, will the firm adhere to that policy while providing services?
- What is the process for resolving disputes or challenges related to the use of GAI in the client's legal matters? Does the law firm disclose to clients when GAI is used in their legal matters, and are clients given the option to opt out of its use if desired?
- Will AI tools be used in the specific project? How are AI tools integrated into the firm's workflows?
- Can the client request the firm use a specific AI tool for a project or matter that the firm is working on?
- Are there any additional costs associated with the use of GAI, and how are these charges determined?
- Can the client request access to the GAI-generated content and information pertaining to their matters?

- What training and expertise do the law firm's attorneys and staff have in working with GAI tools? What training of the lawyers/staff is in place to ensure safe use? Efficient use?
- If the firm is using GAI, what steps is it taking to mitigate risk related to the software supply chain, including both commercial and open source providers?

Benefits and Considerations

- What are the primary benefits and advantages of using AI in the firm's legal services? Does the firm have any comparative data or metrics to support these conclusions?
- Are there any notable success stories or case studies where AI has significantly benefited clients?
- Has the law firm conducted any independent audits or evaluations of its AI systems to assess their effectiveness and legality?
- What safeguards are in place to ensure the accuracy and reliability of the AI tools?
- What steps are taken to keep the GAI technology and GAI-generated content up to date and in compliance with changing legal regulations?
- What steps are being taken to manage the long-term maintainability of AI tools, such as loss of access to the original training materials, loss of access to the specific model or tool, or changes and updates to the model or tool?

Risks and Compliance

- What are the limitations or potential risks associated with the use of AI in the legal work, and how does the firm address them?
- What measures are taken to protect the client's sensitive information and data while using AI tools?
- How does the firm address potential biases that might be present in the AI models?
- What data is being used to train the GAI? What processes are in place to ensure the training data is being used in compliance with relevant property rights, laws, and regulations?
- How does the firm ensure compliance with legal and ethical standards while using GAI?

For several years, Thompson Hine has used AI-enabled tools in a variety of contexts. These include commercially available tools that rely on natural language processing and machine learning to analyze large quantities of documents and analytic tools that incorporate proprietary algorithms we have developed to analyze large quantities of data related to our delivery of legal services.

In keeping with our promise to the market of "Always Innovating," Thompson Hine is assessing adoption of GAI tools to assist in our delivery of legal services to clients as well as in our internal business operations. We will strive to utilize large language model (LLM) and GAI tools as fully and as quickly as we can within necessary guardrails.

Please contact Bill Garcia, Matt Coatney or Julie Honor with any questions.

The authors developed this checklist based upon their experience and available resources regarding generative AI, including ChatGPT, which the authors used to generate ideas and suggested text.