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A legal update from Dechert's Antitrust/Competition Group

# DOJ's Latest "Gun Jumping" Case Raises Questions

## Interim Covenants Provide No Safe Harbor Where Buyer Exercises Control Over Seller's "Significant" Ordinary Course Purchases

**Key Points and Possible Action Items**

- DOJ is taking aim at covenants in transactional documents that preclude the seller from engaging in ordinary course business activities consistent with past practice, no matter how material.
- Submitting "ordinary course" seller contracts to buyer for approval prior to HSR clearance risks a gun-jumping charge, even if the contracts are clearly material and buyer approval is required by covenants in the acquisition agreement. Product sales and input purchase contracts affecting markets of substantive antitrust significance to the enforcement agencies are particularly likely to draw the government's attention.
- If business considerations dictate that covenants affecting the seller's conduct of the business between signing and closing include monetary thresholds, the thresholds should be set above the level of seller's routine past practice.
- To avoid gun-jumping issues, consult antitrust counsel in drafting and implementing interim covenants that require buyer approval of seller business activities. Counsel should also be involved prior to commencement of due diligence, to provide advice regarding permissible information sharing.

The Department of Justice ("DOJ") announced it has reached a $900,000 settlement with Smithfield Foods, Inc. ("Smithfield"), and Premium Standard Farms, LLC ("Premium Standard") relating to allegations that Smithfield was "gun jumping" in violation of the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the "HSR Act") by exercising operational control over a "significant segment" of the business of Premium Standard prior to the expiration of the HSR Act waiting period.[1] The *Smithfield* complaint reflects the most expansive view of gun jumping yet and suggests that even contractual restrictions on sellers entering into material contracts may run afoul of the HSR Act.

The DOJ alleged that Smithfield exercised beneficial ownership in violation of the HSR Act by approving three of Premium Standard's ordinary course procurement contracts during the HSR waiting period. This civil penalty action reinforces the importance of having antitrust-sensitive due diligence and transaction-planning procedures in place at the earliest stages of a transaction in order to avoid potential antitrust liability for engaging in impermissible premerger coordination. Although Smithfield involved only claims

1 Complaint, United States v. Smithfield Foods, Inc., No. 1:10-cv-00120, (D.D.C. Jan. 21, 2010), *available at* [http://www.justice.gov/atr/cases/f254300/254369.htm](http://www.justice.gov/atr/cases/f254300/254369.htm).

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under the HSR Act, gun jumping can violate the both the Sherman Act and the HSR Act.

The HSR Act applies to acquisitions of voting securities or assets that meet certain jurisdictional thresholds. If the jurisdictional tests are met, the acquiring party must submit an HSR filing and observe a waiting period prior to acquiring the shares or assets, unless an exemption is available. During the HSR waiting period, parties to a merger must retain their pre-acquisition identities and continue to exercise independent business judgment until the acquisition closes, so that they remain competitive with one another. If the buyer acquires beneficial ownership of the target during this period, the buyer is deemed to have made a premature acquisition in violation of the HSR Act, often referred to as gun jumping.

## The Alleged Violation

On September 17, 2006, Smithfield and Premium Standard signed an Agreement and Plan of Merger (the "Agreement") under which Smithfield would acquire Premium Standard for approximately $693 million. On October 6, 2006, the parties filed required notification and report forms under the HSR Act, which triggered the 30-calendar day statutory HSR waiting period. The waiting period was extended due to issuance of requests for additional information—known as second requests—on November 6, 2006. The waiting period expired on March 7, 2007—30 days after both parties certified compliance with the requests.

The Agreement contained certain standard "conduct of business" provisions that limited Premium Standard's operations during the HSR waiting period. These included a general requirement that Premium Standard would "carry on its business in the ordinary course consistent with past practice" and a specific covenant that required Smithfield's consent for any purchases by Premium Standard of "inventory, raw materials or supplies" in excess of $2 million in the aggregate. The interim covenants also contained provisions restricting Premium Standard's right to assume new debt, issue new voting securities, and sell assets.

Prior to the acquisition by Smithfield, Premium Standard had been purchasing hogs pursuant to procurement contracts that ranged from one to five years. Shortly after the HSR filings were submitted, Premium Standard submitted three multi-year hog procurement contracts to Smithfield for its consent. According to the complaint, the three contracts were necessary to Premium Standard's ongoing business and entered into in the ordinary course of its business. When seeking consent from Smithfield, Premium Standard provided Smithfield with the proposed contract terms, including the price to be paid, quantity to be purchased, and length of the contract. The contracts in total obligated Premium Standard to purchase, on an annual basis, between 400,000 and 475,000 hogs at a total cost ranging from approximately $57 million to $67 million.

The DOJ alleged that Smithfield had exercised operational control over, and thus acquired beneficial ownership of, a "significant segment" of Premium Standard's business operations, exceeding in value the $56.7 million threshold for HSR reportability then in effect. For this, both the buyer and the seller were charged with a violation of the HSR Act. The violation allegedly continued from approximately September 20, 2006, when Premium Standard began submitting contracts for Smithfield's consent, to March 7, 2007, the date of expiration of the HSR waiting period. To settle the violations, Smithfield and Premium Standard agreed to pay $900,000 (jointly and severally), or approximately $5,357 per day for each day of violation of the HSR Act. The maximum civil penalty under the HSR Act is currently $16,000 per day, but was $11,000 per day during the time period relevant to the alleged violation.

## Questions and Implications

### Approval of Material Contracts As Gun-Jumping

The *Smithfield* complaint did not question the materiality of the hog purchase contracts at issue, just that they were entered into in the ordinary course. A broad reading of the DOJ complaint might therefore suggest that buyer approval of any contracts, even if material, would constitute gun-jumping so long as the contracts were entered in the ordinary course. Whether the DOJ intends to assert such a broad view of gun-jumping beyond the facts of this case remains to be seen. One factor suggesting otherwise is that these contracts involved an area of competitive overlap for a key input which was also a central area of focus in the DOJ's substantive antitrust investigation of the merger, i.e., the possibility of increased buyer power in the purchase of hogs. In either event, the DOJ's investigation demonstrates that:

- The heightened level of scrutiny which the government has always given to buyer control over the seller's sales activities also extends to the seller's purchase of important inputs.

- An increased risk of gun-jumping exists where buyer approval is sought for contracts entered into in the ordinary course of business, as reflected in routine past practice.

**The Relevance of Contract Provisions Defining Materiality or Ordinary Course**

*Smithfield* is the second gun-jumping case in which the provisions of the acquisition agreement played a significant role. In 2006 the DOJ brought a gun-jumping case against QUALCOMM and Flarion Technologies,[2] alleging that during the HSR waiting period QUALCOMM had frequently reviewed details of Flarion's customer proposals, occasionally rejected Flarion's requests for discounts and generally discouraged Flarion from pursuing certain business objectives. The DOJ alleged that much of this activity "involved business decisions well beyond even what the merger agreement purported to require." At the same time, the DOJ also alleged that the merger agreement itself "restricted Flarion's discretion to conduct its own affairs."

Unlike *QUALCOMM*, there was no allegation that Smithfield's conduct went beyond what the merger agreement required, since the value of the contracts at issue in *Smithfield* far exceeded the $2 million threshold in the merger agreement for obtaining buyer approval. Obviously, in the DOJ's view the fact that an acquisition agreement allows the buyer a certain amount of interim control over the seller provides no security against gun jumping if the activity being controlled is in the ordinary course. In effect, DOJ is making a direct attack on the covenants included in the merger agreement, although for reasons that are unclear, this fact is obscured by the drafting of the complaint. Smithfield, therefore, underlines the importance of seeking gun-jumping advice from antitrust counsel when the buyer is exercising or attempting to exercise control or approval rights over the seller's business activities, whether or not such exercise is required or permitted by the acquisition agreement.

**DOJ's Curious ''Significant Segment'' Allegation**

The complaint charged Smithfield with exercising "operational control over a significant segment of Premium Standard's business" (the acquisition of hogs), resulting in beneficial ownership of those assets (apparently the hogs themselves), the value of which exceeded the HSR threshold then in effect. This approach is a significant departure from prior enforcement actions in which the gun jumping was alleged to have resulted in the buyer acquiring beneficial ownership of the entirety of the seller and would appear to suggest that had the hogs been valued at less than the HSR threshold, Smithfield's actions would not have violated the Act. It is unclear whether this was DOJ's intended meaning. If the "significant segment" language has any significance at all, it is more likely to refer to the fact that the segment was significant to the government's substantive investigation of the deal—a further indication that this may have been the determining factor in the DOJ's decision to file a complaint.

## Conclusion

The DOJ's complaint against Smithfield and Standard Premium points out the importance of involving antitrust counsel for both parties very early in a transaction to obtain advice regarding what activities are permissible or impermissible before, as well as during, the HSR waiting period. This type of counseling would include review of the relevant transactional documents in draft, including any interim covenants; advice on compliance with interim covenants that limit the seller's ordinary business activities; and exchange of antitrust-sensitive information in due diligence.

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2 Complaint, United States v. QUALCOMM, Inc., No. 1:06CV00672 (D.D.C., Apr. 13, 2006), *available at* http://www.justice.gov/atr/cases/f215600/215608.htm.

## Practice group contacts

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