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ANTITRUST ALERT

"GUN JUMPING" PENALTY FOR APPROVAL OF MERGER PARTNER'S LONG-TERM SUPPLY AGREEMENTS DURING HSR WAITING PERIOD

On January 21, 2010, the Antitrust Division of the Department of Justice announced a $900,000 civil penalty settlement with Smithfield Foods, Inc. and Premium Standard Farms LLC, stemming from DOJ allegations that the two firms violated the Hart-Scott-Rodino (HSR) Act's "gun jumping" rules. The Antitrust Division's action sends a cautionary signal to companies exercising contractual approval rights over supply agreements entered into by their merger partners prior to expiration of an HSR waiting period.

Smithfield and Premium Standard are companies engaged in the business of purchasing and raising hogs for slaughter and selling pork products. Under a merger agreement signed in September 2006, Smithfield agreed to acquire Premium Standard for approximately $810 million. The agreement required Premium Standard to "carry on its business in the ordinary course consistent with past practice" during the HSR waiting period.[1] The agreement also required Premium Standard to obtain Smithfield's written consent before entering into certain "material" contracts (defined broadly in the agreement and including certain contracts involving assets or payments in excess of $1 million).

Prior to the acquisition, Premium Standard purchased hogs from approximately 11 independent suppliers under contracts ranging in length from one to five years. Following the merger agreement and before the expiration of the HSR waiting period, Premium Standard submitted numerous hog purchasing contracts to Smithfield for approval. For the three hog contracts at issue—multiyear agreements obligating Premium Standard to purchase more than 400,000 hogs in total for a combined price between $57 million and $67 million—Premium Standard provided Smithfield with the proposed contract terms, including purchase price, quantity, and length.

The Antitrust Division charged that this conduct amounted to "gun jumping" in violation of the HSR Act, which requires that merging parties observe a designated waiting period before the acquiring party may "hold" (defined as having "beneficial ownership"), directly or indirectly, the voting securities or assets of the acquired person or company. This provision in effect requires two companies to operate independently—and compete to the extent that the companies competed prior to entering into the acquisition agreement—during the period in which the Antitrust Division reviews the merger. As alleged by the Division, Premium Standard ceased exercising independent business

[1] The statutory HSR waiting period is 30 days, during which the reviewing agency (either the Federal Trade Commission or the Antitrust Division of the Department of Justice) reviews the deal documents and other material in order to determine whether to conduct a broader investigation into whether the transaction violates the antitrust laws. The 30-day period may be extended if the agency makes a request for additional information. In this instance, the Antitrust Division issued a request for additional information on November 6, 2006, and the waiting period expired on May 7, 2007, 30 days after both parties certified compliance with the Antitrust Division's request. Despite the Division's pursuit of the parties for "gun jumping," the underlying transaction was not challenged and was consummated on May 7, 2007.

judgment in "ordinary course of business" hog purchases that were key elements of Premium Standard's ongoing business. The Division contended that requiring a buyer's approval of the seller's ordinary course contracts can prematurely transfer operational control, and, thus, Smithfield unlawfully acquired operational control over a significant segment of Premium Standard's business prior to the expiration of the HSR waiting period. Although the Division alleged a continuing violation from September 20, 2006 through the March 7, 2007 expiration of the waiting period (exposing Smithfield to a potential maximum civil penalty in excess of $2 million), the parties agreed to settle the matter (pending approval by the United States District Court for the District of Columbia) for $900,000.[2]

Of particular note is the Division's apparent reliance on the competitive significance of the contracts at issue in deciding that the parties had jumped the gun. The Division recognized that the prior approvals here were exercised under what the Division characterized as "*customary* interim 'conduct of business' provisions."[3] Nevertheless, despite the fact that the supply agreements appear to have been clearly "material contracts" as defined in the merger agreement, the Division alleged that the hog purchase agreements at issue were not extraordinary business events. In its complaint, the Division highlighted the fact that hog purchasing was an important competitive overlap between the parties that the Division was reviewing during the HSR waiting period. In fact, the Division emphasized that a "purpose of this waiting period is to preserve the acquired firm as an independent company in case the proposed acquisition is blocked or otherwise not consummated so that the competition that the antitrust laws protect does not suffer."

In essence, the Division has signaled that it will apply its own analysis of what is material and in the ordinary course, regardless of what the merger agreement says. Thus, parties relying on the typically standardized "ordinary course" language in acquisition agreements to guide the extent of their pre-closing coordination with each other may be doing so at their peril. Moreover, parties should not take false comfort where the particular activity subject to contractual prior approval rights relates to supply agreements. Commenting on the settlement, Christine Varney, Assistant Attorney General in charge of the Antitrust Division, noted that "[m]erging companies must remain independent in their ordinary business operations, including purchasing decisions, until the end of the premerger waiting period." Finally, by characterizing "prior approval" clauses as "customary," while simultaneously challenging the instant parties' reliance on such a clause, the Antitrust Division appears to recognize that, while such clauses are potentially valid, they may nonetheless prove problematic in the context of a particular target company's business and industry.

The Smithfield/Premium Standard case highlights the Antitrust Division's close scrutiny of ordinary course covenants and serves as a warning to companies contemplating a merger to exercise caution both when contemplating significant business decisions during the HSR waiting period, as well as when drafting and applying "prior approval" clauses in merger agreements. The case also serves as a reminder that the eventual approval of the underlying transaction will not immunize unlawful conduct, including jumping the gun by exercising operational control of the acquired firm prior to the expiration of the HSR waiting period.

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[2] At the time of the conduct at issue, the maximum daily civil penalty for violations of the HSR Act was $11,000. The maximum daily penalty was increased in January 2009 to $16,000.

[3] The Division's reference to these provisions as being "customary" perhaps stems from prior DOJ gun jumping complaints involving such "prior approval" requirements. For instance, in April 2006, the Antitrust Division reached a $1.8 million settlement with QUALCOMM Incorporated and Flarion Technologies Inc. relating to allegations that those companies unlawfully coordinated during the HSR waiting period regarding making customer proposals and hiring employees and consultants. Similarly, in April 2002, the Antitrust Division reached a $638,000 settlement with Computer Associates International Inc. and Platinum Technology International Inc. relating to allegations of unlawful coordination during the HSR waiting period regarding monitoring and approving customer contracts.

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