DOJ OBTAINS SETTLEMENT AGAINST COMPANIES CHARGED WITH ILLEGAL PRE-MERGER COORDINATION

The Department of Justice (DOJ) recently charged Smithfield Foods, Inc. (Smithfield) and Premium Standard Farms LLC (Premium Standard) with a violation of Section 7A of the Clayton Act (the Hart-Scott-Rodino (HSR) Act), claiming that Smithfield wrongfully exercised control over Premium Standard's business prior to merger closure by exercising approval rights over Premium Standard's hog procurement contracts before the waiting period under the HSR Act had expired.[1] The DOJ simultaneously announced that the parties had agreed to a settlement resulting in a US$900,000 civil penalty. The DOJ sought the penalty for violating the HSR Act even though it had previously determined not to challenge the transaction, finding that the merged firm was not likely to harm competition, consumers, or farmers.[2]

The type of violation the DOJ charged is commonly referred to as "gun-jumping"—the acquiring party is "jumping the gun" by exercising control over an entity that it seeks to acquire prior to the expiration of the HSR waiting period (whether the initial 30-day waiting period or an extended waiting period before complying with a "second request"). This conduct can be actionable both under the HSR Act, and, depending upon the nature of the coordination, under the Sherman Act as well, because the acquirer and acquired firm remain separate entities for Section 1 purposes until the merger closes.[3] Gun jumping challenges are not common; the last such action was the April 2006 DOJ action against QUALCOMM and Flarion Technologies Inc., which was settled for a substantial civil penalty of US$1.8 million. Including Smithfield, only eight cases alleging gun-jumping have been brought by either the DOJ or FTC in the last 14 years.[4]

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

2 *See* Statement of the Department of Justice Antitrust Division on its Decision to Close its Investigation of Smithfield Inc.'s Acquisition of Premium Standard Farm Inc., *available at* http://www.justice.gov/atr/public/press_releases/2007/223077.htm.

3 The HSR Act prohibits an acquiring person taking control of its merger partner prior to expiration of the HSR waiting period. Section 1 of the Sherman Act prohibits agreements between merging parties that adversely impact competition before the transaction closes. The Smithfield Foods Complaint does not charge a violation of the Sherman Act.

4 *United States* v. *QUALCOMM Inc.*, No. 1:06CV00672 (D.D.C. April 13, 2006), *available at* http://www.justice.gov/atr/cases/f215600/215608.pdf; *United States* v. *Gemstar-TV Guide Int'l, Inc.*, No. 03-0198, 2003 WL 21799949 (D.D.C. July 11, 2003); *United States* v. *Computer Assocs. Int'l, Inc.*, No. 01-02062, 2002 WL 31961456 (D.D.C. Nov. 20, 2002); Complaint, *United States* v. *Input/Output, Inc.*, No. 99-0912 (D.D.C. filed Apr. 12, 1999), *available at* http://www.ftc.gov/os/1999/04/inputoutput.pdf; *In re Commonwealth Land Title Ins. Co.*,

Brussels
+32 (0)2 290 7800

Denver
+1 303.863.1000

London
+44 (0)20 7786 6100

Los Angeles
+1 213.243.4000

New York
+1 212.715.1000

Northern Virginia
+1 703.720.7000

San Francisco
+1 415.356.3000

Washington, DC
+1 202.942.5000

Although the Complaint in this matter is brief, the prosecution of this case suggests that the DOJ remains concerned where an acquiror engages in decision-making regarding the acquired company's business, particularly where it involves areas that are competitively sensitive. Merger agreements typically include covenants that limit the acquired entity from taking certain actions outside the ordinary course that would affect the value of the assets being acquired without first seeking acquirer consent and that require that the company being acquired to operate its business in the ordinary course consistent with its pre-merger practice. Generally speaking, these covenants do not present an antitrust issue, unless they have the effect of eliminating the business's independence. The DOJ in this case concluded that the act of seeking consent for supply contracts for an integral part of Premium Standard's business had that effect here.

THE SMITHFIELD MATTER

Before the merger, both Smithfield Foods, Inc. and Premium Standard were integrated pork packers, processors, and hog producers. At the time of the acquisition, Smithfield was the largest pork packer, processor, and hog producer in the country, and Premium Standard was the second-largest hog producer and sixth-largest pork packer. To supplement internal hog production, Premium Standard purchased a substantial number of hogs from independent suppliers under contracts with terms ranging from one to five years. Indeed, these purchases were the focus of the Antitrust Division's investigation and of the Second Request the DOJ issued during the waiting period, but DOJ determined that "farmers who sell hogs or hog-raising services to the merged firm would have competitive alternatives that would deter the merged firm from lowering prices paid to the farmers."[5]

According to the Complaint, following execution of the Merger Agreement, however, Premium Standard ceased to act independently from Smithfield in its acquisition of hogs because it sought approval from Smithfield for the three contracts that it executed during the waiting period, all of which were with one unnamed independent producer. There were three such contracts that together obligated Premium Standard to purchase between 400,000 and 475,000 hogs annually, at a total cost of US$57–US$67 million. The Complaint notes that one contract was for "less than one percent of Premium Standard's annual slaughter capacity," potentially suggesting that such a small volume of commerce could not represent a material change in Premium Standard's business practice, and thus that Premium Standard should not have sought Smithfield's consent for this contract. For each contract, Premium Standard provided Smithfield with the proposed contract terms, including the pricing, quantity to be purchased, and contract length.

The Merger Agreement likely had standard provisions requiring consent for certain contracts that may have materially affected the business (a covenant that the DOJ has previously indicated does not in itself present antitrust issues[6]). The Complaint characterizes the Merger Agreements covenants regarding the restrictions on Premium Standard's business as "customary" and thus these provisions themselves do not themselves appear to have triggered the DOJ's concern. (In contrast, in the earlier QUALCOMM matter, the DOJ Complaint claimed that QUALCOMM intentionally structured the covenants in its Merger Agreement because it did not plan to commercialize one of Flarion's products in its current form and wanted to ensure that Flarion did not enter into agreements that were inconsistent with QUALCOMM's future plans.)

Prior Cases Involving Buyer Contract Approval

The DOJ's prior cases involving contract coordination

126 F.T.C. 680 (1998); *In re Insilco Corp.*, 125 F.T.C. 293 (1998); *United States* v. *Titan Wheel Int'l, Inc.*, No. 96-01040, 1996 WL 351143 (D.D.C. May 10, 1996).

5 See DOJ Statement, n.2. supra.

6 The consent decree in the *Computer Associates* matter permits covenants that require the acquired party to operate its business in the ordinary course consistent with past practices and giving the acquiring person certain rights in the event there is a material adverse change in the acquired person's business.

evinced more extensive control by the proposed purchaser in the proposed target's contracting business than is alleged here. In the *QUALCOMM* matter, Flarion was required to obtain written consent from QUALCOMM before it could present business proposals to *any* customer or prospective customer, although this provision was later amended to allow Flarion to present business proposals to customers in the ordinary course of business in accordance with its standard past practice. In addition, in practice, according to the DOJ's Complaint, Flarion sought QUALCOMM's review and consent before marketing products and services to customers and potential customers, submitted draft customer proposals for review by QUALCOMM, requested QUALCOMM approval of price quotations and discounts, and took other unspecified actions that discouraged Flarion from doing business with smaller customers.

Similarly, in the earlier *Computer Associates* matter, Computer Associates exercised extensive control over Platinum's contracting practices, going as far as to place an employee on-site who approved all customer contracts, and limited Platinum's prior discretion in presenting discounts and contract terms.

Although the conduct here was more limited, DOJ found nevertheless that "Smithfield exercised operational control over a significant segment of Premium Standard's business."[7] DOJ's action demonstrates that although provisions requiring the acquirer's consent before the acquired firm may enter contracts outside the ordinary course are standard in merger agreements, their exercise requires considerable caution. First, it is important to determine whether the conduct for which consent is sought is truly outside the ordinary course. Merely entering into significant or long-term contracts may not be outside the ordinary course. And even where the acquired firm's conduct is truly outside the ordinary course, an acquiring firm must exercise caution in exercising any influence over competitively sensitive activities of the acquired firm. As a result, acquiring companies should not assume they can rely on ordinary course provisions to allow them to make decisions about the acquired company's business and should carefully consult with antitrust counsel before seeking to exercise contract review or approval rights.

7 Complaint, n.1 supra, at ¶ 20.

If you would like more information about any of the matters discussed in this advisory, please contact your Arnold & Porter attorney or:

Deborah L. Feinstein
+1 202.942.5015
Deborah.Feinstein@aporter.com

Jonathan Gleklen
+1 202.942.5454
Jonathan.Gleklen@aporter.com

Christopher J. Flack
+1 202.942.6564
Christopher.Flack@aporter.com