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CLIENT ADVISORY

DOJ Obtains Penalties Against Companies Charged With Illegal Pre-Merger Coordination

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The Department of Justice last week charged Qualcomm Incorporated ("QUALCOMM") and Flarion Technologies Inc. ("Flarion") with violating the HSR Act based on QUALCOMM's exercise of operational control over Flarion before expiration of the HSR waiting period. DOJ's action was a reminder to merging companies that the Hart-Scott-Rodino Antitrust Improvements Act ("HSR Act") limits their activities before the expiration of the statutory waiting period. DOJ brought suit even though it concluded after a second request that the acquisition itself did not raise competitive concerns. In the press release announcing the matter, Tom Barnett, the Assistant Attorney General in charge of the Antitrust Division, emphasized that "merging parties must continue to operate independently until the end of the pre-merger waiting period."[1]

It can be difficult to determine precisely what activity is permissible and what activity is inappropriate "gun-jumping" in the period between signing of the transaction and expiration of the HSR waiting period or closing of the transaction.[2] The QUALCOMM action, as well as the DOJ's 2002 action against Computer Associates and a recent speech by the FTC General Counsel, provide some guidance.

THE QUALCOMM MATTER

QUALCOMM's $600 million acquisition of Flarion required notification under the HSR Act, which prohibited the parties from closing their transaction (or QUALCOMM from obtaining "beneficial ownership" of Flarion) prior to the expiration of the statutory waiting period. DOJ claimed, however, that the QUALCOMM-Flarion Merger Agreement prevented Flarion from engaging in basic business activities during the waiting period without QUALCOMM's written consent. The Merger Agreement:

1 www.usdoj.gov/atr/public/press_releases/2006/215617.htm

2 While the Hart-Scott-Rodino Act prohibits an acquiring person taking control of its merger partner prior to expiration of the HSR period, Section 1 of the Sherman Act prohibits agreements between merging parties that adversely impact competition before the transaction closes.

- Prohibited Flarion from entering into agreements to license its intellectual property to third parties;
- Prohibited Flarion from entering into new agreements involving the obligation to pay, or right to receive, $75,000 or more per year or $200,000 or more in the aggregate, except purchaser orders issued by Flarion to suppliers under prior obligations;
- Required QUALCOMM's written consent before Flarion could "hire any employee … except in the ordinary course of business in accordance with its standard past practice;" and
- Required QUALCOMM's written consent before Flarion could present business proposals to any customer or prospective customer. (That provision was later amended to allow Flarion to present proposals "in the ordinary course of business in accordance with its standard past practice.")

According to DOJ's Complaint, QUALCOMM insisted on the provisions because it did not intend to commercialize one of Flarion's products in its current form and did not want Flarion to enter into agreements that were inconsistent with QUALCOMM's future plans for the Flarion technology.

QUALCOMM's control over Flarion, however, allegedly went far beyond the provisions in the Merger Agreement. According to DOJ's Complaint:

- Flarion sought QUALCOMM's review and consent before marketing products and services to customers and potential customers, including submission of entire drafts of customer proposals.
- Flarion requested approval of price quotations and discounts and on at least one occasion QUALCOMM denied Flarion's request to offer a discount.
- Flarion routinely requested permission from QUALCOMM to hire employees.
- QUALCOMM took other actions to discourage Flarion from doing business with smaller customers.

The DOJ Complaint alleges that the effect of the Merger Agreement and other conduct was to transfer "beneficial ownership" of Flarion to QUALCOMM as soon as the Merger Agreement was signed. The parties were thus subject to civil penalties totaling $3.32 million—$11,000 for each party's day of noncompliance between signing the Merger Agreement on July 25, 2005 and the expiration of the HSR waiting period on December 23. DOJ agreed, however, to settle for a civil penalty totaling $1.8 million because "the companies voluntarily reported the existence of gun-jumping problems to the Department and took some measures to change their contract and their conduct."

PRIOR ACTIONS AGAINST IMPROPER PRE-MERGER COORDINATION

DOJ's 2002 action against Computer Associates International, Inc. ("CA") and Platinum Technology International, Inc. ("Platinum") charged the defendants with improper pre-merger coordination and a violation of the HSR Act based on similar claims that CA reviewed Platinum's pricing proposals to customers during the HSR waiting period.[3] That matter, which also charged the defendants with a violation of Section 1 of the Sherman Act for illegal coordination pre-merger, was settled by a consent decree that provides some guidance regarding permissible pre-merger conduct.

The CA/Platinum consent decree prohibited CA from:

- Agreeing with a merger partner to establish the price of any product or service offered in the U.S. to any customer;
- Requiring any merger party to submit customer contracts for review; and
- Requiring any merger party to provide bid information.

[3] *United States* v. *Computer Assocs. Int'l, Inc.*, No. 01-02062, 2002 WL 31961456 (D.D.C. Nov. 20, 2002).

The consent decree also, however, recognized that an acquiring party has a legitimate interest in ensuring that the value of the target company is not diminished during the period between signing of a transaction agreement and closing. Recognizing that certain ordinary course covenants and information exchanges are necessary and permissible, the CA/Platinum consent decree expressly permits merger covenants that:

- Require the acquired party to operate its business in the ordinary course consistent with past practices;
- Give the acquiring person certain rights in the event there is a material adverse change in the acquired person's business;
- Prohibit the acquired person from offering customers enhanced rights or refunds upon a change of control; and
- Allow the exchange of information regarding pending bids, solely for purposes of due diligence and only to the extent that the bids are material to the understanding of the future earnings. Bid information may be exchanged only with appropriate safeguards limiting the personnel with access to the information and their use of the information received in due diligence.

RECENT FTC SPEECH ON PRE-MERGER COORDINATION

The General Counsel of the FTC, Bill Blumenthal, offered some thoughts on the antitrust standards governing pre-closing coordination in a recent speech.[4] Recognizing that effective integration planning in the period before a merger closes is often essential to recognizing the pro-competitive efficiencies enabled by a merger, he expressed concern that the agencies' message on gun-jumping may have been misinterpreted in ways that excessively constrained appropriate integration planning. He noted that "care needs to be taken not unduly to jeopardize the ability of merging firms to implement the transaction and achieve available efficiencies." Without giving precise do's and don'ts, he offered suggestions in three areas where the potential for inappropriate pre-merger conduct occurs.

Due Diligence and Transition Planning While recognizing the need for merging parties to plan for the combined firm, Blumenthal noted that mere discussion might lead the merging firms to alter their conduct before closing the transaction in ways that might adversely affect competition. He suggested that in planning for certain post-merger activities involving sensitive areas, such as pricing and costs, the parties could use (i) lagged or aggregated information, (ii) "clean teams" to conduct the planning activity, e.g., personnel in a different line of business; or (iii) consulting and accounting firms that provide integration and planning service. But the parties may simply need to wait until after closing to do certain kinds of planning.

Planning for Post-Closing Matters Requiring Preliminary Pre-merger Implementation Blumenthal noted that there may be times when a party wants to take an action prior to closing, such as not proceeding with building a new plant, because the merger would render the action unnecessary or inefficient. He emphasized that there is no absolute prohibition on such conduct, but offered no bright line test to determine whether it would violate the antitrust laws. Rather, the agencies will undertake a fact-specific inquiry, asking whether the choice was made unilaterally (versus being imposed by the acquiring firm) and whether the decision is reversible if the merger does not close, and assessing the costs of deferring the project and the impact on the seller's future competitiveness. It is therefore critical that careful thought be given before modifying plans simply as a result of a pending merger and that antitrust counsel work with the

[4] William Blumenthal, "The Rhetoric of Gun-Jumping," Remarks before the Association of Corporate Counsel, Annual Antitrust Seminar of Greater New York Chapter: Key Developments in Antitrust for Corporate Counsel, November 10, 2005.

merging firm's businesspeople to determine the appropriateness of such conduct.

Joint Marketing Blumenthal was emphatic that it is not appropriate for the merging parties to coordinate on prices to be charged pre-closing or the allocation of accounts during that period. But his speech made clear that joint marketing *of the transaction*, such as by the placement of ads in the New York Times touting the benefits of the merger, did not raise gun-jumping concerns. Joint courtesy calls to customers to discuss the merger are also permissible so long as care is taken in the topics being discussed. Antitrust counsel should review the talking points to be used in such meetings to ensure that the courtesy call does not inappropriately stray into areas that raise gun-jumping concerns or collusion concerns under Section 1 of the Sherman Act.

CONCLUSION

The antitrust laws permit an acquiring company to ensure that it gets what it paid for through merger covenants requiring the acquired firm to operate in the ordinary course and to preserve the value of its assets. The antitrust laws also permit integration planning that will make the merged firm a more efficient competitor, so long as those planning activities do not reduce competition *before* closing. But if done improperly, these otherwise legitimate activities can cross the line into an antitrust violation—either the improper exercise of beneficial ownership prior to the expiration of the HSR waiting period or unlawful collusion under Section 1 prior to closing. Merging firms need to recognize the risks in their pre-closing activities and work with antitrust counsel to ensure that they stay on the right side of the line.

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