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Five Million Penalty is Stark Reminder About "Gun Jumping"

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On November 7, 2014, the Antitrust Division of the Department of Justice ("DOJ") announced that it had imposed a civil penalty of $3.8M and disgorgement of $1.15M in profits on Flakeboard America Limited (and its parent company) for "gun jumping," that is, assuming beneficial and operational control over the seller, in this case SierraPine, in violation of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR Act") and Section 1 of the Sherman Act. This case is notable because it marks the first "gun jumping" enforcement action in several years and the first time disgorgement has been obtained in the context of a gun jumping violation.[1] In addition, the asset purchase agreement ("APA") contained an unusual provision requiring the seller to shut one of its mill operations priorto closing. The case thus provided the DOJ with an opportunity to provide some basic guidance for the conduct of a buyer and seller prior to reaching a definitive agreement and, after a definitive agreement is reached, prior to closing a purchase or merger transaction.

HSR Act

The HSR Act requires parties to transactions meeting certain dollar thresholds to notify the antitrust enforcement agencies and observe a waiting period prior to closing. One purpose of the Act is to allow the competition agencies an opportunity to review the competitive effects of a transaction prior to its closing. Under the Act, the acquiring party may not take actual operational control or beneficial control over the target until the statutory waiting period expires or terminates. Moreover, even after the HSR waiting period expires, if the merging parties fail to operate as competitors, they may violate Section 1 of the Sherman Act,[2] proscribing unreasonable contracts in restraint of trade. In short, until closing, the parties to a transaction must remain independent competitors and the failure to do so is known as "gun jumping."

The APA

The *Flakeboard* Case arose out of Flakeboard's agreement to acquire from SierraPine, a competitor mill operator, two particleboard mills in Springfield, Oregon, and Martell, California, and a medium-density fiberboard mill in Medford, Oregon. Before negotiating the APA, SierraPine had no plans to shut down its Springfield mill. During negotiations, however, Flakeboard advised SierraPine that it would not operate Springfield after the transaction closed and insisted that SierraPine close the mill before the transaction was consummated. Accordingly, as part of the APA, SierraPine agreed to "take such actions as are reasonably necessary to shut down and close all business operations at its Springfield, Oregon facility" before the transaction closed.[3] However, the APA also provided that "in no event shall [SierraPine] be required to shut down or close its business operations at its Springfield, Oregon facility" until "[a]ny required waiting periods and approvals…under applicable Antitrust Law shall have expired or been terminated."[4] Thus, when the parties executed the APA, they anticipated that SierraPine would announce and implement the Springfield mill closure after the HSR waiting period expired but before the transaction was consummated.[5]

The transaction was subject to HSR review and the parties filed notification under the Act. The Antitrust Division of the DOJ subsequently issued a request for additional information and documentary material, commonly known as a Second Request. The transaction was later abandoned by the parties in response to competitive concerns raised by the DOJ.[6]

Unlawful Conduct

The Complaint alleges that instead of preserving SierraPine as an independent business, the parties prematurely coordinated their activities and operations. Specifically, rather than waiting until the HSR waiting period expired as the APA required, Flakeboard assumed operational control of SierraPine before the end of the HSR waiting period by entering into a series of agreements to close SierraPine's Springfield mill and move the mill's customers to Flakeboard.[7] Moreover, SierraPine did not compete for most of the Springfield customers from its remaining mill in Martell, California, but instead directed them to Flakeboard. [8] SierraPine further told its customers that Flakeboard would match its prices. Finally, SierraPine gave Flakeboard competitively sensitive information about its Springfield customers—including the name, contact information, and types and volume of products purchased by each of them. Flakeboard gave this information to its sales employees.[9] Thus, "[w]ith SierraPine's assistance, Flakeboard successfully secured a substantial amount of Springfield's business, including a significant number of new customers that Flakeboard had not previously served and additional business from customers that Springfield and Flakeboard's Albany mill both previously served. The increased sales volumes from SierraPine's Springfield customers significantly increased Flakeboard's profits."[10]

Disgorgement and Civil Penalty

The Proposed Final Judgment, which is a negotiated settlement, requires Flakeboard to disgorge the profits that it earned as a result of its unlawful agreement with SierraPine.[11] In its Competitive Impact Statement, the DOJ explained that disgorgement of profits was appropriate because it was impractical to reopen the mill, which had been closed for several months and all of its employees had either left the mill or had been terminated.[12] In addition, the DOJ believed that disgorgement would "deter Flakeboard and others from participating in anticompetitive conduct in the context of a pending transaction," including transactions not subject to the HSR notification thresholds.[13]

Disgorgement remedies the Sherman Act violation, but not the HSR Act violation. A person or entity that fails to comply with the HSR Act is also liable for a civil penalty of not more than $16,000 for each day that the person is in violation of the Act.[14] The Complaint alleged that the defendants were in violation of the HSR Act for 223 days, and therefore defendants could have received a fine of $3.568M. The DOJ agreed to a lower penalty because Flakeboard and SierraPine cooperated with the DOJ during its investigation.[15]

Key Lessons

While reaffirming much of the current M&A thinking and practice, the Proposed Final Judgment provides some key basic guidance in three areas: (a) investigatory due diligence; (b) appropriate business covenants in purchase agreements; and (c) plant closings and other pre-closing restructurings.[16]

A. Investigatory Due Diligence

The Proposed Final Judgment specifically allows the parties to engage in reasonable and customary due diligence relating to a pending transaction as long as such disclosures are:

- reasonably related to a party's understanding of future earnings and prospects;
- made pursuant to a non-disclosure agreement that limits use of the information to conducting due diligence in anticipation of the transaction, and
- not given to any employee of the receiving party who is *directly* responsible for the marketing, pricing, or sales of competing products.[17]

B. Appropriate Business Covenants in Purchase Agreement

The Proposed Final Judgment reaffirms that the typical pre-closing business conduct covenants do not raise HSR gun jumping or Sherman Act concerns. The agencies appreciate the need for such covenants to protect the benefit of the buyer's bargain. Accordingly, the Proposed Final Judgment includes provisions specifically permitting the following conduct:[18]

- Entering into an agreement that a party to a transaction must continue operating in the ordinary course of business;[19]
- Entering into an agreement that a party to a transaction forego conduct that would cause a material adverse change in the value of to-be-acquired assets;
- Disclosing confidential business information related to competing products, subject to a protective order, in the context of litigation or settlement discussions; or
- Entering into a vendor/vendee relationship with a potential merger partner during the pendency of the transaction.

C. Plant Closings and other Pre-closing Restructuring

There may be occasions when business needs and exigent circumstances require the parties to an agreement to restructure the acquired business prior to closing the transaction to protect against loss or disruption at a target business. In Competitive Impact Statement commenting on the Proposed Final Judgment section outlining prohibited conduct,[20] the DOJ obliquely states that this type of coordinated conduct, *e.g.*, "to close a production facility before a transaction is consummated, may be permissible under certain circumstances."[21] The CIS, however, does not specifically delineate the permissible circumstances.[22] In the context of a merger agreement, however, restructuring prior to closing at a minimum requires notification to the competition authorities. Thus, the Proposed Final Judgment provides that Flakeboard (and its parent company) in future transactions may not close "a Production Facility that produces a Competing Product *without prior written notice to and written approval* from the DOJ."[23]

Finally, the Proposed Final Judgment also reiterates that during the negotiation of an agreement and in the interim period before closing, the parties to a transaction may not fix prices or restrict output related to a competing product or allocate or move customers related to a competing product.

[1] In the HSR context, disgorgement as a remedy has also been used in a case where the parties failed to disclose required documents in an HSR filing for a transaction that was later found to be anticompetitive. See *United States v. The Hearst Trust and The Hearst Corporation*, 2001, http://www.justice.gov/atr/cases/f9200/9288.htm.

[2] 15 U.SD.C. §1.

[3] Competitive Impact Statement (N.D. Cal filed Nov. 7, 2014) ("CIS"), p. 4, http://www.justice.gov/atr/cases/f309700/309790.pdf.

[4] Complaint, *U.S. v. Flakeboard America Ltd.*, Case No. 3:14-cv-4949 (N.D. Cal. filed Nov.7, 2014), at ¶ 17, *available at* http://www.justice.gov/atr/cases/f309700/309788.pdf, ("Complaint").

[5] CIS at 4.

[6] CIS at 2.

[7] Complaint at ¶ 18.

[8] Id. ¶ 24

[9] CIS at 6.

[10] Complaint at ¶ 25.

[11] Proposed Final Judgment. (N.D. Cal. filed Nov. 7, 2014), at § VI, *available at* http://www.justice.gov/atr/cases/f309700/309796.pdf.

[12] CIS at 11.

[13] Id.

[14] *See* Section 7A(g)(1) of the Clayton Act, 15 U.S.C. § 18a(g)(1).

[15] CIS at 13-14.

[16] An important area not discussed in the Proposed Final Judgment (because it was outside the scope of the case) is pre-closing integration planning. The parties may engage in general planning for and exchange information reasonably related to "Day One" post-closing operations. Discussion of these matters and exchange of information should be solely for the purpose of planning for integration and should be limited to a small transition team and information about the other company should not be shared with personnel directly responsible for sales, marketing, or customer or supplier relationships.

[17] Proposed Final Judgment, at § VIII. Information exchanges reasonably necessary for post-merger integration are also permissible.

[18] Id. at § VIII.

[19] What is in the ordinary course depends on the facts. For example, APA provisions requiring buyer approval to enter into loans above a certain dollar value, long-term supply contracts, or certain marketing activities may constitute gun jumping. *See, e.g., United States v. Computer Associates Int'l Inc.*, 2002-2 Trade Cas. (CCH) ¶ 73,883, at 95,249 (D.D.C. 2002); United States v. Gemstar-TV Guide Int'l, Inc., 2003-2 Trade Cas. (CCH) ¶ 74,082 at 96,764 (D.C.C.2003); *United States v. Smithfield,* (E.D. Va. 2010), *available at* http://www.justice.gov/atr/cases/f206300/206374.htm.

[20] Proposed Final Judgment at §VII.

[21] CIS at 12. Of course, when restructuring is done unilaterally it likely would not raise meaningful concerns.

[22] The Complaint at ¶16 alleges that Flakeboard did not want to manage the shutdown and its parent company, Arauco, was concerned that its reputation might be harmed if it announced the closure. It is not immediately obvious that these are the types of circumstances that would provide a justification for this type of pre-closing conduct.

[23] Proposed Final Judgment at §VII.4.

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