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DOJ Alleges HSR Gun-Jumping When Seller Submits Multi-Year Procurement Contracts for Buyer's Approval

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Client Alert

On January 21, 2010, the U.S. Department of Justice's Antitrust Division and Smithfield Foods, Inc., entered into a settlement to resolve DOJ allegations that Smithfield engaged in "gun-jumping" in connection with Smithfield's 2007 acquisition of Premium Standard for $810 million.[1] DOJ had investigated the merger and concluded that it was not likely to harm competition.[2] Despite that approval, Smithfield agreed to pay a civil fine of $900,000 to resolve DOJ's gun-jumping allegations.

The *Smithfield* case is noteworthy because the gun-jumping allegations arose from conduct that may appear routine in the context of merger transactions: Pursuant to provisions in the parties' merger agreement aimed at protecting the buyer's interest in maintaining the seller's value, the seller submitted for the buyer's consent several multi-year procurement contracts calling for tens of millions of dollars in purchases. DOJ made no allegation that the seller declined to approve those contracts or that the approval process affected the content of the contracts in any way. Rather, DOJ alleged that Premium Standard's mere *submission* of the contracts for Smithfield's approval resulted in Smithfield exercising "operational control over a significant segment of Premium Standard's business prior to the expiration of the waiting period" in violation of Section 7A.

DOJ's action in *Smithfield* emphasizes that buyers cannot reliably protect themselves from gun-jumping concerns solely by limiting their right to consent to the seller's pre-closing activities to those activities that are "material" or may result in a "material adverse effect."[3] DOJ did not dispute that the contracts, which called for acquisitions totaling between $57 million and $67 million, were *material* to Premium Standard. DOJ's allegations instead focused on the fact that, in the context of Premium Standard's business, those transactions were entered into in the "ordinary course" of business. Indeed, in part *because* of the large size of the contracts, DOJ alleged that the contracts allowed Smithfield to exercise premature control over a "significant segment of Premium Standard's business."

The result in the *Smithfield* case does not prevent prudent buyers from protecting themselves against seller actions – including long-term procurement contracts – that would burden the buyer's business well beyond the consummation of the proposed transaction. The somewhat unusual factual context of the *Smithfield* case helps to explain why the Department objected to Premium Standard's submission of its procurement contracts for Smithfield's approval:

- Premium Standard's core business was the processing and packaging of pork, and in that context the contracts involved – for the procurement of hogs – were not unusual despite their long duration and dollar magnitude. DOJ could readily conclude that "in the ordinary course" Premium Standard needed to "continue to purchase hogs from independent hog producers;" and
- DOJ's antitrust investigation was itself focused on "*monopsony*" issues involving the parties' competition with one another in the purchase of hogs; as a result, hog procurement was a focus of the Second Request issued to the parties during the HSR waiting period, and DOJ undoubtedly viewed the submission of the hog procurement

contracts (including details concerning terms such as "the price to be paid, quantity to be purchased, and length") as raising a potential competitive issue.

Buyers seeking to protect themselves from adverse changes in the value of the seller's business should take the following steps in light of DOJ's enforcement action against Smithfield.

First, buyers may continue to assert the right to review and approve significant transactions that sellers propose to enter prior to closing, so long as those transactions would not be undertaken by the buyer in the "ordinary course" of its business.[4] Determining when a transaction would be entered in the "ordinary course" of the seller's business will typically require judgment informed by the factual context. For example, buyer review of transactions that would significantly alter the scope or focus of the seller's current or planned business typically would not raise significant gun-jumping concerns. Likewise, buyers may require consent for transactions of a duration or monetary value significantly in excess of the norm. On the other hand, a buyer's assertion of the right to review and approve the seller's routine ongoing competitive behavior – the pricing and negotiation of sales contracts, bids for key inputs, ongoing research and development activities, and the like – will raise potential gun-jumping concerns, and should be made only after consultation with antitrust counsel, especially if those very activities are under investigation by the reviewing agency.

Second, although *Smithfield* clouds the issue, buyers should have greater flexibility to require consent for large, ordinary-course transactions that are outside of the core competitive aspects of the seller's day-to-day business. A consent requirement applicable to large, multi-year procurements of commodities having no direct relationship to the seller's core business – e.g., office supplies or IT systems – seems less likely to be thought of by the enforcement agencies as giving the buyer control of a "significant segment" of the seller's business.

Third, as the Department's complaint against Smithfield acknowledges, buyers may negotiate and enforce a variety of other "customary" provisions limiting the seller's ability to undermine the expected value of the transaction, including:

- a general obligation requiring the seller to "carry on its business in the ordinary course consistent with past practice;"
- provisions limiting the buyer's rights to "assume new debt or financing, issue new voting securities and sell assets;" and
- a condition on closing that there has been no "material adverse effect" on the value of the buyer.

Footnotes

[1] DOJ alleged that Smithfield prematurely acquired "beneficial ownership" before the expiration of the HSR waiting period, in violation of Section 7A of the Clayton Act, 15 U.S.C. § 18a(g)(1); 16 C.F.R. § 800 et seq. In the *Smithfield* case the initial waiting period (of 30 days) was extended by DOJ's issuance of a Second Request until the parties substantially complied with that request for additional information. Gun-jumping concerns can also arise under Section 1 of the Sherman Act, when parties to a transaction coordinate their activities prior to closing.

[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 Farms Inc. (May 4, 2007)

[3] The Merger Agreement contained provisions requiring the buyer's consent for (a) asset acquisitions by the seller other than the acquisition of "inventory, raw materials or supplies, and other assets up to $2,000,000 in the aggregate, in the ordinary course of business consistent with past practices" and (b) "Material Contracts" (defined to include "contracts (other than purchase or sale orders in the ordinary course of business that are terminable or cancelable without penalty on 90 days' notice or less) under which the Company or any of its Subsidiaries is a purchaser or supplier of goods and services which, pursuant to the terms thereof, requires payments by the Company or any of its Subsidiaries in excess of $1,000,000 per annum") that would "be expected to have a Material Adverse Effect."

[4] Although DOJ's action in *Smithfield* suggests that transaction agreements should not require buyer consent for ordinary-course transactions, buyers should have greater flexibility to require *advance notice* of

significant proposed transactions so they may participate in determining whether the transaction would be undertaken in the ordinary course.