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New Guidance on Gun Jumping

DOJ Antitrust Division Settlement Clarifies the Risks of Pre-Closing Coordination, while Simultaneously Expanding the Reach of the Division's Disgorgement Remedy

By David L. Meyer

Just five weeks after the Antitrust Division of the U.S. Department of Justice announced that Flakeboard America had abandoned its plan to acquire a medium-density fiberboard (MDF) mill and two particleboard mills from SierraPine in the face of the Division's competitive concerns, the Division has settled separate gun-jumping and Section 1 claims against the same parties relating to their conduct during the course of the Division's review of the transaction.[1]

This enforcement action is a reminder that parties to mergers and acquisitions – whether or not reportable under the Hart-Scott-Rodino Act ("HSR Act") regime – need to exercise care both in structuring the terms of the transaction agreement that affect conduct prior to deal closing, and in their interactions with one another before the deal is closed or abandoned. The Division's settlement, however, provides some useful guidance on when deal terms and party interactions will (and will not) raise red flags, while simultaneously raising the specter of more frequent demands for disgorgement when lines are crossed.

KEY TAKE AWAYS

- When parties are competitors, agreements to implement desired plant closings and other business restructuring steps *before* the underlying transaction is closed run the risk of being treated as per se unlawful under Section 1 of the Sherman Act.
- While a deal is undergoing antitrust review under the HSR Act, coordination around competitive actions runs a high risk of being treated as unlawful gun jumping; the DOJ's consent decree here, however, makes clear that many customary covenants regarding pre-closing activities will not run that risk.
- The Division's demand for the disgorgement of over a million dollars in profits earned by the buyer as a result of the parties' alleged agreement to shift customers to the buyer prior to closing implies that the Division may seek disgorgement more often – perhaps whenever injunctive relief is unlikely to be effective in restoring the competitive status quo ante, and not solely when private damages claims are unavailable.

[1] *See* Division Press Release (Nov. 7, 2014), *available at* http://www.justice.gov/atr/public/press_releases/2014/309786.pdf; *see also* Complaint, *U.S. v. Flakeboard America Ltd.*, Case No. 3:14-cv-4949 (N.D. Cal filed Nov.7, 2014), *available at* http://www.justice.gov/atr/cases/f309700/309788.pdf, and Proposed Final Judgment (N.D. Cal. filed Nov. 7, 2014), *available at* http://www.justice.gov/atr/cases/f309700/309796.pdf.

THE FACTS

In January 2014, SierraPine reached an agreement to sell one MDF mill and two particleboard mills to Flakeboard, which operated competing MDF and particleboard mills. The transaction required notification under the HSR Act. Flakeboard planned to close one of SierraPine's two particleboard mills – located in Springfield, Oregon – but wanted the mill's closing to occur before it took ownership of the SierraPine assets. The transaction agreement therefore specified that SierraPine would close the mill before closing but after the expiration of the HSR waiting period.

That plan changed within days of the deal's announcement, however, when SierraPine determined that a labor issue at the Springfield mill would require either keeping the mill open or announcing its closure before the HSR waiting period would expire. SierraPine consulted Flakeboard, and the parties (allegedly) reached an understanding that (a) SierraPine would announce the closure of the mill promptly (during the HSR waiting period) and proceed to close the mill within weeks of that announcement; and (b) even before that announcement the parties would begin to cooperate in securing a transition of Springfield mill customers to Flakeboard's competing particleboard mill in Albany, Oregon.

Meanwhile, the Division's antitrust review of the overall transaction proceeded apace. An HSR notification was filed on January 22, and the Division issued a Second Request seeking additional information (likely focused on issues raised by the parties' competing MDF operations). The parties complied with the Second Request on July 28, and the HSR waiting period accordingly expired on August 27. The Division continued to have concerns about the impact of the deal for the production of MDF sold to West Coast customers, and the parties ended up abandoning their deal on September 30, 2014.[2] The deal's death came more than six months after SierraPine had completed the shut-down of the Springfield mill, and after SierraPine and Flakeboard had already undertaken to transition that mill's customers to Flakeboard. The Division's Section 1 and gun-jumping complaint followed five weeks after the deal had been abandoned.

THE DIVISION'S COMPLAINT AND CONSENT DECREE

The Division viewed SierraPine and Flakeboard's conduct as illegal for two independent reasons. First, it violated Section 1 of the Sherman Act, because SierraPine and Flakeboard remained competitors until the transaction closed, and their agreement to shut down SierraPine's mill and move its customers to Flakeboard therefore was viewed as a per se unlawful output reduction and customer allocation. The Division regarded these steps as not being reasonably necessary to carry out their asset purchase agreement or any other lawful collaboration, since they were undertaken "without any assurance that their transaction would be consummated."[3]

Second, the conduct was illegal gun-jumping under the HSR Act (Clayton Act, Section 7A) because, before the waiting period expired, Flakeboard exercised operational control of SierraPine's business when it coordinated with SierraPine on the closing of the Springfield mill and the move of customers to Flakeboard.

The parties resolved the Division's claims via a consent decree that requires each of them to pay $1.9 million

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[2] *See* Division Press Release (Oct. 1, 2014), *available at* http://www.justice.gov/atr/public/press_releases/2014/309005.pdf.

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

each in HSR penalties; imposes behavioral injunctions designed to prohibit inappropriate coordination in future transactions, whether or not HSR-reportable; and requires Flakeboard to disgorge $1.15 million in profits it earned during the six months leading up to the settlement from the customers that were illegally shifted to Flakeboard's mill.[4] The Division *did not* require that the SierraPine mill be reopened – the Division viewed doing so as impractical — and the consent decree also did nothing to prevent Flakeboard from retaining (and continuing to earn profits from) all of its newly-obtained customers.

THE IMPLICATIONS

Flakeboard/SierraPine is yet another in a long line of reminders that the antitrust agencies will be on the lookout for inappropriate coordination that takes place during the HSR merger review process. The Division's action in this case is particularly noteworthy for at least three reasons:

Section 1 Risks. First, the action underscores that when the buyer and seller are competitors, the Division will continue to view the parties as capable of engaging in *per se unlawful* horizontal agreements, notwithstanding the pendency of the transaction. This risk can arise in any deal, including when no HSR notification is required. Just as parties to a deal cannot fix prices with one another before the deal closes, so they may not agree to reduce capacity or output, or to allocate customers, at least unless and until the transaction has progressed to the point where those steps are part and parcel of carrying out the parties' underlying transaction.

Two factors likely strengthened the Division's resolve to view the mill closing and customer shift as insufficiently tethered to the underlying asset sale to avoid per se condemnation: (a) the fact that it took place so many months before the deal could have closed, given the pendency of the Division's Second Request investigation; and (b) the uncertainty whether it would close at all, given the deal's substantive antitrust concerns, as driven home by the deal's ultimate abandonment.

On the other hand, the Division's analysis does not preclude parties from undertaking needed restructuring or rationalization of their business during the pendency of merger review. Had SierraPine made a *purely unilateral* decision to close its Springfield mill – exercising flexibility it had negotiated up-front in the transaction agreement – that step should not have raised Section 1 concerns. Likewise, if parties agree *as part of their transaction* that certain steps will take place, there should normally be flexibility to have such steps taken by one party prior to closing, as evidenced by the Division's apparent lack of concern about the transaction agreement's stipulation that SierraPine would close its mill in the interval between HSR expiration and the deal's consummation.[5] Though the Division's ability to assess whether the planned mill closure would be anticompetitive as part of its review of the overall transaction surely influenced the Division's perspective,[6] pre-closing steps that appear disconnected from an overall deal will face high risks even if the Division is otherwise informed of them. The degree of risk will

[4] The HSR penalties were a compromise of the statutory maximum penalty of $3.568 million for the 223 days (at $16,000/day) between the time the parties began to coordinate regarding the closure of the Springfield mill and the expiration of the HSR waiting period. *See* CIS, pp. 13-14.

[5] The Division's CIS stated explicitly that "an agreement to close a production facility before a transaction is consummated may be permissible under certain circumstances." CIS, p. 12.

[6] As one illustration, the Division's Consent Decree prohibits Flakeboard and SierraPine from entering into agreements involving facility closings prior to consummation absent the Division's prior approval. *See* Proposed Final Judgment, Para VII.A.4; CIS, p. 12.

depend entirely on the facts, especially the scope of the underlying agreement and the relationship between the deal rationale and the nature of the agreed pre-closing conduct.

HSR Gun-Jumping Risks. Second, Flakeboard/SierraPine provides some further clarity as to the lines the Division will draw in assessing whether pre-closing coordination rises to the level of impermissible gun-jumping. Section 7A, of course, applies whether or not the parties are competitors, and precludes the buyer from exercising beneficial ownership or control of the seller's business prior to the expiration of the statutory waiting period. The Division's consent decree carves out for the parties several safe harbors for customary deal terms and due diligence processes, and those same categories of conduct should generally pose little risk for other transaction parties. Among the categories of permissible conduct:[7]

- Due diligence disclosures "reasonably related to a party's understanding of future earnings and prospects" undertaken pursuant to an appropriate non-disclosure agreement that, inter alia, prohibits access to competitively sensitive information by employees who are "directly responsible for the marketing, pricing, or sales" of competing products;[8]
- Covenants requiring the seller's business to be operated in the ordinary course of business;
- Covenants requiring the seller to avoid conduct that would cause a material adverse change in the transaction value; and
- Entry into buyer-seller agreements that would be lawful in the absence of the planned acquisition.

Pre-closing coordination of competitive conduct, by contrast, will almost always fall on the other side of the legal line. In this light, the Division's conclusion that Flakeboard jumped the gun when it insisted that the Springfield mill be shut down prior to the expiration of the waiting period, and its demand for cooperation in shifting the mill's customers to Flakeboard's Albany mill, should not be seen as controversial. Decisions about capacity reductions, output levels, and marketing activities are very likely to be regarded as "ordinary course" conduct even when they might be material to the seller's business and the value of the assets being acquired.[9]

Disgorgement. Finally, the Division's settlement here marks an expansion of the circumstances under which the Division will demand disgorgement. The Division pioneered use of that remedial tool in the 2006 *Keyspan* case. There, the Division emphasized that it would not routinely seek disgorgement, but would do so when other remedies were ineffective. That was the case in *Keyspan* because the unlawful conduct had ceased *and* the filed-rate doctrine likely would have precluded injured consumers from recovering damages.[10] Only the first of

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[7] Proposed Final Judgment, § VIII.

[8] *Id.*, § VIII(C). This carve-out does not represent an exhaustive list of the types of information sharing that can be undertaken without meaningful gun-jumping risk. For example, pre-closing activities related to the planning of post-closing integration and merger implementation are generally permissible so long as they are structured appropriately.

[9] As the Division's enforcement action in *Smithfield* shows, the buyer's right of approval over large, multi-year contracts can trigger gun-jumping concerns because, even though material, they are entered into in the ordinary course. *See* Morrison & Foerster client alert, "DOJ Alleges HSR Gun-Jumping When Seller Submits Multi-Year Procurement Contracts for Buyer's Approval" by David Meyer (Jan. 21, 2010), *available at* http://www.mofo.com/resources/publications/2010/01/doj-alleges-hsr-gun_jumping-when-seller-submits-__.

[10] *See* Plaintiff United States' Response to Public Comments, *U.S. v. Keyspan Corp.*, Civ. Action No: 1:10-cv-01415-WHP (S.D.N.Y. filed June 11, 2010), p. 15 ("[A]bsent disgorgement, KeySpan likely would retain all the benefits of its anticompetitive conduct because the filed rate

these factors was arguably present in Flakeboard/SierraPine; the plant was closed and the customers shifted, and the Division did not view a restoration of the *status quo ante* via injunctive relief as practical. But the Division did not make any public statement suggesting that private damages relief would be unavailable here, as the Division perceived it to be in *Keyspan*.[11] It is possible that the Division reached a somewhat different conclusion – that private claims would be unlikely given that the closing of the Springfield particleboard plant did not actually harm competition. The Division did not view the underlying transaction as anticompetitive with respect to particleboard, and likely saw continued competition in that market (despite the illegal closing and customer shift) as disciplining Flakebaord's conduct vis-à-vis its newly acquired customers.[12] Unfortunately, though, if the only predicate for disgorgement is the absence of ongoing conduct to enjoin – without any special circumstances precluding private damages claims – we might expect to see the Division seeking this remedy with increasing frequency.

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doctrine creates significant obstacles to the collection of damages."), *available at* http://www.justice.gov/atr/cases/f259700/259704.pdf. In fact, the Division's view turned out to be correct. *Simon v. Keyspan Corp.*, 694 F.3d 196 (2d Cir. 2012) (holding private damages claims barred by filed rate doctrine).

[11] *See* CIS, pp. 10-11.

[12] The Division explained that it had expressed concerns about the impact of the deal in the MDF market, not the particleboard market. *See* Division Press Release (Oct. 1, 2014), *available at* http://www.justice.gov/atr/public/press_releases/2014/309005.pdf.