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Avoid Antitrust Nightmares: Gun Jumping and M&A Due Diligence that Cross the Line

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ABOUT THIS WHITE PAPER:

The purpose of this paper is to help you avoid antitrust issues by answering these four questions:

- How can you distinguish between proper pre-merger conduct and gun jumping?
- What pre-closing approvals are allowed by the acquiring company?
- What sensitive information can and can't be exchanged?
- What types of pre-closing considerations are appropriate and which are problematic?

There are no bright line tests for these. However, there are plenty of best practices you may follow and questions you can address to help you avoid triggering a costly antitrust investigation.

Mergers and acquisitions are a time of great excitement for the companies involved. Each side is anticipating the "1 + 1 = 3" scenario. Sometimes, in their haste to help this materialize, businesses can run afoul of antitrust regulations before a deal closes.

This can happen unintentionally, because there are few "bright lines" that distinguish proper from improper actions. General counsels or investment bankers often aren't steeped in the nuances of antitrust laws, because this isn't their specialty. The resulting fines and damages—whether or not an agreement actually closes—can be far-reaching and punitive.

It helps to understand the antitrust law involved. This clarifies which provisions in merger agreements are customary versus those the courts have ruled unacceptable. It also helps to identify which types of pre-closing considerations are proper and those that cross the line. Finally, knowing the law will explain why the disclosure of certain kinds of confidential information during due diligence can be problematic.

Gun Jumping and the Acts that Determine It

Gun jumping is improper coordination between firms *before* they merge. Determining if these situations have occurred comes under the purview of the Department of Justice (DOJ) and the Federal Trade Commission (FTC).

Clayton Act, Section 7A is commonly known as the Hart-Scott-Rodino Antitrust Improvements Act (HSR).This requires that companies 1) provide a detailed filing to the DOJ and FTC, and 2) wait for those agencies to determine if the merger will adversely affect U.S. commerce under antitrust rules. If companies take actions that indicate they transferred beneficial ownership *before the waiting period ends*, they have violated the Act. The fine for violating HSR is $16,000 a day.

Sherman Act, Section 1 deals with companies that serve overlapping markets. If these firms' actions result in an unreasonable restraint of trade *before a merger closes*—when they are still technically competitors—they have violated this Act. The Act applies even if the transaction does not have to be reported under HSR. And the Act may continue to apply if 1) an agency has completed its HSR analysis and ended its investigation, or 2) the merger is blocked.

A Platinum Example

Sometimes a tale of what *not* to do can be the best teacher. That's the case with the 1999 Computer Associates (CA) acquisition of Platinum Technology.

CA developed, marketed and supported software products—including systems management software—for a variety of computers and operating systems. Platinum sold mainframe systems management software products. The companies competed in a number of areas.

In March 1999, CA and Platinum announced a merger agreement and filed a Hart-Scott-Rodino (HSR) notification. The Department of Justice (DOJ) opened an investigation and ultimately found the proposed merger would eliminate competition in five markets. In May, the DOJ filed a complaint attacking the merger and filed a proposed final judgment requiring the combined company sell some of its assets.

In September 2001, the DOJ filed suit against CA and Platinum for gun jumping, alleging they had violated the Sherman and Clayton Acts. The final judgment from the District Court fined CA and Platinum $638,000 in civil penalties. It also prohibited CA from certain conduct with future merger partners for 10 years. In addition, the DOJ was allowed to inspect records and interview employees during those 10 years. CA also was required to establish a compliance program.

Here's what the companies did—and didn't do—that led to this adverse ruling.

Customary Terms

The merger agreement contained common merger provisions that required Platinum to run its business as it ordinarily would. This meant that Platinum *couldn't* do any of the following *without* CA's approval:

- Declare or pay dividends or stock distributions
- Issue, sell, pledge or encumber its securities
- Amend its organizational documents
- Agree to acquire other businesses
- Mortgage or encumber its intellectual property or other material assets outside of the ordinary course of business
- Make large new capital expenditures
- Make material tax elections or compromise tax liabilities
- Pay, discharge or satisfy any unusual claims or liabilities
- Start lawsuits other than routine collection of bills

The District Court noted that these provisions limited Platinum's ability to make business decisions without CA's consent. However, the court ruled that these were standard requests. They reflected the underlying goal to prevent Platinum from doing anything that seriously impaired the company's value before the acquisition. As a result, these provisions *didn't* violate the antitrust laws.

Gun Jumping
On the other hand, the court found stipulations in the merger agreement that 1) created a situation where these two competitors were colluding, and 2) imposed extraordinary conduct-of-business limitations on Platinum. This enabled CA to control Platinum's operations and affect an improper transfer of beneficial control *before the deal closed* and also *before the mandatory waiting period* under HSR. For example, the agreement stated Platinum couldn't take any of these actions without CA's approval:

- Enter into any agreement to provide services for more than 30 days at a fixed or capped price
- Enter into customer sale or license agreements with non-standard terms
- Enter into a sale or license agreement offering discounts of more than 20 percent

In addition, the merger agreement changed Platinum's ordinary procedures for approving customer contracts. The court noted that the agreement to limit Platinum's right to independently set its prices was extraordinary and not reasonably related to any legitimate goal of the transaction. These actions were unlawful and qualified as gun jumping.

Exchanging Sensitive Information
The court also found two restraints that further compounded the issue. CA entered into consulting and non-compete agreements with Platinum's CEO, COO and CFO—making them personally liable if the company failed to comply. And, Platinum's sales representatives were told there could be no fixed price contracts without CA's approval—even for sales agreements under the 30-day limit. These provisions resulted in the following actions:

- A database was created that tracked the pre-approval process
- This database contained competitively sensitive data
- CA had access to the database—and no limits were placed on who at CA could see this information
- CA was able to change Platinum's method of booking revenue and reverse previously recognized revenues for customer contracts
- CA cancelled Platinum's participation in a trade show, where the company would have presented products and sought future business

The final judgment on the CA case also has some general implications on pre-closing coordination. These are worth noting for other M&A situations. It stated that the acquirer couldn't enter into an agreement that establishes any price or discount of the other party. And, neither party can grant the right to negotiate, approve or reject any bid or customer contract for the other operation.

In addition, neither company can be required to provide the other with bid information. However, if the companies are competitors, either one may get bid information during the due diligence process as part of understanding the future earnings and prospects for the potential partner. But this is only available under a non-disclosure agreement. As a result, no employees who are directly involved in marketing, pricing or selling a product or service will be able to see this information before a merger closes.

Useful Questions from the FTC

In public presentations, Federal Trade Commission officials have identified a number of questions the organization uses when reviewing situations for gun jumping and exchanging sensitive information:

- Is the information shared and the transition planning done necessary for the merger's success?
- What planning is best postponed until after the merger closes?
- Has access to confidential information been limited to the deal team?
- Has the buyer isolated the seller's marketing and sales information from its personnel in charge of these functions—and vice versa?
- Has the sales and marketing information given to the planning team been historical and aggregated?
- Were any capital spending decisions stopped or postponed until after the merger and under what circumstances?
- Who made the decision not to proceed with a project or retain certain key people?
- To what degree will the seller's competitiveness be harmed if the deal does not close?
- How would the overall level of competitiveness in the market be harmed by the merger?
- To what extent would the merger represent a material change in the seller's operations?
- Was there any coordination on prices to customers before the deal closed?
- Did the allocation of accounts (such as revenues) change during the interim period?
- Did the companies distinguish between joint marketing of competing products and joint marketing of the transaction?
- Did the buyer redirect any of the seller's advertising or dictate the context of the seller's ads for competing products?

Overarching Tests from the Sherman and HSR Acts

Gun jumping becomes more of a concern when the merging companies are horizontal competitors. From an antitrust perspective, the issue is collusion—without any reasonable justifications that this will improve competition in the market. When considering a business combination, it's useful to answer the overarching questions raised by both acts.

The Sherman Act is concerned with coordination and exchange of data *before* the deal closes. It focuses on information that may have an anti-competitive effect without plausible pro-competitive justifications. DOJ or Federal Trade Commission (FTC) investigations under this Act aim to determine if the data shared was *necessary* for an effective merger, or if it facilitates collusion. The Act also focuses on the idea that information must be shared in the least anti-competitive manner. In examining how this happens, the Act looks for the balance between potential adverse effects versus the justifications. It also takes into account whether there were alternative ways to accomplish these objectives.

The overarching test under the HSR Act deals with ensuring merging firms don't effectively transfer beneficial ownership until the waiting period is over. Its examination rests on how much pre-merger coordination and planning amounts to an effective transfer of beneficial ownership before the end of the prescribed waiting period under the Act.

The FTC on Successful M&As

Successful mergers require more than provisions to protect value or permit due diligence. Pre-consummation planning is clearly required. The government antitrust enforcement agencies recognize this. A 2003 FTC survey[1] identified these five points to factor into this process:

- "Early planning for the integration of the new physical and human assets improves the chances of success."
- "Fast-paced integration and early pursuit of available cost-savings improves outcomes."
- "Managers must be cognizant of cultural differences between organizations and avoid conflicts, in part, via frequent, tailored communication with employees, customers and stakeholders."
- "Particularly in mergers involving technology and human capital, managers must retain the talent that resides in the acquired firm."
- "Customer and sales force attrition must be minimized."

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[1] Pautler, Paul. "The Effects of Mergers and Post-Merger Integration: A Review of Business Consulting Literature." Presented at Federal Trade Commission/Department of Justice Workshop: Understanding Mergers: Strategy and Planning, Implementation and Outcomes. January 2003.

What This Means for Your Merger

Here's the bad news. The CA and Platinum case—along with many others—as well as the two Acts don't really give us specific lines not to cross. However, we're still able to draw a number of conclusions and recommendations.

Use Provisions that Protect the Seller and Buyer

The provisions in the agreement must clearly allow the company being acquired to do business in substantially the same way it did before the merger.

However, to protect the buyer, the seller can't take any actions that would cause a material drop in its value. For example, the company being acquired can't offer or enter into contracts that grant enhanced rights or refunds to anyone if control of the company changes. In addition, it's customary to have the buyer give prior approval to any of these actions from the seller:

- Declare or pay dividends or distributions of stock
- Issue, sell, pledge or encumber securities
- Amend organizational documents
- Agree to acquire other businesses
- Mortgage or encumber its intellectual property or other material assets outside of the ordinary course of business
- Agree to make large new capital expenditures
- Make material tax elections or compromise tax liabilities
- Pay, discharge or satisfy any claims or liabilities outside of the usual course of business
- Initiate lawsuits other than routine collection of bills

Be Mindful of Giving Information to Operational Decision Makers

If the two companies have been competitors, they must not exchange proprietary information about operations, customers or sales—unless it's done in a way that minimizes antitrust risk. This can be difficult if the people who are responsible for these areas are part of the team evaluating the deal.

A recent final judgment in a gun jumping case prosecuted by the DOJ sets forth these guidelines for an acceptable exchange of information during due diligence:

- The information is reasonably related to a party's understanding of future earnings and prospects
- The information is shared under a non-disclosure agreement that 1) limits the use of the information to conducting due diligence, and 2) prohibits disclosure of the information to any employee of a party receiving the information that is directly responsible for the marketing, pricing or sales of competing products for the merging companies

In the case of information exchanged during due diligence or pre-closing planning, consider the ancillary restraints doctrine in Antitrust Guidelines for Collaborations Among Competitors as your guideline. This is used by the DOJ and the FTC as a valuable analytical tool. Use these questions as a guideline—because they will be evaluated in any investigation:

Collusion Can Be Costly

When does a merger valued at $107 million 1) cost an acquirer almost $5 million more, and 2) impose government supervision for 10 years on executives? When the DOJ proves there was collusion between companies before a deal closed.

Flakeboard America was acquiring SierraPine. It determined one of SierraPine's plants should be closed. Instead of waiting until after the merger was completed or the HSR waiting period expired, the companies jointly announced the closing.

They also agreed that business from this plant would move to a nearby Flakeboard facility. SierraPine gave Flakeboard competitively sensitive information, such as prices and volumes of products purchased by customers. This was provided to Flakeboard's salesforce. And SierraPine's salespeople were told to refer their clients to Flakeboard, which would match the prices they were receiving today. That increased Flakeboard's sales and profits before the deal closed.

As a result, Flakeboard was fined $3.8 million and required to give back $1.15 million in profits—more than 4.6 percent of the transaction price. In addition, every year for the next 10 years, Flakeboard management must annually certify with the government that they haven't violated the final judgment. They also must suffer the embarrassment of sharing a copy of this judgment with any company considering an M&A with Flakeboard.

- Is the conduct ancillary to an otherwise pro-competitive collaboration?
- Is the information exchange necessary?
- Is the conduct the least restrictive means to accomplish the purpose?
- Is the involvement of key decision-makers necessary to make the pre-consummation planning successful and increase efficiencies from the merger sooner?
- Is the involvement limited so the least restrictive alternatives are used to achieve the efficiencies sought?

Take steps that will support the argument that you are using the least restrictive alternative. This begins with a well-constructed confidentiality agreement. First, it should specify that access to competitive data is available only to employees who are involved in analyzing the merger or doing pre-consummation planning. Second, whenever possible, sensitive data must be historic versus current, and aggregated rather than separated by line of business or operation.

You also may have to make personnel announcements before the merger closes. To avoid any issues, consider this approach. Make a record that shows these changes are absolutely necessary to protect the value of the operation's human capital. You may want to seek clearance from the FTC's HSR staff. Make it clear that these actions are geared toward preserving value rather than interfering with the soon-to-be-acquired company's business.

Protect the Value While Limiting Risks

You're doing a merger or acquisition to create financial or strategic value. The last thing you need is to turn a successful combination into an antitrust nightmare, where you are charged with gun jumping or exchanging sensitive information that stifles a competitive marketplace.

Whether this is your first deal or your 20th, chances are that M&A is not your primary responsibility. That means you may inadvertently miss a step that would keep you out of trouble, or take an action that becomes a problem. The best way to prevent this is to work with attorneys who specialize in antitrust regulations.

Good legal partners understand how to avoid problems. The best ones also offer insights into how you can better structure the agreement. That means they may help you lay the groundwork for the "1 + 1 = 3" outcome, increasing the chances this will happen when the merger is completed.

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