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'Gun-jumping': what are the standards governing pre-consummation activities?

With what is permissible conduct prior to completion of a transactions increasingly unclear, even 'routine' pre-merger activity may attract the unwelcome attention of the antitrust authorities. ***Joseph G Krauss***, partner of Hogan & Hartson, LLP, Washington, DC explains why companies need to be cautious

The Hart-Scott-Rodino Antitrust Improvements Act of 1976 as amended ('the HSR Act' or 'the Act') was intended to provide the US antitrust agencies with an opportunity to review mergers before they occur and to provide the business community with a 'bright-line' rule – consummation of a reportable transaction before the expiration of the HSR waiting period is prohibited. But the interpretations of what is or is not permissible conduct prior to consummation (what has come to be referred to as 'gun-jumping') have, over time, begun to blur this line. Historically, the agencies challenged activities that amounted to an actual or de facto acquisition of the target firm before the expiration of the applicable waiting period. But over the years the Act has been used to prohibit conduct that falls short of an actual acquisition. Most recently, the prosecutions by the Department of Justice (DoJ) against Input/Output and Computer Associates have called into question certain activities that many companies often undertake as part of routine transition planning or due diligence. These cases raise significant issues of what conduct is covered by the HSR Act's gun-jumping prohibitions. Put simply, they demonstrate a need for clearly articulated guidance from the agencies concerning what are permissible pre-consummation activities between merging companies. In the meantime, companies need to be extremely cautious in their transition planning activities and be mindful that 'government eyes' will be watching these pre-consummation activities closely.

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A company's need for due diligence and transition planning

The exchange of information and other cooperative efforts between merging companies are critical elements of a successful merger. This is true from the time merging companies engage in preliminary discussions to the time they consummate the transaction. No company should be expected to acquire another entity without information sufficient to analyse and value adequately the transaction. Due diligence minimises the risk of unfavourable surprises. Similarly, routine transition planning ensures as seamless a transition as possible once the transaction is consummated. Furthermore, acquisition agreements between companies often seek to ensure that the acquired company's value remains intact during the pre-merger stage. Yet, the DoJ's complaints against Input/Output ('I/O') and Computer Associates, Inc ('CA') reveals that certain transition planning activities that some companies may have thought to be 'routine' may be considered to be violations of the HSR Act by the enforcement agencies.

The *Input/Output* case

In September of 1998, I/O, a manufacturer of seismic data acquisition systems, and DigiCOURSE, the sole manufacturer of cable positioning systems that are integral to the effective operation of ocean seismic data acquisition systems, agreed to merge. Consistent with the requirements of the HSR Act, both companies notified the DoJ and the Federal Trade Commission (FTC) of the impending transaction. During the government's review of the merger, the companies took steps that were later argued to violate the HSR Act.

The DoJ, at the request of the FTC, filed a civil suit against the companies, claiming that their activities amounted to premature consummation. Particularly, the government alleged that the following conduct, which occurred pre-closing, constituted HSR violations: (i) the circulation of an internal memorandum that announced the reorganisation of the company and assignments to positions within the merged company; (ii) the transfer of personnel from one company to the other prior to the merger; and (iii) the consultation between executives of the two

companies regarding possible acquisitions being considered by one company prior to the merger. I/O settled the government's charges by agreeing to pay a civil penalty of US$450,000.

The *Computer Associates* case

In March of 1999, CA announced a US$3.5 billion cash tender offer for Platinum Technology, Inc ('Platinum'), its competitor in numerous software markets. Both companies filed their HSR notification forms with the antitrust agencies. Similar to I/O and DigiCOURSE, the companies engaged in what they thought at the time to be routine pre-merger due diligence and planning activities. The merger was ultimately allowed to proceed, subject to certain agreed to divestitures.

Two years later, however, the DoJ filed a lawsuit alleging that certain of CA and Platinum's pre-merger cooperation violated the HSR Act. First, the government claimed that certain provisions of the companies' merger agreement impermissibly prevented Platinum from engaging in particular competitive activities during the HSR waiting period. The provisions at issue required that Platinum obtain CA's approval if it wanted to: a) offer discounts greater than 20 per cent off list price, b) vary the terms of customer contracts from their agreed-upon standard contract, c) offer computer consulting services over 30 days at a fixed price, or d) enter into contracts that provided year 2000 remediation services. Second, the government argued that CA violated the HSR Act because it had reviewed sensitive information regarding Platinum's customers and influenced the company's business strategy. Specifically, the government claimed that CA was not entitled to: a) information regarding the identity of Platinum's prospective customers and the specific price, discounts and contract terms offered to each customer, and b) make day-to-day management decisions regarding revenue recognition policies.

The legal basis for challenging pre-consummation activities

There are two grounds under which pre-consummation activities can be challenged: (i) under the HSR Act as a premature transfer of ownership, and/or (ii) under the Sherman Act as unlawful coordination between two independent competitors. Under the HSR Act, the test for what constitutes a premature transfer of ownership is unclear and the agencies have provided very little guidance to the business community to date. The agencies have premised alleged HSR violations on the concept that the challenged activities constituted a transfer of 'beneficial ownership'. The agency has provided examples of activities that would constitute beneficial ownership, but no authority even identifies all the indicia of beneficial ownership, much less explains how to balance such indicia. As a result, the only guidance on what constitutes the transfer of beneficial ownership is found in consent orders after the fact. Such a 'I know it when I see it' test is unfair and imposes enormous burdens and risks on merging parties.

The government's basis for its challenges against I/O and CA, illustrates this point. The FTC reasoned that I/O attempted to 'control' DigiCOURSE's operations prematurely, which would have precluded the government from obtaining effective relief if any antitrust problems had been found. Likewise, in its complaint against CA, the DoJ claimed that the merger agreement transferred to CA control of Platinum's essential competitive assets – the right to independently set prices and other conditions of sale, and the right to decide whether or not to approve contracts proffered by the Platinum sales force – before expiration of the mandatory HSR waiting period. In addition, CA exercised control over Platinum by reviewing Platinum's competitively sensitive business information and by making numerous day-to-day management decisions.

The DoJ argued that these activities amounted to "unlawful control" under the Act. But while the Act's legislative history makes clear that its purpose is to temporarily halt transactions until the government has reviewed them, the statutory language explicitly prohibits only the actual acquisition of securities or assets during the waiting period. It does not explicitly prohibit the exercise of "control" over the target assets. "Control" for these purposes is neither defined in the Act nor in the regulations. Furthermore, the legislative history does not plainly suggest that Congress intended to make such pre-merger activities illegal.

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The language of the HSR Act is uncomplicated: the Act does not allow a person to "acquire, directly or indirectly, any voting securities or assets of any other person" until the necessary requirements have been met. The scope of business activities and pre-merger coordination regulated by the Act, however, is far from clear.

First, Congress did not define the term "acquire". Instead, it gave the FTC, with the concurrence of the DoJ, the authority to "define the terms as used" in the Act and to "prescribe other such rules as may be necessary and appropriate to carry out the [Act's] purposes". Unfortunately, the FTC has avoided defining the term "acquire". Rather, FTC regulations address "acquire" by providing examples of the types of transactions that are "acquisitions" within the meaning of the Act. The FTC has instead focused on defining "acquiring persons" and "acquired persons." The FTC defines "acquiring person" as "[a]ny person which, as a result of an acqui-

sition, will hold voting securities or assets, either directly or indirectly, or through fiduciaries, agents, or other entities acting on behalf of such a person". FTC regulations then define "hold" to mean "beneficial ownership, whether direct, or indirect, or through fiduciaries, agents, controlled entities or other means". Although seemingly innocuous, herein lies the potential hazard: "beneficial ownership" is not defined in the rules nor is it a term found in the HSR Act. Instead, the only definition is found in the preamble to the HSR rules (the Statement of Basis and Purpose) where various "indicia of ownership" are set out that focus on the transfer of risk of loss or right to gains or the exercise of actual voting rights.

Unfortunately, no court has had the opportunity to address these issues (*CA* was settled before trial). Because the antitrust agencies have not provided definitive guidance on the characteristics of "beneficial ownership" that give rise to violations of the HSR Act, companies may unknowingly 'hold' assets or voting securities according to the antitrust agencies through seemingly innocent pre-merger activities.

Until further guidance is forthcoming, companies need to be more cautious in their due diligence and transition planning activities and should consult antitrust counsel regularly throughout the process

Application of these principles

Historically, HSR violation cases challenged the actual acquisition of securities or assets. In 1984, for example, Coastal Corp ('Coastal') purchased voting securities of Houston Natural Gas Corporation ('HNG') without first reporting the acquisition under the HSR Act. Similarly, in 1986, the government found that Weeks Petroleum Ltd violated the HSR by failing to notify the government prior to acquiring Asarco stock. The government moved away from challenging actual acquisitions for the first time in 1994 when it challenged a purchase agreement between Titan Wheel International, Inc ('Titan') and Pirelli Armstrong Tire Corporation ('Pirelli') that gave Titan the right to negotiate a labour contract applicable to Pirelli's Des Moines plant prior to the end of the HSR waiting period. There, the agency alleged that participation in contractual negotiations amounted to operation of the assets prior to expiration of the HSR period.

The *I/O* and *CA* cases, however, extended this argument further than before. The alleged violations in both cases did not involve the actual transfer of securities or assets. Instead, in both cases, the government arguments centered on "control".

In the *I/O* case, the government claimed that the company had attempted to "control" DigiCOURSE's operations. Admittedly, the transfer of individuals from DigiCOURSE's sales office to I/O's office hints at integration that Congress had intended to prevent. The dissemination of an internal memorandum discussing the leadership of the new company, however, seems to amount to no more than the usual transition planning.

In the CA case, the government argued that CA had impermissibly acquired "control" of "essential competitive assets – the right to independently set prices and other conditions of sale, and the right to decide whether or not to approve contracts proferred by the Platinum sales force". Additionally, the government claimed that CA could not review certain information pertaining to Platinum's business. Certainly, one could consider the actions engaged in by CA as egregious. However, less egregious contractual terms, such as those attempting to preserve the value of the to-be-acquired assets prior to consummation, are typically found in many purchase agreements. For example, it is entirely unclear whether standard contract provisions that require the seller to maintain the status quo and not take certain action without the consent of the seller could be unlawful if that consent is ever sought. Would that constitute indicia of beneficial ownership? Would it amount to a Sherman Act violation? The government's action against CA have given businesses little comfort that these 'standard' provisions might not one day be challenged as "unlawful control".

The future for merging companies

HSR regulations as well as the recent charges against I/O and CA have created an ambiguous legal environment for merging companies. It is unclear what transition planning activities are no longer permissible. Equally unclear is what information can be exchanged. Without a doubt, shareholders expect their companies to perform adequate due diligence. Under the current HSR precedent, however, companies may engage in seemingly traditional pre-merger coordination activities only to find themselves in violation of the Act. While there are clear examples of pre-merger activities that are considered illegal, there is little guidance as to what pre-merger coordination is legal. This trial-and-error approach to delineate the permissible scope of pre-merger activities makes pre-merger coordination costly. Surely, Congress did not intend for such an outcome and we hope that the agencies will provide more full guidance in the near future. However, until further guidance is forthcoming, companies need to be more cautious in their due diligence and transition planning activities and should consult antitrust counsel regularly throughout the process. Otherwise, today's 'routine' merger planning could be the subject of a government investigation and enforcement action tomorrow.

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