Doing Deals: Avoiding Antitrust Pitfalls During Due Diligence and Transition Planning

When competitors start considering a merger, they should involve their antitrust counsel from the beginning. Managing the risk of a pre-closing antitrust violation is important because if a violation is found, it could not only jeopardize the closing of the transaction, but could also result in the imposition of civil or criminal penalties against the companies and the individuals involved in the violations.

Applicable Laws: Sherman Act Section 1 and Clayton Act Section 7A

United States antitrust enforcement agencies recognize that due diligence and transition planning are necessary for companies both to determine the proper valuation for a proposed transaction and to take the steps necessary to operate the new business upon closing. However, the agencies also take the position that the antitrust laws prevent parties to a prospective transaction from acting together and coordinating their activities as one entity, either directly or indirectly, before the applicable waiting period expires and their transaction closes. The two antitrust statues at issue are the Sherman and Clayton Acts.[1]

Section 1 of the Sherman Act prohibits contracts, combinations and conspiracies that restrain trade. In the M&A context, this statute can be violated if the merging companies coordinate their activities pre-closing and reach agreements or understandings on such things as the prices either will charge third parties during the pre-closing period, the customers or territories either will serve, the services either will offer third parties, or the bids in which either will participate.

In addition to Section 1, Section 7A of the Clayton Act prohibits parties meeting the Hart-Scott-Rodino (HSR) statutory threshold for pre-merger notification, regardless of whether they are competitors, from exercising control over the to-be-acquired entity or assets prior to the expiration of the applicable waiting period. In the context of mergers and acquisitions, violations of Section 7A are often referred to as "gun jumping."

Gun Jumping Cases

Both the Department of Justice (DOJ) and Federal Trade Commission (FTC) have brought actions against merging companies for alleged violations of either one or both of the applicable statues. The two most recent examples were brought by DOJ.

In 2003, DOJ brought an action against Gemstar and TV Guide International, Inc. for their alleged conduct prior to closing of their transaction.[2] Gemstar and TV Guide were competing producers of interactive programming guides for television. DOJ's complaint in the matter alleged that the parties agreed on marketing targets, allocated customers for exclusive dealing during the course of their pending transaction, and shared competitively sensitive customer information in order to determine the prices to offer their cable service provider customers. It also alleged combined pre-closing decision-making and exertion of control by Gemstar over TV Guide. As a result of their conduct, the parties agreed to pay fines of over $5.5 million and enter into a consent order that required, among other things, that customers be permitted to renegotiate certain contracts negotiated pre-closing.

In 2006, DOJ filed an action against Qualcomm Incorporated and Flarion Technologies, Inc. for pre-merger activities that violated Section 7A of the Clayton Act.[3] The Complaint alleged that prior to the expiration of the applicable HSR waiting period, Qualcomm obtained operational control of Flarion under the terms of the merger agreement. The agreement called for Flarion to seek Qualcomm's approval for basic business decisions

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including making customer proposals. In addition, although not required by the agreement, Flarion sought Qualcomm's guidance in making decisions on the hiring of consultants. DOJ claimed that this conduct amounted to the transfer of beneficial ownership prior to expiration of the HSR waiting period. The parties entered into a consent decree under which they agreed to pay $1.8 million in civil penalties.

In both Gemstar/TV Guide and Qualcomm/Flarion, the parties were allowed to merge. However, the investigation of the pre-closing activity was continued well after the transaction was cleared. And, as indicated above, both investigations resulted in significant fines and/or consent orders.

Practical Advice: Due Diligence

Gun-jumping risks first may arise during the due diligence phase of a merger. To best manage these antitrust risks, the parties should take precautions to prevent sharing of certain competitively sensitive information prior to the transaction's closing. At the outset of M&A discussions, companies typically enter into a non-disclosure agreement (NDA). Although this type of agreement typically protects the parties from disclosure of information learned during the course of the M&A process to third-parties, it rarely addresses the necessary parameters of information sharing from an antitrust perspective.

There are several practices that can be employed in order to strike a balance between sharing the information necessary for the parties to make an informed and reasoned evaluation about the value of the proposed transaction, while at the same time avoiding violations of Section 1 and Section 7A. In the course of due diligence, competing parties must continue to compete vigorously and, to the greatest extent practicable, limit the information they discuss and disclose to each other accordingly. Ideally, the parties should avoid disclosure of competitively sensitive information, specifically with regard to any products or services in the area of competitive overlap, that is not publicly available. Information that is competitively sensitive can vary depending on the competitive overlapping industry. However, some general categories of competitive information are: pricing plans, strategic plans, marketing plans, costs, customer bids, and profit margins. Historical information on these topics is somewhat less sensitive than information as to the future, especially if presented in aggregate or other form, which does not permit a prediction of future conduct.

Practical Advice for Due Diligence:

- Limit the collection, exchange and dissemination of competitively sensitive information to those employees on due diligence "clean teams."
- Consider using a third party (such as a consulting firm) to collect, screen, and assess competitively sensitive information.
- Consider requesting that outside counsel review competitively sensitive contracts and redact out competitive terms (price, term of contract, etc.).

In the context of a business transaction, it may be necessary to disclose certain sensitive competitive information. In such cases, there are ways to share information while minimizing the risk that such a disclosure will reduce competition and thereby violate Section 1. Most transactions today utilize electronic due diligence rooms;

in the case of these or more traditional physical due diligence rooms, practices can be implemented to reduce the risk of inappropriate information sharing.

Parties can:

- *Limit the collection, exchange and dissemination of competitively sensitive information to those employees on due diligence "clean teams."* A clean team is comprised of individuals that are not in a position to use competitive information to affect competitive decision making. For example, Company A is a national service company looking to acquire Company B, which competes with Company A to provide services in California exclusively. If the area of competitive overlap is limited to California, Company A could designate employees from its New York operations in order to analyze and present the competitive information in an aggregated form to Company A's transaction team. It is useful to document that clean team members are not in a position to use competitive information, nor will be in such a position for a certain fixed period of time (2 years).

- *Consider using a third party (such as a consulting firm) to collect, screen, and assess competitively sensitive information.* In particular, a third party should be used if evaluating pricing terms, prospective bids, or contract rates, and other competitively sensitive terms specific to the industry. A third party may be able to aggregate the competitively sensitive terms and provide a high-level assessment of the value of a target without disclosing specifics of the target's business.

- *Consider requesting that outside counsel review competitively sensitive contracts and redact out competitive terms (price, term of contract, etc.).*

<u>Practical Advice: Transition Planning</u>

After two companies have reached an agreement on the terms of the merger, but before they receive regulatory approval from the antitrust agencies or close the transaction, they likely will want to begin the process of transitioning from two separate entities to one unified company. Appropriate transition planning in this phase of a transaction can allow the combined entity to hit the ground running in order to achieve the merger efficiencies and valuable cost savings that contributed to the overall rationale for the transaction. However, failure to adhere to the antitrust laws during this stage of a transaction can lead to government action resulting in substantial delay or even blocking of the transaction and issuance of fines.

Before the companies have received HSR clearance, the risks are the greatest and the acquiring party must not, under Section 7A, transfer or exercise control over the assets or the entity to be acquired. After a transaction has received HSR clearance, but before companies have closed the transaction, competitors must still be conscious of avoiding collusion and improper information sharing that could be perceived as a violation of Section 1. In instances in which a closing date is set, regulatory hurdles are cleared, and consummation of the merger is certain, antitrust concerns can ease.

However, until the merger receives clearance, and, in the case of competitors, until the transaction closes, the parties must continue to run their businesses separately, to make independent business decisions and to avoid conduct that would make it difficult to "unscramble the eggs" if the deal does not go through. Companies should be cautious during this transition time not to release joint statements about predictions on market share, competitive strategy, customer/supplier relationships, or pricing policies of the combined entity unless legal counsel has been consulted. It is important to ensure that public statements do not imply that the companies are coordinating prior to re-

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ceiving HSR clearance or, in the case of competitors, prior to consummating the transaction.

In the course of transition planning, the transition teams for each company should avoid the following:

- Discussing agreements, reaching understandings, or exchanging information that would eliminate or reduce competition between the parties before the acquisition is completed;
- Disclosing non-public information received by a transition team to others within the companies who could use it for marketing or any other competitive purpose;
- Sharing information that is not reasonably necessary for legitimate integration planning purposes;
- Becoming involved in the day-to-day operational decisions of each other's operations or otherwise seeking to manage the other's business decisions, or take possession or control of any assets or businesses of the other firm, or hold out the employees of the target as employees of the buyer to customers. Do not re-locate employees (with the exception of the transition "clean team") and do not have employees of one firm report to employees of the other;
- Discussing or exchanging information regarding customers, pricing policies, pricing formulas (such as digital download models), prices or other terms of sale, business or marketing plans, bidding activities, costs or cost structures, profit margins, proprietary technologies, pending or planned R&D or product development efforts (except in accordance with the due diligence guidelines outlined above);
- Agreeing on: prices or terms of sale, prices paid for inputs (including terms of supplier or customer contracts), wages, allocation of customers, territories or products in any way (such as by refraining from bidding on a supplier or customer contract they otherwise would have sought), halting a marketing campaign or other competitive initiative, altering plans for competitive bidding, or altering technology or other research programs; and
- Basing individual business decisions on any sensitive information received from the other party during the transition planning process.

Practical Advice for Transition Planning

- Form transition teams that will enable the parties to integrate their operations after the acquisition has closed;
- Identify a subset of transition team members (that have no operational responsibilities) that may have access to competitively sensitive material;
- Develop plans and procedures for the integration of operations that will take place following the closing of the acquisition

The transition teams can take the following steps to enhance their chances of achieving the merger efficiencies and greatest value from the merged company. Note that for parts of the companies' businesses that do not overlap, more flexibility and broader information exchanges for purposes of integration planning may be permissible.

- Form transition teams that will enable the parties to integrate their operations after the acquisition has closed (including information systems, human resources, and systems operations);
- Identify a subset of transition team members (that have no operational responsibilities) that may have

- access to competitively sensitive material, and limit disclosure of such information to this group (and outside counsel and consultants);
- Develop plans and procedures for the integration of operations that will take place following the closing of the acquisition, including the potential organizational structure and staffing plans, and pro forma strategic plans, provided all aspects of plans are protected from disclosure to employees with on-going responsibility for the conduct of independent business operations, and provided they are collected and treated in a manner that is sensitive to the guidelines for exchange of information;
- Engage in *independent* communications with any customer or potential customer, or supplier or customer or potential supplier or customer, about what the *individual* party plans to do and what it will offer after the transaction is complete, but neither party should report to the other about the communication or consult with each other beforehand; and
- Personnel from both companies may jointly meet with customers and suppliers for the purpose of introduction, generally explaining the transaction, discussing post-closing plans, however, it is *not* permissible to make joint calls to sell products or discuss future contracts or terms of supply until late in the process, absent a specific request by the supplier or customer (but the terms of the discussion still must remain focused and general).

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By working with antitrust counsel from the beginning of the merger process, parties can successfully manage the risk of a pre-closing antitrust violation. Counsel can assist in helping to find the right balance between legitimate information sharing and the imposition of safe-guards, which will help ensure that due diligence and transition planning run smoothly.

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[1] It should be noted that the U.S. is not the only jurisdiction that has prohibitions on pre-closing activities. *See* Christine Buckley, European Commission officers raid Ineos and Norsk Hydro, Bus. Times (Dec. 14, 2007), available at http://business.timesonline.co.uk/tol/business/industry_sectors/industrials/article3049078.ece (describing a recent Commission investigation of alleged improper information sharing between Ineos and Norsk Hydro prior to Commission approval and closing of the transaction). The Commission ultimately found no wrongdoing on the part of the Ineos and Norsk Hydro with respect to conduct that occurred prior to the Commission approval of the merger.

[2] *United States v. Gemstar-TV Guide International, Inc.*, No. 03CV0198, 2003 WL 21799949 (D.D.C. July 3, 2003).

[3] *United States v. QUALCOMM Incorporated and Flarion Technologies, Inc.*, No. 01CV00672 (D.D.C. filed April 13, 2006).