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CLIENT ALERT

Illegal Premerger Coordination Leads to DOJ "Gun Jumping" Enforcement Action and $5 Million Settlement— Key Lessons Affecting Health Care Transactions

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On November 7, 2014, the Antitrust Division of the U.S. Department of Justice ("DOJ") reached a $5 million settlement with Flakeboard America Limited ("Flakeboard"), its foreign parents, and SierraPine to settle allegations that Flakeboard had engaged in "gun jumping" activity. This case is noteworthy to health care transactions for several reasons, including how it highlights the government's continued scrutiny of parties' pre-closing conduct, provides guidance on the range of permissible due diligence practices and business covenants, and marks the first time that the government has obtained disgorgement for a gun-jumping violation. Although this settlement took place outside the health care context, the gun-jumping principles and DOJ guidance are readily applicable to transactions in the health care sector.

The doctrine of "gun jumping" prohibits an acquiring party from exercising operational control over the business or assets of a target prior to receiving clearance under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR Act") because this is considered to be prematurely taking "beneficial ownership" of the acquired company or assets.[1] In this case, the DOJ alleged that Flakeboard jumped the gun by assuming beneficial ownership of the SierraPine target assets prior to the expiration of the HSR

[1] 15 U.S.C. § 18a. The HSR Act imposes notification and waiting-period requirements on certain transactions that result in an acquiring person *holding* assets or voting securities valued above certain statutory thresholds (which are indexed annually to GDP). Section 801(c)(1) of the Premerger Notification Rules, 16 C.F.R. § 800 *et seq.*, defines "hold" to mean to have "beneficial ownership." One way by which an acquiring person may prematurely have or obtain beneficial ownership of assets or voting securities that it plans to acquire is by obtaining operational control of the target's business prior to the conclusion of the HSR Act waiting period. This conduct, sometimes referred to as "gun jumping," is a violation of the HSR Act.

Act's statutory premerger waiting period, and by unlawfully conspiring in violation of Section 1 of the Sherman Act.[2]

I. The Asset Purchase Transaction

On January 13, 2014, Flakeboard and SierraPine executed an asset purchase agreement ("APA") pursuant to which Flakeboard would acquire three of SierraPine's mills for approximately $107 million. On January 22, 2014, the parties submitted premerger notification filings to the antitrust agencies, as required by the HSR Act.

Flakeboard and SierraPine own and operate mills in the Pacific Northwest that produce medium density fiberboard ("MDF") and particleboard, which are manufactured wood products used in products like furniture and wooden fixtures. The DOJ alleged that the entities were direct competitors.

Under the terms of the APA, SierraPine agreed to close its Springfield, Oregon, particleboard mill after the HSR Act waiting period—but five days before the transaction closed. Before negotiating the proposed acquisition, SierraPine had no plans to shut down its Springfield mill. However, during negotiations, Flakeboard insisted that SierraPine do so because Flakeboard did not intend to operate the Springfield mill after the transaction closed and did not want to manage the shutdown after the transaction closed.[3] Accordingly, SierraPine agreed in the APA to "take such actions as are reasonably necessary to shut down and close all business operations at its Springfield, Oregon facility five (5) days prior to the Closing."[4]

However, just days after the transaction was announced, a labor dispute arose at the Springfield mill that SierraPine believed would likely require it to publicly disclose the Springfield closure earlier than planned. Discussions then began between the two companies, which led to SierraPine announcing the premature closure of that mill on March 13, 2014—months before the HSR Act waiting period expired.

The DOJ then launched an investigation of the proposed transaction and issued second requests for documents and information, extending its review until the HSR Act waiting period expired on August 27, 2014. The transaction was abandoned on September 30, 2014, in response to the DOJ's concerns about the transaction's likely anticompetitive effects in the production and sale of MDF in certain western states, including California, Oregon, and Washington.[5]

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[2] DOJ Press Release, "Justice Department Reaches $5 Million Settlement with Flakeboard, Arauco, Inversiones Angelini and SierraPine for Illegal Premerger Coordination" (Nov. 7, 2014), *available at* http://www.justice.gov/atr/public/press_releases/2014/309786.pdf.

[3] Complaint, *United States. v. Flakeboard America Ltd. et al.*, Case No. 3:14-cv-04949 (N.D. Cal. filed Nov.7, 2014) at ¶ 16, *available at* http://www.justice.gov/atr/cases/f309700/309788.pdf [hereinafter "Complaint"].

[4] *Id.* at ¶ 17.

[5] *Id.* at ¶ 4. *See also* DOJ Press Release, "Flakeboard Abandons its Proposed Acquisition of SierraPine" (Oct. 1, 2014), *available at* http://www.justice.gov/atr/public/press_releases/2014/309005.pdf [hereinafter "DOJ Oct. 1, 2014 Press Release"].

II. The HSR Act and Section 1 of the Sherman Act

The HSR Act requires that parties to a transaction meeting certain size thresholds notify the federal agencies and observe a statutory waiting period, during which time they must remain separate and independent, and cannot transfer operational control or beneficial ownership by directing how the target conducts its business. The statutory waiting period effectively preserves the status quo while the antitrust agencies investigate the competitive implications of the transaction. Parties are permitted to engage in due diligence and integration planning, but they may not begin integration or otherwise present themselves as a single entity. The waiting period limitation is procedural and antitrust enforcers need not allege any adverse effect on competition. Under the HSR Act, each party to the transaction that "jumps the gun" is subject to a maximum civil penalty of $16,000 for each day that that party violates the HSR Act or by injunctive relief, which can delay or jeopardize closing of the transaction.

Section 1 of the Sherman Act prohibits any "contract, combination . . . or conspiracy . . . in restraint of trade." This prohibition remains in force during the premerger period, and the pendency—regardless of how imminent—of a proposed transaction does not excuse transacting parties from their obligations to compete independently. Thus, until a transaction is consummated, a party that coordinates with its rival on price, output, or other competitively significant matters may violate Section 1 of the Sherman Act. Health care entities engaging in mergers and acquisitions are equally susceptible to the Sherman Act, and the DOJ's enforcement of these provisions is a stark reminder that entities must act independently until closing.

III. Disgorgement and Civil Penalties for Violations of the HSR Act and Sherman Act

Notwithstanding the fact that the parties had already abandoned the transaction, the DOJ filed a two-count complaint in federal district court on November 7, 2014, alleging violations of the HSR Act and Section 1 of the Sherman Act.[6]

The DOJ alleged that Flakeboard and SierraPine violated the HSR Act when Flakeboard unlawfully exercised operational control over SierraPine prior to the expiration of the HSR Act waiting period by coordinating the closure of the Springfield mill and moving the Springfield mill customers to Flakeboard.[7] The DOJ alleged that the parties' HSR Act violation continued for 223 days from January 17, 2014 (when Flakeboard and SierraPine began discussing the closure of the Springfield mill), until the expiration of the HSR Act waiting period on August 27, 2014.[8] Although the duration of the violation could have resulted in penalties exceeding $3.5 million for each

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[6] *See* Complaint, *supra* note 3.
[7] *Id.* at ¶¶ 31–35.
[8] Competitive Impact Statement, *United States. v. Flakeboard America Ltd. et al.*, Case No. 3:14-cv-04949 (N.D. Cal. filed Nov.7, 2014) at 13, *available at* http://www.justice.gov/atr/cases/f309700/309790.pdf [hereinafter "Competitive Impact Statement"].

party, the government reduced the penalties to $1.9 million per party (totaling $3.8 million) to account for voluntary production of premerger evidence and cooperation throughout the investigation.[9]

With regard to the Sherman Act violations, the DOJ alleged that, *inter alia*, Flakeboard directed the premature closure of the Springfield mill, obtained competitively sensitive information from SierraPine—including the name, contact information, and types and volume of products purchased by each Springfield customer—and motivated SierraPine employees to direct its customers to Flakeboard (with a promise that Flakeboard would match SierraPine's prices). As a result of these actions, Flakeboard obtained a substantial amount of new business, including a significant number of customers that Flakeboard had not previously served. The DOJ alleged that the transaction would have reduced the number of MDF manufacturers in the relevant geographic market from four to three and would have given the merged entity a 58 percent market share in the thicker and denser grades of MDF.[10] Because the parties' conduct amounted to an unlawful agreement between competitors to restrict output and allocate customers, this constituted a *per se* violation of Section 1 of the Sherman Act. The violation requires Flakeboard to disgorge $1.15 million—the approximate amount of profits that Flakeboard allegedly illegally obtained by coordinating with SierraPine to close the Springfield mill and move the mill's customers to Flakeboard.

In addition to the monetary penalties, the Proposed Final Judgment (a negotiated settlement) requires both companies to institute an antitrust compliance program, appoint an Antitrust Compliance Officer, grant rights to government inspection, and follow certain conduct restrictions for 10 years.

IV. Permissible Conduct During the Diligence Process

The Proposed Final Judgment is especially important, given the rarity of gun-jumping enforcement and the way it carves out several "safe harbors" for customary deal terms and permissible due diligence processes. Although this was not a health care transaction, these "safe harbors" are highly relevant to health care transactions and should pose a low risk for health care entities engaging in mergers and acquisitions.[11] The categories of permissible conduct include:

- 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;

[9] *Id.*
[10] *See* DOJ Oct. 1, 2014 Press Release, *supra* note 5, at 1.
[11] *See* Proposed Final Judgment, *United States. v. Flakeboard America Ltd. et al.*, Case No. 3:14-cv-04949 (N.D. Cal. filed Nov.7, 2014) at § VIII, *available at* http://www.justice.gov/atr/cases/f309700/309796.pdf.

- 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; and

- entry into buyer-seller agreements that would be lawful in the absence of the planned acquisition.

Although what constitutes "gun jumping" is often a fact-specific inquiry, health care entities structuring or engaging in mergers or acquisitions should be familiar with the transactional "safe harbors" articulated in the Proposed Final Judgment and be careful to avoid conduct construable as gun-jumping prior to closing on the transaction.

V. Practical Tips and Takeaways

- Until closing, the parties to a transaction must remain independent competitors. Failure to do so constitutes gun-jumping and can simultaneously be a violation of the HSR Act and a conspiracy that violates Section 1 of the Sherman Act. The *Flakeboard* case is a potent reminder of the limitations on premerger activities and a lesson that firms involved in mergers and acquisitions must remain truly distinct and operate independently until the transaction closes.

- Parties involved in mergers or acquisitions must carefully balance the buyer's legitimate interests in ensuring that the post-closing business maintains its pre-closing value, as well as other legitimate goals, such as smooth post-consummation integration, with the HSR Act's rigid prohibition against the premature transfer of control from the seller to the buyer.

- While antitrust enforcers are prone to challenge egregious premerger conduct, the *Flakeboard* settlement and Proposed Final Judgment illustrate that reasonable interim operating covenants, such as those intended to protect a transaction's value and "prevent a to-be-acquired firm from wasting assets," remain both common and lawful under the antitrust laws.[12]

- While merging health care entities may begin developing strategic plans and budgets for eventual joint operations, parties should not jointly implement any integration plans, such as closing or consolidating ancillary services, jointly negotiate managed care contracts, or consolidate administrative functions until the transaction has closed. Independent conduct is vital to avoid both the appearance of gun-jumping and any allegations that health care entities are unlawfully colluding as competitors.

[12] Competitive Impact Statement, *supra* note 8, at 12.

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