DOJ Challenges Merging Parties' Pre-Closing Review of Contracts: Scope of Ordinary Course Provision Restricted in Transactions Subject to Hart-Scott-Rodino Act

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Last week, the Antitrust Division of the US Department of Justice (DOJ) announced an important consent agreement relating to the conduct of parties to a merger or acquisition after signing but before closing. In this case, DOJ alleged that the parties violated the Hart-Scott-Rodino Act (HSR Act)[1] by having the buyer review key terms of long-term contracts that the seller executed prior to close. DOJ asserted the seller was engaging in ordinary course business conduct when it entered into the contracts at issue, which were fairly large in value in absolute terms. Accordingly, DOJ alleged the buyer's review of the contracts was impermissible under the HSR Act.

In September 2006, Smithfield Foods announced its intent to acquire Premium Standard Farms. Both Smithfield and Premium Standard are pork packers and processors and hog producers. The transaction was subject to the pre-merger notification requirements of the HSR Act and the parties were thus required to abide by the waiting periods in the Act, which prohibit closing until certain statutory waiting periods expire or are terminated.[2] The Act also prohibits parties to a reportable transaction from engaging in conduct that would effectively transfer control of part or all of one of the parties' businesses to the other before closing. The parties are required to remain fully independent entities until closing and to the extent they competed before the transaction, to continue to do so. Failure to keep the businesses separate or efforts to direct the ordinary course operations of one of the parties is generally viewed as violating the HSR Act.[3] Smithfield and Premium Standard filed their notifications in October 2006 and received a Second Request in November. The HSR waiting period for the transaction expired in March 2007 and the transaction closed in May 2007.

According to the complaint, beginning as early as September 20, 2006, before the HSR notifications had been filed, Premium Standard submitted to Smithfield for its consent at least three hog purchase contracts Premium Standard was considering that were required for it to continue its business. The submitted contracts included all material terms, including price. DOJ alleges that these contracts, which apparently ran from one to five years, were ordinary course purchases and were consistent with past practice. DOJ asserted that the contracts varied in size, with one accounting for less than one percent of Premium Standard's capacity. DOJ did not allege that Smithfield sought changes in any of the contracts or ever withheld its approval, nor did DOJ allege that the fact that Smithfield and Premium Standard were competitors affected its analysis.[4]

DOJ concluded that Smithfield's review of Premium Standard's purchase contracts resulted in Smithfield exercising "operational control over a significant portion of Premium Standard's business prior to the expiration of the waiting period" and thus violated the HSR Act. DOJ has now settled with Smithfield, which has agreed to pay a $900,000 civil penalty.

There is little law on the scope of the HSR Act restrictions on pre-closing coordination among parties to a transaction, only a limited number of settled enforcement actions by the agencies and a few speeches by senior government officials. Historically, nearly all the enforcement actions have been non-controversial – that is, they involved conduct that to all or nearly all antitrust practitioners exceeded what was understood to be acceptable.

This case is somewhat different because the lines in this area are less clear and potentially creates compliance challenges for merging businesses and their advisors.

Most merger or acquisition agreements contain an "ordinary course" provision that (a) requires the seller to operate the business in the ordinary course consistent with past practice and (b) limits or prohibits certain seller actions because they could impact the valuation of the assets or entity involved in the transaction. Typical prohibitions include the sale of assets, the issuance of stock, or the entry into material, non-ordinary course transactions without the consent of the buyer. Nothing in the consent agreement suggests that such prohibitions are improper.

The Smithfield matter turns, rather, on the definition of material, non-ordinary course transactions and how the buyer's rights under such provisions can be exercised. Smithfield likely viewed its review of the hog purchase contracts as reasonable because the contracts were long-term and involved commitments extending substantially beyond the anticipated close date, and thus could affect the long-term economics of the Premium Standard business. Indeed, the DOJ complaint acknowledges that the three contracts at issue obligated Premium Standard to purchase between 400,000 and 475,000 hogs annually at a total cost ranging from approximately $57 million to $67 million.

Smithfield's review of the contracts appears consistent with the terms of the "ordinary course" provision in the Smithfield purchase agreement, which prohibited Premium Standard from entering into any material contract without Smithfield's approval. The purchase agreement between Smithfield and Premium Standard defined "material contract" as, in part, "[a c]ontract (other than purchase or sale orders in the ordinary course of business that are terminable or cancelable without penalty on 90 days' notice or less) under which the Company or any of its Subsidiaries is a purchaser or supplier of goods and services which, pursuant to the terms thereof, requires payments by the Company or any of its Subsidiaries in excess of $1,000,000 per annum . . ." While the case implicitly turns on the question of whether this provision provided Smithfield with too much authority to review the conduct of Premium Standard's business, unlike in other enforcement actions,[5] DOJ did not allege in this case that the provision was unreasonable.

Regardless of the terms of the purchase agreement, DOJ viewed Premium Standard's entry into the hog purchase contracts as ordinary course activities and thus the parties' action in requiring Smithfield approval was an undue and illegal interference into Premium Standard's ordinary course contracts before closing. Accordingly, DOJ challenged the conduct.

Unfortunately, the consent order does not clearly explain the line between ordinary course and non-ordinary course behavior for purposes of the HSR Act, and will therefore likely lead to some confusion and perhaps strategic behavior by sellers that do not want the buyers involved even in what DOJ would view as non-ordinary course conduct. And it is important to note that nothing in the order or the HSR Act suggests that the conduct here violates the law only when the parties to the transaction are competitors; the rule applies to all transactions subject to the requirements of the Act. Thus, at the very least, parties to transactions that are reportable under the HSR Act should carefully consider the scope of their ordinary course provisions, particularly when the transaction may face an extensive antitrust review, and should check with experienced counsel before the buyer reviews or approves conduct of the seller that could be construed as ordinary course business activity.

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[1] 15 U.S.C. §18a (as amended).

[2] Transactions that meet certain thresholds are required to file a notification with the US antitrust agencies and abide by the waiting periods. As of February 22, 2010, most transactions with a value in excess of $63.4 million will need to be reported. The initial waiting period for most transactions is 30 calendar days, which can be extended.

[3] Parties to a transaction that are actual or potential competitors are also subject to the strictures of Section 1 of the Sherman Act, which prohibits agreements that, *inter alia*, restrict competition. Section 1 liability exists up until the moment of closing and is present regardless of whether the transaction was reportable under the HSR Act.

[4] Interestingly, DOJ does not allege that Premium Standard supplying pricing and other key terms of critical, competitively sensitive supply contracts violated Section 1 of the Sherman Act.

[5]*See U.S. v. Computer Associates International, Inc.*, 2002-2 Trade Cas. (CCH) ¶73,883 (D.D.C. 2002); the order can be found here.

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