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Client Alert

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Recent Justice Department Actions Enforce HSR Pre-merger Notification Requirements

Two new enforcement actions by the Antitrust Division of the U.S. Department of Justice (DOJ) confirm the importance of complying with all aspects and requirements of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (HSR Act). The DOJ has filed two separate and serious enforcement actions for failures to compy with two different requirements of the HSR Act. One addresses a failure to notify a reportable transaction, and the second addresses the conduct of the parties prior to closing a reported transaction.

In the first action, *United States v. Smithfield Foods, Inc.*,[1] the DOJ is arguing that the statutory "investment purposes only" exemption to the HSR rules is *not* available when one company takes a significant position in another company in advance of an attempt to acquire or take control of that company; the first company's acquisition of the issuer's voting securities is reportable under the HSR Act. This case has broad implications for hostile deal-making and firms considering unsolicited tender offers or other transactions where the acquiring firm would prefer to secure as many of an issuer's voting securities as possible before filing either a Schedule 13D with the SEC or an HSR Notification Form. The DOJ is seeking more than $5 million in fines and penalties.

In the second case, *United States v. Gemstar-TV Guide, Inc.*,[2] the DOJ obtained $5.67 million in fines and penalties in connection with allegations that Gemstar and TV Guide violated the HSR Act by improperly integrating their operations before the close of the transaction, or "gun jumping." The DOJ settled this matter with Gemstar-TV Guide through a consent decree that includes civil penalties of $5.67 million, as well as injunctive relief. The case is an important indication that the DOJ will closely review parties' conduct for possible gun-jumping during the notification waiting period.

"Parties that violate either the notification or the waiting period requirements of the HSR Act may be subject of civil penalties of up to $11,000 for each day that they are not in compliance with the Act"

Background: The HSR Act

Under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the HSR Act, chaptered as Section 7A of the Clayton Act), parties to mergers or acquisitions that are over a certain size must first notify the DOJ and the Federal Trade Commission (FTC) of the transaction by filing an HSR Notification Form.[3] The parties must then wait at least 30 days after filing their HSR notification before they can consummate the transaction.[4] During that waiting period, either the DOJ or the FTC may investigate the competitive effects of the transaction, and the parties must continue to operate their businesses as separate and independent concerns.

Parties that violate either the notification or the waiting period requirements of the HSR Act may be subject of civil penalties of up to

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$11,000 for each day that they are not in compliance with the Act.[5] In addition, parties who are competitors and who fail to observe the waiting period may be subject to liability under Section 1 of the Sherman Act, which prohibits price fixing, allocation of markets or other restraints of trade between separate firms.[6]

Recent DOJ Enforcement Actions

Enforcing the Notification Requirement: *United States v. Smithfield*

Overview

On February 28, 2003, the Antitrust Division of the DOJ filed a complaint against Smithfield Foods, Inc. (Smithfield), the nation's largest hog producer and pork packer, charging that the company twice failed to comply with the notice and waiting requirements of the HSR Act before making certain acquisitions of stock issued by its competitor, IBP, Inc. (IBP), the nation's second largest pork packer. The complaint alleges that Smithfield twice acquired stock in IBP while also considering and taking steps toward a Smithfield-IBP combination, first in 1998, then in 1999-2001.[7] The complaint seeks the maximum civil penalty of $5.47 million from Smithfield.

Smithfield has responded to the complaint by arguing that the transactions in question were exempt from notification because the acquisitions were "solely for investment purposes." Under the HSR regulations, acquisitions of voting securities that ordinarily would be reportable are exempt from the notification requirements if the acquisition is "solely for the purpose of investment" and if the stock acquired or held does not exceed 10 percent of the outstanding securities of the issuer.[8] While Smithfield did enter into a bidding war for IBP with Tyson Foods, Inc., it appears Smithfield will contend that the specific acquisitions in question were at most prefatory to, and not in connection with, these bids.

The DOJ has rejected this view, arguing that the acquisitions were not exempt because at the time of the transactions, Smithfield also was considering and taking steps toward a Smithfield-IBP combination. "Companies cannot evade HSR Act filing obligations by ignoring the plain language of the exemption," said Principal Deputy Assistant Attorney General Deborah P. Majoras. "Acquisition of stock in a firm that is also a potential takeover target or merger candidate is not an acquisition that is 'solely' for investment."[9]

Applying the Investment Purposes Exemption

The DOJ and the FTC historically have taken a narrow view of the investment purposes exemption, and both agencies have brought actions against firms that they felt were making acquisitions in anticipation of efforts to exercise control over the issuers.[10] In bringing these actions, the agencies have considered such factors as how the acquiring party characterized the investment in its Schedule 13D filing; the proximity in time between the "investment" acquisition and a subsequent tender offer or acquisition proposal; and whether the acquiring firm demonstrated an intent to participate in management or to influence the basic business decisions of the issuer. These cases typically have ended in settlement, however, so there is only limited guidance from the courts on how the exemption will be interpreted. Should this case proceed to judgment, we expect it to be an important addition to the case law on the subject.

Implications for M&A Transactions

With the *Smithfield* case, the DOJ has issued an important warning to any company that may acquire a substantial

minority stake in a company in anticipation of a takeover attempt: if the initial acquisition of stock exceeds the notification thresholds, then the DOJ will take the position that the transaction should be reported, notwithstanding the "investment purposes only" exemption. While this matter is still pending, we would expect the DOJ to take the same view towards similar transactions unless and until there is a judicial ruling to the contrary.

This case is of particular importance to firms that seek to make acquisitions through tender offers or similar transactions by first acquiring a position in the issuer's stock. Under the Securities Exchange Act of 1934, a person who acquires beneficial ownership of more than 5 percent of any class of security must file a Schedule 13D within 10 days of the acquisition, disclosing the purchaser's identity, background, amount and source of funds, purpose of the purchase and other information.[11] It is not unusual for companies considering an unsolicited proposal to acquire just under 5 percent of an issuer's voting securities so as to establish a "toe-hold" position for the acquisition, thereby allowing the company to buy shares at a lower price before publicly announcing its bid and reducing the overall cost of the acquisition. The DOJ's interpretation of the investment purposes exemption in *Smithfield*, however, is an important reminder that an acquiring party must also consider whether its "toe-hold" acquisition exceeds the $50 million HSR notification threshold. If it does, then the company should plan on filing an HSR notification, even if filing a Schedule 13D is not required. The effect of these rules, then, is that a party that wants to postpone announcing its acquisition intentions may only acquire up to the lesser of the 5 percent Schedule 13D filing threshold or up to the $50 million HSR notification threshold.[12]

Enforcing the Waiting Period: *United States v. Gemstar-TV Guide*

Overview

On February 6, 2003, the U.S. Department of Justice entered into a consent decree with Gemstar-TV Guide International, Inc., requiring the company to pay $5.67 million in civil penalties and other relief in order to settle claims that Gemstar and TV Guide had violated federal antitrust laws by combining operations and coordinating business activities before the statutory pre-merger notification waiting period for their transaction had expired and the transaction had closed. This penalty is the largest fine ever levied against a firm accused of completing a transaction before the end of the statutory waiting period and is an important reminder that the government will strictly enforce the pre-merger notification and waiting period requirements that apply to reportable transactions.

Applying the Waiting Period Requirements

The Gemstar-TV Guide case illustrates what specific kinds of pre-merger activities the DOJ will regard as violating these requirements.[13] Parties risk a violation of Section 7A of the Clayton Act if they conduct themselves in a manner that effectively combines the parties' business operations before the close of the HSR notification waiting period. This may include sharing strategic information about customers, submitting one party's strategic plans or pricing decisions to the other party for review or approval, allowing one party to exercise managerial control over the other, treating one party as the agent or representative of the other, requiring customers of one party to deal with the other, acting jointly on business opportunities; sharing confidential competitive information, or otherwise blurring the lines of ownership and

control between the two separate entities. Parties may plan for and discuss their post-transaction integration, but must in the meantime "remain separate and independent until the end of the statutory waiting period."[14]

This settlement and other recent gun-jumping cases[15] further demonstrate that, where parties to a transaction are competitors, the DOJ may treat certain kinds of pre-merger coordination as an unlawful restraint of trade, in violation of Section 1 of the Sherman Act. Specifically, parties who allocate customers or markets between themselves; coordinate on pricing, discounting, or contract terms; or otherwise treat their businesses as integrated before the transaction closes do so at the risk of running afoul of Section 1. If the DOJ believes that pre-merger coordination between the parties harms competition and is not necessary to protect any legitimate interests in preserving the assets or interests to be acquired, there is a serious risk that the department will raise a claim under Section 1 of the Sherman Act.[16]

Implications for Merging Parties

Parties to any reportable merger, acquisition or transaction should strictly observe the pre-merger notification waiting period and should not implement integration plans or otherwise coordinate competitive activities before the consummation of the merger. That being said, the antitrust laws do not prohibit parties from planning the operation of the combined business until after the transaction is completed. The line between these two areas is not always clear: while parties may conduct themselves in a way that contemplates the consummation of the transaction (for example, discussing integration plans for the companies), they should not operate in a manner that restrains trade, fixes prices or allocates markets between the two (for example, agreeing on employee salaries or product prices that both companies will offer before the close of the transaction). We recommend parties seek the ongoing advice of counsel throughout the merger process for guidance on which particular post-closing planning activities are acceptable and which are not.

Endnotes

[1] *United States v. Smithfield, Inc.*, CV 03CV00434, D.D.C. 2003. A copy of the complaint is available at www.usdoj.gov/atr/cases/f200800/200813.htm.

[2] *United States v. Gemstar-TV Guide International, Inc.*, CV 03CV00198, D.D.C. 2003. A copy of the complaint and consent decree is available at www.usdoj.gov/atr/cases/gemstar0.htm.

[3] With certain exemptions, the HSR Act requires parties to file a premerger notification form if: (a) the transaction is valued over $50 million and (b) one of the parties to the transaction is valued at $100 million and another is valued over $10 million. Transactions valued over $200 million must be reported regardless of the size of the parties.

[4] *See* Clayton Act Section 7A(b)(1), 15 U.S.C. §18a(b)(1). The statutory waiting period is 30 days. The DOJ or the FTC can grant parties "early termination" of the notification waiting period. The agencies may also extend the notification waiting period by issuing a "second request" for information about the transaction. When the agencies issue a second request, the notification period is extended until the answering party responds to the request, plus 30 days.

[5] *See* Clayton Act Section 7A(g)(1), 15 U.S.C. §18a(g)(1).

[6] *See* Sherman Act Section 1, 15 U.S.C. §1.

[7] The DOJ complaint charges that Smithfield was in violation of the HSR Act on two occasions: a 97-day period in 1998 and a 410-day period in 1999-2001. At the time of Smithfield's alleged violations, the HSR Act covered transactions valued over $15 million. This threshold has since been raised to $50 million.

[8] 16 CFR §802.9 provides: "An acquisition of voting securities shall be exempt from the requirements of the act pursuant to section 7A(c)(9) if made solely for the purpose of investment and if, as a result of the acquisition, the acquiring person would hold 10 percent or less of the outstanding voting securities of the issuer, regardless of the dollar value of voting securities so acquired or held."

[9] DOJ Press Release, February 28, 2003, *Justice Department Files Lawsuit Against Smithfield Foods For Violating Premerger Notification Requirements*, www.usdoj.gov/opa/pr/2003/February/03_at_125.htm.

[10] *See United States v. Costal Corp.*, 49 Fed. Reg. 36,454 (D.D.C. 1984); *United States v. General Cinema Corporation*, 1991-2 CCH Trade Cas. ¶ 69,681 (D.D.C. 1992).

[11] *See* SEC Rule 13-5.

[12] HSR filings are confidential and are not announced publicly when they are submitted; however, a firm making an HSR-reportable tender offer or similar bid must first provide written notice to the target of the firm's intent to acquire the issuer's stock. *See* 16 C.F.R. §803.5.

[13] The European Union's merger control laws also include prohibitions against gun jumping. *See* Article 14(2)(b) of EC Council Regulation (EEC) No. 4064/89 of 21 December 1989, on the control of concentrations between undertakings, as amended 30 June 1997.

[14] DOJ Press Release, February 6, 2003, *Justice Department Reaches Settlement with Gemstar-TV Guide for Illegal Pre-merger Coordination*, www.usdoj.gov/atr/public press-releases/2003/200740/htm (quoting Acting Assistant Attorney General R. Hewitt Pate).

[15] *See, e.g.*, DOJ Press Release, April 23, 2002, *Justice Department Settles Lawsuit Against Computer Associates for Illegal Pre-merger Coordination*, www.usdoj.gov/atr/public/press-releases/2002/11029.htm. In that case, Computer Associates had directed Platinum Technology to cease certain price discounts pending completion of their transaction. The Justice Department sued Computer Associates under both Section 1 of the Sherman Act and the Clayton Act.

[16] *See* Gemstar Complaint, ¶¶ 37-56.

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If you have any questions about this *Client Alert*, please contact Joshua N. Holian in our San Francisco office or any of the following attorneys.

Boston
David A. Gordon
(617) 663-5700

Brussels
Andreas Weitbrecht
+32 (0)2 788 60 00

Chicago
Kevin A. Russell
(312) 876-7700

Frankfurt/Hamburg
Joerg P. Soehring
+49-69-60 62 60 00

Hong Kong
Mitchell D. Stocks
+852-2522-7886

London
John Kallaugher
+44-20-7710-1000

Los Angeles
Miles N. Ruthberg
(213) 485-1234

Milan
David Miles
+39 02-85454-11

Moscow
Anya Goldin
+7-095-785-1234

New Jersey
James E. Tyrrell, Jr.
(973) 639-1234

New York
Bruce J. Prager
Hanno F. Kaiser
(212) 906-1200

Orange County
Virginia S. Grogan
(714) 540-1235

Paris
Alain Georges
+33 1 40 62 20 00

San Diego
Bruce P. Shepherd
(619) 236-1234

San Francisco
Daniel M. Wall
Karen E. Silverman
Joshua N. Holian
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Silicon Valley
Charles S. Crompton, III
(650) 328-4600

Singapore
Mark A. Nelson
+65-6536-1161

Tokyo
David L. Shapiro
+81-3-6212-7800

Washington, D.C.
Tad B. Lipsky
Michael G. Egge
E. Marcellus Williamson
(202) 637-2200