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Non-Reportable Smaller Deals May Present Greater Risks, Costs Than Big-Ticket Deals That Must Be Reported to FTC, DOJ

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The board of directors has authorized your company to acquire its fiercest competitor in a few key product markets for \$10 million. You are delighted to learn that no pre-merger filing is necessary under the Hart-Scott-Rodino Act because the acquisition price is below the \$50 million size-of-transaction threshold provided under the act. As a result, you expect that the deal will escape the scrutiny of the antitrust regulators at the Federal Trade Commission and Department of Justice.

You are all the more confident that your transaction will evade antitrust review because it even falls below the \$15 million size-of-transaction threshold in effect before amendments to the HSR Act in 2000 raised it to \$50 million. With your blessing, the acquisition closes, and you go to sleep unburdened by worries about a lengthy and expensive government antitrust review that would spoil the deal.

Non-Reportable Deals Challenged

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But recent cases have shown that you shouldn't sleep too soundly. Contrary to a common assumption, the increase in the threshold in 2000 does not mean that a greater number of transactions are escaping antitrust scrutiny. Non-reportable deals—even those involving a transaction price falling far below the former \$15 million HSR threshold—are being challenged by the government. Competitors, customers, and other companies desiring to purchase a targeted company are quick to complain to the antitrust agencies about any transactions that pose the slightest threat of anticompetitive effects. The agencies also regularly monitor the business press, watching for mergers that were not reported but may pose competitive concerns.

Vulnerable Stages

Agencies have shown they are willing to challenge non-reportable transactions during three key stages of the deal. The first is when the transaction is little more than a twinkle in the parties' eyes. In May 2002, the FTC commissioners authorized the FTC staff to bring an action to enjoin the acquisition of Tasco Holdings Inc.'s Celestron International by Meade Instruments Corp. The FTC stepped in even though the parties had only held discussions up to that point about the possibility of a merger as a way to alleviate some of Celestron's financial difficulties. They had not yet executed a merger agreement. After the FTC commissioners authorized the staff to file the complaint, the parties terminated merger negotiations.

The second stage for an antitrust agency to challenge a transaction is when the parties have executed a merger agreement but have not yet consummated the transaction. For example, on April 15, 2003, the DOJ's

Antitrust Division sought to enjoin SGL Carbon AG from acquiring certain assets of the bankrupt Carbide/Graphite Group for approximately \$7 million. Facing the prospect of lengthy and expensive antitrust litigation, SGL Carbon AG decided to walk away from the deal and the relevant assets of Carbide/Graphite Group were awarded to an alternative bidder by the bankruptcy court at a lower selling price.

Unscrambling the Eggs

The third, and most burdensome, point in time when antitrust agencies may challenge a transaction is when the parties have already “scrambled the eggs,” that is, completed the merger and integrated the business.

In June of this year, an administrative law judge for the FTC found that the February 2001 acquisition of the Water Division and the Engineered Construction Division of Pitt-Des Moines Inc. by Chicago Bridge & Iron Co. NV (CB&I) would substantially lessen competition in four relevant markets. The ALJ entered an order requiring CB&I to divest all of the assets acquired in the acquisition in order to restore competition as it existed prior to the acquisition. That decision is subject to review by the full Commission.

In other recent cases, the FTC commenced an administrative proceeding against Aspen Technology in August of this year seeking complete rescission of its acquisition of Hyprotech Ltd. on May 31, 2002, for \$106 million. The DOJ’s Antitrust Division and the Attorney General for the State of Kentucky sought similar relief from a federal court in April of this year, seeking an order requiring the Dairy Farmers of America Inc., to divest its interests in Southern Belle Dairy Co. LLC, which it acquired in February 2002 for \$19 million.

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In addition to the burden of unscrambling the eggs of a consummated merger, the legal fees to defend a company involved in an investigation of a non-reportable transaction can approach or exceed the value of the transaction itself. MSC Software Corp. had the misfortune to learn that lesson when the FTC brought an administrative action in October 2001 challenging its June 1999 acquisition of Universal Analytics Inc. and November 1999 acquisition of Computerized Structural Analysis & Research Corp. The two companies were MSC’s competitors in the market for advanced versions of Nastran, an engineering simulation software program used in the aerospace and automotive industries. The acquisitions, like the Carbide/Graphite Group transaction, were small ones; one company was acquired for approximately \$8.4 million and the other for \$10 million.

On the eve of an administrative trial, MSC agreed to divest at least one clone copy of its current advanced Nastran software, including the source code. Furthermore, the divestiture was required to be through royalty-free, perpetual, non-exclusive licenses with one or two FTC-approved acquirers. Also, MSC agreed that certain customers could terminate paid-up licenses entered into after the acquisitions and refund a portion of the advance consideration paid by its customers.

What seems to have driven MSC to settle was the need to stop incurring legal fees in defending itself. By the time the administrative hearing was to begin, MSC had spent approximately \$9.5 million in legal fees responding to the FTC’s investigation, over half the amount spent on the acquisitions themselves.

Protective Pre-Closing Clause

What can companies do to protect themselves from the risks of the government challenging a non-HSR reportable deal? First, consider including a clause in all merger agreements that addresses the possibility of a pre-closing antitrust challenge. If the transaction has substantial value to the acquiring company and the parties’ analysis leads to the conclusion that it does not pose material antitrust concerns, the merging parties should include a clause in the merger agreement that provides that the parties would expend their best efforts to respond to an investigative demand (and/or to any

subsequent challenge), tempered perhaps by a further proviso that “best efforts” would be satisfied if the costs of complying with the investigation or defending the transaction exceed a certain percentage of the deal or are more generally unreasonable in light of the size of the transaction.

Any acquisition—whether large or small—that raises antitrust issues may draw the attention of antitrust agencies.

The parties should also consider including a clause that provides mutual rights to terminate the agreement if an antitrust agency commences an investigation or decides to challenge the acquisition. The key issue for the parties to focus on is at what time the right to terminate should accrue. They may want the right to terminate the agreement at the point where an antitrust agency commences an antitrust investigation, or later when a complaint is filed, or only if an injunction bars the parties from consummating the transaction (which would require considerable time and expense to defend the transaction). If such a provision is not included and the antitrust agency obtains an injunction barring a company from consummating the acquisition, the company may be required to pay a substantial break-up fee or be liable for breach of contract.

An additional strategy to consider is asking one of the antitrust agencies to review the transaction prior to consummation even when no HSR filing is required. Both the FTC and the Antitrust Division of the DOJ have been receptive to such reviews. The Antitrust Division allows a party to submit a proposed transaction to the assistant attorney general for the Division, who will then respond with a business review letter containing the Division’s position with respect to the transaction.

The FTC has a formal and an informal process by which the merging parties may request either the Commission itself or Commission staff to render advice on the proposed transaction. Although both FTC processes begin by a company sending a written request to the

Secretary of the Commission, obtaining advice from the Commission itself will typically be a much more lengthy and involved proceeding. Thus, in recent years it has been increasingly common for parties to seek only informal opinions from Commission staff, which can be issued either orally or in writing. If the merger is likely to raise antitrust issues in regional markets, the parties should also consider providing informal notice to the attorneys general in the states in which the greatest competitive impact may be felt.

Balancing the Risks

In deciding whether to provide the antitrust agencies with notice of the transaction when none is required, companies must carefully balance the risk of opening the transaction to antitrust scrutiny where none is required against the risk of a post-consummation challenge ordering the divestiture of the acquired business. Companies must also consider whether waiting for the conclusion of the agency informal review may significantly delay the closing of the transaction.

Moreover, in order to conduct even an informal review, agencies may request detailed information about the nature of the transaction and the industry. This would require the involvement of the company’s employees, possibly disrupting business operations and affecting employee morale. Even informal reviews can be costly. Finally, providing such informal notice does not preclude the reviewing agencies from later challenging the transaction, although it does provide a greater sense of security as to whether the transaction will be challenged.

The next time your company is presented with a proposed acquisition that does not exceed the reporting threshold of the HSR Act, you may want to think twice before heading to “happy hour” to celebrate with your new business partner. Any acquisition—whether large or small—that raises antitrust issues may draw the attention of antitrust agencies. If such attention is raised after the merger is consummated and the assets have been intermingled, unscrambling the merged companies could prove much more costly and burdensome than a pre-merger review. Thus, it is prudent to thoroughly consider all of the antitrust issues before any merger impacting competition is consummated.