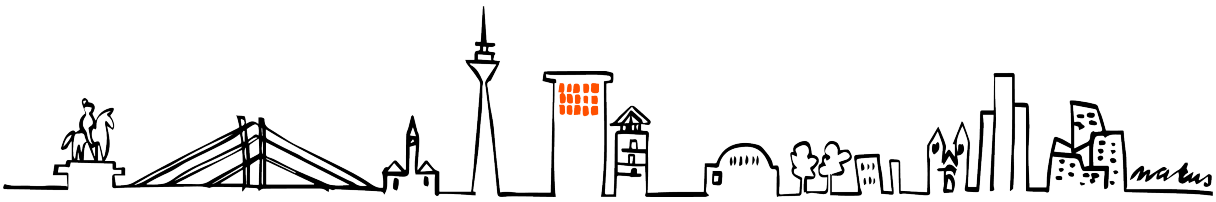

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Pre-closing covenants and gun jumping: Are you aware of the risk?

The enforcement and sanctioning of gun jumping in merger control is and will remain a focus of the competition authorities. The Federal Trade Commission ("FTC") only recently announced that it obtained a record USD 5.6 million civil penalty to settle allegations against three crude oil producers that they engaged in illegal gun jumping. The three companies were accused that the Transaction Agreement ("TA") allowed the acquirer to take control over significant aspects of the target's day-to-day business and the parties, which were competitors, exchanged competitively sensitive information. Amongst others, the FTC was critical of very broadly drafted pre-closing covenants. Pre-closing covenants have also repeatedly played an important role in the European decision-making practice. This blog post explains which behavior of the three oil companies led to the record fine and how the conduct, especially the conclusion of pre-closing covenants, would have to be assessed under European merger control and competition law.

In the recently settled FTC case, the jointly managed crude oil producers XCL Resources Holdings, LLC ("**XCL**"), and Verdun Oil Company II, LLC ("**Verdun**") agreed to acquire certain parts of EP Energy LLC ("**EP**") operations. The USD 1.4 billion transaction was subject to notification under the Hart-Scott-Rodino Act ("**HSR Act**"). The HSR Act requires merging parties to submit an HSR form to the US Federal Competition Agencies if certain thresholds are exceeded and to observe a waiting period before transferring any ownership or control of the target entity to the acquirer. This waiting period ensures that the parties to a proposed transaction remain separate and independent entities during the merger control review. Moreover, prior to the closing of a transaction, parties are also prohibited by statute from exchanging competitively sensitive information.

These compliance requirements often conflict with the interests of the buyer, who wants to protect the value of the target company during the waiting period. Therefore, TAs usually contain pre-closing covenants. Pre-closing covenants typically impose obligations on the seller or the target to maintain the value of the target company between signing and closing. To achieve this, they often require the seller to run the target business in an orderly manner within the scope of ordinary or past business practice. Additionally, the acquirer may be provided with veto rights or reservations of consent for specific measures of the target company. Pre-closing covenants can therefore

conflict with the standstill obligation under merger control law as well as the prohibition of cartels. In practice, a major risk for the parties is that pre-closing covenants are drafted too broadly. Various examples from the decision-making practice of the FTC and the European Commission ("**Commission**") show that the risk is real and can lead to substantive fines.

I. FTC: "A paradigmatic case of gun jumping"

In its complaint, the FTC held that the three crude oil companies were in breach of their obligations under the HSR Act. They transferred significant operational control over EP's ordinary-course business to XCL and Verdun during the waiting period and shared competitively sensitive information before closing. The three companies' unlawful gun-jumping activities during the HSR waiting period included in more detail:

- XCL and Verdun ordered a stoppage to EP's planned well-drilling and development activities. Upon signing the TA, XCL immediately stopped EP's ordinary-course well-drilling design and planning activities in Utah.
- XCL and EP coordinated to manage EP's customer contracts, relationships, and deliveries in the Uinta Basin region of Utah. For example, XCL requested and received from EP detailed information about EP's actual and projected production volumes, delivery capabilities, and customer supply obligations – including details about the customers' contracted volumes and pricing terms. XCL then proceeded to coordinate with EP to manage and direct EP's fulfillment of its contractual obligations to its customers, with XCL covering the volume shortages under EP's customer agreements.
- Verdun also coordinated with EP on EP's contract negotiations with certain customers in the Eagle Ford production area. Specifically, Verdun observed that certain EP contracts included below-market prices and directed EP to raise them in the next contracting period. EP complied with these directions.
- The TA required EP to submit all expenditures above USD 250,000 for XCL's or Verdun's review and approval. As these provisions had no ordinary-course exception, these approval requirements applied to many of EP's ordinary-course expenditures and effectively transferred control over a significant portion of EP's day-to-day operations to XCL and Verdun. The FTC alleged that USD 250,000 was a relatively low value for the crude development and production business. In addition, EP needed to secure XCL's or Verdun's approval for other basic activities, such as hiring field-level employees and contractors necessary to conduct its drilling and production operations in the ordinary course of business. Further, there was also evidence the buyer received and approved expenditure requests from EP falling below the USD 250,000 threshold.
- EP exchanged competitively sensitive information with XCL and Verdun without adequate safeguards to limit access or prevent misuse. EP also gave XCL almost-unfettered access to EP's competitively sensitive business information – including EP's site design plans, customer contract and pricing information, and daily supply and production reports – in the months after the parties signed the TA.

II. Gun Jumping under the EUMR

Like the HSR Act, Art. 7 of the European Merger Regulation ("**EUMR**") and corresponding regulations in the Member States of the EU such as Germany also provide for a so-called standstill obligation. The standstill obligation requires merging companies not to consummate a merger until it has been cleared by the Commission. In addition, the prohibition of cartels (Art. 101 TFEU) is particularly important if the acquirer and the target company are actual or potential competitors. These provisions require the parties to continue to act as independent companies until closing, not to coordinate their (market) behavior, and not to exchange competitively sensitive information with each other.

1. Rather clear violations of the European standstill obligation and the prohibition of cartels

The conduct of which the three crude oil companies were accused involved relatively clear violations of the standstill obligation, which would also be prohibited under Art. 7 EUMR. Taking control of the target's day-to-day business, such as the termination of the target's business activities or the coordination between the acquirer and the seller on important customer contracts and prices for the target's customers, would also be assessed and sanctioned by the Commission as infringements of the standstill obligation. Likewise, the exchange of competitively sensitive information on customer contracts or pricing information without appropriate safeguards between signing and closing is a violation of Art. 101 TFEU.

2. Pre-closing covenants following Altice: Where are the limits?

Also the Altice case gives reason to carefully assess pre-closing covenants with regard to their antitrust law compliance. The Dutch cable and telecommunications company Altice intended to acquire sole control of its Portuguese competitor PT Portugal through an SPA concluded in December 2014. This acquisition was notifiable under the EUMR. In the SPA, certain business decisions of the target company were made subject to approval in favor of Altice for the period between the signing of the agreement and its closing. Amongst others, the Commission assessed the signing of the SPA on the basis of the pre-closing covenants as a breach of the standstill obligation (Art. 7 EUMR) and the obligation to notify (Art. 4 EUMR) and ultimately imposed fines of EUR 62.25 million on Altice for each of those violations. The GC and the ECJ essentially confirmed the Commission's decision. However, the fine for the breach of the notification obligation was reduced by 10%. For a more detailed discussion of this decision, see our blog post on the judgment of the GC in German.

According to the European decision-making practice in the Altice case, pre-closing covenants are permissible if and to the extent that they are necessary to maintain the value of the target in the period between signing and closing. At the same time, it is important to ensure that the acquirer is not given the opportunity to exercise decisive influence over the target. According to the European courts, the violation of the standstill obligation does not require the buyer to make use of rights from the SPA because the possibility of exercising decisive influence already establishes control and may therefore only be granted after merger control clearance.

Accordingly, the conclusion of pre-closing covenants constitutes a violation of the standstill obligation (i) if the scope of affected business decisions is too broad, (ii) if also decisions are affected that are in the ordinary course of business, and (iii) if decisions are restricted that cannot have a significant impact on the value of the target company. It follows from the ECJ's Altice decision that the parties should refrain from agreeing reservations of consent or veto rights respectively with regard to

- the appointment and the dismissal of the target's senior management staff,
- the target's pricing policy and terms and conditions with customers, and
- the conclusion of contracts and liabilities if these exceed certain (low) value thresholds; the conclusion, amendment and termination of contracts of material importance to the target company; and the acquisition of assets whose value exceeds a certain (low) threshold.

With regard to the last point, the Commission held that having a veto right over almost all commercial actions with a low monetary threshold in the context of the target's business goes beyond what would be necessary to guard against material changes to a target's business for the purposes of preserving its value. This holds particularly true for actions falling within a target's ordinary course of business.

While other than in the FTC's most recent decision, no specific thresholds can be distilled from the Altice case it still provides an important point of reference. In the Altice decision, the Commission criticized the monetary thresholds on the grounds that they were purely the result of negotiations and did not attempt to set a threshold for the threat to the value of the target company based on objective criteria. In the Commission's view, such objective criteria include

- the size and scope of the Target's activities (the purchase price for the target and the turnover of the target), and
- the value of the target's contracts that were examined as part of the due diligence process.

III. Gun-jumping: Key Takeaways for the transaction practice

Recent decisions in the USA and corresponding decisions in the European Union underline the importance of strict competition law compliance during pending merger control proceedings. The companies involved in the transaction must continue to operate as independent entities until clearance is granted. Companies whose proposed merger is subject to merger control must, in particular, observe the requirements of the decision-making practice for pre-closing covenants when negotiating the TAs.

- As a rule of thumb, pre-closing covenants should be drafted as narrow as possible, clearly defined and not interfere with the "ordinary course of business" of the target company.
- A breach of the standstill obligation can arise, in particular, if the monetary thresholds, which pre-closing covenants typically make subject to approval, are set too low.
- Further, there is a need to ensure that irrespective of contractual obligations, the practical implications of pre-closing conduct do not amount to *de facto* control.

Pre-closing covenants that give the acquirer too much influence over day-to-day business entail a high risk of fines in the USA as well as in the EU. However, the fines imposed in the EU for violations of the standstill obligation in the past were many times higher than in the USA. In the Altice decision referred to above, the fine, which was slightly reduced by the court, amounted to more than EUR 110 million.

Information exchange after signing is not generally prohibited but should be subject to the same safeguards as pre-signing. In particular, the exchange of commercially sensitive information should be limited to what is strictly necessary and only occur with established safeguards, such as "clean team" arrangements.

Even if the violations in the FTC case were relatively obvious, the parties must not lose sight of the fact that the principles of competition law outlined above must also be observed for more subtle actions when planning the integration. Ideally, the target should be able to continue its activities seamlessly within the structures of the new group on "Day 1" after closing. With regard to the standstill obligation, only measures that prepare the implementation of the project are permissible (Day 1 readiness). In contrast, it is not permissible for the companies involved to take legal or factual measures prior to clearance that (*de facto*) anticipate the economic effect of a merger in whole or in part.

Contact

Dr Silke Möller

Partner

Phone: +49 211 20052-130
Email: s.moeller@glademichelwirtz.com

Dr Thomas Willemsen

Associate

Phone: +49 211 20052-370
Email: t.willemsen@glademichelwirtz.com