Transaction attorneys can no longer take for granted the conduct-of-business covenant contained in almost every acquisition agreement. On April 13, the Antitrust Division of the U.S. Department of Justice filed a complaint and settlement against Qualcomm Inc. and Flarion Technologies Inc., imposing $1.8 million in civil penalties for violating the Hart-Scott-Rodino premerger waiting period requirements. The complaint was based on provisions contained in conduct-of-business covenant and actions taken during the preclosing period.

For most acquisitions, some time period expires between signing the agreement and closing the acquisition. This delay is usually attributable to some condition that must be fulfilled, for example expiration of the HSR waiting period. Consequently, most acquisition agreements that contemplate a delayed closing also contain a covenant regarding how the target will conduct its business in the interim. Typically, this covenant affirmatively requires the target to conduct its business in the ordinary course consistent with past practice, then, through a series of negative covenants, proscribes actions the target may take without obtaining the acquirer's approval.

The covenant's purpose is to maintain the status quo of the business until all conditions to closing have been met. As Qualcomm makes clear, this covenant may not be used by the acquirer to operate the target's business or to begin integrating its business into the acquirer prior to HSR expiration.

The DOJ identified as problematic certain restrictions contained in the conduct-of-business covenant that prohibited Flarion from licensing intellectual property, entering into contracts involving amounts of $75,000 or more, hiring employees except in the ordinary course, presenting business proposals to customers and selling certain products.

In addition, the DOJ identified certain actions by employees of the two companies that indicated control by Qualcomm over Flarion's business decisions "well beyond even what the merger agreement purported to require." These included Qualcomm's review and consent before Flarion marketed products and services, denying requests by Flarion to offer discounts, discouraging Flarion from pursuing business opportunities and sending representatives to Flarion customer meetings.

According to the DOJ, through the merger covenants and the conduct described, Qualcomm, from on or about the date of the merger agreement, acquired beneficial ownership of Flarion's assets and "substituted its business interests and judgment for those of Flarion and exercised operational control over Flarion's business before the expiration of the waiting period required by [HSR]."

Prior to the Qualcomm case, the DOJ and the Federal Trade Commission had brought six "gun jumping" cases. Five of them dealt only with the parties' preclosing business conduct. Only one, United States v. Computer Associates International Inc., included discussion of preclosing covenants. In Computer Associates, however, the DOJ acknowledged that conduct-of-business provisions are typically not problematic but that the merger agreement in question contained provisions "not normally found in merger agreements that severely restricted [the target's] ability to engage in business as a competitive entity independent of CA's control." In particular, the offending provisions prevented the target from undertaking certain competitive activities during the HSR waiting period without CA's approval, including determining the prices and terms it would offer to customers.

One significant difference between the Qualcomm and Computer Associates cases is the nature of the offending preclosing covenants. In Computer Associates, the offending provisions dealt directly with competitive activity, such as what pricing terms could be offered in the interim period. In Qualcomm, the provisions did not deal directly with competitive activity, but rather in their totality suggested that the company had effectively acquired beneficial ownership of Flarion's assets prior to expiration of the waiting period. Nevertheless, Qualcomm is another illustration of the argument that bad facts make bad law.

One could question whether the DOJ would have complained about merger agreement restrictions had the parties not acted "well beyond" its provisions. No question, the covenants in the merger agreement were unusually tight, especially considering that the six-month interim period was relatively short and the purchase price was less than 1% of the buyer's market capitalization. But while we should keep in mind, and carefully consider, the specificity with which we draft the conduct-of-business covenant (perhaps limiting it to just the affirmative covenant), of significantly more importance is the parties' implementation of those provisions and their general premerger conduct, whether or not circumscribed by the merger agreement. This case serves as a wake-up call about the potential risks of that
behavior. All transaction attorneys should ensure that their clients understand the risks of "gun jumping" and how to preserve a deal's value while addressing those risks

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