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FOCUS: FOOD & BEVERAGE

MCC INTERVIEW: R. Trent Taylor, Christopher A. Ripple, J.D. Costa & John B. Hoke / McGuireWoods LLP

Hot Topics Facing the Food and Beverage Industry

A smorgasbord of questions is laid out and waiting

Even before last year's election, there were some large uncertainties hovering over the future of the food and beverage industry. As it has in so many areas, the surprise election results simultaneously expanded and sharpened the questions. MCC asked four ***McGuireWoods*** *lawyers with special expertise in this industry to discuss some of the big issues that are likely to define 2017.* ***Trent Taylor, Christopher A. Ripple, J.D. Costa*** *and* ***John B. Hoke*** *took on such subjects as the impact of the Food Safety Modernization Act, the likely effect on class action litigation of Neil Gorsuch's joining the Supreme Court and the possible ways the Trump administration's policies will influence M&A activity within the industry. Their remarks have been edited for length and style.*

TOPIC 1: Food Labeling Issues on the Horizon

MCC: Is the food and beverage industry likely to see an increase in food labeling litigation over the next year?

Taylor: I think so. Activity in these types of cases has slowed substantially in recent months as many cases have been stayed pending several important food labeling class actions on appeal and pending guidance and rulemaking from the Food and Drug Administration. But several of these appeals have been resolved, or will be soon, and FDA guidance on terms such as "natural" may be issued soon. When these stayed cases become active and are joined by the addition of new cases, 2017 may be one of the busiest years for food labeling class actions ever. The one caveat to this pronouncement is the current political climate. The House of Representatives has already passed a bill that would curb the filing of class actions. If this bill becomes law, it could greatly dampen the appetite for new food labeling class actions by plaintiffs.

2017 may be one of the busiest years for food labeling class actions ever.
– R. Trent Taylor

MCC: What are the new targets for class actions and what key issues are before the appellate courts this year?

Taylor: Some of the new targets for class actions have been "made in the USA" claims, slack fill, trans fat, premium ingredients, the absence of particular ingredients based on laboratory testing and "craft" claims. We are also seeing more suits based on health claims that are allegedly misleading. Conversely, we are seeing fewer suits based on "natural," but there are two key issues before appellate courts. The first is ascertainability and whether courts must find at the class certification stage that the class must be administratively feasible or not. The U.S. Court of Appeals for the Ninth Circuit recently held that there is no such requirement, deepening a circuit split on the issue. The U.S. Supreme Court may soon resolve this split. The second issue involves damage models in food labeling class actions. Plaintiffs have had a difficult time finding damage models that pass judicial scrutiny. That trend continued in 2016, and both plaintiffs and defendants will continue to keep a close eye on how this issue develops in appellate courts in 2017.

MCC: Last year, Congress passed the National Bioengineered Food Disclosure Standard. What impact do you think the legislation will have on genetically modified labeling litigation?

Taylor: The passage of this law was a very significant development for at least two reasons. First, it singlehandedly put a stop to the efforts of several state legislatures to pass and/or enforce strict GMO labeling laws. By passing a federal standard, Congress saved the food and beverage industry from making significant labeling changes based on requirements imposed by only a few states. In doing so, it effectively puts an end to most GMO labeling litigation, at least for now. Second, and perhaps most importantly, the passage of this law demonstrated that Congress is paying close attention to food and beverage issues. At a time when congressional inaction is seemingly at an all-time high, Congress was able to pass a bill on this issue fairly quickly. This is no doubt reassuring to the food and beverage industry, and signals that Congress will not hesitate to protect the industry from external threats.

MCC: What will Neil Gorsuch mean for class actions when he joins the Supreme Court?

Taylor: Unfortunately, the court from which Gorsuch will come to the Supreme Court – the Tenth Circuit – is not known as a hotbed of class actions, thus making it difficult to predict how he will approach class actions as a new justice. There is one case that offers at least some insight as to his thinking. In the 2008 case *Shook v. Board of County Commissioners of the County of El Paso*, Gorsuch, writing for the Tenth Circuit, affirmed the denial of class certification. That decision suggests that Gorsuch will strictly hold plaintiffs to Rule 23 standards, holding that "careful attention to the requirements" of Rule 23 "remains . . . indispensable." The decision also emphasized "cohesiveness" in the context of a proposed Rule 23(b)(2) class and suggested that a number of alternatives to class relief were available to the plaintiffs. While this decision includes several of the types of things that opponents of class actions prefer hearing, it would be a mistake to read too much into it. Many of the decision's holdings are fairly routine and may ultimately be case-specific. The chief take-away from this and the other class actions he has adjudicated as a judge is that he has generally sided with the defense and is considered to be a judicial minimalist who will not endorse novel approaches, but he has not shown any willingness to be an anti-class action crusader. Only time will tell how he will rule on this issue as a Supreme Court justice.

TOPIC 2: Preparing for the Food Safety Modernization Act

MCC: Compliance deadlines for some FSMA rules have passed and others are quickly approaching. Where is the industry generally in terms of the rollout of the new regulations?

Much of the discussion this year will focus on enforcement and supply chains.
– Christopher A. Ripple

Ripple: The compliance deadlines under FSMA vary in different circumstances, but the industry is generally entering a second phase of compliance. One of the foundational FSMA rules is referred to as the Preventive Controls Rule. It requires facilities that manufacture, process, pack or hold food to develop written food safety plans that evaluate potential hazards, and then to implement "preventive controls" to significantly minimize or prevent those hazards from occurring. Large facilities were required to comply with these rules by this past September, and some of these facilities, if they are manufacturers or processors receiving raw materials or ingredients from suppliers, were required by as early as mid-March to implement programs to manage certain supply chain risks. Smaller facilities will need to comply with preventive control requirements by as early as mid-September.

The industry is also managing compliance dates for the other FSMA rules. Companies engaged in food transportation operations had to comply with new requirements relating to the sanitary transportation of food by rail or motor carrier in early April, and "importers" of food from foreign suppliers must implement supplier verification programs as early as late May. Separate deadlines apply to new and revised good manufacturing practice regulations, and other deadlines apply specifically to the animal food industry. The number of exemptions and special circumstances under each of the rules is significant, so firms should review these dates carefully.

MCC: If you had to identify two issues that will dominate industry discussion on FSMA for the rest of this year, what are they?

Ripple: Much of the discussion this year will focus on enforcement and supply chains. One of the most frequently discussed issues is whether the FDA will have sufficient resources to enforce the new regulations to ensure that they have meaningful impact. As we get deeper into the compliance periods under the new rules this year, particularly for the Preventive Controls Rule, we will have our first real glimpse at how inspections are conducted and whether inspectors have been adequately trained under the new requirements. Related to enforcement, there is a great deal of attention on the importance of environmental controls in the context of ready-to-eat foods, and the FDA's use of a technique known as "whole genome sequencing." This is a scientific method that allows the FDA to show connections between a particular pathogen, incidents of foodborne illness and the location where the strain originated. Increased use of whole genome sequencing on samples taken during inspections will provide the FDA with a powerful tool to track pathogens. As a result, facilities will be under greater pressure to manage environmental controls and address persistent strains at their facilities.

It is likely that there will be another mega-merger between two large food conglomerates . . .
– J.D. Costa

A second major issue this year will be domestic and international supply chains. The supply chain program requirements under the Preventive Controls Rule require manufacturers and processors that receive raw materials or ingredients to control for potential hazards in their supply chains by using only approved suppliers and conducting supplier verification activities. For serious hazards – those involving a risk of serious adverse health consequences or death to humans or animals – an onsite audit of the supplier is the presumptively appropriate verification activity. A similar rule focused on foreign foods, called the Foreign Supplier Verification Program rule, requires importers to implement comparable supply chain programs. The FDA is also implementing a program by which foreign suppliers may request an audit from an auditor that is accredited under an FDA-administered program. Although participation in the accredited auditor program is voluntary, it is re-

quired if a foreign supplier wants its food to receive expedited treatment at entry through a system being rolled out by the FDA later this year called the Voluntary Qualified Importer Program (the VQIP). If the FDA incentivizes the VQIP by providing for significantly expedited entry, this could have a significant effect on international supply chains.

MCC: What impact might the new administration have on the implementation of FSMA across the industry?

Ripple: There obviously has been a great deal of discussion about the potential for deregulation under the new administration. In the FSMA context, we are more likely to see this in the form of decreased enforcement or informal agency actions, rather than any formal attempt to roll-back FSMA. The FDA cannot enforce the FSMA regulations, including through training and dispatching investigators, without substantial resources, so the funding for FSMA enforcement will remain an important issue in the years ahead. And although it seems unlikely that the new administration will attempt to roll-back major portions of FSMA through the more time-consuming and resource-intensive procedures of the rulemaking process or more formal agency action, the FDA can nevertheless do a great deal to lessen the effect of the new regulations through issuance of "interpretations," agency guidance, or other informal documents. Whether these types of agency actions actually reduce costs and burdens is not always clear. In any event, until the FDA signals a new direction, the industry needs to continue to be prepared.

TOPIC 3: Food and Beverage Mergers Are Expected to Ramp Up

MCC: Many market observers expect a significant uptick in mergers and acquisitions in 2017. What factors are driving activity within the food and beverage industry?

Costa: The largest factors contributing to activity in food and beverage M&A are the same as those contributing to increased M&A activity generally – the still relatively cheap cost of capital and the pressure on companies to create year-over-year growth where organic growth is not always easily achievable. While multiple interest rate increases were expected in 2016, the Federal Reserve only raised rates once, in December, constituting just the second rate hike in a decade. The Fed has penciled in three rate hikes for 2017, the first of which occurred in March. As long as rate increases remain modest, the cost of credit will still be very appealing to M&A investors.

Additionally, given the competitive nature of the current M&A market, many private equity funds have not been able to make as many investments as they would like, leaving them with funds to deploy. Strategic investors with M&A budgets are facing a similar situation. This surplus of "dry powder" will likely contribute to continued heightened activity.

We are also likely to see an uptick in acquisitions of smaller, startup food companies by larger, better-known food producers.
– John B. Hoke

Hoke: A portion of the jump in activity is due to the preceding slowdown earlier in 2016. As of the third quarter of 2016, M&A activity was down approximately 20 percent year-over-year from 2015. Analysts largely attributed that dip to political uncertainty about Brexit and the U.S. presidential election. M&A activity rebounded significantly in the fourth quarter of 2016, once the questions were answered. Given the otherwise positive market conditions for M&A, most analysts expect to see M&A activity continue at fourth quarter 2016 levels.

MCC: What kinds of food and beverage companies are likely to be targets for deals this year?

Costa: It is likely that there will be another mega-merger between two large food conglomerates like AB InBev's acquisition of SABMiller, which closed last year. Margins are tight and sales growth is slow among the world's largest food companies, and many are struggling to grow their business organically. Most of the largest food companies have accepted that the easiest way to grow their business right now is through strategic acquisitions. As a result, it is likely that that we will see continued M&A activity by some of the world's largest food producers.

Hoke: We are also likely to see an uptick in acquisitions of smaller, startup food companies by larger, better-known food producers. Many of these smaller food producers have deep brand loyalty that larger food producers struggle to cultivate, particularly in the natural and organic food space. Rather than developing their own organic and natural products, large food conglomerates will likely continue to acquire these smaller food producers throughout 2017.

MCC: What impact might the Trump administration's policies have on M&A activity within the industry?

Costa: The Trump administration has made several statements regarding policies that could impact M&A activity in general that also would specifically affect food and beverage M&A. One example is Trump's proposal of a tax holiday on the repatriation of foreign earnings of U.S. companies. Currently, companies generally pay a 35 percent tax on repatriated earnings. The administration is proposing to drastically reduce that tax to something closer to 10 percent for a period of time. While its primary goal is for companies to reinvest that money in order to grow and increase jobs, the last time a similar tax holiday was implemented in 2004, many companies used some portion of the repatriated funds to pursue M&A opportunities. Analysts expect to see another uptick in M&A if, in fact, the administration implements such a tax holiday.

Hoke: The Trump administration is focused on decreasing regulation across a broad range of industries. In fact, on Feb. 24 Trump signed an executive order directing federal agencies to create task forces to identify burdensome regulations to be eliminated. A reduction in burdensome regulations could have a positive impact on food and beverage M&A. While many strategic acquirers tend to have a good understanding of regulations affecting industries in which they already participate, and how to evaluate an acquisition target's compliance, financial and strategic buyers looking to expand into new industries or sectors are often weary of heavy regulation. So a relaxation of the more onerous regulations could expand the pool of acquirers, increasing not only M&A activity in general, but competition and, therefore, valuations.

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