Paul|Weiss

Private Equity Digest

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Hart-Scott-Rodino Top Ten Tricks, Traps and Trends . . . In No Particular Order

Overview

The HSR Act's thresholds, rules and exemptions are complex. Compliance and failures to file by hedge and private equity funds are currently subject to a high degree of scrutiny by the agencies. Inadvertent failures to file, which can result in civil fines of up to $16,000 per day of violation, are not uncommon, and generally occur as a result of a small acquisition that is not properly aggregated with prior holdings. For example, extreme caution should be taken in cases where one currently holds voting securities of a company and then makes a non-traditional acquisition – an option exercise or a relatively small stock acquisition either via a standard purchase transaction or another route, such as a PIK dividend – which may result in holding an aggregate value exceeding the $76.3 million threshold. While the actual option exercise or stock acquisition could be of voting securities with a very small value of $1 million, if one already holds voting securities of the company worth $75.5 million, an HSR filing could be required prior to that exercise or purchase. This is often a surprise for executives acquiring shares, and has resulted in several enforcement actions.

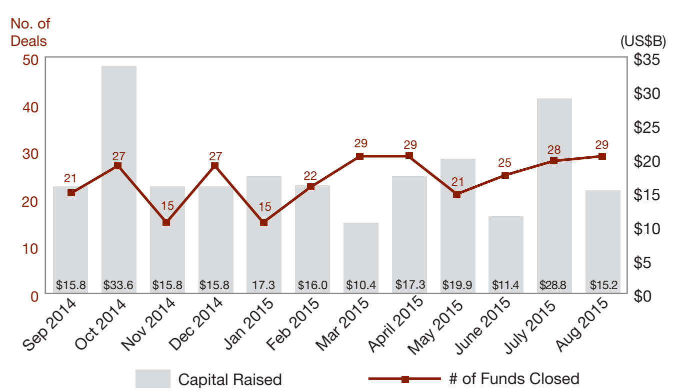
Discussion

To alleviate the probability of falling into a HSR Act "trap," dealmakers will want to consider the following "Top Ten" HSR points while negotiating transactions and moving towards closing.

1. **Nonreportable transactions are not immune to challenge.** Even if a deal is not reportable under the HSR Act, it may still be challenged by regulators, prior to or even after closing. The HSR Act allows antitrust regulators an opportunity to review deals in their incipiency, but any transaction that is perceived as potentially having anticompetitive effects can be reviewed and challenged by the antitrust agencies at any time. It should not be assumed that a transaction will be under the radar simply because it falls below the HSR Act filing thresholds or is otherwise exempt from filing. Dealmakers will always want to consider (in both reportable and nonreportable transactions) whether it is likely that customers of the target company will complain about the proposed transaction, as this fact will increase the likelihood of review by antitrust regulators.

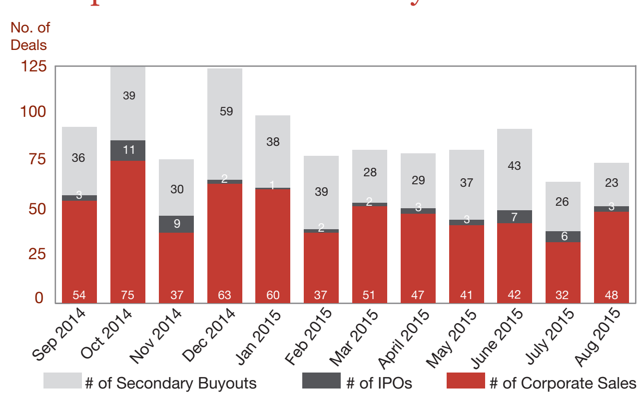
2. **Acquisitions of interests in LPs, LLCs and other unincorporated entities are only reportable if "control" is acquired.** "Control" of noncorporate entities is defined as having the right to 50% or more of the profits of the entity or having the right to 50% or more of the entity's assets upon dissolution. Note that HSR "control" of noncorporate entities is based only on economic interest and often differs from operational control. If three persons hold interests in a noncorporate entity of 49.5%, 49.5% and 1%, and profits and assets on dissolution are distributed pro rata, none of the individuals would be deemed "controlling" for HSR purposes regardless of the governance arrangements among the members. However, in a limited partnership, a general partner with less than 50% economic interest is not deemed to control the limited partnership, whereas a passive investor with a 50% or greater economic interest is deemed to "control" the limited partnership.

U.S. Private Equity Fundraising



Source: Pitchbook

U.S. Sponsor-Backed Exits By Number



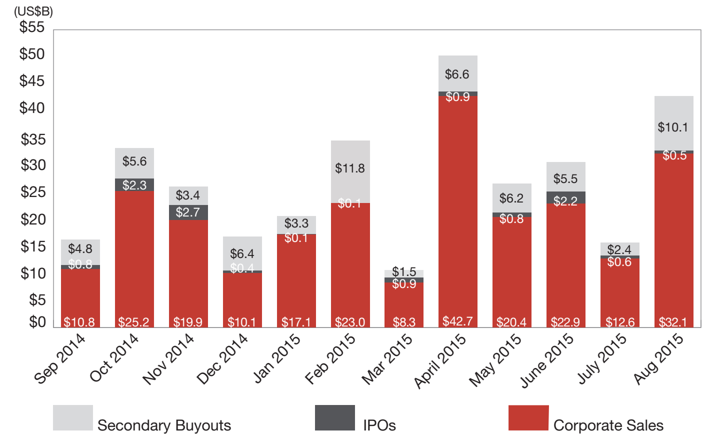
Source: Pitchbook

3. **The "pass through" out for Newcos.** A "pass through" out may apply if a new buyer vehicle is created and funded only with cash to make an acquisition, at least three separate investors (or "persons" under the HSR rules) hold interests in that acquisition vehicle, no single investor is deemed to "control" the vehicle under the HSR regulations' definition of control, and the deal value does not exceed $305.1 million. As an example, let's say investors A, B and C agree to acquire Target X for $200 million in cash, with A and B investing 40% ($80 million) of the equity and C investing 20% ($40 million) of the equity. The investors form Buyer LLC as the acquisition vehicle. A and B are respectively entitled to 40% of the profits and assets on dissolution of Buyer LLC. C is entitled to 20% of the profits and assets on dissolution of Buyer LLC. Therefore, no investor "controls" Buyer LLC for HSR purposes and thus Buyer LLC is its own ultimate parent entity. In this scenario, Buyer LLC may fail the $15.3 million size of parties test because a newly-formed buyer, not controlled by any other entity and not having a regularly prepared balance sheet, can exclude certain items from its total assets calculation, specifically, cash to be used to make the acquisition, cash used to pay for incidental transaction expenses and the value of previously purchased securities of the target company or its subsidiaries. Once those items are excluded, a Newco buyer, such as Buyer LLC, generally does not have $15.3 million in total assets, and as a result, no filing would be required.

4. **The investment purpose exemption is narrowly construed.** Acquisitions solely for the purpose of investment are exempt from filing if: (a) as a result of the acquisition, the buyer will hold 10% or less of the voting securities of the target; and (b) the buyer has "no intention of participating in the formulation, determination or direction of the basic business decisions" of the target. This exemption is construed very narrowly. For example, having a representative on the board or nominating a director is viewed as inconsistent with the investment purpose exemption. Voting shares held is permitted, however, any conduct beyond "merely voting" may be viewed as non-investment activity. Suggesting corporate action to management, such as putting the company up for sale, selling a division or paying a dividend would likely be viewed as inconsistent with the investment purpose exemption. Thus, activist investors are generally advised not to rely on this exemption.

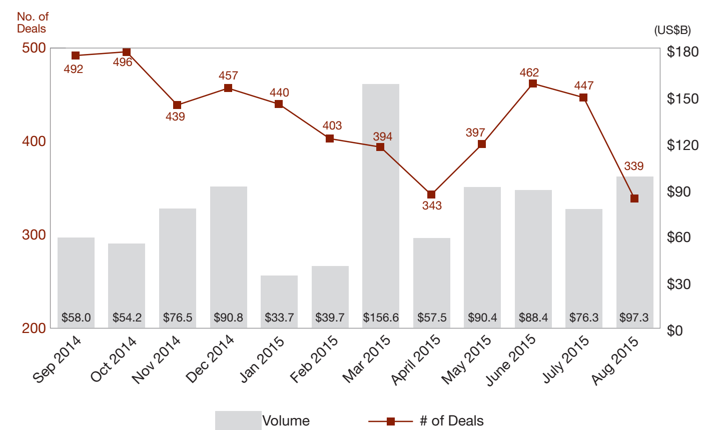
5. **Acquisitions by institutional investors.** A purchase of voting securities by an institutional investor is generally exempt if: (a) made directly by an institutional investor; (b) made in the ordinary course of business; (c) made solely for the purpose of investment – any involvement in the business other than merely voting the shares will render the exemption inapplicable; and (d) as a result of the acquisition the buyer would hold 15% or less of the outstanding voting securities of the target. "Institutional investors" include banks, savings banks, savings and loan or building and loan companies or associations, trust companies, insurance companies, investment companies registered with the U.S. Securities and Exchange Commission under the Investment Company Act of 1940, finance companies, broker-dealers, small business investment companies, certain stock bonus, pension or profit-sharing trusts, bank holding companies, entities that are controlled

U.S. Sponsor-Backed Exits By Dollar Volume



Source: Pitchbook

Global Sponsor-Related M&A Activity



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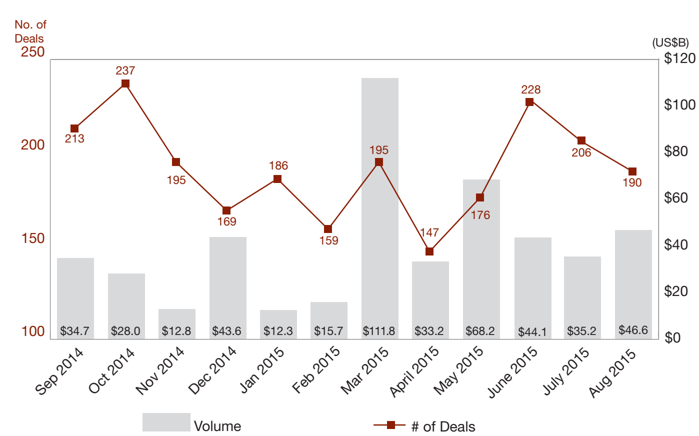
U.S. Sponsor-Related M&A Activity



Source: Dealogic

directly or indirectly by an institutional investor and the activities of which are in the ordinary course of business of the institutional investor, entities that may supply incidental services to entities that it controls directly or indirectly but that performs no operating functions and are otherwise engaged only in holding controlling interests in institutional investors and certain nonprofit entities.

6. **Don't skimp on the document search.** This is a very important point for dealmakers and should be considered from the very beginning of deal negotiations. Buyers, sellers and lawyers should be aware that every document they create addressing Item 4(c)/(d) subject matter (*i.e.*, for the purpose of evaluating or analyzing the acquisition with respect to market share, competition, competitors, markets, potential for sales growth or extension into product or geographic markets), including but not limited to strategic or financial plans, board presentations, and computer files and emails, is subject to disclosure in HSR filings. It is critical when addressing 4(c)/(d) subject matter in negotiations and diligence that the parties not be myopic in their assessments of the markets in which they operate, particularly in strategic deals. Parties do not want to end up pitching a business for sale in an offering memo or detailing a transaction to the Board of Directors or Investment Committee and then later having to explain to regulators why things may not be as they appear in their own documents. It is good practice in strategic deals to brief officers and directors in advance to avoid unwelcome surprises in documents that are later required to be produced and to stress that every potentially responsive document should be sent to deal lawyers for review and potential inclusion with the HSR filing. Additionally, in order to avoid personal liability, the individual certifying the HSR Form should be familiar with HSR requirements and should not sign the HSR certification until comfortable that the filing was prepared in compliance with HSR Form instructions and rules, especially as to the adequacy of the search for 4(c)/(d) documents.

7. **Early termination of the waiting period could result in premature announcement of the transaction.** When submitting an HSR filing, the parties must indicate whether or not they are requesting early termination of the applicable HSR waiting period. If early termination of the waiting period is requested and granted, notice of the early termination is published on the FTC's website, tweeted to followers of @FTC and subsequently published in the Federal Register. The notice contains the names of the ultimate parent entities of the buyer and seller and also the names of the acquired entities. Accordingly, requesting early termination could set up a difficult situation if early termination is granted in two weeks but the parties otherwise desire to keep the existence of the transaction confidential, perhaps because they have only executed a letter of intent, confidentiality is a concern or other consents are required and have not yet been obtained. In such cases, the parties may prefer not to request early termination to avoid premature disclosure of the existence of a transaction.

8. **Pre-closing information exchange and integration may violate the antitrust laws.** This is a tricky area which, to protect both the buyer and seller, is best managed by legal teams. The exchange of information and the process for making corporate decisions can have significant antitrust implications prior to closing and should not take place without the advice of counsel, especially where buyer and seller are competitors. Parties face dual prohibitions under the U.S. antitrust laws prior to closing: (a) Section 1 of the Sherman Act prohibits anticompetitive collusion among competitors, and (b) the HSR Act forbids closing the transaction prior to expiration of the pertinent waiting period – including a prohibition on effective control of the target by the buyer (*i.e.*, "gun jumping"). If closing does not occur, the pre-closing exchange of competitively sensitive information, without adequate safeguards, could lead to antitrust liability. If there is a genuine need to exchange competitively sensitive information because it is essential to conduct due diligence or necessary to plan for post-closing integration, the antitrust liability risks can be minimized. Information exchange should be covered by a written confidentiality agreement and only information reasonably necessary for evaluation or planning should be provided. Moreover, the exchange of competitively sensitive information should be avoided or severely limited – perhaps provided only to outside consultants.

9. **Interlocking directorates may be prohibited.** Section 8 of the Clayton Act provides that no person shall, at the same time, serve as a director or officer in any two corporations that are competitors, such that elimination of competition by agreement between them would constitute a violation of the antitrust laws. There are several "safe harbors" that render the prohibition inapplicable under certain circumstances, such as when the size of the corporations, or the size and degree of competitive sales between them, are below certain dollar thresholds. Competitor corporations are subject to Section 8 if each one has capital, surplus and undivided profits aggregating more than $31,084,000, although no corporation is covered if the competitive sales of either corporation are less than $3,108,400. Even if the dollar thresholds are exceeded, other exceptions preventing the applicability of Section 8 may be available (*e.g.*, the percentage of competitive sales relative to total sales). Section 8 is especially relevant in the private equity context, where firms may have minority interests coupled with the right to board representation in competitor companies.

10. **HSR filing fees.** HSR filing fees vary based on the size of transaction. For transactions valued at more than $76.3 million, but less than $152.5 million, the filing fee is $45,000. For transactions valued at $152.5 million or more, but less than $762.7 million, the filing fee is $125,000. For transactions valued at $762.7 million or more, the filing fee is $280,000. Unless the parties agree otherwise, the filing fee must be paid by the buyer. The valuation of a transaction under the HSR rules is complex and turns on, among other things, whether the acquisition is of voting securities/noncorporate interests or assets. For asset acquisitions, the value of assumed liabilities must be included in the value of the transaction. For acquisitions of voting securities or noncorporate interests, the following can generally be excluded from the value of the transaction: debt of the target being repaid at closing, non-voting shares, cashed-out warrants and options and transaction expenses.

This publication is not intended to provide legal advice, and no legal or business decisions should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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