K&LNG Alert

JANUARY 2006

Antitrust & Competition

Hart-Scott-Rodino Act's Exemption for Acquiring Securities "Solely for the Purpose of Investment"

Earlier this year, the Antitrust Division of the United States Department of Justice ("DOJ"), in collaboration with the Federal Trade Commission ("FTC"), imposed civil penalties on a hedge fund manager for failing to comply with the premerger notification and waiting requirements of the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended, 15 U.S.C. § 18a (the "HSR Act") before the hedge fund bought stock in two operating companies.[1] Since then, there has been increased interest in the scope of investor activity that can qualify for the "solely for the purpose of investment" exemptions from the notification and waiting requirements of the HSR Act. This alert describes available guidance on the scope of the "solely for the purpose of investment" exemptions.

THE HART-SCOTT-RODINO ACT

The HSR Act requires certain persons making prescribed acquisitions of assets, voting securities, and noncorporate interests (i.e., interests in partnerships and limited liability companies) (a) to file premerger notifications with the FTC and the DOJ, and (b) to wait until the expiration of a waiting period (usually 30 days) before consummating the acquisition.

The following persons are generally required to observe the Act's notification and waiting period requirements:

- Persons acquiring voting securities, assets or noncorporate interests who will hold voting securities and assets of the acquired person with an aggregate value of $212.3 million or more as a result of the acquisition;[2] and
- Persons acquiring voting securities, assets or noncorporate interests who will hold voting securities or assets of the target with an aggregate value in excess of $53.1 million but not more than $212.3 million as a result of the acquisition, provided that either the acquiring or the acquired person has net sales or total assets of $106.2 million or more and the other person in the transaction has net sales or total assets in excess of $10.6 million.

A person for purposes of the HSR Act includes any entity that is not "controlled" by any individual or another entity (an "Ultimate Parent Entity"), together with all entities that are directly or indirectly controlled by the Ultimate Parent Entity. "Control" of a corporation means holding 50% or more of its voting securities or having the present right to designate 50% or more of its directors. "Control" of a partnership or limited liability company means having the right to 50% or more of its profits or the right to 50% or more of its assets after payment of its debts upon its dissolution.

Although a premerger notification may be required prior to the acquisition of as little as $53.1 million in voting securities or assets, a person who files a notification for an acquisition at that level would have to file additional notifications for acquisitions of voting securities or assets (but not noncorporate interests) before crossing further thresholds of (a) $106.2 million, (b) $530.7 million, (c) 50% of voting securities valued at $53.1 million or more, and (d) 25% of voting securities worth $1.06 billion or more.[3]

[1] The enforcement action against the hedge fund manager was the subject of a K&LNG Alert dated October 2005.

[2] An acquiring person purchasing non-corporate interests must obtain as a result of the acquisition the right to fifty percent (50%) or more of the profits of the non-corporate entity or the right to fifty percent (50%) or more of its assets after the payment of its debts in the event of dissolution for a premerger notification filing to be required under the HSR Act.

[3] The last two thresholds do not apply to acquisitions of assets.

ACQUIRING VOTING SECURITIES "SOLELY FOR THE PURPOSE OF INVESTMENT"

The rules promulgated under the HSR Act, 16 C.F.R. §§ 801-803 (the "Rules") include two exemptions that obviate the need for HSR filings for acquisitions that would otherwise require filings, provided that the acquisitions are "solely for the purpose of investment." Section 802.9 of the Rules exempts from the premerger notification requirements of the HSR Act any acquiring person who acquires voting securities of any issuer if:

(a) the acquisition is "solely for the purpose of investment," and

(b) as a result of the acquisition, that person will hold 10% or less of the outstanding voting securities of the issuer, regardless of the value of those securities.

Section 802.64 of the HSR Rules provides an additional "solely for the purpose of investment" exemption applicable only to institutional investors, which effectively increases the exemption limitation from the 10% limitation set forth in Section 802.9 to 15%. This exemption is applicable only if:

(a) The acquiring person is an "institutional investor";[4]

(b) The acquisition is made in the ordinary course of business of the institutional investor;

(c) The acquisition is made "solely for the purpose of investment";

(d) The institutional investor will not control the issuer as a result of the acquisition;

(e) The institutional investor will hold 15% or less of the issuer's outstanding voting securities as a result of the acquisition;

(f) The issuer is not a competitor of the "institutional investor"; and

(g) The acquiring person does not include an entity (i) that is not an institutional investor and (ii) that holds voting securities of the issuer whose voting securities are being acquired.

Certain Actions Are Generally Inconsistent With a "Solely for the Purpose of Investment" Intent

The Premerger Notification Office of the FTC (the "PNO"), which is responsible for interpreting the HSR Act and Rules, has interpreted the "solely for the purpose of investment" language very narrowly. The PNO has declared that the exemptions apply only to passive investors that do not have the "intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer." Exempted investors may vote their stock, but cannot otherwise influence the issuer's basic business decisions or participate in its management.

The Statement of Basis and Purpose for the HSR Rules identifies several types of conduct that may be viewed as evidence of intent inconsistent with a passive investment purpose and accordingly disqualify an acquiring person from relying upon the "solely for the purpose of investment" exemptions as grounds for not making a premerger notification filing. These types of conduct include:

- Nominating a candidate for the board of directors;
- Proposing corporate action requiring shareholder approval;
- Soliciting proxies;
- Having a controlling shareholder, director, officer, or employee simultaneously serving as an officer or director of the issuer;
- Being a competitor of the issuer; and
- Doing any of the above with respect to a parent or affiliate of the issuer.

Furthermore, in informal advice to an investor, the PNO advised that formulating plans or proposals to merge, liquidate or reorganize a company, demanding the company's shareholder list for the purpose of communicating with the company's shareholders about a proposed transaction between the company and the shareholding investor, and retaining the services of a proxy solicitation firm were activities inconsistent with a "solely for the purpose of investment" exception.

[4] An "institutional investor" is limited to (i) a bank within the meaning of 15 U.S.C. 80b-2(a)(2), (ii) a savings bank; (iii) a savings and loan or building and loan company or association; (iv) a trust company; (v) an insurance company; (vi) an investment company registered with the U.S. Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a-1 *et seq.*); (vii) a finance company; (viii) a broker-dealer within the meaning of 15 U.S.C. 78c(a)(4) or (a)(5); (ix) a Small Business Investment Company or Minority Enterprise Small Business Investment Company regulated by the U.S. Small Business Administration pursuant to 15 U.S.C. 662; (x) a stock bonus, pension, or profit-sharing trust qualified under section 401 of the Internal Revenue Code; (xi) a bank holding company within the meaning of 12 U.S.C. 1841; (xii) an entity that is controlled directly or indirectly by an institutional investor and whose activities are in the ordinary course of business of the institutional investor; (xiii) an entity that supplies incidental services to entities that it controls directly or indirectly but that performs no operating functions, and that is otherwise engaged only in holding controlling interests in institutional investors; and (xiv) a nonprofits entity within the meaning of Sections 501(c)(1) through (4), (6) through (15), (17) through (20), or (d) of the Internal Revenue Code.

Investors who seek to be members of the board of directors of an issuer, of a subsidiary of an issuer, or of any other affiliated entity are presumed not to have passive investment intent, and therefore to be ineligible for the exemption. In *United States v. Gates*, for example, the DOJ claimed that Bill Gates, through a personal investment company, acquired more than $50 million of the voting securities of an issuer in 2002 without complying with the HSR Act's reporting requirements. The complaint asserted that Gates did not qualify for the "solely for the purpose of investment" exemption because he intended to participate in the basic business decisions of the issuer through, among other things, his longstanding membership on its board of directors. The parties eventually reached a settlement, and Gates agreed to pay $800,000 in civil fines.[5]

In *United States v. Pennzoil Company*, the government took the position that an acquisition of voting securities in a competitor while the acquiring person's board members are "anticipating" membership on the competitor's board and consequent future participation in the formulation of the competitor's basic business decisions is not eligible for the "solely for the purpose of investment" exemption. The defendant paid the government $2.5 million in civil penalties pursuant to a settlement agreement.

Investment Intent Should Be Measured at the Time of Acquisition

An acquisition of voting securities that is exempt from the HSR Act because it is made "solely for the purpose of investment" does not retroactively become reportable if the investor subsequently decides to play a more active role in the issuer's affairs. However, if this change of intent becomes evident too soon after the initial purchase of voting securities, it may cause the antitrust authorities to doubt that the acquiring person truly intended to be a passive investor at the time of the acquisition. The FTC and DOJ have filed and successfully settled a number of civil penalty actions in which they contested the credibility of an investor's alleged change of intent from a passive to an active investment shortly after the closing of the acquisition.

Moreover, any investor that changes its strategy and intends to become more active in the management and business affairs of an issuer must reexamine its entitlement to the exemption prior to acquiring any additional voting securities of the issuer, because it may be required to make a premerger notification filing in connection with such an acquisition. The obligation to file prior to any acquisition is based upon the total value of the voting securities that will be held following the acquisition, including the current value of voting securities that were originally acquired pursuant to the "solely for the purpose of investment" exemption. The acquisition of a single additional share therefore may require a premerger notification filing, and an investor who now intends to take a more active role in the management of an issuer no longer will be able to rely upon the "solely for investment" exemption.

On the other hand, an investor also must be cautious when it purchases voting securities of an issuer with a clear intent to gain control of the issuer, but later changes its mind, and thereafter makes additional purchases of the same issuer's voting securities "solely for the purpose of investment." Although the earlier intent to control the issuer does not by itself disqualify the investor from the exemption with respect to the new acquisition, it may be difficult to convince the FTC and the DOJ that the new acquisition was undertaken without any continuing intent to influence the management of the issuer.

Intent to Purchase More Than Ten Percent (or Fifteen Percent) of an Issuer's Voting Securities in a Future Acquisition, but Less Than a Controlling Interest, Does Not Necessarily Make the Exemption Unavailable

The "solely for the purpose of investment" exemption applies to acquiring persons other than institutional investors only if the investor's holdings will not exceed 10% of the outstanding voting securities of the issuer as a result of the acquisition. An institutional investor's exemption only applies if its holdings will not exceed 15% of the issuer's outstanding voting securities as a result of the acquisition. The investor's intent, however, becomes irrelevant once its holdings exceed 15% in the case of an institutional investor and 10% in the case of all other investors, and the "solely for the purpose of investment" exemption no longer applies.

The PNO, however, has taken the position that a declaration of intent to exceed the maximum investment percentage under the "solely for the

[5] A maximum civil fine of $11,000 per day may be assessed for each day after a party has consummated an acquisition without making a required premerger notification filing under the HSR Act.

purpose of investment" exemption does not, by itself, preclude application of the "solely for the purpose of investment" exemption to a current acquisition for investment purposes. Thus, acquisitions that do not result in holdings exceeding 10% (or 15%) of the voting securities of an issuer may still be completed during the statutory waiting period following the filing of a premerger notification under the HSR Act for an acquisition pursuant to which the acquiring person will exceed the exemption's ceiling, provided that the existing investment remains "solely for the purpose of investment."

However, any consideration of acquiring control of the issuer (even if working control can be achieved by holding substantially less than 50% of the issuer's voting securities) immediately disqualifies the acquiring person from the "solely for the purpose of investment" exemption. In *United States v. Farley*, the DOJ took the position that the acquiring person improperly purchased voting securities of an issuer without observing the notification and waiting requirements of the HSR Act. The DOJ asserted that the acquiring person could not have been acting solely for the purposes of investment because it was considering the possibility of acquiring control of the issuer when it began acquiring its voting securities.

The DOJ and the acquiring person eventually reached a settlement in which the acquiring person paid a $425,000 civil penalty.

CONCLUSION

A complex legal and factual analysis may be required to determine whether or not a purchase of voting securities by an investor will require a premerger notification under the HSR Act. Investors will be subject to significant civil penalties if they consummate an acquisition of voting securities without making a required premerger notification filing under the HSR Act. An investor therefore should consult with counsel prior to making a significant purchase of voting securities or prior to any change of strategy with regard to its involvement in the management of a company in which it holds voting securities.

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