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Exercise of Options Resulted in Hart-Scott-Rodino Violation Despite Closing into Escrow

On June 23, 2009, the Antitrust Division of the U.S. Department of Justice announced that it had reached a \$1.4 million settlement with an individual executive and shareholder (the “Executive”) relating to a series of violations of the premerger notification program under the Hart-Scott-Rodino Antitrust Improvements Act (the “Act”). First, the Executive had between 2005 and 2008 completed a series of purchases of stock in a cable television entertainment company (the “Cable Network”) without filing premerger notifications under the Act, in the mistaken belief that his filings under the Act for his interests in the Cable Network’s former parent company (the “Parent”) would suffice. In addition, prior to the expiration of the waiting period for his corrective filing under the Act relating to these purchases, the Executive exercised nearly expired options to purchase additional shares in the Cable Network, but closed them into escrow. This enforcement action highlights the following principles under the Act’s premerger notification program:

1. Closing an acquisition into escrow prior to the end of the Act’s waiting period does not necessarily prevent the transaction from creating a prohibited transfer of beneficial ownership to the beneficiary of the escrow arrangements;
2. The exercise of an option for voting securities is a reportable transaction if the value of the transaction meets the Act’s size criteria; and
3. The Federal Trade Commission (“FTC”) is free at any time to change its informal interpretations of the Act and the regulations thereunder, and reliance on the FTC’s published informal interpretations is not the equivalent of a conversation with the FTC’s Premerger Notification Office to confirm the FTC’s current policy and the application of the Hart-Scott-Rodino rules to a particular transaction.

According to the complaint, the Executive in 2005 filed a proper notification under the Act to acquire additional shares in the Parent, while the Cable Network was a subsidiary of the Parent. Parent then spun off the Cable Network to the Parent’s shareholders (including the Executive), in a transaction which did not require a notification under the Act because all of the Parent’s shareholders received *pro rata* shares in the Cable Network. When the Executive acquired additional shares in the Cable Network between 2005 and 2008, he failed to file premerger notifications for the purchases because he erroneously relied upon an out-of-date informal interpretation by the FTC of the rules under the Act (the “Rules”). In June 2008, the Executive discovered the mistake and made a corrective filing for the 2005 through 2008 acquisitions. In 1991, he had made a similar corrective filing for an inadvertent violation of the Act in connection with the purchase of shares in a different company in 1985.

On June 14, 2008, prior to the July 14, 2008 expiration of the waiting period for his corrective filing, the Executive exercised options for the acquisition of additional Cable Network shares, because the options would have expired prior to the end of the waiting period. The Executive had arranged for the shares acquired under the options to be held in escrow until the expiration of the waiting period. Neither the Executive nor the escrow agent could vote the shares during the escrow period. The escrow agent was required (i) to deliver the shares to the Executive upon expiration of the waiting period, or (ii) if the waiting period had not expired in 120 days, to sell the shares and deliver the proceeds to the Executive.

According to the Justice Department's complaint, the exercise of the options during the waiting period violated the Act because beneficial ownership of the shares immediately transferred to the Executive. The complaint notes that the FTC had previously announced its interpretation of the Rules that an escrow agent is not the beneficial owner of shares held in escrow and that a transfer into escrow may be deemed an acquisition by the beneficiary of the escrow if the escrow results in a transfer of beneficial ownership of the shares to that beneficiary. In this case, the complaint notes that the Executive paid the full exercise price for the shares on June 14, and that the Cable Network received payment for the shares at that time. After that date, the complaint reasons, the Cable Network had no right to receive the shares back, had no economic interest in the shares, had no right to vote the shares and had no right to dispose of the shares. Although the Executive could not vote the shares while they were in escrow, all the gains and all the losses from any change in the value of the shares during the escrow period were for his account, and any dividends paid during that period would also be held for his benefit. According to the complaint, these facts were sufficient to transfer beneficial ownership of the Cable Network shares to the Executive while the shares were held in escrow.

The FTC has consistently declared that an escrow arrangement must prevent a transfer of beneficial ownership during the term of the escrow arrangement if the escrow is to prevent a violation of

the Act. Significant criteria for the escrow include limitations on (i) transfer of title to the buyer, (ii) the ability of the buyer to exercise voting rights, (iii) the buyer's receipt of dividends, and (iv) the right to dispose of the shares, as well as a provision allowing the escrow agent to unwind the transaction if the acquisition is challenged. Nevertheless, a comparison of the recent complaint's description of the escrow there with the escrow descriptions in a limited number of FTC informal interpretations that approved the use of an escrow reveals only minor variations between the details of the approved and the penalized escrow structures. Current FTC policy, however, is to accept escrow arrangements as a means of proceeding with a transaction before completing compliance with the Act only "in very unusual circumstances." Thus, the reason for proceeding with the transaction before completing the waiting period under the Act is, in the FTC's opinion, as important as the escrow structure in avoiding a violation.

The recent enforcement action demonstrates the hazards of relying on one's own understanding of the Act, the Rules and the Premerger Notification Office's previously published informal interpretations, rather than using those resources as a basis for a discussion with the Premerger Notification Office staff to confirm the office's current policy and its application to specific facts. The complaint points out that in 2005 the Executive's counsel did not check the database of informal interpretations provided on the FTC's website to confirm that the FTC's earlier interpretation of the filing requirements for purchases of a subsidiary's stock was still valid. In addition, his counsel did not contact the Premerger Notification Office regarding its current policy. Furthermore, after making the corrective filing, according to the complaint, the Executive's counsel did not contact the Premerger Notification Office to ask whether it was permissible to use the escrow arrangement to close the additional transactions before the waiting period expired. In contrast, there is no record of any Hart-Scott-Rodino enforcement action being undertaken against a party that had acted in accordance with the advice the party had received from the Premerger Notification Office relative to a specific transaction.

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