Changes to the Hart-Scott-Rodino Act Rules Affecting Acquisitions Involving Partnerships, LLCs and Other Unincorporated Entities

WIGGIN AND DANA

Counsellors at Law

In a long-anticipated move, the Federal Trade Commission (the "FTC") on March 8, 2005 published important revisions to the premerger notification rules applicable to acquisitions of interests in partnerships and other unincorporated entities, such as limited liability companies ("LLCs"), under the Hart-Scott-Rodino Antitrust Improvement Act of 1976 (the "HSR Act"). The amendments to the rules, which will take effect on April 7, 2005, are intended to narrow the existing "partnership loophole" and allow the federal antitrust authorities to treat corporations and unincorporated entities more uniformly.

Under the HSR Act, parties contemplating a merger or acquisition that satisfies certain thresholds - in particular, the transfer of assets or voting securities worth over $53.1 million - must notify the FTC and Department of Justice of the transaction, pay a substantial filing fee, and observe a mandatory waiting period before completing the merger or acquisition. During this period, the antitrust agencies decide whether or not to challenge the proposed transaction or to seek further information about its competitive significance.

The "Partnership Loophole"

Until now, acquisitions involving unincorporated entities have been treated quite differently under the HSR rules from those involving corporations. The formation of, and virtually all acquisitions of interests in, partnerships and most LLCs were generally excluded from the premerger notification process, while the formation of corporations and the acquisition of corporate securities were subject to notification under the HSR Act. In particular, acquisitions of interests in existing partnerships were only reportable if, as a result of the acquisition, the acquiring person would hold all of the interests in the entity. Thus, acquisitions or transfers of minority, or even majority, interests in a partnership were not reportable if the acquiring person would hold less than 100% of such interests as a result of the transaction. By contrast, acquisitions of corporate voting securities were reportable so long as the applicable size-of-transaction and size-of-person tests (described below) were met. This anomaly was often referred to as the "partnership loophole."

The FTC has long believed that this loophole created an unjustified incentive to choose one corporate form over another (i.e., to structure a merger as the formation of a partnership rather than a corporate entity), even though the form of the deal is generally irrelevant to whether or not a transaction raises substantive antitrust issues. To address this concern, the Commission has approved a number of changes to the HSR Act regulations that will effectively eliminate the disparate treatment of corporations and non-corporate entities for purposes of the HSR Act.

The New Reporting Requirements

The new rules will subject the formation of, or acquisition of an interest in, an unincorporated entity to the requirements of the HSR Act if:

(1) upon formation or as a result of an acquisition, at least one person will acquire "control" of the entity. "Control" for these purposes generally means the right to 50% or more of the profits, or 50% or more of the assets, of the entity, in the event of dissolution;

(2) the value of the interests in the unincorporated entity to be held by the controlling person as a result of the acquisition (including any previously-held interests) is at least $53.1 million

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(this is the "size-of-transaction" test applicable to all deals); and

(3) the person controlling the entity has annual net sales or total assets of at least $106.2 million and the entity has total assets of at least $10.7 million (or, alternatively, the person controlling the entity has annual net sales or total assets of at least $10.7 million and the newly formed entity has total assets of at least $106.2 million) (this is the "size-of-person" test). If, however, the transaction is valued at over $212.3 million, then the size-of-person test does not apply.

Thus, under the amended rules, the formation of, or acquisition of an interest in, an unincorporated entity will be reportable and trigger the statutory waiting period when a controlling interest in the entity is acquired and the statutory size-of-person and size-of-transaction tests have been met. The rules shift reporting from the acquisition of 100% of the interests in an entity to the more significant point when control of the entity is transferred.

Note, however, that the amended rules do not entirely eliminate the distinction between acquisitions of corporate and non-corporate interests. A remaining distinction is illustrated in the following example: A, B and C each hold 33 1/3% of the interests in Partnership X. D pays $53.1 million cash to the partnership and in return, D receives a 40% interest in Partnership X, and A, B and C are each reduced to 20% interests. In this case, neither D nor the partnership (nor any of A, B, or C) will have to make any filing, because there is no transfer of a controlling interest in the partnership. However, if D receives a 60% interest in the partnership in return for the same payment, the transaction would be reportable under the amended rules as an acquisition by D. By contrast, any acquisition of corporate voting securities valued at over $53.1 million - whether or not it confers control over the corporate entity - is reportable.

Another interesting aspect of the new regulations relates to how the FTC defines "control" for purposes of the reporting requirements. Many argued that control should be measured in the traditional governance sense, rather than solely by measure of owning a majority of the equity interests (i.e., the right to 50% of the entity's assets or profits on dissolution). The FTC determined, however, that a governance test (i.e., the right to control the management of the entity) could not be used in the case of partnerships and other unincorporated entities because these can be structured by contract in so many diverse ways that it is impractical to identify every possible measure of governance control.

Overall, however, these amendments to the rules under the HSR Act should allow the federal authorities to treat corporate and non-corporate entities far more uniformly than under the current regime. As a result, there will be less of an incentive for businesses to choose one form of organization over another solely in an effort to avoid antitrust scrutiny. Perhaps more importantly, the long-awaited elimination of these anomalies should increase both legal practitioners' and the public's understanding of, and compliance with, the HSR Act and its attendant rules.

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Robert M. Langer
860.297.3724
rlanger@wiggin.com

Suzanne E. Wachsstock
203.363.7601
swachsstock@wiggin.com

Steven B. Malech
860.297.3731
smalech@wiggin.com