Comments from Kirkland & Ellis LLP
HSR Proposed Rulemaking, Project No. P989316

Background

Kirkland has a very large private equity practice, in which many acquisition vehicles and portfolio companies are structured as non-corporate entities. This has been done for non-HSR reasons, and we are not aware of any problem of antitrust-sensitive private equity transactions escaping scrutiny because of the current treatment of non-corporate entities. As a practical matter, combining two operating companies of sufficient size already triggers a filing obligation, and that will not change under this proposal. Therefore, we think that any undue burden imposed on private equity transactions should be given considerable weight.

In principle, we endorse the idea of using a 50% equity threshold for acquisitions of interests in non-corporate entities and expanding certain exemptions as proposed, but only if the 50% threshold for non-corporate interests can be defined in a manner that simplifies and clarifies the determination of control in standard private equity structures.[1] This is the problem we address in our comments.

The Practical Problem

We see one very serious problem with the proposal: ***It needs a simple, clear method for making the required control determinations***. This single problem actually encompasses two distinct difficulties.

1. The exclusion of non-corporate debt is not spelled-out.

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[1] We also assume that the final Rule changes will correct an apparent oversight regarding the expansion of Rule 801.21 to include the formation size-of-person tests for newly-formed entities. This is necessary to accomplish the intended goal of avoiding needlessly burdensome formation filings where the formation of an acquisition vehicle has no antitrust significance.

The Background statement suggests, quite properly, that the Commission is concerned with "equity" rather than debt interests in non-corporate entities. Consistent with this focus on equity, the discussion of proposed Rule 801.50 says that "if any person contributing to the formation receives the right to 50% or more of the assets of the entity *once all its debt has been repaid*, then that person is deemed to have acquired control of the entity." (Emphasis supplied.) But the proposed definition of "non-corporate interests" in Rule 801.1(f)(1)(ii) does not say anything about this important distinction between debt and equity.

2. Profit and asset distributions are both indeterminate in standard private equity structures.

The 50% "equity" test used to determine control over a non-corporate entity does not produce a clear outcome when the ownership of the entity includes preferred interests, and this indeterminacy applies equally to both the profit and the asset prongs of this control test. Until now, the indeterminate nature of this test has not been a major problem, but that will change if it becomes a reporting threshold.

The Commission's discussion of proposed Rule 801.50 reflects only a partial acknowledgment of this problem. The indeterminacy is not limited to formations and is not limited to the profits prong of the control test. The proposed solution is not workable because it assumes that asset distribution percentages can be determined, even when profit percentages cannot, and this is not the case. Because preference rights affect asset (as well as profit) distributions, asset percentages cannot be calculated without knowing what price the assets would fetch in a hypothetical dissolution scenario. This makes the asset percentages even more conjectural than the profit percentages in many standard private equity structures. The following simple hypothetical illustrates the problem with the asset prong of the "equity" control test.

Three owners, A, B, and C each invest $100 with A's interest all in preferred, C's all in common and B's split 50/50 between common and preferred.

A balance sheet (actual or pro forma) at formation would show total owner equity

of $300. The underlying accounting books and records would reflect each owner's total equity as well as its split between preferred and common. These individual owner accounts would support the total equity number shown on the balance sheet. Individual percentages of total owner equity could be calculated without ambiguity (each owns one third).

But if we had to calculate the percentage of assets going to each owner in the event of dissolution, then the answer would depend upon how much the assets would be worth in dissolution. For example, if an asset sale would fetch $300, then each owner would receive one third, and no one would control. But if the assets would fetch $600, then A would receive $100, B would receive $200, and C would receive $300; and, in this case, C would control. On the other hand, if the assets would only fetch $150, then all the money would go to pay the preferred interests; and, in this case, A would control.

Practical Solutions

We have tried to identify practical solutions to the above problem, which would provide a reasonably simple and clear method for determining control under a 50% "equity" test for non-corporate entities. Each of the following assumes that the definition of equity "interests" is clarified to remove any question about the exclusion of debt.

1. Define Equity Based On Capital Accounts.

Balance sheets for non-corporate entities generally state a total amount of owner capital, which could be used to calculate percentages for individual owners. The current size-of-person rules would be a good starting point for identifying what balance sheet should be used and for indicating when a pro forma should be prepared. Both staff and private attorneys have considerable experience with those rules. The advantage is clear: he control determination would not depend on a prediction of future profits or on conjectures about what price assets would fetch in a hypothetical dissolution. Rather, it would be based on the capital account in the balance sheet.

2. If the Profits Prong Is Retained, Use a Good Faith Determination Procedure for Future Profits.

The first solution would eliminate the need to predict the level of future profits and would be preferred for that reason. However, if the profits prong of the current control definition is retained, it should be revised to provide a means for parties to arrive at a clear outcome. One possibility would be to use a process analogous to the good faith determination of fair market value in Rule 801.10(c)(3) This approach would be more determinate than the current proposal but less determinate than the first proposed solution. It also would require the commission to define a specific time horizon over which the level of expected profits would be "determined" for this purpose.

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