Comment #: 10

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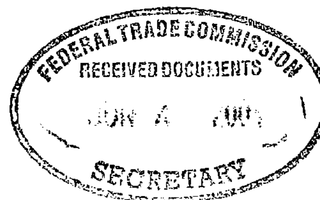


Federal Trade Commission
Office of the Secretary
Room H-159 (Annex E)
600 Pennsylvania Avenue, N.W.
Washington, D.C. 20580

Re: HSR Proposed Rulemaking, Project No. P989316
Application of HSR Rules to Unincorporated Entities

Ladies and Gentlemen:

On behalf of the Business Law Section of the Virginia State Bar, I am pleased to submit comments on the proposed changes to the premerger notification rules (the "HSR Rules") implemented pursuant to the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the "HSR Act"), as proposed by the Federal Trade Commission (the "Commission") on March 30, 2004 (the "proposed rules"). I am also authorized to advise you that the Colorado Bar Association Business Law Section joins in these comments.

For many years, the HSR Rules allowed parties to determine whether a premerger notification filing would be required based on the form of entity used in a transaction. For example, in "joint venture" transactions that otherwise met the size of party and size of transaction tests, the transaction may be made to fall outside the reporting requirements by forming the joint venture as a general partnership instead of a corporation. Several years ago, with the issuance of Formal Interpretation 15, this gap in the HSR Rules was addressed in a partial manner, but Formal Interpretation 15 did not change the way the rules were applied (or not applied) to partnerships.

The proposed rules address partnerships and other unincorporated entities by bringing transactions in which such entities are involved within the coverage of the HSR Rules.

Although these changes will result in additional filings, we acknowledge that it is time to eliminate the disparate treatment of transactions under the HSR Rules based solely on the type of entity chosen to effect the transactions. That being said, we are concerned that the proposed rules, as now drafted, impose tests that will result in requiring the wrong parties to make premerger notification filings, and that will cause partnerships and unincorporated entities to be disadvantaged because the use of unincorporated entities may trigger HSR filings by parties that would not be required to file were a corporation to be used in the underlying transaction. Because we believe that it is the intent of the Commission to ensure that the proper "control" party be responsible for making any required HSR filing, and that the HSR Rules, insofar as possible, be neutral with respect to the form of entity chosen, we urge the Commission to rethink both the proposed new definition of "control" under § 801.1(b) and the exemptions available under § 802 in order to address these problems.

Based on our review of the proposed rules, we believe the problems described above occur in both formation and acquisition transactions, and our concerns are further explained in the remainder of this letter.

1. ***In formation transactions involving unincorporated entities, the proposed rules would make investors without de facto control subject to the filing requirements, to the exclusion of actual control parties.***

The use of the profits or dissolution proceeds test as the sole basis for determining the party that "controls" an unincorporated entity will cause passive investors in some transactions to be deemed the filing party, even when actual control is vested in one or more parties with day-to-day de facto control of the entity.

> *Example 1.* Assume a limited partnership formation transaction that otherwise meets the size of parties and size of transaction tests. Limited Partnership X is structured with general partner Y, and a limited partner Z with a more than 50% profits interest. The limited partner contributes only cash. If the transaction were structured using a corporation, § 801.1(b)(1)(i) would define the control party as the shareholders with the ability to elect a majority of the corporation's board of directors, either through the holding of voting securities or the contractual right to vote voting securities. In the corporate setting, if the limited partner were instead the holder of preferred stock that did not give it the right to elect a majority of the directors, the preferred stockholder, as an investor, would presumably have no filing obligation. There would be a filing obligation in the transaction only if the transaction included at least one shareholder (or ultimate control party of one or more shareholders) that was acquiring control of assets that it did not control prior to the transaction. If the parties structure the transaction in partnership form, however, the proposed rules would impose a filing obligation solely on investor limited partner Z,

and would eliminate any obligation of an actual new control party to make a filing. Thus, the selection of a partnership structure, for tax or other business reasons unrelated to HSR or antitrust concerns, will substantially alter the filing obligation.

As now proposed, the exemption in § 802.65 would not necessarily be sufficient to eliminate the limited partner's obligation to file. That exemption is limited to circumstances where the 50% interest is by its nature temporary, and thus does not accommodate a purely passive but 50% or greater economic interest holder. Moreover, the ordinary course condition to the § 802.65 exemption is vague, and is not likely to provide the level of certainty that many investors would require in order to be certain that the premerger notification obligations do not apply.

2. ***The proposed rules may misidentify the control party in acquisition transactions involving unincorporated entities.***

Under the current HSR Rules, an acquisition by an unincorporated entity of assets or securities meeting the size of transaction test will require a filing by the entity itself or by the ultimate party or parties (assuming two 50% owners) that control the unincorporated entity. The existing control test is disjunctive, so that if an unincorporated entity is deemed to have voting securities, or is subject to a contractual mechanism by which a party has the power to designate 50% of more of the individuals exercising functions similar to those of the directors of a corporation, the alternative profits/dissolution rights test in existing § 801.1(b)(1)(ii) does not come into play[1]. Accordingly, when a reportable acquisition by an unincorporated entity takes place, and the unincorporated entity is structured so that its interests should be treated as voting securities for HSR purposes, a filing obligation presently falls upon any party or parties with actual control in the form of the ability to select and direct management of the entity. By contrast, the proposed rule eliminates the use of any voting securities test for unincorporated entities, and instead imposes a filing obligation on the party or parties holding 50% or more of the profits interest or dissolution rights in the entity. The effect of the change will be to create a situation in which choice of entity may be the sole factor dictating the identity of the reporting party. If a corporation is the entity making the acquisition (and does not have an unincorporated entity as its ultimate parent entity), the corporation or the ultimate parent entity that controls the corporation will be the reporting party. However, if an unincorporated entity is used, the de facto control party may be excused from any filing obligation, and the obligation may be imposed on a passive investor, even if that investor lacks voting rights that rise to a control level. Two examples are illustrative:

[1] We understand that in practice, the staff may disregard the lead-in to present § 801.1(b)(ii), which currently states that the profits test does not apply at all when an unincorporated entity has "voting securities" that permit the election of persons performing board functions. The analysis in this letter assumes the present rule is applied as written.

Example 2. A limited partnership includes managing general partner A and limited partner B. Limited partner B has a greater than 50% profits interest in the partnership. The limited partnership acquires assets or securities of another entity that meet the HSR size of transaction test, and the parties meet the size of parties test. Under the existing rules, either the partnership itself or general partners with the power to designate the managing general partner would be likely to be the ultimate entity responsible for making the HSR filing. Under the proposed rules, limited partner B would be the sole party obligated to make the filing, even though that party may not be exercising control, and may be a less appropriate subject for antitrust scrutiny than the alternate filing parties.

Example 3. Private equity fund is controlled by management company C (as a managing general partner or LLC manager), and investor D has the right to more than 50% of the profits. Again, under the existing HSR Rules, either the fund itself or the management company C, if the ultimate parent entity of the fund, would be the appropriate filing party. Under the proposed rules, however, the passive investor in the fund would be obligated to make a filing whenever the fund engaged in a transaction that meets the size test, even though that investor may exercise little or no control over operations or the ability to select management. This would be a wholly unexpected result for investors in private equity and venture capital funds, and is inconsistent with the current language of the HSR Rules. Moreover, bringing passive investors in funds within the coverage of the HSR filing requirements does not serve the underlying purpose of the HSR Rules or the HSR Act.

3. ***Possible solutions.***

We acknowledge that the present definition of "control" does not provide the same bright line comfort, either to the Commission or to potential filers, as the simple corporate test, which turns on the ability to elect a majority of a corporation's board of directors. By their very nature, unincorporated entities tend to be contractual in nature, and their management arrangements reflect a broad continuum of contractual options. That being said, we believe the Commission could further its goal of equalizing the treatment of corporate and unincorporated entities, without introducing substantial complexity, by adopting one or more of the following solutions:

- Expand the § 802.65 exemption to eliminate conditions (b) and (c) (the ordinary course condition and the condition that requires that the 50% interest be temporary). Those conditions might be replaced with a new condition that requires that the cash investor not be entitled to select the persons exercising board of directors or similar management functions of

the unincorporated entity, with an appropriate exception for removal rights upon default or for cause.

In the examples described above, this altered exemption, without any further change in the proposed definition of "control", would make the unincorporated entity itself the reporting party for the purposes of an acquisition transaction.

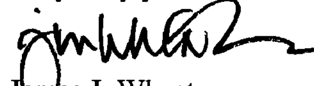
- Establish a new exemption that applies to nonvoting interests in unincorporated entities.
- Modify the definition of control so that the proposed new subsection 801.1(b)(ii) would be deemed not to apply for the purposes of determining control with respect to any unincorporated entity for which there is a person, other than the 50% profits interest holder, that exercises de facto control in the form of the ability to designate 50% or more of the individuals exercising functions similar to those of a board of directors.

These suggestions are non-exhaustive, and we recognize that the staff and the Commission may wish to explore other options

We appreciate the extensive effort by the Premerger Notification Office in preparing the proposed rules. We understand that it has taken many years to produce the current draft, and we hope that the staff and the Commission will consider the concerns expressed in this letter in refining the proposed rules into a more workable final product.

Should you have any questions about the comments contained in this letter, please feel free to contact the undersigned by telephone at (757) 687-7719 or by email at jim.wheaton@troutmansanders.com, or to contact Robert R. Keatinge (on behalf of the Colorado Bar Association Business Law Section) at (303) 295-8595 or rkeatinge@hollandhart.com.

Very truly yours,



James J. Wheaton
Chairman, Board of Governors
Business Law Section, Virginia State Bar

cc: Robert R. Keatinge, Esq.