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LEGAL DEVELOPMENTS

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FTC Announces Revised Reporting Rules Under the Hart-Scott-Rodino Act For Partnerships, LLCs, and Other Unincorporated Entities

On February 23, 2005, the Federal Trade Commission, with the concurrence of the U.S. Department of Justice, announced new rules pursuant to the Hart-Scott-Rodino Antitrust Improvements Act of 1976, largely aimed at more closely aligning the treatment of unincorporated entities such as partnerships, limited liability companies, and business trusts with that currently given to corporations. Specifically, the new rules, which will be effective on or about April 1, 2005:

- Eliminate the loophole that had allowed acquisition of less than a 100% interest in a partnership to go unreported, along with the special rules for LLCs, replacing both with a single change-of-control test
- Expand the "intraperson transaction" exemption to cover a wider range of business relationships
- Close certain loopholes related to the aggregation of prior acquisitions
- Formalize a variety of FTC staff interpretations, including those related to the formation of holding companies and not-for-profit entities.

Definition of a "non-corporate interest": The basic building block of the amendments is the definition of a "non-corporate interest" as "an interest in any unincorporated entity which gives the holder the right to any profits of the entity or in the event of the dissolution of that entity the right to any of its assets after payment of its debts." The acquisition of debt interests, even in unincorporated entities, thus remains outside the coverage of the HSR Act.

Acquisitions conferring control of an unincorporated entity must be reported: Under the revised rules, the acquisition of a non-corporate interest is reportable if the transaction satisfies the ordinary size-of-transaction and size-of person tests and the acquisition gives the acquiring person "control" of the unincorporated entity, defined as the right to receive 50% of the profits of the entity or, upon its dissolution, 50% of the entity's assets. Those are the exclusive tests for control of an unincorporated entity under the HSR Act; the ability to control the day-to-day operations of the entity or to designate the managers or directors of the entity are irrelevant for HSR purposes.

In the commentary accompanying the new rules, the FTC explains how it intends to deal

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with situations in which the allocation of profits or assets upon dissolution depends on variables not known at the time of the acquisition. If one formula is fixed and the other variable, the fixed formula controls. If, however, both the distribution of profits and assets depend on variables that could change over time, the formula for the distribution of assets upon dissolution should be applied as of the time of the acquisition (i.e. hypothesizing an immediate dissolution of the company), using the entity's last regularly prepared balance sheet or, for a newly formed entity, a pro forma balance sheet prepared for that purpose.

Acquisitions that do not confer control are not reportable: In contrast to the rules for a corporation's voting securities, the acquisition of a minority interest in an unincorporated entity is not reportable, regardless of its value. In essence, only the 50% notification threshold applies to non-corporate interests. Similarly, since the expanded intraperson exemption now applies to non-corporate interests, a majority partner's acquisition of the remaining minority interests in a partnership is no longer reportable.

Valuation of non-corporate interests: For purposes of computing the size of a transaction, non-corporate interests being acquired must be aggregated with all other non-corporate interests in the same unincorporated entity already held by the acquiring person, and the resulting aggregation is valued using a method parallel to that used for non-publicly-traded voting securities. For the interests involved in the new acquisition, if the acquisition price is determined, it controls; otherwise, those interests are valued at their fair market value. The value of previously-acquired non-corporate interests is always taken to be their fair market value at the time of the calculation (not at the time they were acquired). When calculating fair market value, only the proportionate interest in the unincorporated entity actually held by the acquiring person need be valued, despite the fact that, for purposes of the size-of-person calculations in subsequent HSR filings, a person is deemed to hold all of the assets of any non-corporate entity which it controls, regardless of the actual size of its controlling interest.

Contribution of assets or voting securities to an existing unincorporated entity: In contrast to the prior rule for LLCs, in which each new contribution to the LLC was treated as a re-formation of the LLC, the new rules provide that whenever a person contributes assets or voting securities to an existing unincorporated entity (including, but not limited to, an LLC), the entity (through its UPE) is treated as an acquiring person and the contributor as an acquired person, and the transaction is not subject to the formation rule (described below). Of course, the transaction is only reportable if the size-of-person and size-of-transaction tests are met and the acquisition is not otherwise exempt. In particular, a contribution to an unincorporated entity by a person who controls the entity is an exempt intraperson transaction.

If the interests in the unincorporated entity are realigned such that the contributor gains control of the entity, the contributor may have a filing obligation as an acquiring person. In such a situation, the entity files as the acquired person, and need not (by virtue of the intraperson transaction exemption) make a separate filing with respect to its acquisition of the contributed assets from its newly-controlling person.

Formation of a new unincorporated entity: The revised rules provide that the formation of a new unincorporated entity is reportable in essentially the same circumstances as the formation of a new corporation is reportable, subject to the caveat that as with other acquisitions of non-corporate interests, only the 50% notification threshold applies. Therefore, a person must file notification as an acquiring person in connection with the formation of a new unincorporated entity (other than in connection with a consolidation) if the person gains control of the unincorporated entity and either (1) the value of the non-corporate interests received by the acquiring person exceeds $200 million (as adjusted); or (2) the value of the non-corporate interests exceeds

$50 million, and the acquiring person and the newly-formed entity are, respectively, $10 million (as adjusted) and $100 million (as adjusted) persons, or vice versa. In such a circumstance, any qualifying acquiring person must file, but the newly-formed entity is exempt from a filing requirement as the acquired person.

Exemption for certain financing transactions: The revised rules include a new exemption from the HSR Act for the acquisition of non-corporate interests in existing or newly-formed unincorporated entities when three conditions are present: (1) the acquiring person contributes only cash to the unincorporated entity, not a business; (2) the contribution is "for the purpose of providing financing"; and (3) the terms of the financing agreement provide that the acquiring person will cede control of the unincorporated entity once it has realized its preferred return.

Although the principal purpose of the amended rules was to address the treatment of unincorporated entities, the FTC also included several more generally-applicable changes to correct what it identified as drafting errors or oversights in its earlier rulemakings:

Expanded intraperson exemption: As discussed above, the intraperson exemption has been expanded to cover any transaction in which the acquiring and at least one of the acquired persons are the same, as determined by the applicable tests of control under the HSR Act and rules. The revised exemption further provides that a person's contribution of assets or voting securities to a newly-formed corporation or unincorporated entity are exempt from the HSR Act with respect to that person.

Aggregation of prior asset acquisitions: Under existing rules, an acquiring person who signed an agreement or letter of intent to purchase assets from an acquired person was required to aggregate the value of those assets with any assets which it had acquired from the same acquired person within the previous 180 days. If the aggregate value exceeded the size-of-transaction threshold, the second transaction was reportable. However, the previous rule applied only if the prior acquisition had closed, which created what the FTC viewed as an anomalous result. The newly-revised rule extends the aggregation requirement to also cover assets which the acquiring person has agreed to purchase under an agreement or letter of intent, entered into within the previous 180 days and which is still valid and unconsummated. No aggregation is required if the earlier transaction was reported pursuant to the HSR Act, if the earlier acquired assets are no longer held by the acquiring person as of the time of the second acquisition, or if the earlier letter of intent or agreement is no longer in effect.

Aggregation of foreign acquisitions: Under existing rules, an acquiring person need not aggregate an earlier acquisition of foreign assets or voting securities of a foreign issuer with a subsequent acquisition if the earlier acquisition was exempt unless, in pertinent part, the foreign assets or the foreign issuer generated sales in or into the United States in excess of $50 million (as adjusted), or had assets of more than $50 million (as adjusted) in the United States. The revised rule makes clear that where an acquiring person has previously acquired both foreign assets and voting securities of a foreign issuer from the same acquired person, the total sales in or into the United States or the total assets in the United States attributable to both the assets and the voting securities must be summed before testing against the $50 million (as adjusted) threshold; therefore, if the foreign assets generated sales of $40 million in the United States, and the voting securities of a foreign issuer with sales of $30 million in the United States were each acquired from the same acquired person, the exemption does not apply.

Formation of holding companies: The revised rules formalize the FTC's longstanding informal interpretation that whenever two or more independent entities become wholly-owned subsidiaries of a single holding company, the result is a consolidation under the

HSR Act, regardless of whether the entities are incorporated or unincorporated, and regardless of whether they retain their separate legal identifies as subsidiaries.

Formation of not-for-profit entities: The formation of any not-for-profit corporation or unincorporated entity, as defined by the relevant portions of the Internal Revenue Code, is now formally exempt from the HSR Act (earlier rules had covered only those entities issuing voting securities).

Pro-rata reorganizations: The existing exemption for stock splits and dividends has been expanded to exempt any acquisition of voting securities or non-corporate interests as a result of the conversion of a corporation or unincorporated entity into a new entity if no new assets are contributed to the entity as part of the reorganization and either the acquiring person did not increase its relative holding in the new entity or the acquiring person already controlled the original entity.

Issuers holding exempt assets: The acquisition of voting securities in an issuer or non-corporate interests in an unincorporated entity is now exempt if the acquisition of the issuer or unincorporated entity's assets would be exempt from the HSR Act, and the entity holds less than $50 million (as adjusted) of non-exempt assets, valued at fair market value.

Timberland acquisitions are not exempt: Fixing an earlier drafting error, the FTC reaffirmed that the acquisition of timberland is not exempt under the agricultural property exemption.

Related developments: In conjunction with the announcement of the new rules, the FTC has also issued a new Formal Interpretation 18, rescinding Formal Interpretation 15, which had governed transactions involving LLCs since 1998. It has also released a new version of the HSR form itself and new instructions for its completion, each reflecting the new filing requirements.

Special transitional rules apply to transactions currently under investigation by either the FTC or the Department of Justice.

If you would like further information regarding the newly-announced rule changes or any other HSR matter, please contact Lauren Albert at (212) 728-2230.