PRIVATE EQUITY MEETS ANTITRUST… COMPLICATIONS ENSUE

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I. INTRODUCTION

The term "private equity" sometimes seems to be more of an epithet than a description. Private equity is neither the shining savior of the American economic system, nor is it something that slithered up from the underworld. It is simply a way in which an investment entity is structured. The real debate is not over what private equity is, but rather what it claims to do when it acts differently from a traditional purchaser of stock or assets.

The truth is that when we talk about private equity in its "different" role, without raising our voices, there is general agreement as to the core concepts of the term: (a) an investment vehicle that is not publicly traded; which (b) acquires whole or partial interests in other companies; and (c) steers those companies through a transition period of (hopefully) performance improvement (which may involve reduction in the number of employees, asset sales, change in management and change in makeup of the Board of Directors); and (d) sells out (again hopefully) at a profit.[2] Typically private equity firms exercise influence over their portfolio companies through representation on the portfolio company boards of directors.[3] They seek to add value to the portfolio companies through financial, governance and operational engineering.[4] While there can be a dispute over whether a private equity firm actually *does* add value to companies in which it invests, it seems to be generally accepted that a private equity investment is usually a prelude to changes in the company in which the investment is made.

Antitrust gets involved because when a person or company, private equity or otherwise, owns all or a part of various companies that may compete with one another in their own markets, two sets of antitrust issues arise. First, the substantive rules of Section 7 of the Clayton Act prohibit the acquisition of stock or assets by any person (natural or corporate) where the effect may be a substantial lessening of competition.[5] This rule is tempered by an exemption from the statute for acquisition of such stock or assets "solely for investment,"[6] which is defined as "… not using the same by voting or otherwise to bring about or attempting to bring about, the substantial lessening of competition."[7] The case law is tolerably clear that if you are *not* seeking representation on the target board of directors, and are *not* able or seeking to become able to exert operational influence over the target, then even substantial equity investments may qualify for the Section 7 exemption.[8]

But Congress and the Agencies had two separate concerns. There was the substantive issue of a potentially adverse impact on competition (the Section 7 issue). But perhaps equally important was that the Agencies often had no notice of or ability to investigate transactions to determine if they would violate Section 7. There had been a wave of midnight acquisitions, which were done and closed before the government had adequate time to investigate (and perhaps challenge) them.

> The data suggest that close to 70% of the problematic mergers were not detected in time to seek preliminary relief. In these cases the parties could close the deal, integrate the assets, reap the profits – some illegitimate and some not – and pursue a protracted strategy of delay. There were strong incentives in favor of the midnight deal, and thus the odds were stacked against the antitrust enforcers.[9]

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2 See generally Barber & Goold, The Strategic secret of Private Equity, Harvard Business Review (September 2007), available at: https://hbr.org/2007/09/the-strategic-secret-of-private-equity.

3 Barber & Goold, supra note 2, at page 3.

4 Gompers, Kaplan & Mukharlyamov, What Do Private Equity Firms Say They Do? Harvard Working Paper 15-081 (2015) available at: http://www.hbs.edu/faculty/Publication%20Files/15-081_9baffe73-8ec2-404f-9d62-ee0d825ca5b5.pdf. The financial engineering can take the form of creating new financial incentives for the management team; governance engineering deals with control of the Board of Directors, and operational engineering can be the bringing of expertise gained through other companies and investments to bear on the current project.

5 Clayton Act Section 7; 15 U.S.C. Section 18.

6 Clayton Act Section 7; 18 U.S.C. Section 18; see also Dubrow, Challenging the Economic Incentives Analysis of Competitive Effects in Acquisitions of Passive Minority Equity Interests, 69 ABA Antitrust Law Journal 113, 115 (2001).

7 18 U.S.C. Section 18. See also Dubrow, supra note 6, page 115.

8 See, e.g. *Crane Co. v. The Anaconda Co.*, 411 F.Supp. 1210 (S.D.N.Y. 1975); *United States v. Tracinda Investment Corp.*, 477 F. Supp. 1093 (C.D. Cal. 1979)

9 Baer, Reflections on 20 Years of Merger Enforcement under the Hart-Scott-Rodino Act (speech before the Conference Board, October 1996; available at: https://www.ftc.gov/public-statements/1996/10/reflections-20-years-merger-enforcement-under-hart-scott-rodino-act.

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That led to the enactment of the Hart-Scott-Rodino ("HSR") Act of 1976.[10] The HSR Act requires premerger filings, information disclosure and waiting periods to allow for the FTC or the Antitrust Division to investigate the transaction before it takes place.

The HSR Act has its own exemption for the acquisition of less than 10 percent of the issuer's outstanding voting securities, regardless of the value of those securities, if the acquisition is made "solely for the purpose of investment."[11] If an acquirer believes that it is exempt, it will not file. But in the absence of filings and disclosure, how are the enforcement agencies to plumb the depths of the acquirer's heart? Here the difference in potential harm between a violation of Section 7 and a violation of the HSR Act is mirrored by a distinction in the application of the remedy.

The Section 7 harm would occur upon the implementation of the acquisition (Section 1 covers everything before that). So if the transaction was enjoined and therefore never implemented, then there would have been no harm and accordingly there are no fines or civil penalties.

The HSR Act is fundamentally different. It is designed to give the enforcement agencies notice and time to review a transaction in order to determine whether to challenge it. It is enforced by civil penalties. A party cannot avoid those penalties simply by terminating the transaction if the agency comes calling. The violation occurred when the purchase was made without the required filings and notice period. Unwinding the deal stops the clock on further penalties, but does not wipe out any penalties that have already accrued. And those accrued penalties can be substantial.

II. THE EXEMPTIONS APPLIED

It is safe to say that the FTC and DOJ do not like the "solely for investment" exemption to the HSR Act, and view it as requiring a purity of heart that is very rare in the investment world. As Malcolm Pfunder (who, as Assistant Director for Premerger Notification at the FTC participated in drafting the implementation rules for the HSR Act) noted, the investment exemption means essentially that except for voting the shares, the acquirer must intend to remain wholly passive.[12] The acquirer must have no intention (and obviously must take no action) to participate in the formulation, determination or direction of the issuer or the business affected.[13] In other words, the acquirer can't do anything that private equity traditionally wants to do. It is sort of like letting a child have an ice cream cone, but only on condition that he not eat it.

That standard has not gotten any looser over the years since it was formulated. In 2015 the FTC Bureau of Competition revived a 1988 opinion in which the agency warned that if an acquirer was even seriously *considering* a possible takeover attempt of the target, but had not yet made any final decision either way, it was not buying stock "solely" for the purpose of investment.[14]

Indeed, something as basic as which SEC filing the acquirer makes can and will be used against it in a court of law.[15] The filing with the SEC of a Schedule 13D (as opposed to a Schedule 13G) may be taken as evidence of non-passive intent for the purposes of the exemption.[16] The FTC's aggressive approach to limiting the application of the exemption may seem harsh, but is supported by the reasons underlying the HSR Act. The agencies want to learn about these transactions, and review them, before they come effective. From that perspective, possible over inclusiveness is a forgivable sin.

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10 15 U.S.C. 18a.

11 15 U.S.C. Section 18a(c) (9); 16 C.F.R. Section 802.9. Note that if the value of the transaction is below the HSR jurisdictional threshold, there is no filing requirement regardless of the buyer's intent. The statute simply is not triggered.

12 Pfunder, Shareholder Activism and the Hart-Scott-Rodino Act Exemption for Acquisitions of Voting Securities Solely for the Purpose of Investment, Antitrust (Summer 2008) 74. The agencies had to allow for voting of the shares, given that the statute speaks in acquiring them as an investment. It would be an odd investment that had a ban on voting the shares.

13 Idem.

14 Feinstein et al., "Investment-only" means just that...., FTC News Release (August 24, 2015), available at: https://www.ftc.gov/news-events/blogs/competition-matters/2015/08/investment-only-means-just.

15 Apologies to *Miranda v. Arizona*, 384 U.S. 436 (1966).

16 Schedule 13D covers active investors, whereas 13G is meant to passive investors. See Novaworks LLC, Quick Guide: Schedule 13D vs. Schedule 13G (2015), available at: https://www.novaworkssoftware.com/blog/archives/38-Quick-Guide-Schedule-13D-vs.-Schedule-13G.html. See also Nili, The HSR Act's Investment-Only Exemption for Targets and Activist Investors, The Harvard Law School Forum on Corporate Governance and Financial Regulation (2015), available at: https://corpgov.law.harvard.edu/2015/02/23/the-hsr-acts-investment-only-exemption-for-targets-and-activist-investors/; Pfunder, supra note 12, page 75.

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For example, Kinder Morgan and Magellan competed in providing gasoline and petroleum terminal services. When Carlyle and Riverstone Holdings, an investment group that owned a 50 percent interest in Magellan, attempted to acquire a 22.6 percent interest in Kinder Morgan, the FTC challenged the transaction. The FTC alleged that although Carlyle and Riverstone did not have a majority stake in either company, their joint ownership interests would give them material control over the competing firms. They might seek representation on both companies' boards, and/or exercise a veto power at Magellan. The case was settled by a consent decree that required the acquirer (Carlyle) to remove its agents from the Magellan board, and prevented the firms from attempting to control or influence Magellan's operations.[17]

Sometimes the harm is less hypothetical. In 2011 three Third Point LLC funds made multiple acquisitions of Yahoo voting securities that exceeded the applicable HSR thresholds. Third Point did not make HSR filings in connection with those acquisitions, arguing that the shares were acquired for "investment only" and therefore exempt from the filing requirements. However in the period before Third Point made remedial HSR filings, it (a) contacted individuals to gauge their willingness to become CEO or a board member of Yahoo; (b) assembled a slate of potential directors for the board of Yahoo; (c) drafted correspondence to Yahoo announcing that Third Point was prepared to join the Yahoo board; (d) stated publicly that it was prepared to propose a new slate of directors at Yahoo's next annual meeting, and (e) internally discussed possibly launching a proxy fight to change the Yahoo board composition. The parties settled for injunctive relief only (it was Third Point's first bite at that apple), but the FTC set out a laundry list of actions that were prohibited if Third Point wanted to rely on the "investment only" exemption in the future. Not surprisingly, items (a) through (e) were all on that "banned" list.[18]

In *Third Point* the FTC reiterated that the "investment only" exemption is a very narrow gate. Any attempt or request to join the target's board immediately slams that gate shut, leaving you outside of the exemption, as Biglari Holdings discovered to the tune of an $850,000 civil penalty settlement.[19] Perhaps it is the fact that all of the cases have settled that leads investors to keep pushing to see how far they can stretch the idea of a "passive" investment. In 2016 Value Act Capital was hit with a DOJ Complaint seeking $19 million for the failure to properly file and wait under the HSR Act. Value Act purchased over $2.5 billion in stock of Halliburton and Baker Hughes after those companies had announced a merger. Value Act did not file under the HSR Act, nor did it observe any waiting periods. Rather, it relied on the "investment only" exemption, and it looked as if this one might go to trial. No such luck. Value Act settled for $11 million.[20] Of course, the fact that the fine for HSR violations had increased from $16,000 per day to $40,000 per day, and that the new fine applied to violations occurring before it's effective date, might have had something to do with the election to settle.[21] So while there still has not been any court decision endorsing the narrow interpretation of the exemption taken by the enforcement agencies, only a brave or foolhardy investor would challenge the core elements of the doctrine of "no board seats" and "no influencing management."

III. PARTIAL ACQUISITIONS

If a person holds a share in one company and acquires a share in a competing company, the question of influence or control doesn't just go to whether the stock ownership is strictly "for investment" under Section 7 and the HSR Act, but whether any coordination of the activities of the two subsidiaries could be treated as a Section 1 violation. While HSR violations can implicate big fines, Section 1 violations are felonies that carry jail time. But if the shares in the two subsidiaries are truly held purely for the sake of investment, can that ownership (exempt from Section 7) still create a violation of Section 1?

Since most cases deal with active participation by the common owner, the issue of the application of Section 1 to an acquisition that is exempt from Section 7 and the HSR Act as strictly passive seldom arises. Logically (and logic isn't always the winner here), if the investment

17 See Keyte & Schwartz, Private Equity and Antitrust: A New Landscape, Antitrust (Fall 2016) 21. See also: https://www.ftc.gov/news-events/press-releases/2007/01/ftc-challenges-acquisition-interests-kinder-morgan-inc-carlyle.

18 *United States of America, Plaintiff, v. Third Point Offshore Fund, Ltd.; Third Point Ultra Ltd.; Third Point Partners Qualified L.P.; and Third Point, LLC, Defendants*, (1:15-cv-01366) (D.DC. 2015). The filings are collected at: https://www.ftc.gov/enforcement/cases-proceedings/121-0019/third-point-llc.

19 See, e.g. *United States v. Biglari Holdings*, (1:12-cv-01586) (D.DC. 2013). The filings are collected at: https://www.ftc.gov/enforcement/cases-proceedings/1110224/biglari-holdings-inc.

20 *United States v. VA Partners et al.*, (16-cv-01672) (N.D. Cal. 2016). The filings are collected at: https://www.justice.gov/opa/pr/justice-department-obtains-record-fine-and-injunctive-relief-against-activist-investor.

21 See Nigro, ValueAct Settlement: A Record Fine for HSR Violation, The Harvard Law School Forum on Corporate Governance and Financial Regulation (2016), available at: https://corpgov.law.harvard.edu/2016/07/19/valueact-settlement-a-record-fine-for-hsr-violation/. See also, Justice Department Obtains Record Fine and Injunctive Relief against Activist Investor for Violating Premerger Notification Requirements, Press Release (July 12, 2016), available at: https://www.justice.gov/opa/pr/justice-department-obtains-record-fine-and-injunctive-relief-against-activist-investor.

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is truly passive, none of the concerns raised by the enforcement agencies should apply. The activity that concerns us, such as coordinating the actions of the partially owned subsidiaries, or even acting as a conduit for information exchange between the subsidiaries, would by themselves take the ownership out of the "solely for investment" exemptions. If the two subsidiaries are wholly (or majority) owned, they are treated as one with the parent for Section 1 purposes. But to get there, and exercise control once there, the actions of the investor necessarily take the investment outside of the exemption. Filing and waiting (or risking a hefty fine) seems almost inevitable.

IV. OTHER THINGS TO KEEP IN MIND

A. Section 8 of the Clayton Act

Most antitrust lawyers have at least a passing familiarity with Section 8 of the Clayton Act, known commonly as the interlocking directorates provision.[22] It deals with one person (natural or corporate) serving as the director of two corporations that compete with one another [23] such that the elimination of competition between them by agreement would violate the antitrust laws.[24] Like Section 7, Section 8 is an incipiency statute, designed to "nip in the bud" potential violations by removing the opportunity (or temptation) to such violations arising from interlocking directorates.[25] Section 8 has certain jurisdictional thresholds which are adjusted each year.

The key thing to remember for our purposes is that even if the interlock is exempt from liability under Section 8, Section 1 of the Sherman Act (and Section 5 of the FTC Act) still apply to prohibit collusive behavior or information sharing among competing companies.[26] The limits on the interlock prohibition, like the exemptions from the HSR filing requirements, are not a blank check for anticompetitive conduct after or during the acquisition.

B. The SEC: What You File and How It Can and Will be Used

Although we focus on antitrust, we touched on the SEC filing issue earlier. When judging the intentions of a shareholder (whether to influence management or to be strictly passive), one key piece of evidence is whether the shareholder files a form 13G or a form 13D with the SEC. A Schedule 13G is a beneficial ownership disclosure statement intended for passive investors who own less than 20 percent of a public company's outstanding shares. A passive investor is considered one who does not intend to exert control over, or seek change in, the company invested in.[27] Even if there is no intent to exercise control, the very ability to exercise such control, or to directly or indirectly influence the management of the issuer, makes the issuer's officers and directors ineligible to file on Schedule 13G.[28]

What the antitrust agencies have taken away from this is that a shareholder's decision to file a schedule 13D, strongly suggests at least a potential activist intent.[29] To the FTC, an investor would not file a 13D (indicating that she might seek control of the target at a later date, and that while she had no present plans to merge with, reorganize or liquidate the target, she might formulate such plans in the future) if the investment were truly passive under the antitrust rules.[30] There is no "Let me be exempt now and I will file if and when I decide to influence the company" clause here. Although there is a provision under the HSR Act that acquisition of non-voting convertible stock may not be a reportable transaction,

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22 15 U.S.C. Section 19(a). See Keyte & Schwartz, supra note 17, page 25. See also, ABA Antitrust Law Developments pages 436-440 (7the Ed. 2012).

23 See Keyte & Schwartz; supra note 17, pages 25-26.

24 15 U.S.C. Section 19(a) (1) (B).

25 *U.S. v. Sears Roebuck & Co.*, 111 F. Supp. 614, 616 (S.D.N.Y. 1953).

26 See generally Wagoner, Interlocking Board Members and Officers: What You Need to Know (Shumaker Loop & Kendrick) (July 27, 2017), available at http://www.lexology.com/library/detail.aspx?g=0a122efb-7e60-4560-a416-39ed51c3867b.

27 SEC Compliance and Disclosure Interpretations, Guidance Regulation 13d, Exchange Act Section 13(d) and 13(G) and Regulation 13D-G Beneficial Ownership Reporting, Question 103.4 (2016) available at: https://www.sec.gov/divisions/corpfin/guidance/reg13d-interp.htm.

28 SEC Guidance, supra note 27.

29 Pfunder, supra note 12.

30 See Nili, supra note 16, page 2. See also Aronson et al. Interpretation of Antitrust Exemption at Heart of DOJ Action Against ValueAct, Skadden Insights (April 8, 2016), pages 2-3, available at: https://www.skadden.com/insights/publications/2016/04/interpretation-of-antitrust-exemption-at-heart-of.

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and that the conversion into voting shares is the reportable acquisition that may require filing and waiting,[31] there is no parallel two-step process that would allow voting shares to be acquired without a filing and only trigger, a filing requirement when the investor implemented changes in the target. An investor cannot claim to be passive for the purposes of availing itself of an antitrust exemption while at the same time being potentially activist in its securities law filings.

What all of this cross-confirms is that the very narrow path to avoiding the need for antitrust filings (and waiting periods) is unlikely to be available to a private equity fund in its capacity as an investor in other companies. And this is further reinforced by a totally separate statutory structure that would not normally trigger an antitrust lawyer's alarm bells.

C. Say Hello to ERISA

There is one further twist in the complex world of antitrust and private equity, and it is a beauty. We have seen that private equity would prefer to go about its business without having to make filings and undergo antitrust reviews. And we have seen that there is indeed a way to avoid filing and waiting, but only if the investment is truly passive, and the investor does not have even the right to interfere with the management of the company in which it is invested.

Many private equity funds have limited partners that are pension plans, or other vehicles subject to the Employee Income Retirement Security Act ("ERISA").[32] ERISA is an enormously complex field of its own. By having ERISA benefit plans as limited partners, the assets of the private equity fund will be considered "plan assets" subject to all of the rules and regulations of ERISA unless the fund can come under an ERISA exemption. The exemption of choice seems to be the so-called Venture Capital Operating Company ("VCOC") exemption.[33]

But this creates a problem. While a full discussion of the VCOC is light years beyond the scope of this article, the key point for our purposes is that under the VCOC exemption, the fund must have or obtain management rights in the company in which the investment is made. But having such control over the company takes the investment out of the "solely for the purpose of investment" HSR exemption. To avoid the ERISA, you almost are required to walk face first into the HSR brick wall.

V. CONCLUSION

The dilemma faced by a private equity firm here can be simply summarized:

> The FTC's narrow interpretation of the investment-only exemption has been a significant restriction for activist investors because they cannot both move quickly to gain a substantial position in an issuer (by availing themselves of an HSR exemption) and attempt to influence the issuer's behavior.[34]

The problem is that the business model of at least a large part of private equity is activist. It attempts to come in, improve the company, and get out again. Passive investment, this is not. But this is only one of the issues. We have noted earlier that the SEC requires the filing of a Schedule 13D if the acquirer has the intent to take certain actions. But conceding the possibility of that intent for SEC purposes may be read as conceding it for HSR purposes as well, and thereby making the "investment only" exemption inapplicable.[35] To be honest about what you intend to do, may make it impossible to get that done. It is indeed, a puzzlement.[36]

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31 See 16 C.F.R. 802.31 and 801.32.

32 29 U.S.C. Chapter 18; Johnson, The VCOC Exemption and Initial Fund Investments, Taft Private Equity Insight (2016) available at: http://www.taftprivateequitylawinsight.com/2016/03/the-vcoc-exemption-and-initial-fund-investments/. See also The U.S. Private Equity Fund Compliance Guide, Chapter 14 (by S. John Ryan) (2010) available at: http://www.sewkis.com/files/Publication/f1d7efed-2e02-4382-a055-798a915cff65/Presentation/PublicationAttachment/23a9ff38-321d-4211-b922-79b854f8f045/The%20US%20Private%20Equity%20Fund%20Compliance%20Guide%20-%20Chapter%2014.pdf.

33 Johnson, supra note 32; Wilkinson and White, Private Equity: Antitrust Concerns with Partial Acquisitions, Antitrust 28, 29 (Spring 2007); Ryan, supra note 32, pp. 152-153.

34 Aronson et al., Interpretation of Antitrust Exemption at Heart of DOJ Action Against ValueAct, Skadden Insights (April 8, 2016), available at: https://www.skadden.com/insights/publications/2016/04/interpretation-of-antitrust-exemption-at-heart-of.

35 See Nili, supra note 16; see also Aronson, supra note 30.

36 Rogers & Hammerstein, The King and I, song by the King of Siam, "A Puzzlement" (1951).

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Avoiding the need to make an HSR filing for a private equity investment is proving to be difficult. So why not just file and wait? In the case where a private equity fund is targeting a single company, and where it is not interested in competing companies, a filing should clear quickly. To the argument that the need to file and wait delays the ability to improve the target and increase shareholder value, claiming that the investment is wholly passive and exempt doesn't simply delay the ability to act, it blocks it completely. If the private equity fund is making investments in companies that do compete with each other, the antitrust analysis is less clear cut.[37] But where there are investments in competing companies, it may be harder to convince a skeptical FTC that all of those investments are truly passive.

37 See the debate between O'Brien and Salop on one side, and Dubrow on the other. O'Brien & Salop, Competitive Effects of Partial O'Brien & Salop, Reply, 69 Antirust L.J. 611 (2001).

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