

# Client Alert

## NEW HSR RULES REGARDING THE TREATMENT OF UNINCORPORATED ENTITIES

### Introduction

On March 8, 2005, the Federal Trade Commission (the “FTC”) published in the Federal Register certain changes to the rules implementing the Hart-Scott-Rodino Act (the “Act”). The revised rules come into effect on April 7, 2005. The most significant changes under the revised rules relate to the treatment of the acquisition of interests in partnerships, LLCs, and other unincorporated entities.

### Summary of Key Changes

Under the revised rules:

- The acquisition of a controlling interest in a partnership, LLC, or other unincorporated entity is a reportable acquisition, assuming the Act’s jurisdictional thresholds have been satisfied and none of the Act’s exemptions is applicable.<sup>1</sup>
- Control of an unincorporated entity (such as a partnership or LLC) is defined as having either (i) the right to 50% or more of the profits of the entity or (ii) the right in the event of dissolution to 50% or more of the assets of the entity. This formalizes the FTC’s long-held position that control of partnerships and LLCs is determined solely by reference to the economic interest held.
- The formation of an unincorporated entity is a potentially reportable transaction by any person acquiring a controlling interest in that entity.

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<sup>1</sup> The Act has two main jurisdictional thresholds that must be satisfied in order for a transaction to be subject to its notification and waiting period requirements: the “size-of-transaction” test and the “size-of-person” test. These thresholds are adjusted annually. Presently, the size-of-transaction test is satisfied if, as a result of an acquisition, the acquiring person will hold assets or voting securities of the acquired person with a value in excess of \$53.1 million. The size-of-person test is generally satisfied if one person that is a party to the transaction has \$106.2 million in annual net sales or total assets and the other has \$10.7 million in annual net sales or total assets. Transactions valued in excess of \$212.3 million are deemed to satisfy the jurisdictional thresholds without regard to the size-of-person.

In discussing the reportability of particular transactions, each of the examples in this memorandum assumes the Act’s jurisdictional thresholds are met and none of the Act’s exemptions are applicable.

- The exemption relating to intra-person transactions has been broadened to apply to non-corporate as well as to corporate acquisitions.
- Acquisitions of interests in entities holding assets the direct acquisition of which would be exempt will not trigger an HSR filing so long as the entity does not hold non-exempt assets in excess of \$53.1 million. This exemption applies to acquisitions of interests in unincorporated entities and to acquisitions of voting securities (*e.g.*, interests in corporations) and has the effect of exempting the formation of an acquisition vehicle whose assets consist largely of cash.
- The acquisition of a controlling interest in an unincorporated entity is exempt from the Act if the acquiring person is contributing only cash to the unincorporated entity, for the purpose of financing, and will no longer control the entity after realization of the acquiring person's preferred return.

### **Current Treatment of Interests in Unincorporated Entities**

Currently, the acquisition of an interest in an existing partnership, LLC or other unincorporated entity is not reportable, unless the acquiring person is acquiring 100% of the interests in the unincorporated entity, in which case the acquisition of the interest is deemed to be an acquisition of the underlying assets of such entity. Additionally, the formation of a partnership is not a reportable transaction. The formation of an LLC is a reportable transaction, however, provided that two or more separately controlled businesses are being contributed to the LLC and at least one of the members of the LLC will have control (*i.e.*, a 50% or greater economic interest) of the LLC.

The existing treatment of the acquisition of interests in unincorporated entities leads to incongruous results. At present, the acquisition of 80% of the interests of a partnership is not reportable. Nevertheless, under the Act, the acquiror is deemed to hold 100% of the partnership's assets. An acquisition of the remaining 20% of the partnership interests by the same person is reportable as an acquisition of the underlying assets of the partnership, even though the acquiring person is already deemed to hold the assets.

### **Treatment of Interests in Unincorporated Entities Under the Revised Rules**

The revised rules attempt to address the incongruous results derived from application of the existing rules by making the acquisition of control of unincorporated entities—and not the acquisition of 100% of the interests of such entities—the HSR reportable event. Unincorporated entities are defined broadly to include, among other entities, GPs, LPs, LLPs, LLCs, cooperatives and business trusts. Interests in unincorporated entities, known as “non-corporate interests,” are defined as interests that give the holder the right to any profits of the entity or the right to any assets of the entity in the event of dissolution of that entity after payment of its debts.

Control of unincorporated entities is defined as having either (i) the right to 50% or more of the profits of the entity or (ii) the right in the event of dissolution to 50% or more of the assets of the unincorporated entity. This formalizes the FTC's long-held interpretation that control of partnerships and LLCs is determined solely by reference to the economic interest held (*i.e.*, participation in management committees or similar bodies is irrelevant). In the Statement of Basis and Purpose accompanying the revised rules, the FTC provides guidance on how to determine control if either the right to profits or the right to assets upon dissolution is variable. In such cases, the non-variable right shall control. In situations where the right to profits and the right to assets upon dissolution are both variable, control will be determined by applying the formula used to calculate the person's right to assets upon dissolution at the time of the acquisition, as though the entity were being dissolved.

To determine whether an acquisition of a non-corporate interest satisfies the Act's size-of-transaction test, the revised rules indicate that the value of the non-corporate interest being acquired is the acquisition price if determined, or if undetermined, the fair market value. The valuation approach adopted by the revised rules is akin to the approach adopted for the valuation of acquisitions of non-publicly traded voting securities, and a departure from the existing rules in which an acquisition of 100% of the interests of an unincorporated entity is based on the value of the entity's assets. Applying the valuation rules should be relatively straightforward in most instances.

The formation of a newly-formed unincorporated entity also will be reportable under the revised rules provided that the persons forming the unincorporated entity meet certain special size-of-person tests and at least one person is acquiring control of the unincorporated entity.

### **Exemptions**

Under the current rules, transactions in which the acquiring and acquired person are the same by reason of holding of voting securities are exempt. Thus a transfer between a parent company and its corporate subsidiary is not reportable. Where assets or voting securities are held through unincorporated entities such as LLCs or partnerships, however, such transactions are not exempt. For example, if Company X holds 60% of the partnership interests in Partnership B, and transfers assets from Partnership B to itself, the transaction is reportable. Under the revised rules, the exemption relating to such intra-person transactions has been expanded to encompass transactions in which the acquiring and acquired person are the same by reason of holding of non-corporate interests. Therefore, considering our hypothetical transaction under the revised rules, X's acquisition of B's assets is exempt.

Two exemptions will provide significant relief from the need to file for the acquisition of interests in special purpose vehicles used in connection with acquisitions and refinancings.

First, acquisitions of interests in entities holding assets, the direct acquisition of which would be exempt, will not trigger an HSR filing so long as the entity does not hold non-exempt assets in excess of \$53.1 million. Cash is an exempt asset for HSR purposes. This exemption applies both to acquisitions of interests in unincorporated entities and to acquisitions of voting securities. This is a significant expansion of an existing exemption which is limited to acquisitions of voting securities of companies holding a narrow category of assets. As a result of this expanded exemption, the formation of an acquisition vehicle whose assets consist largely of cash is no longer reportable.

Second, an acquisition of a controlling interest in an unincorporated entity is exempt from the Act if the acquiring person is contributing only cash to the unincorporated entity, for the purpose of financing, and will no longer control the entity after realization of the acquiring person's preferred return. The FTC considers this type of financing arrangement, in which the investor acquires an equity interest only long enough to obtain a return on its investment, analogous to a creditor acquiring secured debt in the entity, and thus, unlikely to raise antitrust concerns.

### **Other Changes**

The revised rules also include conforming changes introducing the terms “unincorporated entity” and “non-corporate interest” to other areas of the rules, the Official HSR Instructions and Notification and Report Form, and certain other changes to address drafting problems associated with earlier revisions of the rules.

The Federal Register notice which includes the text of the revised rules can be found on the FTC's website at <http://www.ftc.gov/bc/hsr/hsr.htm>.

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Issues of HSR reportability are highly-fact specific. You are advised to consult counsel familiar with the Act to determine whether any given transaction is subject to the Act's notification and waiting period requirements.

*The Global Antitrust Practice Group of White & Case LLP includes more than 140 lawyers on 4 continents. For more information about the new HSR rules regarding the treatment of unincorporated entities, please contact Washington, D.C. partner J. Mark Gidley at +1 202 626 3609 or [MGidley@whitecase.com](mailto:MGidley@whitecase.com) or New York partner M. Elaine Johnston at +1 212 819 8736 or [MEJohnston@whitecase.com](mailto:MEJohnston@whitecase.com).*

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