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Passive Means Passive! Missed HSR Filing Spurs Antitrust Enforcers' Ire - But Change May Be Coming

September 2, 2015

The Federal Trade Commission, in its latest enforcement action relating to Hart-Scott-Rodino Act compliance, reminds investors that strict adherence to HSR filing requirements is a must, but also may have signaled that a long awaited new approach with respect to the passive investor exemption is again under consideration.

You are a large investor. You sometimes take a position in a company based on your expectation of future performance. But this time, you hope that you may – one day – succeed in getting representation on the board, and eventually influence management's direction of the company. Your plan is not yet clear. But one thing is: You don't yet have any present ability to exercise control or influence management. Your position in the company is small – under 10 percent – and you have not yet taken any actions to fulfill your plan, preferring instead to bide your time until better circumstances present. The FTC has long held that your intent makes you an "active investor." Why does this matter? Because being designated an "active investor" means you need the FTC, (or DOJ's) approval before you can proceed.

That has been the rule for some time. But it is a heavily criticized rule, contrary to the spirit of the antitrust laws which care about effects, not intent, and about competition, not financial investments. Nonetheless, in a 3-2 decision, the FTC reiterated its approach in an enforcement action relating to a hedge fund's acquisition of shares of Yahoo. The enforcement action signals that the existing intent-based interpretation of the rule is alive and well and must be heeded.

But in a curious move, the FTC also seemed to acknowledge that the rule might be in need of reconsideration. It imposed no monetary penalty, and expressly agreed to sunset its injunctive relief provisions in the event that the rule changes in the future. Whether that was a "sleeves-off-the-vest" concession – or one that reveals skepticism of the existing rule within the Agency – remains to be seen. But it does suggest that the FTC recognizes the winds of change may soon blow in a different direction.

Background on the Passive Investor Exception and Enforcement

The HSR Act is an antitrust statute that requires parties to certain acquisitions over a specified dollar threshold (presently $76.3 million) to file notification with the FTC and the Antitrust Division of the Department of Justice, and to observe a statutory waiting period prior to completion – typically 30 days. But the Act exempts acquisitions "solely for the purpose of investment" that fall below 10% of the target company outstanding stock.

Neither the statute nor the regulations define what constitutes "solely for the purpose of investment." But the agency historically has taken a narrow view of the passive investor exemption, and has said in speeches and enforcement actions that any intent at the time of the acquisition to influence the basic business decisions of the company or to participate in management, renders the exemption inapplicable, without regard to actions taken or not taken, and without regard to actual ability to effect influence. The FTC does not consider the mere voting of the issuer's stock to be inconsistent with the passive investor exemption, but acts that go beyond this level of participation, as least in the guidance provided by the FTC, will remove the availability of the exemption. Such acts include:

- Nominating a candidate for the board of directors;
- Proposing corporate action requiring shareholder approval;
- Soliciting proxies;
- Having a director, officer or employee serve as an officer or director of the issuer; and
- Being a competitor of the issuer.

The FTC staff generally has considered some or all of the following factors in prior investigations relating to the passive investor exemption:

- Closeness in time of the purchase to the announcement of the offer for control;

- Dollar size of the total investment;
- Adoption of antitakeover defenses by the company;
- Approaches to potential lenders for financing an acquisition of control; and
- Preparation of analyses and pro forma financials of a business combination.

Several enforcement actions have been brought in recent years for failure to file on a variety of bases not directly related to the passive investor exemption, but the 2012 *Biglari Holdings* matter related directly to the passive investor exemption and was based on a similar set of facts. These included contacting senior management with ideas to improve shareholder value, and making requests to be appointed to the board of directors. In an earlier matter in 2004, Manulife was considering a Manulife-John Hancock combination, and thus its intent was not "solely" for the purpose of investment. In that case, the companies were competitors who previously had discussed the possibility of combining on several occasions. Smithfield Foods' 2003 acquisition of stock of IBP Inc. similarly did not qualify under the passive investor exemption because the companies were competitors and were considering and taking steps towards a possible business combination.

Criticism of the Intent-based Passive Investor Interpretation

A 1988 Notice of Proposed Rulemaking in fact would have exempted all acquisitions that did not result in a holding of more than 10 percent of the company's voting stock on the basis that transactions of that nature are unlikely to violate the antitrust laws. The move was widely supported by the business community and the antirust bar but failed in the face of congressional opposition. According to *Axinn Fogg*, a leading treatise on HSR Act compliance, "The FTC's narrow construction of the term 'solely for the purpose of investment' and particularly the word 'solely' creates a significant problem with respect to the nature and the sufficiency of the evidence required to establish the requisite investment intent." The commentator also says that "under the FTC's current interpretation, it is possible that even if 99% of the evidence indicates that the acquisition was made as an investment, but 1% suggests that control was contemplated, the exemption would not apply." *Axinn Fogg* urges a relaxing of the operative language of the rule to "*primarily* for the purpose of investment," rather than the existing "*solely* for the purpose of investment" language. For these reasons, the business community and the antitrust bar also have urged the relaxing of the Agency's position limiting the availability of the exemption to just a narrow class of cases. They say that acquisitions of less than 10 percent of the voting stock of a company would be unlikely to result in competitive harm, despite any intent or actions of the investor, and thus should be exempt from filing. In accord with this, two commissioners said in a dissenting statement in the current enforcement action that "there is significant evidence that transactions . . . in which the buyer acquires less than ten percent of the seller's voting securities—are highly unlikely to result in a substantive antitrust challenge under the Clayton Act."

The FTC's Latest Move

Despite this criticism, in the FTC's latest enforcement action it reaffirmed its long-standing intent-based test. There, a hedge fund acquired shares in Yahoo, but in doing so it also made a 13D filing with the SEC, which investors typically file when acquiring more than 5 percent of a company and their intent is not passive (a more abbreviated 13G filing is typically filed when the investor does not intend to exert control). The fund also sent a letter to management demanding "sweeping changes in both the Board of Directors (the "Board") and Company leadership." The Fund also contacted individuals to gauge interest and willingness to become the CEO of Yahoo or a potential board candidate of Yahoo; assembled an alternate slate for the Yahoo board; and internally discussed the possible launch of a proxy battle for directors of Yahoo. Notably, there was no indication that the hedge fund succeeded in placing representatives on the board or otherwise exercising control or influence over the company.

In finding that this conduct turned the hedge fund into an active investor, the Director of the FTC's Bureau of Competition, Debbie Feinstein, reiterated that "the test for the investment-only exemption is the acquirer's intention, and that determination may not turn on any particular conduct." Consistent with this view, the Proposed Final Judgment prohibits the fund from relying on the passive investor exemption with respect to future investments if, *during the four-month period prior to the acquisition,* it has nominated board candidates, proposed actions that require shareholder approval, solicited proxies, or had its representatives serve as officer or director.

Analysis and Implications

This enforcement action serves as a reminder of the Agency's narrow view of the passive investor exemption, the challenge of creating a strong evidentiary record weighing in favor of the applicability of the exemption, and for the need thus to file HSR in all but the clearest cases of passive investments. The Agency has not wavered in its position and has taken every opportunity to broadcast the risk of overreliance on the passive investor exemption. The Agency will look not only at steps taken post-investment but at evidence of the investor's plans at the time of or prior to the investment in making its assessment. Pushing the boundaries of the exemption is likely to bring a costly and distracting enforcement action, is unlikely to yield a good result, and is exponentially more trouble than making the required HSR filing at the right time.

The action is also notable, though, for a nod in the Proposed Final Judgment to the potential for a "Flat Exemption," and for the dissenting statement of two Commissioners urging the reconsideration of the parameters of the investment-only exemption. The Proposed Final Judgment provides that if the current exemption is replaced by a Flat Exemption, the Final Judgment would expire on the effective date of the Flat Exemption, rather than run for its full five-year period. Similar to prior proposals, the "Flat Exemption" envisioned in the Proposed Final Judgment would, except in the case of competitor acquisitions, exempt all acquisitions that result in holding of "less than a specified percentage of the outstanding Voting Securities of the Issuer." Moreover, the dissenting Commissioners encouraged consideration of "modifications to the HSR Rules or a legislative amendment to the HSR Act designed to eliminate filing requirements for a category of stock acquisitions that have proven unlikely after 40 years of experience to raise competitive concerns." This, along with the Agency's decision not to impose a monetary penalty in this case, may indicate changes afoot with respect to the scope of the exemption, and to a possible expansion of its availability.

Conclusion

While any potential rule or policy change may still be far off, and strict adherence to the current narrow scope of the exemption remains an imperative, there is reason to believe that a change either in the law, the rules, or the Agency's interpretation of the existing rules, will result ultimately in a welcome and more practical and workable approach to the passive investor exemption. We will continue to monitor the state of the law and enforcement, but at present the important take-away is that reliance on the passive investor exemption must be limited to only those cases where the investor's intent is purely passive and there are no plans to influence management or the business or governance of the company.

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