Hart-Scott-Rodino Antitrust Improvements Act Violations Continue Trend of Heightened Enforcement, Increased Fines in 2016

Article By:

Harry T. Robins

David R. Brenneman

The past year was a challenging one for investors purchasing voting securities in public corporations with respect to compliance with the Hart-Scott-Rodino Antitrust Improvements Act.

US antitrust agencies announced fines on January 17 in connection with two separate Hart-Scott-Rodino Antitrust Improvements Act (HSR Act) enforcement actions:

1. *United States v. Ahmet H. Okumus*—fines of $180,000 against defendant for allegedly acquiring and holding shares in an issuer valued in excess of the $156.3 million (as adjusted) threshold for 18 days before selling enough shares so that the threshold was not exceeded.

2. *United States v. Mitchell P. Rales*—fines of $720,000 against defendant for allegedly acquiring shares in excess of filing thresholds, without HSR approval, in two different issuers. With respect to one acquisition, the defendant's wife allegedly acquired the shares. Under HSR rules, shares held by a shareholder's spouse and minor children are attributed to the shareholder.

This recent announcement of settlements of $900,000 in fines—for which the US antitrust agencies could have sought up to $184 million—is a continuation of last year's heightened HSR enforcement. In 2016, US antitrust agencies entered into settlements that accumulated record fines totaling over $12 million (more than a 1,200% increase from 2015 and a 155% increase from 2014) from violators facing up to $188 million in HSR Act exposure; and increased the per day statutory fine thresholds from $16,000 to $40,000. Interestingly, during this period of substantial fine increases, the estimated total number of HSR Act filings submitted in fiscal year 2016 increased by only about 1.5% from fiscal year 2015.[1]

Agencies also continued to pursue enforcement actions with respect to the two HSR Act rules that frequently affect private equity sponsors, hedge funds, and other investors:

1. “Investment-only exemption”—exempting passive investments of 10% or less
2. “Five Year Rule”—requiring investors to make a new filing prior to acquiring a single share of public company stock if the prior approval is five or more years old

Increased HSR Enforcement and Statutory Fines in 2016

In 2016, US antitrust agencies entered into settlements that accumulated record fines totaling $12.2 million from the following HSR Act violations:

- *United States v. Fayez Sarofim*[2]—fines of $720,000 imposed against defendant for crossing three different filing thresholds between 2001 and 2012 without HSR approval (the investment-only exemption did not apply because the defendant was a board member of the issuer)
- *United States v. VA Partners I* [3]—$11 million settlement for defendant allegedly improperly relying on the investment-only exemption
- *Federal Trade Commission v. Caledonia Investments PLC*[4]—$480,000 settlement for defendant allegedly failing to re-file before obtaining additional shares but after receiving HSR approval over five years prior for an investment in the same corporate issuer

These enforcement actions, along with the enforcement actions announced yesterday continues a two-year trend of increased enforcement. Since 2015, US antitrust agencies have brought eight HSR enforcement actions—compared with five in total from 2012–2014. Moreover, the $12.2 million in total HSR settlements in 2016 is a significant uptick from 2015 ($896,000) and 2014 ($4.8 million).

In addition, as a result of the Federal Civil Penalties Inflation Adjustment Act Improvements Act of 2015, which requires federal agencies to adjust civil penalties for inflation, the statutory maximum per day penalty for HSR Act violations increased from $16,000 to $40,000—effective August 1, 2016—and will continue to be adjusted annually. The $40,000 per day fine will be applied to violations that occurred both before and after the increase. HSR Act fines can be extremely large because they begin to accrue from the date of closing until a corrective HSR Act filing is made and approval is obtained.

Investment-Only Exemption’s Uncertainty Increases and Applicability Narrows

The United States may be the only developed country in the world that requires investors to obtain pre-closing antitrust approval for open market purchases of over 10% of the outstanding voting securities of a public corporation—regardless of whether the acquisition confers the right to board seats or any type of control or influence. This is the case despite widely accepted economic principles showing that competition is not affected until a much higher percentage threshold is crossed.

What’s more, US law captures acquisitions of 10% of voting securities or less if (i) the prescribed above-$78.2 million dollar (adjusted annually) threshold is satisfied; and (ii) the investment is not passive. Unfortunately, the US Federal Trade Commission (FTC) and US Department of Justice (DOJ) have not provided clear guidance on what constitutes a qualifying passive investment; instead, investors are stuck with a vague and largely untested "intents" based "investment-only" test that attempts to assess whether the buyer will make its purchase "solely for the purpose of investment."[5]

Under the HSR Act rules, the acquisition of voting securities "solely for the purpose of investment" is exempt so long as two elements are satisfied:

1. As a result of the acquisition, the acquiring person holds 10% or less of the outstanding voting securities of the issuer; and

2. the acquiring person "has no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer."

What makes an acquisition "solely for the purpose of investment"?

The investment-only exemption has long been the source of controversy because there are no bright line rules available for investors to determine which investment actions make the investment-only exemption inapplicable. Indeed, the FTC has visited changing the rule to a strict percentage-based test similar to the 13D filings of the Securities Exchange Act of 1934 so that investors would truly be on notice of the circumstances under which a pre-acquisition HSR Act filing would be required. But for now, we are left with guidance that merely identifies a handful of activities that the government has decided are inconsistent with those taken by a passive investor and thus not "solely for the purpose of investment," including[6]

- nominating a candidate to the board of an issuer;

- proposing corporate action requiring shareholder approval;

- soliciting proxies;

- having a controlling shareholder, director, officer, or employee simultaneously serve as an officer or director of the issuer;

- being a competitor of the issuer in some circumstances; and

- doing any of the foregoing with respect to any entity controlled by the issuer.

Merely voting the shares acquired does not make the investment-only exemption inapplicable. While some of the above indicia are clear, others are not (e.g., what constitutes a competitor?). And, as described further below, investor activities that are not one of these indicia still may be enough to render the exemption unavailable.

DOJ alleged ValueAct Capital sought to influence business decisions of merging companies

On April 4, 2016, the Antitrust Division of the DOJ filed a complaint against ValueAct in US district court in Northern California alleging that ValueAct had violated the HSR Act by acquiring voting securities with intent that was inconsistent with the investment-only exemption. The DOJ settled with ValueAct on July 12, 2016, imposing both a record $11 million fine as well as certain injunctive relief. (The actual potential fine was over $19.6 million at the $16,000 per day level, and the same exposure would be over $49.1 million at the current $40,000 per day level.)

The DOJ's complaint alleged that, without first obtaining HSR approval, ValueAct funds acquired, in the aggregate, over $2.5 billion of Halliburton and Baker Hughes voting securities, constituting less than 10% of the outstanding voting securities of each company. The DOJ claimed that the investment-only exemption did not apply to ValueAct's acquisitions because they were not made "solely for the purpose of investment" and thus violated the HSR Act.

According to the DOJ, ValueAct took several actions inconsistent with being a passive investor, including having meetings and teleconferences with senior management of the companies; contacting Halliburton to offer assistance in advance of the shareholder vote on the merger; engaging with Halliburton on the company's plans for post-merger integration; discussing synergies and executive compensation with Halliburton's CEO; and reaching out to Baker Hughes's CEO "to plant the seed to seek alternative options" if the deal fell through. ValueAct also made standard disclosures in a Schedule 13D Securities and Exchange Commission filing that it might discuss "competitive strategic matters" with the company's management and that it might "propose changes" in its operations, which the DOJ also alleged was inconsistent with the investment-only exemption.

One of the lessons of the ValueAct settlement is that it is a mistake to believe that the investment-only exemption should apply when the conduct at issue arguably has no effect on competition, even though the purpose of the exemption is to avoid HSR Act burdens for such acquisitions that have no such affect.

Terms of ValueAct settlement increase uncertainty

As discussed above, ValueAct settled with the DOJ for $11 million in July 2016. In addition, the company agreed to become enjoined from relying on the investment-only exemption when it has either (a) an intent to influence the issuer or (b) an investment strategy where it identifies circumstances in which it "may" influence the issuer—in each case with respect to an issuer's mergers, sales, acquisitions, or strategies with regard to the issuer's products, services, production capacity, or production output.

The settlement's prohibition on ValueAct's use of the investment-only exemption further muddies the water with respect to what actions constitute "solely for the purpose of investment." Is a shareholder's attempt to influence corporate action that does not require shareholder approval inconsistent with "solely for the purpose of investment"? Does an investor need to have an actual intent to influence an issuer at the time of acquiring its shares in order to make the investment-only exemption inapplicable? Or is merely having a strategy—which the investor may ultimately abandon—that *may* influence the issuer sufficient to disqualify the use of the investment-only exemption? With the real threat of increased high fines and enforcement, investors should act with considerable caution.

FTC further narrows the investment-only exemption and increases uncertainty

FTC's Premerger Notification Office (PNO) has taken the position that an investor's otherwise passive acquisition of less than 10% of a competitor's voting securities is inconsistent with passive intent on the basis of being a competitor (although it is not a *per se* disqualifier). However, what constitutes a "competitor" remains unsettled.

One of the few informal interpretations provided by the PNO with respect to what constitutes a "competitor" became nullified in 2016, increasing uncertainty with respect to applying this factor to the investment-only exemption. Specifically, prior to 2016, the PNO had taken the position that an investor that only competed with an issuer outside of the United States was not a "competitor" with respect to applying the investment-only exemption.[7] On May 4, 2016, the PNO updated one such informal interpretation by stating "[t]his no longer represents the position of the PNO."[8] (The PNO did not update another such informal interpretation.[9])

Accordingly, investors should consult with counsel to determine to whether the issuer is a competitor for purposes of applying the investment-only exemption.

"Five Year" Investment Rule Continues to Confound Investors

The HSR Act also has many other difficult-to-apply rules. Among the most tricky is the so-called "Five Year Rule."

The rule works like this: Once the applicable waiting period for an HSR filing has expired (or early termination has been granted), an acquiror has one year to cross the applicable HSR threshold as notified in the filing.[10] After obtaining approval, the investor has five years to acquire additional shares without crossing the next threshold. But after the five years expires, the investor cannot buy one additional share if the aggregate shares held plus the shares to be acquired cross the lowest above-$78.2 million threshold (as adjusted).

> **Example**: The 30-day waiting period for Investor X's HSR filing, in which it indicates that it will exceed the $500 million (as adjusted) threshold with respect to Corporation A's voting securities, expires on January 1, 2017. Investor X acquires voting securities of Corporation A in excess of the $500 million (as adjusted) threshold during the 2017 calendar year. As of January 1, 2022, Investor X must submit a new HSR filing and observe the applicable waiting period to acquire a single additional share of Corporation A's voting securities if the aggregate shares held plus the shares to be acquired cross the lowest above-$78.2 million threshold (as adjusted).

The FTC continued its pursuit of violators of the Five Year Rule in 2016. On August 10, 2016, Caledonia Investments plc agreed to a $480,000 penalty for failing to submit an HSR filing for its 2014 acquisition of voting securities of Bristow Group Inc. after receiving HSR approval and subsequently closing in 2008. Bristow continued to hold shares above the threshold and then decided to acquire some additional shares that, on their own, would not exceed the applicable HSR Act threshold at the time. (As such, there was a second HSR rule at play as well—the duty to aggregate the value of shares held with shares to be acquired.)

Caledonia claimed that the violation was inadvertent and submitted a corrective filing in 2015. However, this was Caledonia's second offense; Caledonia had previously self-reported a failure to submit an HSR filing in 1997 and did not receive a fine. Its $480,000 settlement was significantly less than the possible penalty of more than $5.8 million at the $16,000 per day level or $14.5 million at the $40,000 per day level.

Maybe the most important HSR lesson from 2016—consult HSR experts early and often!

[1] The FTC's fiscal year ends on September 30th. The percentage increase reflects 1,801 transactions notified to the FTC under the HSR Act during fiscal year 2015 (including those ultimately deemed non-reportable, incomplete transactions and transactions withdrawn) and an estimate of all HSR Act filings submitted during fiscal year 2016 based on Morgan, Lewis & Bockius LLP internal statistics.

[2] Civil No. 1:16-cv-02156 (DC DC filed Oct. 27, 2016)

[3] Civil No. 16-cv-01672-WHA (N.D. Cal filed Apr. 4, 2016)

[4] Civil No. 1:16-cv-01620 (D.D.C. filed Aug. 10, 2016)

[5] 15 U.S.C. §18a(c)(9)) and 16 C.F.R. §§ 801.1(i)(1) and 802.9.

[6] It's worth noting that none of the above *indicia* is binding law, but merely guidance that the FTC published when it released the final HSR rules in 1978. *See* 43 Fed. Reg. 33,450, 33,465 (1978).

[7] *See, e.g.,* HSR Informal Interpretation Letters, #0705006 (May 10, 2007); HSR Informal Interpretation Letters, #1202014 Informal Interpretation (Updated May 4, 2016).

[8] *See* HSR Informal Interpretation Letters, #1202014 (Updated May 4, 2016).

[9] *See* HSR Informal Interpretation Letters, #0705006 (May 10, 2007).

[10] 16 C.F.R. § 802.21.

National Law Review, Volume VII, Number 18

Source URL:https://natlawreview.com/article/hart-scott-rodino-antitrust-improvements-act-violations-continue-trend-heightened