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I Need to Report That?!? Hart-Scott-Rodino Notification Requirements for Individuals

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The Hart-Scott-Rodino ("HSR") Act is generally thought of, and indeed is most often applicable, in the case of corporate mergers and acquisitions. The Act, with its requirement to make a notification prior to closing a transaction, is considerably broader than that and potentially relates to *any* acquisition of voting stock or assets (the jurisdictional requirements of the HSR Act are summarized below). *Individual persons* are often surprised to learn that many of their own acquisitions of voting securities—most often the purchase of stock of the company of which they are an officer, director or other insider—could indeed require reporting under the Act.

Simply stated, anytime an entity *or person* acquires stock in a corporation (referred to here simply as "Company") by any means (open market purchase, negotiated purchase, exercise of options or warrants, ESPP participation, etc.) such that the acquirer will then hold more than $53.1 million worth of Company stock *in the aggregate,* based on *current total value at the time of acquisition,* an HSR filing may be required. And because under the HSR rules one must aggregate new acquisitions of stock with stock already held, and value all shares at current market value, many persons who already hold Company stock valued at greater than $53.1 million may be required to file prior to consummating a new acquisition of *even one additional share.*[1]

The HSR Act is, in its simplest terms, a procedural act and does not differentiate between acquisitions that raise antitrust concerns and those that do not. While HSR filings in many cases do not raise substantive antitrust concerns, it is still necessary to be aware of, and comply with, any HSR filing requirements. The failure to do so can result in substantial fines, of up to $11,000 per day running from the time the unreported acquisition closes. For example, in a 2004 settlement with the Federal Trade Commission (FTC), Bill Gates agreed to pay $800,000 to settle claims that he personally (unrelated to his capacity as Chairman of Microsoft) had acquired shares of ICOS Corp., a company on which he served as a member of the board of directors, without filing an HSR notification. Gates likely was fined because he had inadvertently violated the HSR Act once before, in 2001 (it is uncommon for the FTC to fine a violator for their first HSR infraction if it is truly inadvertent, but repeat offenders will be fined and all must pay the filing fee).

In this article, we described some (but not all) common scenarios that may not be obvious, but which potentially give rise to HSR reporting obligations:

Scenario #1: *John Smith, an officer of Company A, purchases $5 million worth of Company A Stock. He previously purchased $15 million in Stock in Company A, which today has a current value of $50 million.* The acquisition of such stock likely is reportable under the HSR Act.

Scenario #2: *Jane Doe is an officer of Company B, and participates in the Employee Stock Purchase Plan ("ESPP") of the Company. In the third quarter of last year, she had an unusually large distribution, which resulted in her holding more than $55 million in total in shares in Company B, and increased her ownership in Company B from 1% to 1.1%.* The acquisition of such stock likely is also reportable under the HSR Act.

Scenario #3: *Henry Jones acquires, by open market purchase, $1 million of Stock in Company C, increasing his ownership rights in Company C to $60 million. At the same time, he confers with his financial advisor about buying a majority interest in Company C, and comes up with a plan to make additional open market purchases during the next 3 years.* Again, this $1 million acquisition likely is reportable under the HSR Act.

Overview of HSR Reporting Requirements

Any acquisition of voting securities and/or assets requires pre-closing reporting to the FTC and the Department of Justice under the HSR Act[2] if the following tests[3] are satisfied and if no exemption applies.[4]

1. Transactions valued at $53.1 million or less are not reportable: If as a result of acquisition, the acquiring person will hold an aggregate total amount of voting securities and assets of a Company valued *at $53.1 million or less,* then the HSR Act does not apply *regardless* of the size of the parties involved;

2. Transactions valued in excess of $212.3 million are reportable: If as a result of acquisition, the acquiring person will hold an aggregate total amount of voting securities and assets of a Company valued *in excess of $212.3 million,* the HSR Act applies and the parties must file prior to the acquisition *regardless* of the size of the parties involved;

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3. Transactions valued in excess of %53.1 million but not in excess of $212.3 million: If as a result of the acquisition, the acquiring person will hold an aggregate total amount of voting securities and assets of a Company valued *in excess of $53.1 million but not in excess of $212.3 million,* then the HSR Act applies *only if the following also are met:*

   - One party to the transaction, or its Parent (Called the Ultimate Parent Entity or in HSR parlance "UPE"),[5] must have $106.2 million *or* more in total assets or annual net sales; *and*

   - The other party to the transaction, or its UPE, must have $10.7 million or more in total assets *or* annual net sales.[6]

Where an HSR notification is required, the parties must file, the acquiring party must pay a filing fee (either $45,000, $125,000 or $280,000, depending upon transaction size), and the parties must observe a 30 calendar-day waiting period (which can be terminated early by the government) prior to closing, or else risk fines of up to $11,000 per day.

Common Exemptions That May Eliminate an Individual's Need to Notify Under the Act

The "Passive Investment" Exemption – While there are many exemptions provided for in the HSR Act, the so-called "passive investment" exemption is often the most relevant to individuals acquiring stock. It provides that an otherwise HSR reportable acquisition of voting securities (regardless of value) is exempt *if* after the acquisition, the acquirer will hold ten percent[7] or less of the outstanding voting securities of a Company, *and* if the acquisition is made "solely for the purpose of investment." This standard, discussed further below, does not apply when, among other things, the individual acquiring the stock is an officer or director of the Company or has any "intention of participating in the formulation, determination, or direction of the basic business decisions" of the Company.[8]

The "Pro Rata" Exemption – Also relevant, particularly regarding many ESPP purchases (and also stock splits), is the so-called "pro rata" exemption, which provides that individuals need not report under the HSR Act "if as a result of such acquisition, the voting securities acquired do not increase, directly or indirectly, the acquiring person's per centum share of outstanding voting securities of the issuer."[9]

What to Look Out For: Common Scenarios That Could Lead to HSR Notification

Insider/Competitor Acquisition of Voting Securities – When an insider (or a competitor, as discussed below) makes a Company stock acquisition of any size (in the open market or through a negotiated purchase, by way of examples), and as a result will hold more than $53.1 million of Company stock in the aggregate, an HSR filing may be required, subject to the rules discussed above, unless an exemption applies.

The *passive investment exemption* is generally not available to insiders. If the insider is an officer or director of Company, the exemption is clearly not available, because, of course, by their very nature, officers influence the direction of the Company. For example, in the Gates case, in imposing its fine the government contended that Gates intended to participate in the basic business decisions of ICOS through his longstanding membership on that company's board of directors.[10] For other "insiders," their subjective intent is the determining factor, but reliance on the exemption is not likely given their "inside" relationship with Company. The applicability of the exemption should be carefully assessed on a case-by-case basis.

Likewise, interpretations of the passive investment exemption, suggest that it is probably not available to a competitor under *any* circumstances, and it clearly will not be available if the competitor is even *considering* an outright acquisition of Company. For example, in 2004 Manulife Financial Corp. was fined $1 million for violating the HSR Act by not reporting an investment in insurance company John Hancock in the Spring of 2003. Manulife had contended that the passive investment exemption should apply, but it was found to be unavailable because Manulife was considering combining with John Hancock at the time of the investment (a combination that was agreed to in September 2003 and closed in April 2004).[11]

Finally, when an open market purchase is made, a Company will not always be aware of the circumstances that give rise to an HSR reporting requirement. The HSR rules provide that in such cases the *acquirer* (in our example an individual), rather than Company, has the duty to conduct an HSR analysis and begin the filing process by notifying the Company, if necessary.[12] Otherwise, Company would usually not be aware of its reporting obligation under the HSR Act.[13]

Stock Option Exercises by Company Officers, Directors and Employees – The exercise of stock options, believe it or not, may also be reportable. When an officer, director or employee exercises Company options of any amount, and as a result will hold more than $53.1 million of Company stock in the aggregate, an HSR filing may be required, subject to the rules discussed above, unless an exemption applies.

It is important to note that for purposes of this HSR valuation analysis the *holdings of Company stock of an individual person must be aggregated with the holdings of their spouse and any minor children.* Additionally, any shares held in trust by such person or their spouse and/or minor children will also be included in the total holdings of that person *if either* the trust is revocable, or the settlor(s) of the trust retain(s) a reversionary interest. If neither of these conditions is met, the trust is treated as separate and need not be included in the individual's holdings (of course, such a trust is a separate holder of Company stock for purposes of HSR analysis, and it could trigger its own HSR reporting requirements if it acquired shares of Company stock, the HSR thresholds were satisfied and no HSR exemption applied).[14]

The passive investor exemption will never be available to officers and directors, as discussed above. For other employees, it depends on their management role and whether they have a subjective intention to influence business decisions. Again, these situations should be assessed on a case-by-case basis if the HSR thresholds are otherwise met in consultation with Counsel.

Finally, the government has expressed that true cashless, net exercises of options where the option is exercised and the shares are sold instantaneously, so that the optionee never has beneficial ownership of

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the shares are exempt. However, if the stock is held even for a short time period the acquisition may well require an HSR filing before consummation if the HSR thresholds are otherwise met.

ESPP Purchases by Company Officers, Directors and Employees – Participation in an ESPP by an officer, director or employee of Company results in acquisitions of stock which must be analyzed for HSR reportability like any other acquisition of Company stock by such persons. ESPP purchases raise issues identical to those discussed in the stock option exercise section above.

In addition, a critical HSR exemption, applies in the case of many ESPP purchases that is not generally available in the other scenarios previously discussed—namely, the "pro rata" exemption. This exemption applies *if,* for a given acquisition of Company stock, the acquisition does not increase the acquiring person's percentage holdings of outstanding Company voting securities immediately prior to the acquisition.

Whether the pro rata exemption applies is a fact sensitive analysis and needs to be assessed on a case-by-case basis, but because ESPP's typically involve many persons acquiring stock simultaneously, which therefore typically dilute each other, the result often is that after the purchase of shares in an ESPP, the acquirer has not increased his or her percentage of stock held (in other words, the percentage has stayed the same or decreased). In such cases, an ESPP purchase is exempt from HSR reporting even if the jurisdictional thresholds are reached. If, on the other hand, the acquirer increases his or her percentage holdings through an ESPP purchase *even slightly,* the exemption is not available; and if the acquisition satisfies the jurisdictional thresholds, and no other exemption applies, then HSR reporting would be required prior to the time that the shares are delivered.

Conclusion

People often do not consider the HSR Act in connection with individual acquisitions of voting securities, and do not realize that for some, such acquisitions are reportable to the FTC and DOJ. First and foremost, the HSR Act is a rigid regulatory statute that may require an individual who acquires stock in a company, to notify the antitrust agencies. If required, an HSR filing is unlikely to raise substantive antitrust concerns in such circumstances. However, the potential fines for failure to file a required HSR are substantial (as shown by the recent Gates example), so it is critical to identify and comply with any HSR requirements in a timely manner.

Notes

1. Appreciation in the value of previously held stock alone will *not* require HSR reporting, however, absent a new acquisition taking place.
2. 16 C.F.R. §§ 801-803.
3. Note that these HSR thresholds now increase annually based on GNP adjustments.
4. 15 U.S.C. § 18a(a)(2).
5. A UPE is an entity not controlled by any other entity. 16 C.F.R. § 801.1(a)(3). In the case of a corporation, control means either, holding 50% or more of the outstanding voting securities or having the contractual power to designate 50% or more of the directors. An individual is always his or her own UPE. §801.1(a)(3) and (b).
6. Note that where the acquired party is the smaller party to a transaction, its total assets are always relevant, but its annual net sales are only relevant to the $10.7 million threshold if the entity is "engaged in manufacturing." 15 U.S.C. § 18a(a)(2)(B)(ii). To be, engaged in manufacturing means deriving in excess of $1 million in annual net sales from products within NAICS codes in sectors 31-33. § 801.1(j). Finally, the determination of whether an individual person meets the $10.7 million size-of-party test is discussed below.
7. Note that another exemption (analyzed similarly) for acquisitions of stock by "certain institutional investors" permits in certain cases the acquisition by such "institutional investors" of up to 15%, rather than 10%, of a company's stock without requiring an HSR filing, if the acquisition is also made as a passive investment only. 16 C.F.R. § 802.64.
8. 16 C.F.R. § 802.9 and 801.1(i)(1).
9. 15 U.S.C § 18a(c)(10).
10. See http://www.usdoj.gov/atr/cases/gates.htm.
11. See http://www.usdoj.gov/atr/cases/manulife.htm.
12. In general, scenarios in which an acquisition of Company stock results from a unilateral action by the buyer (e.g., open market purchase, exercise of option or warrant, ESPP participation, etc)—rather than a negotiated agreement between the parties—are governed by § 801.30 of the HSR regulations. In such cases, the acquiring party has the duty to make the analysis of whether its acquisition of Company stock will trigger HSR reporting prior to making the acquisition. If so, the acquiring party is required to file its HSR notice, and also to notify Company in writing of this fact and of the fact that Company will also be required to file HSR as an acquired party; Company then has 15 calendar days to make its filing.
13. In such passive situations, it is generally not the duty of the acquired party—Company—to independently "police" whether acquirers see meeting their HSR obligations in such cases. Company could, of course, *elect* to monitor stock acquisition activity by insiders for compliance with the HSR Act even though it has no duty to do so.
14. See 16 C.F.R. § 801.1(c)(2)-(5). Also, one favorable HSR exemption, particularly for family members, is that any shares of Company stock that are acquired by gift, intestate succession, devise or irrevocable trust are *exempt* from reporting under the HSR Act regardless of value. 16 C.F.R. § 802.71.