

The New “Non-Corporate Interest” Rules Under the Hart-Scott-Rodino Act—A Detailed Look at How They Will Work

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The following discussion may test the patience and endurance of even the most avid Hart-Scott-Rodino buffs.¹ Final HSR rules that are effective as of April 7, 2005, make some significant changes in premerger notification and waiting period obligations relating to the formations of partnerships, LLCs and other unincorporated entities, and to the acquisitions and transfers of “interests” in such entities.² The rules received a fair amount of attention and commentary when they were originally announced, but the proposals turned out to be relatively uncontroversial, as only seven comments were filed in the rulemaking proceeding.

The newly promulgated rules may be harder to understand and to apply than they look. They will raise a variety of practical questions in their application—not because they are not well thought out, but because application of otherwise familiar HSR principles and analysis to acquisitions of “interests” in unincorporated entities may not come easily.

This article explores two broad scenarios in detail: formations of incorporated and unincorporated entities under previous and newly promulgated HSR rules, and acquisitions of “non-corporate interests” that “confer control” of the underlying entity under the new rules.³ Rule 801.1(f)(1)(ii) defines the term “non-corporate interest” to mean an interest in any unincorporated entity which gives 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 and after payment of the entity’s debts. Current rules

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¹ The Hart-Scott-Rodino Act, 15 U.S.C. § 18a, requires parties to certain mergers and acquisitions of assets or voting securities valued at more than \$50 million (as adjusted annually for indexing) to file notification with the Federal Trade Commission and the Antitrust Division of the U.S. Department of Justice, and thereafter to wait for a period of time—generally thirty days—before completing a reportable transaction, provided that certain size-of-person tests are met. *See infra* note 7.

As a result of statutory amendments to the HSR Act in 2001 and rules promulgated by the FTC earlier this year, all of the dollar-denominated reporting thresholds in the Act and most of those in the HSR rules have been adjusted upward. 70 Fed. Reg. 4987, 5020 (Jan. 31, 2005). During calendar year 2005, for example, the \$50 million threshold as adjusted by the requirement of annual indexing is \$53.1 million. To avoid having to amend the rules annually, the Commission has amended the HSR rules to insert the phrase “(as adjusted)” throughout the rules, to indicate where the original thresholds are subject to this annual adjustment. *See* Malcolm R. Pfunder, *Indexing Comes to the HSR Act*, ANTITRUST SOURCE (Jan. 2005), http://www.abanet.org/antitrust/source/01-05/02_Jan05_pfunder.pdf.

² The proposed rules were issued on March 30, 2004, and published in the *Federal Register* at 69 Fed. Reg. 18,685 (Apr. 8, 2004). Final rules were published at 70 Fed. Reg. 11,501 (Mar. 8, 2005), and are effective for transactions closing on or after April 7, 2005. <http://www.ftc.gov/os/2005/02/050223premergerfrn.pdf>. The current rules are (and the new rules will be) codified at 16 C.F.R. Parts 801–803.

³ Specific examples of unincorporated entities named in the rules include general partnerships, limited partnerships, limited liability partnerships, limited liability companies (LLCs), cooperatives and business trusts but exclude trusts described in existing Rules 801.1(c)(3)–(5). While an unincorporated entity may be wholly owned (and formation of such an entity is always exempt), the following discussion assumes that any such entity will have at least two persons with interests in the entity’s profits and/or its assets in dissolution. It is also assumed throughout the discussion that any other exemptions under the HSR Act or rules will be separately considered and applied.

define “control” of an unincorporated entity as having a right to 50 percent or more of the entity’s profits or a right to 50 percent or more of the entity’s assets in the event of dissolution.⁴

Formations of Unincorporated Entities

Reportable Formations of New Entities Under Present HSR Rules. HSR rules have, to date, treated formations of three different kinds of entities in three different ways. Until now, the formation of a partnership simply was never reportable, and contributions of assets to a partnership in connection with its formation were never reportable, by the partnership, or by the contributing partner, or by any of the other partners.⁵ That much is easy.

Formations of LLCs have been reportable only under a specific, and somewhat unusual set of facts. While the HSR rules themselves do not address formations of LLCs, so-called “Formal Interpretation 15” lays out filing tests and procedures relating to LLC formations.⁶ Under Formal Interpretation 15, formation of an LLC has been reportable only if (a) two or more pre-existing businesses that are not under common control are contributed to the LLC by different persons, and (b) at least one of the forming members will “control” the new LLC, and (c) contributions of non-exempt assets by the other forming members are valued collectively at more than \$50 million, and (d) the HSR Act’s size-of-person tests are met by the controlling member and the members contributing non-exempt assets.⁷ This convoluted scenario just doesn’t arise very often, and the practical effect is that to date most LLCs have been formed without HSR filing obligations.

Formations of “joint venture or other corporations” by multiple forming shareholders have been reportable under Rule 801.40 since the HSR Act first went into effect in 1978. Formation of a corporation results in the forming shareholders’ acquisitions of voting securities of the newly formed corporation. Each such acquisition is reportable by the ultimate parent of the forming shareholder if (a) a special three-way size-of-person test is satisfied,⁸ (b) the value of the voting securities of the new corporation being acquired by that shareholder exceeds \$50 million (as adjusted), and (c) the acquiring shareholder and the new corporation meet the traditional statutory two-party size-of-person test. Filings are made only by acquiring persons that satisfy these tests; there is no “acquired person” filing.⁹ A single waiting period begins when all acquiring persons required to file do so.¹⁰ The new corporation’s “acquisitions” from its contributing shareholders in connection

⁴ Rule 801.1(b)(1)(ii). Existing Rule 801.1(b)(2) also purports to define an unincorporated entity as controlled by a person having the contractual power presently to designate 50% or more of the individuals exercising functions similar to those of corporate directors. However, the FTC staff has long taken the position that unincorporated entities do not have individuals who exercise functions similar to those of corporate directors, thereby effectively reading this provision out of the rules. The new rules formally repeal this provision for unincorporated entities, leaving it in place for corporations and trusts.

⁵ By contrast, sales to an unincorporated entity (or corporation) at the time of its formation, by a person who does not acquire an interest in the unincorporated entity (or become a shareholder in the corporation), are and remain subject to normal HSR Act treatment.

⁶ 64 Fed. Reg. 5808 (Febr. 5, 1999).

⁷ Under these tests, the ultimate parent of either the acquiring or the acquired person must have annual net sales or total assets of at least \$100 million (as adjusted), and the other must have annual net sales or total assets of at least \$10 million (as adjusted). (The \$10 million test for an acquired person ignores annual net sales if the person is not engaged in manufacturing.) Under the 2001 amendments to the HSR Act, size-of-person tests are inapplicable to transactions valued at more than \$200 million (as adjusted). Subsequent references to size-of-person or “SOP” tests in this article should be read to include their inapplicability to transactions of this size.

⁸ Rule 801.40(c).

⁹ Rules 801.40(a), (b), and 802.41.

¹⁰ Rule 803.10(a)(2).

with its formation are not separately reportable.¹¹ All of this does not happen all that often either, but it happens.

Reportable Formations Under the Newly Promulgated Rules. The new rules are intended generally to make the reporting obligations arising from formations of unincorporated entities more nearly parallel to the obligations applicable to formations of corporations by multiple shareholders. The new rules do not alter the existing Rule 801.40 regime relating to formations of such corporations.

Formations of unincorporated entities are reportable under new Rule 801.50 where (a) at least one of the forming parties will “control” the new entity,¹² (b) the value of that controlling party’s interest exceeds \$50 million (as adjusted), and (c) a special size-of-person test¹³ applicable to this scenario is satisfied.¹⁴ Sounds simple enough. But it isn’t.

Formation Transactions Are Treated Differently from Other Acquisitions. The HSR Act treatment of transactions arising from the formation of a corporation or an unincorporated entity by multiple forming parties is different from that of conventional acquisitions of assets or voting securities, in the following respects:

- Special size-of-person tests apply, and the existing tests for formation of a corporation under Rule 801.40 are somewhat different from the new tests that apply to formation of an unincorporated entity in Rule 801.50.¹⁵
- Even though the newly formed entity “acquires” the assets that are contributed to it by its forming shareholders or partner/members in connection with its formation, the new entity has no filing obligation as an acquiring person.¹⁶
- Similarly, forming parties that contribute assets in connection with formation of a new entity have no filing obligation as acquired persons as a result of such contributions.¹⁷

¹¹ Rules 803.10(a) and 802.41.

¹² Since “control” of an unincorporated entity arises where a person is entitled to 50% or more of the entity’s profits, or its assets in dissolution, an unincorporated entity can have multiple “controlling” partners or members if two parties each have a right to exactly 50% of the entity’s profits or assets in dissolution, or if one party has a right to at least 50% of the entity’s profits and a different party has a right to at least 50% of its assets in the event of dissolution.

¹³ Here, too, if the value of the interest acquired by the controlling partner/member (valued under Rule 801.10(d)) is greater than \$200 million (as adjusted), neither the statutory size-of-person tests nor the special size-of-person tests under Rule 801.50(b) apply.

¹⁴ The current reporting requirements in Formal Interpretation 15 for formations of LLCs will be repealed when the newly promulgated rules become effective.

¹⁵ This is really as hard as it gets: Existing Rule 801.40 makes acquisitions of voting securities of newly formed corporations potentially reportable if either (a) the acquiring person has annual net sales or total assets of at least \$100 million (as adjusted) and the new corporation will have total assets of at least \$10 million (as adjusted) and at least one other acquiring person has annual net sales or total assets of at least \$10 million (as adjusted), or (b) the acquiring person has sales or assets of at least \$10 million (as adjusted) and the joint venture will have total assets of at least \$100 million (as adjusted) and at least one other acquiring person has sales or assets of at least \$10 million (as adjusted). Rule 801.50(b) makes acquisitions of controlling interests in newly formed unincorporated entities potentially reportable if either (a) the acquiring person has annual net sales or total assets of at least \$100 million (as adjusted) and the new entity will have total assets of at least \$10 million (as adjusted), or (b) the acquiring person has sales or assets of at least \$10 million (as adjusted) and the new entity will have total assets of at least \$100 million (as adjusted). The requirements differ in that for formations of unincorporated entities, only controlling interests are reportable and the sizes of the non-controlling interest holders are irrelevant.

¹⁶ Rules 801.40(a) and 802.41. Acquisitions by the new entity from persons that do not take back voting or non-voting securities or non-corporate interests in return are subject to normal HSR Act analysis and reporting obligations. Such persons are not “forming” parties or shareholders, and the acquisitions from them are not “contributions” made “in connection with” the formation. See *supra* note 5.

¹⁷ Rule 801.50(a) extends to formations of unincorporated entities this principle from the existing rules for formations of corporations.

- Even though the newly formed entity issues voting securities or non-corporate interests to the forming parties, the new entity has no filing obligation as an acquired person.¹⁸
- Contributions that the forming parties have agreed to make to the newly formed entity at any time, and any amounts of credit that the forming parties have agreed to extend or obligations that the forming parties have agreed to guarantee at any time, have to be included in determining the total assets of the new entity.¹⁹
- If two or more forming parties are required to file notification in connection with formation of a new entity,²⁰ a single waiting period begins once all such parties have filed their notifications.²¹
- The “intraperson exemption,” Rule 802.30, is generally inapplicable to acquisitions in connection with formation of a new entity, although there is an exception under certain circumstances.²²
- Unless the acquisition price is specified, valuation of the voting securities or non-corporate interests acquired by the forming parties in connection with formation of a new entity is essentially the total value of the contributions to the new entity at the time of formation, allocated across all the voting securities or non-corporate interests that the forming parties receive as consideration for their contributions.
- “Formation” of an unincorporated entity does not arise unless the parties intend to form a new entity. Thus, mutual contractual undertakings that might be viewed as creating joint venture or partner-like relationships are not subject to the HSR Act unless the parties intend to create a partnership or joint venture or some other kind of separate legal entity to perform or implement those undertakings.²³

Acquisitions of Non-Corporate Interests in Existing Entities

Use of Non-Corporate Interests to Define Control of an Unincorporated Entity. Rules in effect since 1987 state that any person having a right to 50 percent or more of the profits of an unincorporated entity, or to 50 percent or more of its assets in the event of dissolution, “controls” that entity and is deemed to hold 100 percent of the unincorporated entity’s assets and must include the annual net sales of the entity in computing its own annual net sales.²⁴ This rule affects what

¹⁸ Rule 802.41 extends to formations of unincorporated entities this principle from the existing rules for formations of corporations.

¹⁹ Rule 801.40(d) is made applicable to formations of unincorporated entities by Rule 801.50(c).

²⁰ This could occur in the formation of a corporation if two shareholders each acquire more than \$50 million (as adjusted) worth of the stock of the corporation. Two or more forming persons may control a newly formed unincorporated entity and may therefore be required to file in connection with its formation. *See supra* note 12.

²¹ The final rules amend existing Rule 803.10(a)(2) to apply to formations of unincorporated entities under Rule 801.50 (it already applies to formations of corporations under Rule 801.40) in the specific situation where two (or more) forming parties acquire control of a new unincorporated entity.

²² Rule 802.30(c) exempts assets and voting securities contributed to a new corporation by the controlling shareholder or to a new unincorporated entity by a controlling party in connection with the formation. This is an exception to the parenthetical phrase in Rule 802.30(a) that otherwise precludes application of the intraperson exemption to formation transactions.

²³ Of course, formation of a corporation involves no comparable ambiguity, because specific legal procedures are required to create the new entity and to issue its voting securities.

²⁴ *See supra* text accompanying note 4.

you count for the size-of-person and size-of-transaction test under Rule 801.11,²⁵ but it does not tell you when or whether an acquisition has occurred. Because the HSR Act applies only to acquisitions, the “control” rule does not by itself define when filing obligations arise.

Acquisitions Become Potentially Reportable if They Confer Control. To date the HSR rules have not viewed partnership or other non-corporate interests as either assets or voting securities when they are acquired, and such interests could be created, acquired, or transferred without any HSR Act implications unless, as a result of a transaction, a person would hold all of such interests. Where one person obtains a right to all the profits of the entity and to all of its assets in dissolution, that person is deemed to be acquiring all of the assets of the partnership, and HSR filings are required if size-of-person and size-of-transaction tests are met. Otherwise, “acquisitions” of partnership and other non-corporate interests have been non-reportable.

Under the new rules, an “acquisition” resulting in a right to 50 percent or more of the profits of an existing unincorporated entity (or to 50 percent or more of its assets in dissolution) is said to “confer control” of that entity. Such transactions are reportable under the HSR Act if (a) the value of the non-corporate interests held by the acquiring person as a result of the transaction exceeds \$200 million (as adjusted) or (b) the value of such interests exceeds \$50 million (as adjusted) and the normal size-of-person tests are met. Like voting securities acquisitions, potentially reportable acquisitions of non-corporate interests may occur on a clean slate, or a transaction may increase the minority interests of an existing interest holder so that they reach or exceed 50 percent.²⁶

When Does an “Acquisition” of Non-Corporate Interests Occur? In many situations, there will be no doubt when such a transaction occurs. For example, an agreement may be negotiated under which existing partnership interests are explicitly transferred, or an agreement may specify that, in return for a contribution to an existing partnership, the contributor will simultaneously acquire a stated percentage interest, with the other partners’ shares being comparably diluted. Under the new rules, these kinds of transactions are analyzed similarly to transactions involving voting securities of corporations.²⁷

But application of the new rules can be potentially confusing when partners’ entitlements to partnership profits (or assets in dissolution) shift by reason of some event that does not look like a transaction. For example, it is not uncommon for investment vehicles to be created by persons that agree to share different levels of profit differently. One partner might be entitled, say, to 100 percent of the first \$2 million of profits, the other partner to 100 percent of the next \$2 million of

Application of the new rules can be potentially confusing when partners’ entitlements to partnership profits (or assets in dissolution) shift by reason of some event that does not look like a transaction.

²⁵ If a person controls an unincorporated entity, that person holds all of the entity’s assets and must include the annual net sales of the entity in determining its own annual net sales. If a person holds a non-controlling interest in an unincorporated entity, none of the entity’s annual net sales are attributable to the person, and the person includes the value of the non-controlling interest in the person’s total assets only to the extent that that non-controlling interest is reflected on the person’s most recent regularly prepared balance sheet. Whether a person preparing a pro forma balance sheet under Rule 801.11(e) would include a non-controlling interest in an unincorporated entity depends upon the accounting procedures normally used by that person.

²⁶ A parallel change in Rule 801.4 makes potentially reportable a secondary acquisition of voting securities resulting from a primary acquisition of non-corporate interests that confers control of the holder of the voting securities. Note that a reportable secondary acquisition of non-corporate interests cannot occur because, by definition, a secondary acquisition is an indirect acquisition of a minority interest. Acquisitions of minority non-corporate interests are not reportable under the new rules. (There is an odd exception where a person already holding a minority interest in a partnership makes a secondary acquisition of additional non-corporate interests that, when combined with the previous holdings, confers control of the entity.)

²⁷ The new rules do not reach acquisitions of non-corporate interests that do not “confer” or shift control of the entity, unlike voting securities acquisitions which may be reportable if the resulting holdings are valued in excess of \$50 million (as adjusted), even if the acquiring shareholder does not control the issuer.

profits, and the two partners to equal shares thereafter. Under this arrangement, the first partner would control the partnership until it had earned \$2 million; the second partner would control the partnership after it had earned \$2 million and until it had earned \$4 million; and both partners would control the partnership thereafter.

Would these apparent shifts of control result in potentially reportable acquisitions of non-corporate interests under the new rules? Would the second partner “acquire” a controlling interest in the partnership from the first partner when the partnership passes the \$2 million profit mark? Would the first partner re-acquire control (which it then shares with the second partner) after the partnership earns an additional \$2 million of profits?

The new rules themselves do not answer these questions explicitly. The specific rule that defines the reporting obligation purports to apply only to “an acquisition of non-corporate interests which results in an acquiring person controlling the entity” but remains ambiguously circular.²⁸ However, the accompanying statement of basis and purpose explains that whenever the right to profits and/or the right to assets upon dissolution is not fixed, the Commission will determine in the following manner whether a controlling interest has been acquired.

If the right to profits is variable and the right to assets upon dissolution is fixed, the right to 50 percent or more of the assets upon dissolution will be deemed to confer control, and the right to profits is ignored.²⁹ Conversely, if the right to assets in dissolution is variable and the right to profits is fixed, the right to 50 percent or more of the profits will be deemed to confer control, and the right to assets is ignored. Where both the right to profits and the right to assets upon dissolution are variable, “control will be determined by applying the formula for determining rights to assets upon dissolution to the total assets of the unincorporated entity at the time of the acquisition, as if the entity were being dissolved at that time.”³⁰

In order for there to be a filing requirement when an acquisition “confers control,” the controlling person must acquire a right either to profits or to assets in dissolution.³¹ Note also that an acquisition may “confer control” even if somebody else already has (and retains) control. Here is an example: a 25 percent partner buys out the interest of another 25 percent partner, resulting in two equal 50 percent partners. The acquisition by the 25 percent buying partner is potentially

²⁸ Rule 801.2(f)(1)(i).

²⁹ Thus, in the above example, because the rights to profits are variable, acquisition of an interest in this partnership would confer control on the acquiring person only if as a result of that acquisition the acquiror received a right to 50% or more of the assets of the partnership in dissolution. This would be true in either a formation transaction or a subsequent acquisition, and it would not matter how much profit the partnership had earned or what the partners’ respective rights to profits were at the time of the acquisition.

³⁰ One could imagine opportunities for shenanigans in structuring ostensibly nonreportable arrangements conferring contingent or conditional rights to profits or assets, where the contingencies or conditions are essentially a sham. Rule 801.90 presumably would apply to any transaction or device entered into for the purpose of avoiding compliance with the HSR Act.

³¹ Contrast this example. Suppose that a partnership having two equal partners receives assets from a third party valued at \$60 million, and the third party takes back a 30% interest in the partnership as consideration. Because the partnership was already in existence, the transaction is not a “formation” and Rule 801.50 does not apply. *See* Rule 801.2(f)(2). If the share of each of the original partners is reduced to 35%, control has shifted from each of the original 50% partners to the partnership itself. However, the partnership is not viewed as having “acquired” control of itself, because the partnership did not obtain a right to its own profits or to its own assets in dissolution. Thus no filing is required because no acquisition of a controlling non-corporate interest has occurred. However, the partnership must file for acquisition of the \$60 million asset that it received from the third party, and each of the original controlling partners must file as an acquiring person in that transaction.

reportable because it confers control on that partner, even though there is already another controlling (50 percent) partner.³²

Another example: one person acquires a right to 60 percent of a partnership's assets in the event of dissolution; a different person already has a right to 60 percent of the partnership's profits. The person acquiring the right to assets in dissolution has a potential reporting obligation because acquisition of that interest confers control on that person, even though another person already controls the partnership and will continue to do so.

Acquisitions of Non-Corporate Interests from Current Holders of such Interests. If a person acquires a non-corporate interest from a current partner/member, that transaction is reportable only if the acquisition confers control of the unincorporated entity on the acquiring person. If a filing is required, the *acquired* person that must also file is the pre-acquisition ultimate parent of the entity.³³ That may or may not be the partner/member from whom the interest was acquired. It might instead be the entity itself (if no one controlled it prior to the acquisition).³⁴

Acquisitions by Existing Partnerships from Their Own Partners. If instead of acquiring a non-corporate interest from an existing holder, a person transfers assets to an existing partnership or other unincorporated entity and takes back a newly created interest in that entity, the person acquiring the non-corporate interest may or may not have a filing obligation, depending upon whether the acquisition confers control of the entity.³⁵

But because this is not a formation transaction governed by Rule 801.50, the entity may also have a separate filing obligation with respect to its acquisition of the contributed assets from the new partner/member. Of course, a contribution of cash is not reportable by the recipient,³⁶ and there are a number of other kinds of assets that may be acquired without filing (e.g., real estate assets covered by Rule 802.2). But if no exemption applies,³⁷ the entity and the partner/member from which it acquires the contributed assets may have a separate filing obligation.

To state it differently, a contribution of assets to an existing unincorporated entity may give rise to two distinct sets of reporting obligations. First, if the contributor acquires control of the entity, that contributor may have to file for its acquisition of the controlling interest, depending upon the value of the interest that is held as a result of the acquisition. Second, if the contributed assets are large enough, the unincorporated entity (or its ultimate parent, which may be the person that acquires control of the entity as a result of the contribution) may have a reporting obligation for its acquisition of assets, depending upon the value of the assets contributed.

³² Conversely, a transaction as a result of which a partner acquires a right to 50% or more of the partnership's assets in dissolution does not "confer control" if that same partner already had a right to 50% or more of the partnership's profits. (Alternatively, the intraperson exemption may be viewed as applying to such a transaction.)

³³ Rule 801.2(f)(1)(i).

³⁴ In an odd case, it might be a different partner/member. Suppose, for example, that partners A, B, and C each have a right to one-third of the partnership's assets and D has a right to all of the partnership's assets in the event of dissolution. If A acquired B's right to partnership profits, the acquisition would confer control on A, who would have a potential reporting obligation. If a filing is required, the acquired person would be the pre-acquisition ultimate parent of the partnership, namely D.

³⁵ See discussion *supra* at text accompanying note 26. Acquisitions by existing unincorporated entities and acquisitions of interests in existing unincorporated entities are not viewed as "formations" of a new entity and are not covered by new Rule 801.50. This contrasts with to-be-withdrawn Formal Interpretation 15, which deems a new LLC to be formed whenever assets are contributed to an existing LLC and the members' entitlements to the profits and assets of the LLC are altered.

³⁶ Rule 801.21(a).

³⁷ See especially the discussion of amended Rule 802.4, *infra* at text accompanying note 42.

The Intraperson Exemption Enlarged

Here, however, the new rules may provide relief. Rule 802.30(c) expands the existing “intraperson exemption” applicable to transactions *other than* the formation of a corporation or unincorporated entity. Where an acquiring person and at least one acquired person are the same person (i.e., their ultimate parents are literally the same), the acquisition is exempt. “Control” for this purpose includes holding 50 percent or more of the stock of a corporation, or having a right to either 50 percent of an unincorporated entity’s profits or 50 percent of its assets in dissolution; it does not include control of a corporation through a contractual power presently to designate half or more of its directors.

Assets held by an existing corporation may be transferred to or from an existing partnership, where the corporation and partnership are already under common control.

Thus, for example, assets held by an existing corporation may be transferred to or from an existing partnership, where the corporation and partnership are already under common control. This is a considerable expansion of the present rule, which exempts acquisitions only where the acquiring and acquired persons are the same person *by reason of holdings of voting securities*. Since unincorporated entities do not issue voting securities, transfers to or from partnerships or LLCs have to date been unable to utilize the intraperson exemption.

But the intraperson exemption can be tricky to apply. Here is an example right out of the new rules (following Rule 802.30(a)):

A and B each have the right to 50% of the profits of [existing] partnership X. A contributes assets to X valued in excess of \$50 million [as adjusted]. B contributes cash to X. [Presumably the partners’ respective rights to profits and assets remain unchanged.] Because B is an acquiring person but not an acquired person, its acquisition of the assets contributed to X by A is not exempt under §802.30(a). However, A is both an acquiring and acquired person, and its acquisition of the assets it is contributing to X is exempt under §802.30(a).

Let’s take the same example more slowly. When A contributes a potentially reportable quantity of assets to the partnership that A already controls (by its 50 percent interest), this is a classic application of the intraperson exemption. A is the acquiring person because it controls the partnership; it is the acquired person because it transfers the assets. Because it is both the acquiring and the acquired person *with respect to the transfer of these assets*, it is entitled to the exemption. The partnership’s acquisition of A’s contributed assets is therefore not reportable by A. However, with respect to that same transfer of A’s assets, B is also an acquiring person, because B also controls the partnership (by reason of its 50 percent interest). B is not an acquired person, because the assets being acquired by the partnership are not B’s assets. Therefore, B does not get the exemption and has to file notification for the partnership’s acquisition of A’s assets. At the same time, B’s transfer of cash results in a separate acquisition by the partnership (and therefore by each of its controlling partners), but an acquisition of cash is non-reportable by reason of Section 801.21(a), and the application of the intraperson exemption is therefore not required. Note that no acquisitions of any non-corporate interests occur in this example.

Complicate this example slightly by supposing that A and B each make separate asset transfers to the fifty-fifty partnership, each of which is valued in excess of, say, \$55 million. A controls the partnership and has to file for the acquisition of B’s assets. B is exempt from filing *for that acquisition*, because B is both an acquiring person (through its control of the partnership) and an acquired person (as transferor of the assets) and therefore claims the intraperson exemption. B’s acquisition of the assets of A must be separately analyzed and is reportable by B (because it controls the partnership and is not eligible for the intraperson exemption *in that acquisition*) but not by A (because of the intraperson exemption). Again, no non-corporate interests are acquired.

The moral of this story is that nearly every transaction between an existing non-corporate entity and one of its partner/members has two sides to it—an acquisition of non-corporate interests by the partner/member and an acquisition of assets by the non-corporate entity.

To illustrate the nuances of the intraperson exemption further, alter this same example in one simple respect. In return for their respective asset transfers valued in excess of \$55 million, A's right to partnership profits and to assets in dissolution is increased from 50 percent to 52 percent, and B's interest is correspondingly reduced to 48 percent. In other words, in return for transfers of assets by A and B, A increases its controlling interest in the partnership, and B's interest is reduced so that it is no longer controlling.³⁸ The partnership's acquisition of A's assets remains intraperson exempt for A, which both controls the partnership and transferred the assets. The partnership's acquisition of B's assets remains reportable by A. The partnership's acquisition of A's assets is not separately reportable by B, because as a result of the acquisition B no longer controls the partnership and thus is not viewed as acquiring either A's assets or B's own assets that were transferred to the partnership.

Finally, take one more similar example. Suppose that A has a 48 percent interest and B a 52 percent interest in a partnership. A and B then each transfer assets to the partnership valued in excess of \$55 million. But A's assets are more valuable, so its share of the partnership is increased to 52 percent, and B's is correspondingly reduced to 48 percent. Thus, the partnership has acquired assets from each of its partners, and as a result of those acquisitions, control of the partnership has shifted from B to A. Here is the result: A files for its acquisition of a controlling interest in the partnership. (The intraperson exemption does not apply because A is not an acquired person in that transaction because it did not control the partnership prior to the transaction.) Neither the partnership nor its now controlling partner, A, files for acquisition of the additional assets transferred by A (intraperson exemption applies). The partnership's separate acquisition of assets from B is also reportable, so the partnership's controlling partner, A, will file as the acquiring person and B, as the transferor of its assets to the partnership, will file as the acquired person.

The moral of this story is that nearly every transaction between an existing non-corporate entity and one of its partner/members has two sides to it—an acquisition of non-corporate interests by the partner/member and an acquisition of assets by the non-corporate entity. Any such transaction must always be analyzed in both directions for potential reportability. The intraperson exemption will often, but not always, come into play. And simultaneous transactions between an unincorporated entity and several of its partner/members can require a complicated series of analytical steps.

Valuation of Potentially Reportable Acquisitions of Non-Corporate Interests

When an acquisition of a non-corporate interest confers control of an unincorporated entity upon an acquiring person, reportability of that acquisition must be determined. The new rules state that a person that acquires control of an unincorporated entity is viewed as holding all of the assets of that entity.³⁹ However, the new rules require the acquiring person to determine the value of the controlling non-corporate interests that it holds as a result of the acquisition, rather than the value of the unincorporated entity's underlying assets. Roughly speaking, the value of the non-corporate

³⁸ Recall that where a person transfers more than \$50 million (as adjusted) of assets to an existing unincorporated entity and takes back a non-controlling interest in the entity, the intraperson exemption will not apply, and the acquisition of the assets by the entity will be reportable by the entity (or its ultimate parent, if it has one) as the acquiring person, and by the new minority partner/member (as an acquired person transferring its assets). The contributor's acquisition of the minority interest in the entity is, of course, non-reportable.

³⁹ Rule 801.2(f)(1)(i).

rate interests held (and the relevant value under the statutory size-of-transaction test) will normally reflect only the acquiring person's proportionate share of the total assets or value of the enterprise.

New Rule 801.10(d) is quite similar to existing Rules 801.10(a)(2) and 801.13(a), which determine the value of voting securities of a corporation held as a result of an acquisition. Under Rule 801.10(d), if the acquisition price of the non-corporate interests now being acquired is determined, then the acquiring person adds that acquisition price to the fair market value of any additional non-corporate interests in the same entity that it already holds. If the acquisition price of the to-be-acquired interests is not determined, then the acquiring person uses the fair market value of all the non-corporate interests that will be held as a result of the acquisition.⁴⁰

The result, again roughly speaking, is that a person that will hold a 60 percent interest in an unincorporated entity as a result of an acquisition will value that 60 percent interest. This contrasts with present rules, under which no filing is required for an acquisition that confers control of an unincorporated entity, but an acquiror that will hold 100 percent of the interests in such an entity is deemed to be acquiring 100 percent of the assets of that entity, even if the acquiror already held an interest in that entity, and even if that interest was a majority interest.

Because of the dual tests for control of an unincorporated entity, valuation can have some odd twists. How does one value a right to, say, 60 percent of a partnership's profits? To the extent that the parties agree on an "acquisition price" for a 60 percent interest, the question is answered, even though the rationale may not be evident. But where the acquisition price is not determined, acquiring persons may be faced with some difficult theoretical questions.⁴¹ Similarly difficult issues can also arise under the present rules but will likely be exacerbated by application to a potentially larger number and variety of unincorporated entities.

Valuation issues are likely to raise a whole range of new and ephemeral questions.

Valuation issues are likely to raise a whole range of new and ephemeral questions. Is the value of a right to half the profits of a partnership equal to the value of half the partnership's assets? Is the value of a right to half the profits of a partnership equal to a right to half the assets of the partnership in dissolution?

And what if a person were to acquire a right to 60 percent of the profits of a partnership, but someone else had a right to 60 percent of the partnership's assets in the event of dissolution? One might plausibly claim that a right to majority of profits is worth somewhat less if one does not also have a right to a majority of assets in dissolution. But how much less? What are the relevant valuation criteria and considerations? Because it is contingent, any right to a partnership's assets in the event of dissolution would appear normally to be worth less than a comparable right to the present profits of the partnership. But how much less? One could imagine a circumstance where dissolution of a highly profitable partnership might seem so remotely contingent as to render a right to a majority of the partnership's assets of limited value. Conversely, one might imagine a situation where a struggling partnership's profit potential is nearly non-existent, while the rights to its assets (e.g., intellectual property rights) in dissolution could be significant.

⁴⁰ This valuation rule is also used when valuing acquisition of a controlling interest in the formation of an unincorporated entity.

⁴¹ Consider, for example, the situation where a one-third partner buys out the interests of one of the other one-third partners for \$20 million. Rule 801.10(d) says that the newly acquired one-third interest is valued at its acquisition price of (\$20 million), and the acquiror's initial one-third interest must be separately valued at fair market. But is that FMV by itself (i.e., a minority interest) or in combination (i.e., half of a majority interest)? Is valuation based on the value of the partnership's assets, or its enterprise value? The new rules do not provide any guidance on those issues. (Nor do the present rules provide guidance for similar issues arising with respect to voting securities acquisitions.)

Fortunately, there are not likely to be very many transactions in which control of a partnership is conferred solely by acquisition of a right to a majority of its assets in dissolution. Most partnerships are likely to divide rights to profits and to assets in dissolution in the same way, so that what is acquired is essentially a percentage equity interest in the enterprise.

Other Newly Promulgated Rules

The existing exemption in Rule 802.4 is expanded in two ways that are likely to be helpful in acquisitions of non-corporate interests that confer control of an unincorporated entity.

The existing exemption in Rule 802.4 is expanded in two ways that are likely to be helpful in acquisitions of non-corporate interests that confer control of an unincorporated entity. Present Rule 802.4 was part of a package of rules promulgated several years ago that exempted acquisitions of certain types of real estate assets. That rule presently exempts acquisitions of voting securities of corporations that hold assets that would be exempt if acquired directly under the related real estate and certain other exemption rules, so long as the issuer does not hold more than \$50 million (as adjusted) worth of other “non-exempt” assets. Amended Rule 802.4 would expand this exemption to acquisitions that confer control of unincorporated entities and would expand the kinds of “non-exempt assets” that don’t count against the \$50 million (as adjusted) trigger to include any assets that can be acquired under any exemptions in the HSR Act and rules.⁴²

Another new exemption allows conversion of an unincorporated entity into a new entity provided no new assets are contributed to the new entity as a result of the conversion and either (i) as a result of the conversion the acquiring person does not increase its percentage entitlement to profits or assets in dissolution or (ii) the acquiring person controlled the original entity.⁴³

There are a number of other proposed rules that become effective with the non-corporate interest rules. A number of these have little or nothing to do with non-corporate interests and simply clean up existing small glitches in the rules.⁴⁴

What the New Rules Don’t Reach

While the new rules will require notification in a variety of situations that the current rules do not reach, there nevertheless remain a significant number of common scenarios involving formations

⁴² In this example, note the interplay between the intraperson exemption and amended Rule 802.4 in a formation transaction under the new rules. A and B form a 50/50 partnership, which is controlled by each of them. A contributes \$60 million worth of assets and B contributes \$40 million in cash. A has acquired control of the partnership. The value of A’s interest is the acquisition price of \$60 million. Thus, A’s acquisition would be reportable, unless an exemption applies. Rule 802.4 provides such an exemption if the new partnership will hold less than \$50 million worth (as adjusted) of “non-exempt assets.” Rule 802.30(c) (the intraperson exemption) says that for purposes of applying Rule 802.4 to a formation transaction, A’s \$60 million worth of contributed assets are “exempt assets”. The cash contributed by B is also exempt, under § 801.21(a). Thus the new partnership has non-exempt assets of less than \$50 million (as adjusted) (in fact it has none at all), and A’s acquisition of its controlling interest is therefore exempt under Rule 802.4. B has also acquired control of the partnership, but its acquisition is also non-reportable, because B’s acquisition price of \$40 million does not meet the minimum filing threshold under the HSR Act.

⁴³ Rule 802.10(b).

⁴⁴ Rule 801.2(d)(iii) states that any combination of corporations and unincorporated entities into an upstream holding company is potentially reportable, and all parties that lose their separate identities in such a transaction are treated as both acquiring and acquired persons. Dual-listing arrangements were originally proposed to be covered by this rule but have been deleted from the final rule.

Rule 802.2 is amended to revoke the exemption previously applicable to acquisitions of timberland, timber tract operations, and logging.

Rule 802.65 creates a new exemption for financing transactions in which one party contributes only cash and receives a preferential right to 50% or more of an unincorporated entity’s profits that drops below 50% (or disappears altogether) once the financing party has received its preferential return.

Rule 802.80 makes the new reporting requirements inapplicable to unincorporated entities that were under investigation and supplied information or documentary material under compulsory process prior to the effective date of the rules.

of unincorporated entities and acquisitions of interests in existing unincorporated entities that remain non-reportable under the new rules. Here are some examples.

It would not be surprising if it takes a while for the new rules to be widely understood and for full compliance with them to be achieved.

- All formations of unincorporated entities in which none of the forming parties controls the new partnership. (In order for this to occur, there must always be at least three forming parties.)
- All formations of unincorporated entities in which no forming party (including its affiliates) acquires non-corporate interests valued at more than \$50 million (as adjusted) as consideration for its initial contribution of assets or voting securities to the new entity. (Any number of otherwise unaffiliated forming parties may acquire non-corporate interests valued at less than \$50 million.)
- All formations of unincorporated entities in which one forming party contributes more than \$50 million (as adjusted) worth of assets (e.g., technology) or voting securities, that party alone controls the new entity, and the other forming parties contribute any amounts of cash or other exempt assets, but do not collectively contribute more than \$50 million worth of non-exempt assets.
- All acquisitions of non-corporate interests in existing entities by minority partner/members that remain minority owners after their acquisitions.
- All acquisitions of non-corporate interests in existing entities by controlling parties that continue to control the entities after their acquisitions.
- All acquisitions of minority interests in existing non-corporate entities by new partner/members.
- All contributions of non-exempt assets to existing unincorporated entities, where the contributed assets are valued at less than \$50 million (as adjusted) (unless Rule 801.13(b), relating to multiple post-formation acquisitions from the same acquired person, applies).

Conclusion

One of the major uncertainties relating to these new rules arises because it is not known how frequently transactions of these types occur and because the degree of formality or informality that characterizes them is not well understood. The rules explicitly will not reach inadvertent formations of unincorporated entities; a formation is not reportable unless the parties intend to form a new legal entity. However, it is less clear that transactions conferring control of an unincorporated entity must similarly reflect an intentional acquisition or a transfer of an equity interest in the entity. Moreover, while people may be somewhat used to thinking about whether mergers or acquisitions of assets or voting securities may be reportable, transactions that shift entitlement to an unincorporated entity's profits or to its assets in dissolution may be less familiar contexts in which to consider possible reporting obligations. It would not be surprising if it takes a while for the new rules to be widely understood and for full compliance with them to be achieved.

Those of us who practice in the HSR area have only just begun to consider the implications of these new rules. The journey is likely to be interesting. ●