

# HSR Update: Increasing Risk in Relying on Passive Investment Exemption

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On April 4, 2016, the Department of Justice (“**DOJ**”) filed a complaint against certain ValueAct entities (“**ValueAct**”) for failing to comply with the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (“**HSR Act**”). Specifically, the DOJ alleges that ValueAct improperly relied on the “passive investment exemption” with respect to the acquisition of shares in Baker Hughes Incorporated (“**Baker Hughes**”) and Halliburton Company (“**Halliburton**”). The DOJ is seeking a \$19 million civil penalty as well as injunctive relief to prevent future HSR violations.

This complaint, together with the DOJ’s enforcement action against ThirdPoint LLC (“**ThirdPoint**”) in August 2015, signals that the investigation and enforcement of potential violations of the passive investment exemption is a priority for the DOJ as well as the Federal Trade Commission (the “**FTC**,” and, together with the DOJ, the “**agencies**”).

## Summary of Exemption

The exemption provides that an acquisition of shares is exempt from the HSR Act if the acquisition is “solely for the purpose of investment” and the investor will hold less than 10 percent of the issuer’s voting securities as a result of the acquisition—even if the value of the shares is greater than the size of the transaction threshold under the HSR Act (currently \$78.2 million).

The phrase “solely for the purpose of investment” is defined in the rules promulgated under the HSR Act to mean that the investor does not have an intent “to participate in the management or basic business decisions of the issuer.” Over the years, the agencies have repeated this strict standard in press releases and enforcement actions when discussing the exemption. However, exactly what it means as a practical matter, especially in the current environment where shareholder engagement and activism are commonplace and encouraged, remains to be seen. Institutional investors, among others, that talk frequently with the management of public companies must be very cautious in attempting to rely on this exemption.

## Alleged Facts and Violation

The current DOJ action against ValueAct represents the third time that the DOJ has alleged ValueAct failed to comply with the requirements of the HSR Act. For the first violation in the early 2000s, no penalty was imposed as is consistent with agency practice. However, ValueAct paid a \$1.1 million civil penalty in late 2007 for a second violation of the HSR Act.

In the current complaint, the DOJ alleges that ValueAct acquired shares of both Baker Hughes and Halliburton over several months, beginning shortly after their announcement that a merger agreement had been signed between those companies. Ultimately, ValueAct held more than \$2.5 billion in shares of the two companies.

The DOJ focused on the following alleged facts as evidence that ValueAct's intent in acquiring shares did not comply with the exemption:

- ValueAct holds itself out as an activist investor on its webpage and included language to this effect in its Schedule 13D filings;
- ValueAct had a strategy from the beginning of its investment to influence the management of both Baker Hughes and Halliburton to increase the probability of the completion of the merger. The complaint alleges that ValueAct reached out to Baker Hughes and began a dialogue with senior management immediately after it began purchasing shares.
- Regardless of whether the merger would be completed, ValueAct intended to influence the business decisions of both companies.

Supporting facts alleged in the complaint include the following:

- In March 2015, ValueAct offered to use its position as a shareholder to pressure Baker Hughes' management to change its business strategy in ways that could affect its competitive future;
- ValueAct offered Halliburton assistance in obtaining the requisite shareholder vote for the merger;
- ValueAct communicated with the companies on integration plans and the ability to achieve synergies as a result of the merger;
- ValueAct delivered a 35-page presentation to Baker Hughes proposing changes to Baker Hughes executive compensation;
- ValueAct discussed its restructuring plans with Halliburton's CEO, including proposals to acquire selected assets of Baker Hughes;
- ValueAct delivered a 55-page presentation to Baker-Hughes proposing operational and strategic changes to the company and on the same day talked with Halliburton's senior management regarding alternative ways to complete the merger.

## Takeaways for Investors

The risks of relying on the investment only exemption are increasing. These risks include the following:

- The agencies will work to ascertain the investor's intent in hindsight based on an extensive review of data. In cases where an investor acquires shares over a period of time, the agencies may have a large "window" of time to determine intent because the requisite investment intent must be satisfied at the time of each acquisition of shares which would otherwise require a filing. In the case of ValueAct, the DOJ was able to focus on actions over a period of several months.
- The investor may become the target of an investigation by the agencies which may be burdensome, time-consuming and expensive. The complaint indicates that the DOJ reviewed extensive internal data including emails of ValueAct and the subject companies. In addition, the complaint focused on language in an early draft of an internal memo which was deleted by the time the memorandum to ValueAct investors was finalized.
- The investor may become the target of an enforcement act by the agencies. The agencies can impose a civil penalty of up to \$16,000 per day of the violation as well as seek an

injunction similar to that in the ThirdPoint enforcement action where for a period of five years, ThirdPoint may not rely on the investment exemption for an acquisition of shares if it has taken any actions in a specified list within the prior four months (instituting a “cooling off” period).

- The investor will bear the burden of proof to show justified reliance on the exemption and in many cases will be required to rebut a presumption that the intent was not solely for the purpose of investment. The agencies have stated that various facts create a presumption that the intent does not satisfy the exemption, including:
  - Filing a Schedule 13D instead of a Schedule 13G;
  - Being an investor in a competitor of the issuer;
  - Having board representation or taking actions related to nominating a director;
  - Soliciting proxies;
  - Having a controlling shareholder, director, officer or employee simultaneously serving as an officer or director of the issuer;
  - Proposing actions that require shareholder approval; or
  - Doing any of the foregoing with respect to any entity directly or indirectly controlling the issuer.

Investment funds that regularly invest in multiple companies within the same industry should note the presumption regarding owning shares in a competitor. In prior informal interpretations, the staff of the Premerger Notification Office of the FTC has indicated that (1) passive ownership under 10 percent of B, a competitor of A, does not preclude reliance on the exemption for ownership of A; (2) ownership of 50 percent or more of B, a competitor of A, precludes reliance on the investment exemption for ownership of A; and (3) if the ownership of B is between 10 percent and 50 percent, a rebuttable presumption exists that the investment exemption may not be relied upon for the ownership of A. Please note that as stated on the website, informal interpretations are not binding legal precedent that may be relied upon but are intended to serve as guidance in interpreting the rules.

## Concluding Remarks

It remains to be seen how the tension between shareholder engagement and the strict interpretation of the investment only exemption will be resolved by the agencies. Institutional investors frequently talk with management of public companies as a part of monitoring their investment. Shareholder engagement is generally regarded as part of good corporate governance for public companies. Notably, in the ThirdPoint action, a dissenting minority cautioned that strict interpretation of the exemption could have the effect of chilling shareholder engagement activities which may benefit companies as well as shareholders. Whether the minority view continues to have a voice as the ValueAct case goes forward is uncertain. For now, investors must be cautious about relying on the exemption as the risks of being second-guessed may far outweigh the benefits of avoiding HSR filings.

If you have any questions, please contact one of the following lawyers: