

## HSR Civil Penalty Suit Demonstrates Importance of Compliance Procedures to Track Holdings and Timing of Prior Filings

### Key Points and Possible Action Items

- The FTC monitors compliance with the HSR Act through public sources. Failure to comply with the HSR Act carries a maximum civil penalty of up to \$11,000 per day.
- Investors should ensure that they as well as their investment adviser and/or manager have in place a compliance system that tracks the expiration dates of any HSR filings made, as well as the value and size of existing holdings and additions thereto.
- Any party that relies on an exemption, such as the investment-only exemption, in determining that an HSR filing is not required, must fully understand the legal requirements for complying with that exemption and monitor continued compliance.
- Any violation of the HSR Act should be brought to the prompt attention of counsel for advice on possible mitigation of penalties.

The Federal Trade Commission ("FTC") recently reached an \$800,000 settlement with ZAM Holdings, L.P. ("ZAM") and ESL Partners, L.P. ("ESL") relating to their failures to file Notification and Report Forms under the Hart-Scott-Rodino Antitrust Improvements Act

of 1976, as amended (the "HSR Act" or "the Act"). The violations related to acquisitions of voting securities of AutoZone, Inc. ("AutoZone") in September and October of 2004 and an improper reliance on certain exemptions under the HSR Act. ZAM improperly relied on the narrowly available investment-only exemption, which permits acquiring parties to hold 10% or less of the outstanding voting securities of any issuer, provided the acquisition was made solely for the purpose of investment. ESL improperly relied on the five-year exemption, which exempts further acquisitions of an issuer's voting securities within the relevant notification threshold for five years after a party has filed an HSR form and observed the statutory waiting period (30 calendar days) in connection with the acquisition of voting securities from that issuer. To settle these violations, ESL agreed to pay a \$525,000 civil penalty, or approximately \$3,758 per day, and ZAM agreed to pay a \$275,000 penalty, or approximately \$1,950 per day. The maximum civil penalty under the HSR Act is \$11,000 per day.<sup>1</sup>

The HSR Act applies to certain acquisitions of voting securities or assets that meet certain jurisdictional thresholds.<sup>2</sup> The "size-of-transaction" test is met

<sup>1</sup> The FTC has announced that the civil penalty applicable to the HSR Act has been increased to a maximum of \$16,000 per day. This change will become effective 30 days after publication in the Federal Register, and is expected to take effect in February of 2009.

<sup>2</sup> 15 U.S.C. § 18a(2)(A) and (B).

if the acquiring person will “hold” an aggregate amount of voting securities or assets valued in excess of HSR threshold—currently \$63.1 million. “Hold” has a specific meaning under the HSR Act, and includes beneficial ownership, whether direct or indirect, through fiduciaries, agents, controlled entities, or other means.<sup>3</sup> The “size-of-person” test is applicable only to transactions that are valued in excess of \$63.1 million, but not in excess of \$252.3 million, and requires that the parties be of a certain size.<sup>4</sup> If the jurisdictional tests are met,<sup>5</sup> the acquiring party must submit an HSR filing and observe a waiting period prior to acquiring the shares or assets, unless an exemption is available. Two exemptions available in acquisitions of voting securities include the five-year exemption and the investment-only exemption. Among the criteria that negate an investor’s ability to take advantage of the investment-only exemption is an intention to participate in the formulation, determination, or direction of the basic business decisions of the issuer (i.e., to be a passive investor). The FTC’s position is that having a representative on the issuer’s Board is one action that is inconsistent with an investment-only intent.

## The Violations

ESL allegedly violated the HSR Act by acquiring voting securities that resulted in its holding voting securities in excess of the HSR threshold, after the five-year exemption relating to a prior HSR filing had expired. ESL filed an HSR Form in August of 1999 in connection with the acquisition of voting securities of AutoZone. After the five-year period had elapsed on the 1999 filing, ESL acquired additional shares of AutoZone that resulted in its holding shares of AutoZone valued at more than the then-current HSR threshold. ESL was required to make a new filing prior

<sup>3</sup> 15 U.S.C. § 801.1(c).

<sup>4</sup> The test requires that one party have annual net sales or total assets of at least \$126.2 million, while the other party must have annual net sales or total assets of at least \$12.6 million. § 18a(2)(B). These thresholds are adjusted annually up or down based upon changes in inflation rates.

<sup>5</sup> The tests are met if the acquiring party will either “hold” voting securities of any issuer valued in excess of \$63.1 million and the “size-of-person test,” or if it will hold voting securities of any issuer valued in excess of \$252.3 million.

to acquiring these additional shares; it did not qualify for the investment-only exemption because it held more than 10% of the shares of AutoZone. After this initial violation, ESL further violated the HSR Act by continuing to make additional acquisitions of AutoZone stock. Once informed of the violation by the FTC, ESL made the required filing under the Act. ESL was found to be in continuous violation of the HSR Act from September 28, 2004, its first acquisition of voting securities after the 1999 HSR filing expired, until February 28, 2005, the date of the expiration of the waiting period on the corrective HSR filing.

ZAM also allegedly violated the HSR Act by acquiring voting securities of AutoZone valued in excess of the HSR threshold without making an HSR filing and observing the statutory waiting period. As a result of the acquisition, ZAM held voting securities of AutoZone valued in excess of \$270 million. ZAM improperly relied on the investment-only exemption, relying solely on the fact that because it held less than 10% of the voting securities of AutoZone, its acquisition was not reportable. However, because the individual who managed and operated ZAM’s investment adviser was on the board of directors of AutoZone, the exemption was not available. Thus, ZAM’s acquisition was a reportable transaction. ZAM was found to be in continuous violation of the HSR Act from October 12, 2004, the date of the acquisition, until March 2, 2005, the date of the expiration of the waiting period on the corrective HSR filing.

## Compliance Procedures Are Important

In the wake of this matter, investors should ensure that they as well as their investment adviser and/or manager have in place a compliance system that tracks the expiration dates of any HSR filings made. The compliance system must also track acquisitions of voting securities that will be reportable under the HSR Act before they actually occur, by considering not only the value and percentage of voting securities to be acquired, but also the value and percentage of voting securities that will be “held” as a result of an acquisition. The tickler system should also manage compliance with the other elements of the investment-only exemption, including its continued application to any given holding of voting securities based on the investment intention of the investor. ZAM’s lower civil penalty may reflect the fact that although ZAM was aware of the existence of the investment-only exemption, and continued to hold less than 10% of the

outstanding voting securities of AutoZone, it did not fully understand the legal implications of complying with that exemption. The investment-only exemption is complex. The compliance system should also track acquisitions of assets, as well as acquisitions of non-corporate interests, which are both also subject to the HSR Act.

Further, parties should be aware that the FTC continuously monitors HSR compliance. Because AutoZone was a publicly traded company, information was readily available to the FTC to audit both ZAM's and ESL's HSR compliance with respect to holdings of this

issuer's stock, in terms of the number of shares held by the shareholder, their value, and the percentage of outstanding voting securities held. The FTC brought the violations to the attention of ZAM and ESL—it was not the parties who discovered these violations. However, parties should not wait for the FTC to alert them to a violation of the HSR Act. Civil penalties may be more severe in instances where the FTC discovers a failure to file, versus circumstances where the parties discover the violation and bring it to the attention of the FTC. If you believe you have missed a filing obligation, you should discuss resolution of this issue with counsel.

## Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at [www.dechert.com/antitrust](http://www.dechert.com/antitrust).

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