SHEARMAN & STERLING LLP

CLIENT PUBLICATION

ANTITRUST/COMPETITION GROUP,
MERGERS & ACQUISITIONS,
CAPITAL MARKETS

September 28, 2012

Passive Investors Beware: Recent FTC Fine Affirms Narrow Scope of HSR Exemption

On September 25, 2012, the US Federal Trade Commission ("FTC") announced that it imposed a civil penalty of $850,000 against Biglari Holdings Inc. ("Biglari Holdings") for failing to file a premerger notification and observe the statutory waiting period in connection with its 2011 purchase of shares of Cracker Barrel Old Country Store Inc. ("Cracker Barrel") in violation of the Hart-Scott-Rodino Antitrust Improvements Act of 1976, 15 U.S.C. § 18a ("the HSR Act").

Out of Bounds: Biglari Holdings Fined $850,000 for Overstepping HSR Exemption

According to the government's complaint, in May and June 2011, Biglari Holdings acquired a sufficient number of Cracker Barrel shares such that the value of its total holdings on June 8, 2011 was in excess of the then applicable $66 million HSR filing threshold. In the days immediately following these acquisitions, Sardar Biglari, chairman and CEO of Biglari Holdings, called and met with Cracker Barrel executives and stated that he had ideas to improve shareholder value and traffic at Cracker Barrel and requested two seats on Cracker Barrel's board.

Under the HSR "passive investment" exemption, acquisitions of voting securities that are made solely for the purpose of investment, regardless of the dollar value of the securities, are exempt from the requirements of the HSR Act provided that the purchaser will not hold more than 10 percent of the issuer's voting securities as a result of the transaction. Voting securities are held or acquired "solely for the purpose of investment" if the person holding or acquiring such voting securities has no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer. The mere voting of the stock will not be considered evidence of the absence of investment intent; however, any investor who anticipates seeking to influence management decisions is regarded by the FTC as an "active investor" and is not entitled to rely on the investment exemption.

The FTC alleges that at the time of Biglari Holdings' acquisitions of Cracker Barrel voting securities in June, the investor intended to actively participate in the management of Cracker Barrel and could not rely on the passive investment intention. Biglari Holdings claims that it never attempted to rely on the passive exemption; rather, this was an inadvertent failure to file an HSR form. While it is hard to know why Biglari Holdings didn't file, the lesson from the FTC here is quite clear: the "passive investment" exemption should be read and applied narrowly. The exemption only applies to those investors whose sole purpose is investment; once that intent changes, any additional purchases of shares of the target would require filing an HSR form if the applicable HSR thresholds are met.

First Strike You're Out?

This isn't the first time the FTC has imposed fines for overstepping the passive investment exemption. Most recently, in 2004, the FTC fined William H. Gates III $800,000 for violating HSR reporting requirements for his acquisition of shares in ICOS Corporation, where he served on the board of directors. Although Gates's percentage holdings in ICOS was minimal, since the value was over the HSR filing threshold and he served on the board of directors, the passive investment exemption was not available. The missed ICOS filing was Gates's second violation in a six-month period. After the first violation, the FTC, which has historically afforded parties one strike for inadvertent violations, did not recommend civil penalties. The second time around, the FTC's position was that Gates should have known better. Brian L. Roberts, the CEO of Comcast Corporation, had two inadvertent HSR violations before he was fined $500,000 for his acquisitions of Comcast stock earlier this year for his third offense. There is no indication in the Biglari Holdings complaint that this wasn't Biglari Holdings' first violation. This could be a sign that the FTC is taking a harder line for inadvertent failures to file.

Passive Investment Ground Rules

The FTC deems certain types of conduct to be evidence of a lack of investment intent. Such conduct includes: (1) nominating a candidate for the board of directors of the issuer; (2) proposing corporate action requiring shareholder approval; (3) soliciting proxies; (4) having a controlling shareholder, director, officer, or employee simultaneously serving as an officer or director of the issuer; (5) being a competitor of the issuer; and (6) doing any of the foregoing with respect to any entity directly or indirectly controlling the issuer. As the FTC showed with Biglari Holdings, the investor does not have to be engaging in the "offensive" conduct at the time of the stock purchases; planning on doing any of the above is enough to run afoul of the exemption, if evidence of such plans exists.

The FTC has also recently made it clear that the passive investment exemption is not available to company executives who receive company stock as part of their executive compensation, regardless of how small the executive's percentage holding might be. If the executive's receipt of the stock brings the executive's holdings above an HSR filing threshold – the lowest of which is currently $68.2 million – an HSR filing may be required.

In determining whether an investor has properly invoked the passive investment exemption, the FTC will also weigh other factors, including the following:

- the suitability of the stock purchase as a passive investment, in light of the financial characteristics of the stock and the issuer, the terms and conditions under which the stock was purchased, and the fit of the purchase with the other investments of the acquiring person;
- the stated purpose and "directions" for managing the investment;
- the proximity in time of the last purchase of the issuer's shares to the announcement of an intent to acquire control;
- the aggregate dollar size of the investment compared to the dollar sizes of other investments by the acquiring person;
- the timing of the acquiring person's approaches to potential lenders, dealer-managers, information agents, proxy solicitors, and others whose services are necessary for an attempted acquisition of control compared to the timing of the investment; and
- the "suggestion" by the acquiring person to the issuer of business decisions the issuer should take, especially with regard to business relationships with the acquiring person.

One easy rule of thumb for investors: if you are planning on filing a Form 13D with the SEC for your investment and the total value of your holdings is in excess of the HSR filing threshold, you probably need to make an HSR filing before your holdings reach an HSR threshold, the lowest of which is currently set at $68.2 million. That said, since the HSR and SEC definition of "control" differ, just because you're planning to file a Form 13G as a "passive investor" under the SEC Rules doesn't mean that you can automatically avail yourself of the HSR exemption. Of course, since SEC filings are generally done post-investment, while HSR forms need to be submitted, and a (generally) 30-day waiting period observed prior to the investment, by the time you are making your SEC filing, it's probably too late.

What Happens if an Investor's Intent Changes?

Often, an investor will make an otherwise reportable transaction of securities "solely for the purpose of investment" and then, sometime subsequently, decide to participate in the management of the issuer. This change in intent will not require the investor to make an HSR filing. However, any additional purchase of shares of the issuer – even one share – will require the filing of an HSR form, provided that after the acquisition the investor will hold shares in excess of the Act's thresholds.

Nothing in the HSR Act or the Rules requires an investor who has properly utilized the investment exemption to maintain the investment intent for any specified period of time. A change of intent, however, if close in time to the investment, could be seen as evidence of lack of requisite intent for the original purchase.

Implications for Investors

The lesson learned is that the FTC interprets the investment exception as being limited to those investors whose sole – not merely principal or predominant – purpose is investment. An investor who plans to become active in the future will also not qualify for the exemption. Companies and investors that run close to the line face significant risks of FTC investigation and potentially large fines.

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