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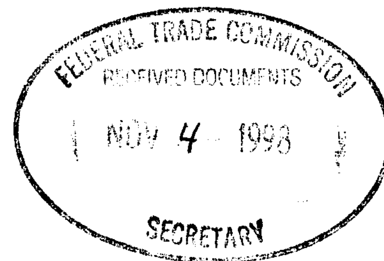

Mr. Krauss,

I spoke to Richard Smith yesterday about Formal Interpretation Number 15 (the "Interpretation"), relating to the circumstances in which the formation of a limited liability company ("LLC"), or the transfer of an existing interest in an LLC, will require the filing of premerger notifications. Specifically, I explained to Mr. Smith that one of our firm's clients is contemplating a financing transaction in which one or more institutional investors will acquire a 50%-or-more membership interest in a newly-formed LLC that will acquire, by capital contribution, certain assets from our client (which will be the other member of the LLC). Although the transaction will be treated as a sale for accounting purposes, it will be treated as a loan for federal tax purposes, and it raises no substantive antitrust concerns.

Mr. Smith suggested that I contact you and explain why I believe that such financing transactions should not be covered by the Interpretation. Rather than take up your time on the telephone, I thought it would be more efficient for me to send you written comments. I have also taken the liberty of discussing a few other issues that are raised by the Interpretation.

Please forgive the informal nature of these comments. Because Mr. Smith said that your office is receiving numerous calls regarding the applicability of the Interpretation to financings, I thought I should get these comments to you as soon as possible.

> Financing Transactions. The Interpretation's focus on combinations
> of "businesses" is certainly a useful way to determine which transactions
> are likely to present antitrust issues. Such issues are unlikely to be
> raised, however, by financing transactions. Unfortunately, under a very
> literal reading, the Interpretation could be construed to cover LLC
> transactions that are, in fact, merely financing arrangements. Many
> "structured finance" transactions today are being structured through the
> use of LLCs, with the creditor or other financier acquiring a membership
> interest in the LLC. Often the membership interest represents the right
> to receive 50% or more of the distributions from the LLC, but only until
> the creditor/financier receives distributions equal to its capital
> contribution to the LLC (i.e., the financed amount), plus a specified
> return thereon. To ensure that the creditor/financier is treated as an
> owner of the membership interest for accounting purposes, it may also be
> necessary to give the creditor/financier a true "upside" equity interest.
> Because the transaction is really a financing, any such "upside" interest
> is likely to be small or subject to limitations (such as an arrangement
> that will permit the other party to buy out the creditor/financier's
> "upside" equity interest. (Depending upon the way in which a particular
> transaction is structured, it may or may not qualify for the financing
> exemption under Rule 802.63.) Significantly, these types of transactions
> are commonly treated as loans, rather than as sales, for federal tax

> purposes.
>
Such financing transactions should not be covered by the Interpretation because they do not represent a true combination of "businesses." Under a very literal reading of the Interpretation, however, one could argue that the business of being a creditor or financier is itself a "business" for purposes of the Interpretation, thereby potentially subjecting such financing transactions to a reporting requirement. Cf. Example 3 (reportable transaction if "B" contributes cash, acquires a controlling interest and "is engaged in a business"). Because such transactions are highly unlikely to raise substantive antitrust issues, I suggest that the Interpretation be clarified to expressly exclude such financing transactions.

> Non-Strategic Investments. Antitrust issues are also unlikely to be
> raised by "non-strategic" investments in LLCs -- i.e., cash investments
> that are made for investment purposes, rather than strategic business
> purposes. Such investments do not involve a true combination of
> businesses. Under a very literal reading of the Interpretation, however,
> one could argue that the business of being an investor is itself a
> "business" under the Interpretation. If adopted, this reading of the
> Interpretation would essentially eviscerate the Interpretation's
> fundamental rule that investments in LLCs are reportable only if they
> involve the combination of two or more businesses. Under such a strict
> reading, every investment of a controlling interest in an LLC would be
> reportable, because, almost by definition, the acquiring person would be
> engaged in the "business" of investing by making the investment in the
> LLC. (The investor's office equipment could be considered "assets that
> are operated . . . as a business undertaking in a particular location,"
> thereby constituting an "operating unit" and, under the Interpretation, a
> "business.")
>
> The existing "investment" exemptions do not adequately address this issue,
> for the following reasons:
>
> The "investment-only" exemption of Section 7A(c)(9) is technically
> inapplicable because the LLC interest is not a "voting security." Even if
> it were, however, the 7A(c)(9) exemption is too limited for many LLC
> transactions. The 10% limitation may be appropriate for corporations,
> many of which are publicly traded. It is inappropriate for LLC
> transactions, however, most of which are privately negotiated among a
> relatively small number of persons or companies who each acquire a
> significant LLC interest. (There are extremely few publicly-traded LLCs.)
> In addition, the definition of "solely for the purpose of investment" is
> appropriate for corporations (particularly publicly-traded ones), because
> most shareholders are passive investors. Most LLC investors, by contrast,
> negotiate for some approval or veto rights with respect to the LLC's
> ability to undertake material actions that may harm the value of their
> investment. Even "passive" investors normally insist on such protections.
>
> The "institutional investor" exemptions in Section 7A(c)(11) and Rule
> 802.64 are also inappropriately restrictive for LLCs, for many of the same
> reasons discussed above.
>

> These comments are not intended as a criticism of the existing
> "investment" exemptions or of the policies underlying them. Because the
> PNO has concluded, however, that investments in LLCs are reportable only
> if they involve the combination of two or more businesses, it is necessary
> to ensure that the Interpretation does not inadvertently cover other,
> "non-strategic" investments in LLCs -- even if they do not satisfy the
> existing "investment" exemptions because of fundamental differences
> between corporations and LLCs.
>
> One way to clarify that "non-strategic" investments are not covered by the
> Interpretation is to clarify that the business of investing is not a
> "business" (unless two or more investment businesses are being combined,
> cf. Rule 802.64(c)(1)). This solution, however, ignores the fact that
> many investors, including institutional investors, are under common
> control with entities that conduct non-investing businesses. This is also
> increasingly true of financial institutions (and other creditors and
> financiers), and therefore relevant to the "financing" exemption proposed
> above. One solution would be to ignore such affiliated businesses if (a)
> the purpose of the transaction is to effect a financing or non-strategic
> investment, rather than to combine any of the investor's (or creditor's)
> affiliated businesses with the business being contributed to the LLC by
> the other party to the transaction.
>
> * * * * *
>
> In addition to the foregoing general comments, I have the following more
> specific comments.
>
> Use of Rule 801.40. The Interpretation characterizes the reportable
> acquisition of a controlling interest in an LLC as an asset acquisition,
> but it also imports some of the principles of Rule 801.40, which applies
> to acquisitions of voting securities in the formation of corporate joint
> ventures. Although I certainly understand the attraction of using
> joint-venture concepts developed under Rule 801.40 -- many LLCs are, after
> all, joint ventures -- I am concerned that this "apples-and-oranges"
> approach may not work very well. For example, Rule 801.40 is designed to
> cover the formation of corporate joint ventures regardless of whether any
> one shareholder will acquire a controlling interest, and regardless of
> whether any existing business is being contributed to the new corporation.
> In essence, Rule 801.40 is designed to ensure that the formation of
> corporate joint-ventures is covered by the Act even though there is no
> acquisition of assets or voting securities by one existing "person" from
> another existing "person." By contrast, the Interpretation applies only
> if there will be a controlling owner of the LLC and only if at least one
> existing business is being contributed to the LLC. An alternative
> approach would be to treat the transaction solely as an acquisition of the
> assets of the contributed business by the person that is acquiring a
> controlling interest in the LLC. The acquired person, by contrast, would
> be the person that is contributing the business to the LLC. The parties
> could be instructed to provide the information required by Item 5(d), but
> to otherwise treat the transaction as an asset acquisition rather than a
> Rule 801.40 transaction.
>
> I admit that this approach may lead to more filings, and therefore a

> larger reporting burden, than the proposed rule. (For example, the
> Interpretation would not require a filing from the person that is
> contributing a business to the LLC, unless that person is acquiring a
> controlling LLC interest. My approach, by contrast, would require that
> person to file as an acquired person.) Nevertheless, I believe that the
> approach I have described is more appropriate for the types of
> transactions that are covered by the Interpretation.
>
> Extension of Interpretation to Partnerships. The PNO requested
> comments on whether the policy set forth in the Interpretation should be
> extended to partnerships. I believe the policy should not be so extended.
>
> To be sure, almost any business that can be conducted in LLC form
> (or, for that matter, corporate form) is also capable of being conducted
> in partnership form. The parties' choice between different types of
> entities is usually based on tax considerations.
>
> As a practical matter, however, relatively few operating businesses
> choose to form as a partnership rather than an LLC or corporation.
> Ironically, my home state of Texas happens to be one of the very few
> states in which there is a significant advantage to the partnership form.
> In Texas, LLCs and corporations are subject to the state franchise tax,
> but partnerships are not. In the vast majority of other states, LLCs are
> classified as partnerships rather than corporations for state tax
> purposes. Although Texas is a large and commercially important state, its
> unusual tax bias against LLCs is a de minimus consideration and should be
> ignored for purposes of national antitrust policy. As a practical matter,
> operating businesses in the vast majority of states are more likely to
> form as LLCs or corporations, rather than partnerships, thereby suggesting
> that there is no need to extend the LLC policy to partnerships.
>
> Mergers. On page 54714 of the Federal Register version of the
> Interpretation, at the bottom of the left-hand column and in footnote 5,
> there are incorrect statements regarding LLCs and mergers. A large number
> of states, including Delaware, now permit LLCs, partnerships and other
> entities to engage in mergers. Indeed, the most efficient way to combine
> two businesses in an LLC form may be through a merger. In that case,
> notwithstanding footnote 5, the two businesses may well "lose their legal
> identities," depending on whether they merge directly into the
> newly-formed LLC or into two separate subsidiaries of the LLC. This
> technical error should be corrected.
>

Shifting Interests. In many LLC transactions, the governing
documents will provide for one or more shifts of interests among the members
of the LLC, either upon the occurrence of certain events (such as the
receipt by an investor of its capital contribution and a specified return
thereon), or, less commonly, on a particular future date.

As you know, this is an issue that applies to partnerships as well as LLCs.
Partnership and LLC laws give parties a great degree of contractual
flexibility in structuring their internal economic arrangements. By
contrast, a number of factors (such as federal tax rules, stock market
considerations and the rigidity of corporation laws) make it more difficult
to achieve the same result in a corporation. Indeed, the contractual

flexibility of partnerships and LLCs, including the ease of providing for "shifting interests," is one reason these entities are so popular.

The PNO has dealt with the "shifting interest" issue primarily in the case of determining the "control" of a partnership, LLC or other unincorporated entity under Rule 801.1(b)(1)(ii). As I understand it, the PNO's position is that a shift is generally ignored prior to its occurrence -- even if it is certain that the shift will occur, and even if it will occur relatively soon after the entity is formed. Of course, I assume that the magnitude of the Rule 801.90 risk may be inversely correlated to the length of time between the formation and a "certain" shift.

I suggest you consider mentioning this issue in the Interpretation, perhaps by describing the PNO's current policy with respect to determining "control" and stating that that policy will also apply to determine control under the Interpretation.

>* * * * *

Finally, it may be helpful for me to give you a brief description of my practice and credentials, so that you can better evaluate the perspective I bring to these issues.

First, I work extensively with LLCs, partnerships and other unincorporated entities. For example, I have assisted many clients in structuring businesses, investments, financings, joint ventures and other arrangements using LLCs, partnerships and other entities. I have co-authored a treatise on Texas LLCs, and I am the Chair of the Limited Liability Company Committee of the Business Law Section of the State Bar of Texas. As such, I am currently drafting extensive amendments to Texas's LLC statute. I have also spoken about LLCs and partnerships at a number of legal conferences.

In addition, I am a Hart-Scott-Rodino attorney. As such, I have assisted numerous clients in analyzing the applicability of the Hart-Scott-Rodino act to particular transactions, including ones LLCs and partnerships, and, if necessary, in making any premerger notifications that are required.

In short, your office's new Formal Interpretation lies at the "intersection" of two principal areas of my legal practice -- hence my interest in ensuring that your office receives all of the relevant information regarding LLCs before finalizing its policy.

Please feel free to give me a call at the number shown below if you have any questions or if you would like to discuss these issues in more detail.

In addition, please note that my client's proposed transaction must be consummated by the end of the year, and sooner if possible. As a result, I would greatly appreciate receiving a call from someone in your office when you finalize your position on financing transactions involving LLCs.

Thank you for considering these comments.

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