

Spring 2010

### Editor's Note

It is our pleasure to welcome you to the inaugural issue of the Winston & Strawn Private Equity Newsletter, a quarterly publication intended to provide insight into the latest legal and industry developments affecting private equity funds, and their managers, investors and portfolio companies. We hope that you will find our Newsletter informative and a resource for timely discussion of various issues affecting private equity.

Though the economic downturn of recent years has taken a toll on the private equity industry, we believe private equity is showing signs of recovery in early 2010. On the deal front, we have seen the number and quality of deals steadily improve since the end of 2009 as the gap in expectations between buyers and sellers has narrowed. Buyers have been resourceful in bridging the debt gap through a combination of seller notes, an increase in the amount of seller rollover participation and through the use of earn-outs. Perhaps most encouragingly, we have seen the debt markets begin to thaw over the past several months. On a similar positive note, we've seen limited partners become more receptive to fundraising efforts. These developments, along with the relative stabilization of the economy, have made us cautiously optimistic for the private equity market in 2010. As always, we will keep you abreast of any developments as they occur.

Dominick DeChiara  
*Co-Chair, Private Equity Practice*

### In This Issue:

- The potential impact on Private Fund Advisers of proposed financial regulatory reform
- Regulatory compliance issues to be considered in connection with health care-related acquisitions
- Reporting on Medicare tax increases applicable to high-income individuals following recently enacted health care reform
- Gauging the temperature of today's credit markets
- Considerations to keep in mind in connection with HSR filings

## Financial Regulatory Reform May Require SEC Registration of Certain Private Fund Sponsors - How Might This Affect You?

The U.S. House of Representatives passed the Wall Street Reform and Consumer Protection Act of 2009 (the “House Bill”) on December 11, 2009. More recently, on March 15, 2010, Senate Banking Committee Chairman Christopher Dodd introduced an updated draft of his financial reform legislation, titled the Restoring American Financial Stability Act of 2010 (the “Dodd Bill”). Portions of the House Bill and the Dodd Bill relate to managers/advisers to private funds (“Private Fund Advisers”).<sup>1</sup> This article provides a summary of the potential impact of the House Bill and the Dodd Bill on Private Fund Advisers if either is passed into law.

Under current law, many Private Fund Advisers rely on the “private adviser” exemption under the Investment Advisers Act of 1940, as amended (the “Advisers Act”), and are not required to register with the SEC. Generally, the “private adviser” exemption exempts from registration any Private Fund Adviser that has had fewer than 15 clients (with each fund counting as one client) in the preceding 12-month period. Both the House Bill and the Dodd Bill would eliminate the private adviser exemption and require many investment advisers that are currently exempt from registration to register as investment advisers under the Advisers Act.

*“Both the House Bill and the Dodd Bill would eliminate the private adviser exemption and require many investment advisers that are currently exempt from registration to register as investment advisers under the Advisers Act.”*

## Registration Requirements Under the House Bill and the Dodd Bill

Under both the House Bill and the Dodd Bill, the requirement to register with the SEC would apply to all investment advisers to any “private fund.” Generally, a “private fund” is defined as a company that would be an investment company but for certain exceptions contained in the Investment Company Act of 1940.

While both the House Bill and the Dodd Bill would eliminate the private adviser exemption, there are differences between the bills in other areas, including the exceptions to the registration requirement. Generally, the following categories of Private Fund Advisers would be exempt from registration in each case as noted:

- *Advisers to Smaller Funds.* Advisers to private funds with less than \$150 million in assets under management are not required to register under the House Bill. The Dodd Bill does not provide an exemption based on the size of a fund being advised, but does have an exemption for advisers that have less than \$100 million of assets under management across all funds.
- *Venture Capital Fund Advisers and Private Equity Fund Advisers.* Advisers to venture capital funds would also be exempt from registration per both the House Bill and the Dodd Bill. The term “venture capital fund” is not defined under either bill, with the responsibility for defining this term left to the SEC. The Dodd Bill goes further and also exempts advisers to “private equity funds” from registration and requires the SEC to define that term as well. While the House Bill requires the SEC to impose special reporting and recordkeeping obligations on venture capital funds, the Dodd Bill does not, but

<sup>1</sup> Title V, Subtitle A of the House Bill – Private Fund Investment Advisers Registration Act and Title IV of the Dodd Bill - Private Fund Investment Advisers Registration Act of 2010.

instead requires that the SEC issue final rules to require private equity fund advisers to maintain such records and reports as the SEC determines are necessary and appropriate.

- *Advisers to Family Offices.* The Dodd Bill, but not the House Bill, provides a new exclusion from the definition of “investment adviser” under the Advisers Act for a “family office,” another term to be defined by the SEC.
- *Small Business Investment Company Advisers.* Under both the House Bill and the Dodd Bill, private advisers to SBICs regulated by the Small Business Administration are exempt from registration.
- *Foreign Private Advisers.* Finally, both bills exempt foreign private advisers. In general, to qualify as a “foreign private adviser,” an adviser must have no place of business in the United States, have fewer than 15 clients in the United States, manage less than \$25 million in assets attributable to clients in the United States and not hold itself out to the public in the United States as an investment adviser.

### How Might This Legislation Affect You?

*Likely to be Some Impact, but Specifics Are Yet to be Determined.* The House Bill is not law, as it has just been passed in the House. The Dodd Bill is the Senate’s version of this legislation and, if passed by the Senate, the differences between the House and Senate versions will require some ironing out. Obviously, knowing which and how Private Fund Advisers will be impacted depends on the legislation that Congress ultimately passes. While there is some uncertainty as to the final content of the legislation that may be enacted, at a minimum, many advisers are likely to be subject to additional reporting obligations.

*Private Fund Advisers May be Required to Register.* If either bill is passed by Congress in its current

form, the private adviser exemption traditionally relied upon will be eliminated and many private advisers that are currently exempt will be required to register with the SEC.

Once registered, a Private Fund Adviser will be subject to additional provisions of the Advisers Act. While registration will lead to additional obligations and the incurrence of additional costs, most managers should be able to comply with the Advisers Act without significant implications on their business.

*“While there is some uncertainty as to the final content of the legislation that may be enacted, at a minimum, many advisers are likely to be subject to additional reporting obligations.”*

The way the SEC defines the terms “private equity funds” and “venture capital funds” will have far-reaching implications. For example, it is unclear whether a Private Fund Adviser to a distressed, real estate, mezzanine, fund-of-funds, or other closed-end fund would fit within the exceptions. Depending on the way “private equity fund” is defined, certain private equity funds with more than 15 clients that are currently registered may no longer be required to register. We suspect putting contours around these definitions will be no easy task in light of the historical difficulty the SEC has had in trying to limit registration to hedge funds and exempt private equity funds under prior legislation.

The following is a short, non-exhaustive list of the practical effects registration could have on a Private Fund Adviser:

- *Registration on Form ADV.* Registered investment advisers must file a Form ADV with the SEC and keep it current by filing periodic amendments, including an annual amendment on Schedule I to Form ADV.

- *Prohibition on Performance Fees from Non-Qualified Clients.* In general, the Advisers Act only permits private advisers to receive straight performance-based compensation (e.g., carried interest) from (i) qualified purchaser (QP) funds, (ii) business development companies, (iii) non-U.S. persons, or (iv) “qualified clients” (generally persons with at least \$750,000 in assets under management with the private adviser or a \$1.5 million net worth). This prohibition on performance-based compensation would be problematic for private advisers to non-QP Funds with investors that are not “qualified clients.” It is unclear how the new legislation would deal with this issue.
  - *Compliance Program, Recordkeeping Requirements and Audits.* The Advisers Act imposes certain compliance and recordkeeping requirements on private advisers, including requirements that they must:
    - adopt compliance policies and procedures and maintain books and records;
    - appoint a chief compliance officer;
    - make and maintain filings with the SEC; and
    - maintain certain records and make them available to the SEC upon request.Registered advisers would also be subject to periodic SEC audits.
- In addition to the current disclosure requirements under the Advisers Act, both the House Bill and the Dodd Bill authorize the SEC to require private advisers to maintain records and submit reports that are determined to be “necessary or appropriate in the public interest for the protection of investors or for the assessment of systemic risk.” Under both bills, a private adviser would have to make a report with respect to each private fund it advises, disclosing:
- counterparty credit risk exposure;
  - trading and investment positions and trading practices; and
  - other information that the SEC determines necessary or appropriate to, among other things, the assessment of systemic risk.
- In addition to the above, the Dodd Bill would also require a description of:
- valuation policies and practices of the fund;
  - the types of assets held; and
  - side letters entered into with fund investors.
- *Custody Rules/Surprise Audits.* Registered investment advisers are subject to the custody rule of the Advisers Act. Among other things, the custody rule requires registered investment advisers with custody of client funds or securities to maintain them with a “qualified custodian” and contain quarterly client account statements and annual surprise examination requirements. The surprise examination requirement is an examination by an independent accountant to verify the existence of client securities and funds. The surprise examination is not required if a Private Fund Adviser delivers audited financial statements (prepared in accordance with GAAP) to investors within 120 days (180 days for a fund-of-funds) of the fund’s fiscal year end.

### **Conclusion**

In summary, both the House Bill and the Dodd Bill would eliminate the private adviser exemption under the Advisers Act and require certain Private Fund Advisers to register with the SEC. We note that the Department of Treasury’s June 17, 2009 White Paper on Financial Regulatory Reform emphasized the role that highly leveraged hedge funds played in the financial crisis and stated that registration of these types of funds would allow regulators to monitor their market activity. However, the current regulatory efforts are overbroad in that they do not focus on the types of hedge funds that pose significant risks

- the fund’s assets under management;
- use of leverage (including off-balance sheet leverage);

to the financial markets. The SEC could limit the reach of the proposed registration requirements in how they define “private equity funds” and “venture capital funds.” However, since there is no bright line distinction between a hedge fund, a private equity fund, or venture capital fund, the SEC will likely have a very difficult time establishing definitions as required under the House Bill and the Dodd Bill. Due to this definitional difficulty, there is a risk that the SEC will err on the side of being over-inclusive, thereby requiring more adviser registration than it should or Congress intended.

Requiring the registration of many additional private advisers under the Advisers Act would be both costly and burdensome not only to advisers but also to the SEC in its oversight role. However, registering as an investment adviser in accordance with the current provisions of the Advisers Act should be a management undertaking for most Private Fund Advisers.

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## Considerations in Health Care Acquisitions

No potential investment in a health care company should be contemplated without considering federal health regulatory compliance issues and completing adequate due diligence to address these issues.

The Office of Inspector General of the Department of Health and Human Services and the Department of Justice have ramped up their enforcement efforts for violations of applicable law. Penalties for non-compliance are large and accumulate rapidly, and statutes of limitations for violations of health care laws are long.

Health care companies that receive even one dollar of federal health care program money are subject to federal fraud and abuse laws. This is true even if

the government does not pay the company directly, but instead, the company has a compensation arrangement with a health care provider or supplier that files claims with federal health care programs.

The most prevalent of these laws are the Anti-Kickback Statute (“AKS”), the Civil Monetary Penalty Law (“CMPL”), the patient referral law known as “Stark,” and the False Claims Act (including whistleblower or *qui tam* suits).

### What’s a Kickback?

The AKS covers all remuneration, paid knowingly and willfully, in cash or in kind, directly or indirectly, in return for the referral of an individual, to induce the referral of an individual, or to arrange for the referral of an individual, for any item or service payable by any federal or state health care program. The AKS covers the offer and payment of remuneration and the solicitation and receipt of payment.

A kickback is usually thought of by laymen as an overt bribe to induce referrals. However, the government takes a much more expansive view of kickbacks. Common business practices that are entirely legal and proper outside of the health care arena are viewed by the government as kickbacks. For example, in many start-up business ventures, the founders would allocate ownership interests in accordance with the customers or clients each founder is expected to generate, and capital contributions are often made in accordance with such allocations. However, if the founders are all surgeons and establish an ambulatory surgery center to which each is expected refer patients, they cannot allocate ownership in accordance with their expected referrals. The government would likely determine that they are being paid for their referrals, constituting an illegal kickback.

Other behavior viewed as kickbacks includes changing ownership interests as referrals change

(increasing ownership if referrals increase, decreasing or redeeming ownership interests if referrals decline); contracts to provide phantom services (or little services) given to persons in a position to refer patients; below fair market value leases given to tenants expected to provide referrals and above fair market value leases to tenants who are expected to receive referrals; and above fair market value employment or independent contractor agreements with providers of referrals. Earn-outs paid to a seller post-closing based on referrals to be provided by the seller following the closing can also be viewed as kickbacks.

*“Health care diligence should be in the forefront of any investor’s due diligence investigation of a health care company “*

The AKS is a criminal statute. Violation is a felony punishable by up to \$25,000, up to five years in prison or both. The government can also prosecute a violation of the AKS as a civil violation under the CMPL. The offending conduct would be the same, but the government has a lesser burden to prove its case under the CMPL. The civil penalties are up to \$50,000 per act and up to three times the amount of payments received from the government.

### Stark and Other Referral Laws

The Stark law, named for Congressman Pete Stark, prohibits referrals by a physician of Medicare patients for certain “designated health services” to an “entity” with which the physician or an immediate family member of the physician has a direct or indirect financial relationship unless an exception in the Stark law or regulations permits the referrals. Most states also have enacted patient referral laws that may be more stringent than Stark,

covering a broader range of health care providers than physicians, and covering more services than just the ten “designated services” under the Stark law.<sup>1</sup>

Stark financial relationships include ownership interests, investment interests, and compensation arrangements. It is often the compensation arrangements that are overlooked in diligence. Medical director agreements, leases, management services agreements, and similar arrangements must be scrutinized to ensure compliance with Stark laws.

Most exceptions to the requirements of the Stark law require remuneration at fair market value, among other things. Each element of an available exception must be satisfied in order for a financial arrangement to qualify. If a financial arrangement does not comply fully with a Stark exception, all of the physician’s referrals to the entity are tainted. The entity cannot bill Medicare or Medicaid, the patient, or any other person for the services. In addition, there is a \$15,000 per violation penalty for causing such a claim to be presented.

### False Claims Act

The federal False Claims Act prohibits, among other things, the submission of a false or fraudulent claim to a government health plan for services. A false claim can include a claim for services not rendered, filing for services at a higher rate (upcoding), and overpayments. Courts have increasingly found that if an arrangement violates either the AKS or Stark, any claims filed can form the basis of a False Claims Act case. A provision in the health reform bill enacted into law in March codifies this interpretation with regard to AKS violations.

<sup>1</sup> The Stark “designated health services” are clinical laboratory services, radiology and other diagnostic imaging, radiation therapy, outpatient drugs, perenteral and enteral equipment and supplies, home health services, occupational therapy, physical therapy (including speech therapy), durable medical equipment, prosthetics and orthotics and prosthetic devices and supplies, and inpatient and outpatient hospital services.

The False Claims Act is also used as a vehicle by whistleblowers (also referred to as *qui tam* plaintiffs) to sue on behalf of the government. Many of the large health care fraud settlements were originated as *qui tam* suits.

### How to Protect Your Investment

Health care diligence should be in the forefront of any investor's due diligence investigation of a health care company. It is important to scrutinize relationships with anyone in a position to make referrals for health care items or services. This includes a review of company structure, employment and independent contractor agreements, leases, and agreements with suppliers. Amounts paid to or received from referral sources must be at fair market value. Business formation documents should be reviewed to determine the basis on which initial and later granted ownership interests, if any, were allocated and the basis on which distributions are made. In addition, it is important to note whether the company has in place a corporate compliance plan that targets fraud and abuse issues, training given to employees, and how comprehensive the plan is. In addition to reviewing the compliance plan structure, compliance committee minutes should be reviewed.

*"...it is important to note whether the company has in place a corporate compliance plan that targets fraud and abuse issues, training given to employees, and how comprehensive the plan is."*

Once an investment in a company is made, it is important to ensure that the company maintains a vibrant compliance program. The compliance committee should meet on a regular basis. Training for employees should be ongoing. Employees who believe there may be a violation should have a way to voice their concerns. New arrangements with referral sources and potential referral sources must be

structured carefully to comply with fraud and abuse laws. In short, the company should have a culture of compliance.

Winston & Strawn's health care practice group brings an interdisciplinary approach to assist investors and companies in identifying and addressing health care issues. We have extensive experience in conducting health care due diligence in connection with acquisitions and financings and in preparing companies for potential sale transactions. Please contact us if you have any questions regarding the foregoing.

*Marion Goldberg, Partner*

### Tax Spotlight: Health Care Reform Includes Medicare Tax Increases

On March 23, 2010, President Obama signed into law the Patient Protection and Affordable Care Act (the "Patient Protection Act"). In addition, President Obama completed the second and final installment of health care reform on March 30, 2010 by signing into law the Health Care and Education Reconciliation Act (the "Reconciliation Act"). Both the Patient Protection Act and the Reconciliation Act contain a Medicare tax increase applicable to high-income individuals.

#### Increase in Medicare Tax on Wages and Self-Employment Income

Beginning January 1, 2013, the Patient Protection Act increases the current 2.9% Medicare tax to 3.8% (a 0.9% increase) with respect to an individual's wages and self-employment income in excess of \$200,000 (\$250,000 if the individual files a joint return).

The current 2.9% Medicare tax on wages is payable half by the employer and half by the employee. The Patient Protection Act does not change the employer portion. Instead, the new 0.9% Medicare tax will be payable solely by the employee.

In addition, whereas self-employed individuals may currently deduct one-half of the self-employment tax imposed on them, such individuals will not be permitted to deduct any portion of this 0.9% additional Medicare tax.

### New Medicare Tax on Net Investment Income

Beginning January 1, 2013, the Reconciliation Act applies a new 3.8% Medicare tax to unearned income for certain high-income individuals. Specifically, the new 3.8% tax will apply to the lesser of (i) an individual's "net investment income" and (ii) the excess of the individual's modified adjusted gross income ("AGI") over \$200,000 (\$250,000 if the individual files a joint return).

For example, if a single individual has modified AGI of \$230,000 consisting of wages of \$180,000 and net investment income of \$50,000, that individual will not be subject to the 0.9% increase in Medicare tax on wages but will pay the new 3.8% Medicare tax with respect to \$30,000 of his or her net investment income. Alternatively, if the individual has modified AGI of \$300,000 consisting of wages of \$250,000 and net investment income of \$50,000, then the individual will pay the 0.9% increase in Medicare tax on \$50,000 of wages and the new 3.8% Medicare tax on all \$50,000 of net investment income.

The Reconciliation Act defines "net investment income" to include the following categories of investment income (net of any deductions properly allocable to such income):

- gross income from interest, dividends, annuities, royalties, and rents;
- net gains (ordinary and capital) from the disposition of property;
- other gross income derived from a business that is a passive activity of the taxpayer; and
- income from a trade or business of trading

financial instruments or commodities as defined by existing mark-to-market tax rules for dealers of commodities.

An individual's allocable share of income from a business as to which the individual actively participates is exempt from the new 3.8% Medicare tax (but may be subject to the additional 0.9% Medicare tax on self-employment income described above). Likewise, an individual's gain on the sale of a business as to which the individual actively participates is also exempt from the 3.8% Medicare tax. This would include income from, or gain from the sale of, an interest in a partnership, LLC, or S corporation that is not a passive activity of the taxpayer. In addition, the tax does not apply to distributions from qualified retirement plans or any income taken into account in determining self-employment income. Finally, the tax does not apply to nonresident aliens.

### New Effective Tax Rates

In addition, President Obama has proposed allowing the top individual ordinary tax rate of 35% to return to 39.6% and setting the top tax rate on long-term capital gain and qualified dividend income at 20% each as of January 1, 2011. If, as is expected, such proposed tax hikes become law, then beginning January 1, 2013 (when the new 3.8% Medicare tax becomes effective), a high-income individual could expect an effective tax rate on long-term capital gains and qualified dividends of 23.8% and an effective tax rate on net investment income other than long-term capital gains and qualified dividends of 43.4%.

*Roger Lucas, Partner*  
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## Today's Credit Markets: a Snapshot

While new issuance U.S. syndicated loan volume in 2009 for large and middle market companies reached its lowest point in nearly 20 years, positive signs of recovery continue to emerge in early 2010. The secondary loan and bond markets (the trading market for existing loans and bonds) rallied strongly in 2009, recovering to a more normalized level that continues today. High yield bond new issuance had a significant resurgence in 2009 and is expected to continue at a relatively strong pace. Perhaps most telling of the recovering markets, default rates for below investment-grade loans and bonds appear to have peaked and are projected by many market participants to decrease significantly by late 2010. These improving market dynamics have led to increased confidence and competition among lenders and other credit providers. However, despite improving conditions, this renewed confidence appears to have been tempered by significant uncertainties that may challenge a sustained recovery.

*“...activity in the new issuance loan market improved in late 2009 and early 2010 and appears to be on course to continue this upward trend at a more accelerated pace.”*

The SMi100 (an index of the 100 most widely held loans) reached a low point in December 2008, but since that time has returned close to the general trading range that existed prior to the credit crisis (by contrast, the equity market rally has yet to approach pre-crisis levels). The recovery of the secondary market was driven in part by large inflows of capital to take advantage of the perceived value proposition resulting from what many market participants viewed as artificially or technically depressed market values for existing loans and bonds. Inflows of capital to high yield bond funds have led to increased high yield bond demand, opening up that market segment

for many companies. High yield bond issuance has in turn relieved some capacity and pricing concerns in the leveraged loan market, as proceeds have in many cases refinanced outstanding leveraged loans, further assisting market value recovery for loans.

With the normalization of the secondary credit markets and increased access to capital through the bond market for some companies, yields and spreads in new issue loans have contracted to a more reasonable range. These changing dynamics have resulted in more favorable conditions for a renewed new issuance loan market. In fact, activity in the new issuance loan market improved in late 2009 and early 2010 and appears to be on course to continue this upward trend at a more accelerated pace.

Improving conditions have led to increased competition among banks to lead and arrange new transactions and increased demand by recovering CLO funds for new product. These improving supply dynamics have resulted in repricings of some 2008 and early 2009 vintage loans, as well as oversubscription and downward price flex on late 2009 and early 2010 vintage new loans. The pre-crisis loan market was largely fueled by CLO funds and other institutional investors. Despite recent CLO participation in new loans, concern over the longer term institutional market has resulted in changes in loan structure and syndicate composition.

In particular, there has been a shift from the institutional tranche to the pro-rata tranche, affecting the type of loan products being offered. The institutional tranche has historically been characterized by passive investors holding a small piece of the longer maturity, minimally amortizing term “B” loan. These investors typically maintain small hold positions of numerous loans in an effort to diversify risk across a broad portfolio. They hold loans for investment purposes and, because of the relative small size of any given investment, are generally passive managers of their loan assets. The pro-rata tranche is usually comprised of working

capital lenders holding a pro-rata share of the revolving credit facility and the shorter maturity, amortizing term “A” loan. As a general rule, these investors are actively engaged in the business of lending, and their hold sizes in any particular loan are relatively significant as compared to those of their institutional counterparts. Given the increased risk inherent in this type of investing, the pro-rata tranche is characterized by a more “hands on” approach, which often subjects the borrower to tighter monitoring and controls. The shift away from the institutional tranche to the pro-rata tranche has been prompted by a combination of a risk adverse lending mentality coupled with institutional market contraction. As a result, a smaller, active lending group, or “club,” is the more prevalent market provider today, particularly in the middle market, as opposed to the widely syndicated, institutional investor driven market of the past.

As the pro-rata tranche gains dominance in today’s market, the type of loan products being offered are also changing. The popularity of the asset-based lending product, which has become the norm, can be explained by the risk averse mindset that continues to dominate the credit markets. This mentality has led to the use of asset-based loans even in the large-cap market; a market traditionally not associated with asset-based lending products. In the middle market, the widespread use of the asset-based lending product, along with the “club” deal mentality by which it is typically accompanied, has helped stabilize this market segment and reduce volatility relative to overall market volatility. However, the overall loan market, aided principally by the large-cap market, is generally more efficient in responding to economic changes. With its recent commitment to asset-based loan products, the large-cap market has pushed the overall market to outpace the middle market in its recovery.

As indicated above, middle market activity is slowly gaining ground and large-cap efficiencies

are showing some promising signs. However, despite this increased level of new lending, overall market activity remains far short of the level that will be required to refinance the trillions of dollars in debt expected to mature through the end of 2014. This so-called “refinancing cliff” will continue to pose a significant risk to loan parties so long as refinancing generally is not a viable alternative. As a result, many borrowers will continue to rely on the amendment process to either extend the maturity of their loans or address default scenarios that otherwise would subject these loans to acceleration. Depending on the market, borrowers may also continue to seek out high yield or mezzanine financing. These products may be used to replace maturing debt or to provide borrowers with debt in amounts above the levels offered by their current financing programs. In most cases, however, in order to attract additional debt, borrowers can be expected to make increased investments in their capital structure in the form of additional equity or subordinated debt.

While the credit markets continue on the road to recovery, the refinancing cliff serves as a reminder that recent improvements should be considered on a relative basis with the liquidity challenges that still lie ahead. That said, current financing activity levels clearly indicate that industry confidence, one of the primary intangible drivers necessary for the sustained health of any market, is on the rise in the credit markets.

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## Hart-Scott-Rodino Filing Considerations

### Hart-Scott-Rodino Antitrust Improvements Act

Over 30 years ago, Congress passed the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the “HSR Act”). The HSR Act provided a mechanism pursuant to which parties to an acquisition of assets or voting securities would be required, assuming certain thresholds were met, to file a notification form with the antitrust enforcement agencies – the Federal Trade Commission (the “FTC”) and the Department of Justice, Antitrust Division (the “DOJ”)—and observe a waiting period before they consummated the transaction. The HSR Act empowered the FTC to promulgate rules and regulations governing the circumstances under which the parties would be required to submit an HSR Act filing.

The FTC established the Premerger Notification Office (the “PNO”) to administer the HSR Act program and review HSR Act filings for compliance with those rules and regulations. Because the HSR Act rules and regulations are extensive and extremely complex, a well-established practice has developed that allows counsel to consult with PNO staff to obtain guidance in applying the rules and regulations to specific situations. Although such advice is deemed “informal” and is not binding on the FTC, it is relied upon daily. Letters from counsel, annotated by the PNO staff, are available on the FTC’s website as a resource for HSR Act practitioners. Counsel will often rely on these letters in advising clients regarding the clients’ specific transactions. A case last year, however, called this practice somewhat into question.

### United States v. Malone

In *United States v. Malone*,<sup>1</sup> the U.S. government sued an individual named John Malone for violation of the HSR Act. *Malone* was the first HSR Act enforcement action in which the defense was based on reliance upon an informal interpretation letter from the PNO staff. In May 2005, Mr. Malone, who already held voting securities of Liberty Media Corporation (“Liberty”), made an HSR Act filing in connection with a proposed acquisition of additional Liberty voting securities. At that time, Liberty had a subsidiary, Discovery Holding Company (“Discovery”). Shortly after the HSR Act filing, Discovery was spun-off. Thereafter, Mr. Malone made several acquisitions of Discovery shares between August 2005 and April 2008, but never made an HSR Act filing in respect of those acquisitions. Mr. Malone apparently did not file because he relied on advice contained in an informal interpretation letter from 2001, in conjunction with an explicit regulation. That 2001 position, however, was subsequently disavowed and the reversal of the position was noted in a February 2005 informal interpretation letter. In June 2008, Mr. Malone made a corrective filing for the acquisitions of Discovery shares that he had made in violation of the HSR Act, explaining that neither he nor his counsel checked the FTC database, or contacted PNO, to determine whether the 2001 position was still valid. Two days after making the corrective filing, Mr. Malone, through an escrow arrangement, exercised his options on additional Discovery shares without waiting for the expiration of the waiting period for that corrective filing, again in violation of the HSR Act. As a result of these violations, the DOJ brought suit against Mr. Malone and the parties entered into a consent whereby Mr. Malone agreed to pay \$1.4 million in civil penalties.<sup>2</sup>

<sup>1</sup> *United States v. Malone*, 2009 WL 2208117 (D.D.C).

<sup>2</sup> Importantly, the acquisition of Discovery shares was not the first time that Mr. Malone had inadvertently violated the HSR Act. In 1991, Mr. Malone was obligated to make a corrective filing for purchases of voting securities he made in an unrelated company in 1985. It is not unreasonable to assume that because of the multiple violations of the HSR Act, including one associated with the corrective filing itself, the government felt compelled to make a statement.

## Conclusion

It is unlikely that this case will stand for the proposition that enforcement agencies will seek civil penalties for every inadvertent missed filing. Indeed, the FTC has long held a “one bite at the apple” policy, whereby the agencies will not seek civil penalties the first time a party misses a filing, assuming the failure to file was inadvertent.

*“...the FTC has long held a ‘one bite at the apple’ policy, whereby the agencies will not seek civil penalties the first time a party misses a filing, assuming the failure to file was inadvertent.”*

Nevertheless, HSR Act practitioners and their clients must take notice that the enforcement agencies do expect them to check whether informal advice obtained in the past is still regarded as good policy with the PNO. As the FTC stated in its press release announcing the consent, the bottom line is this: “Although informal interpretations of the premerger rules are available on [the FTC’s] website and may provide useful information to filers, it is important that filers confirm whether a particular interpretation reflects the current view of the Premerger Notification Office.”<sup>3</sup>

*Jay Levine, Partner*

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<sup>3</sup> See <http://www.ftc.gov/opa/2009/06/Malone.shtm>

Private Equity Update  
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## Firm Overview

Winston & Strawn LLP is a full-service, international law firm with offices in North America, Europe and Asia. The firm's depth and geographic reach enable it to manage virtually every type of business related legal issue. Winston & Strawn serves the needs of enterprises of all types and sizes, in both the private and the public sector.

## Private Equity Practice

Winston & Strawn's Private Equity Team provides strategic advice and legal counsel to private equity, distressed and venture capital funds, hedge funds, portfolio companies, and institutional investors. We focus on middle market transactions, understand the dynamics of deals in this space, and have a firm grasp on where the market is at any point in time.

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