WILMERHALE

Venture Financing and the Hart-Scott-Rodino Act

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Venture capital investors should be aware that they may be required to comply with the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the "Act") in venture financing transactions. Whether a particular transaction is subject to the Act will depend on the facts of the transaction.

General

If a transaction is subject to the Act, each of the investor and the issuer must file a notice (the "Filing") describing the transaction and providing information regarding their respective businesses and ownership and organizational structures. The Filings must be submitted to each of the Federal Trade Commission and the Department of Justice (the "enforcement agencies") and each investor that is required to make a Filing must also pay a fee of at least $45,000 to the Federal Trade Commission. The actual amount of the fee will depend on the value of the transaction. The filing fee is (i) $45,000 for transaction values that are less than $100 million; (ii) $125,000 for transaction values that are less than $500 million but equal to or greater than $100 million; and (iii) $280,000 for transaction values of $500 million or more. After the Filings have been made and the fees have been paid, the parties must observe a statutory waiting period before the transaction may be consummated. The statutory waiting period is 30 days, but early termination of the waiting period can be requested.

Analysis of Filing Requirements

The following analysis must be performed for each new investment. The analysis relied upon in previous investments may change with the specific facts of a new investment.

The analysis can be divided into four primary components: (i) the value of the transaction; (ii) the size of the entities; (iii) acquisitions by related investors; (iv) exemptions for passive investors; and (v) exceptions for acquisitions that do not increase percentage of holdings. Each of these components is discussed in detail below. An investment will only be subject to the reporting and waiting period requirements of the Act if both the value of the transaction and the size of the entities meet the minimum thresholds discussed below.

Value of the Transaction

Any acquisition of voting securities which will result in an investor holding voting securities of an issuer with an aggregate value in excess of $50 million (the "$50 million threshold") may be subject to the reporting and waiting period requirements of the Act. The value of securities of privately held companies is their purchase price. However, it is important to note that all voting securities, including previously acquired securities, held by the investor are taken into account when calculating the value of the transaction. All voting securities of the issuer held by the investor at the time the new investment is made are valued at their then current market value.

> Here's an example: Investment Fund A acquires five million shares of Company XYZ at a purchase price of $1 per share in January 2001. In January 2002, Investment Fund A intends to acquire an additional one million shares at $10 per share. All of the shares currently held by Investment Fund A will be valued at their fair market value of $10 per share. The value of the shares purchased in January 2001 will be $50 million and the value of the shares purchased in January 2002 will be $10 million. Therefore, the January 2002 acquisition will result in Investment Fund A holding voting securities of Company XYZ with an aggregate value of $60 million, tripping the $50 million threshold and possibly triggering a Filing under the Act.

Size of the Entities

Filings are required to be made by the ultimate parent entity ("UPE") of the investor and the issuer. The UPE is the person or entity, who for purposes of the Act, is deemed to control a party to the transaction. For purposes of the UPE analysis, a person or entity controls (i.e., is the parent of) (i) a partnership or LLC, if the person or entity has the present right to 50% or more of the profits or 50% or more of the assets upon dissolution; and (ii) a corporation, if the person or entity holds 50% or more of the voting securities or has the contractual right to appoint 50% or more of the directors. Therefore, in the case of most venture capital funds, each fund is likely to be treated as a separate UPE, even if two or more funds have a common general partner. This is the case as most funds are partnerships or LLCs in which no one person or entity is entitled to 50% or more of the profits or assets of the fund.

If the value of the transaction is $200 million or less, a Filing will not be required unless both the investor and the issuer have $10 million in gross sales or total assets, and at least one of them has $100 million in gross sales or total assets. Gross sales and total assets are determined by aggregating the gross sales and total assets of each of the investor and the issuer with the gross sales and total assets of all entities within the chain of control of their respective UPEs. If the value of the transaction is greater than $200 million, a Filing will be required without regard to the size of either the issuer or the investor.

Acquisitions by Related Investors

Acquisitions of voting stock of the same issuer by different funds within the same UPE must be aggregated for the purpose of determining whether the $50 million threshold has been met. Therefore, three investments in an issuer of $20 million each, by three different funds of an investor

with a common UPE would cross the $50 million threshold. Acquisitions by affiliated or related investors which are not under common control for UPE purposes are not aggregated, and are analyzed as separate transactions. Having a common fund management company, common general partner, or common shareholders does not affect the definition of control for UPE purposes.

Determining whether the affiliated funds are under common control for UPE purposes is crucial to determining whether a particular investment is subject to the Act. If an investor has various funds which are not under common control for UPE purposes (i.e., each is its own UPE), allocating acquisitions among the various funds may allow for the investment by each fund to remain below the $50 million threshold (i.e., each of three funds with a common general partner which is not a UPE could invest $20 million in the issuer without tripping the $50 million threshold). However, an acquisition by each fund that is a separate UPE which results in that fund holding voting securities with a value in excess of $50 million could require a Filing and the payment of the associated fee.

Exemption for Passive Investors

There is an exemption to the requirements of the Act for passive investors, but investments by venture capital funds typically do not qualify for the exemption. To be eligible for the passive investor exemption, an investor, and its related investors (the UPE and those controlled by the same UPE), must hold 10% or less of the outstanding voting securities of an issuer and it must intend to act as a passive investor. An investor's ownership interest is calculated on a voting power basis and, therefore, warrants and options are not factored into the calculation, and the number of shares represented by preferred stock is based on the number of votes to which such shares are entitled. An investor will not qualify as a passive investor if:

- the investor intends to nominate a candidate to the Board of Directors;
- the investor intends to propose corporate action requiring shareholder approval;
- the investor intends to solicit proxies regarding any matter to be brought before the issuer's shareholders;
- the investor or a director, officer, employee or controlling shareholder of the investor serves as an officer or director of the issuer or any entity within the organizational structure of the issuer's UPE; or
- if the investor or any entity within the organizational structure of investor’s UPE is a competitor of the issuer or any entity within the organizational structure of the issuer's UPE.

An investor who has the ability to designate a director, as is often the case with fund investors, cannot be a passive investor for purposes of the exemption from the Act.

The same aggregation for purposes of determining the $50 million threshold can be applied to this exemption. Each UPE can hold 10% or less of the securities of the issuer. If an investor has various funds which are not under common control for UPE purposes, allocations of even large acquisitions among the various funds may keep each entity’s holding below the 10% threshold.

As a result of the UPE test described above, most funds that are under the control of the same decision maker, such as a common general partner or fund manager, will be viewed as distinct UPEs. However, if the common decision maker engages in any of the five stated types of non-

passive conduct on behalf of all funds/partnerships under its management (i.e., appoints a director), then none of the funds/partnerships will qualify for the passive investor exemption. The issue of whether a common decision maker is acting on behalf of all of the funds will depend on the particular facts. However, if the common decision maker will be engaging in any of the five stated types of non-passive conduct, one should assume that the passive investor exemption will not be available for any of the funds. Therefore, if Investor Management, Inc. is the general partner of 20 funds (Investor Fund I, Investor Fund II, etc., each its own UPE), and invests $60 million from each fund for an aggregate of 20% of the voting securities of the issuer (1% for each fund) and gets to appoint one director of the issuer, then none of the funds will qualify for the passive investor exemption. Because each fund has crossed the $50 million threshold, each could trigger a separate requirement to file under the Act. (Of course, the investment could be allocated so that most of the funds hold less than $50 million of voting stock, and some of the funds may not meet the $100 million/$10 million size test discussed above).

Exemption for Acquisitions that do not Increase Percentage of Holdings

There is also an exemption to the requirements of the Act for an acquisition by an investor which does not increase, directly or indirectly, the investor's percentage ownership of the outstanding voting securities of an issuer. This exemption allows an investor to participate in additional rounds of financing as long as the investor's percentage ownership of voting securities remains the same or lower.

The timing of the investor's acquisition is important. For example, if an investor's percentage is reduced from 12% to 11% in a Series B round in which the investor did not participate, the investor cannot use the exemption that would have been available to it in the Series B round to make an acquisition during the Series C round, nor can the investor use that exemption to acquire securities after the Series B round closes. In other words, once the investor's ownership percentage is reduced to 11%, it cannot later rely on this exemption to increase its ownership percentage to 12%. However, the exemption would be available to the investor in the Series C round to allow it to maintain its 11% ownership position. This exemption will also allow an investor to acquire additional shares at the time of an IPO if as a result of the IPO the investor's percentage will not increase.

Splitting Acquisitions into Exempt and Non-Exempt Transactions

If it is determined that a Filing is required and that no exemption is available, there are ways to provide capital to the issuer prior to making a Filing by splitting the acquisitions into exempt and non-exempt transactions. For example, an investor who would be required to make a Filing could acquire convertible notes (an exempt transaction because the investor is not acquiring voting securities) which would convert into voting securities (a non-exempt transaction) after the Filings have been made and the waiting period has terminated. It should be noted that it is a violation of the Act to artificially structure a transaction to avoid the Act and, therefore, any proposed action should be closely coordinated with counsel to avoid any violation of the Act.

by the Hale and Dorr Venture Capital Group

The Act and the rules promulgated thereunder are technical and complex and this publication is only intended to alert you to the possibility that certain of your portfolio investments may require you to make a Filing. This publication is not intended to resolve specific questions. We have attorneys with extensive experience in matters involving the Act and we would be happy to assist you with any specific questions that you may have.