

# 1976 Act May Impact Transactions

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**FTC holds certain licensing arrangements subject to Hart-Scott-Rodino antitrust law**

**T**he U.S. Federal Trade Commission staff has made clear in recent pronouncements that certain licensing arrangements are subject to the pre-acquisition notification requirements of the Hart-Scott-Rodino Antitrust Improvements Act.<sup>1</sup> When the Act was passed in 1976, the number of licensing arrangements meeting the Act's filing thresholds were few and far between. However, given the magnitude of consideration currently involved in many licensing arrangements, it is now far more commonplace for a licensee to require pre-acquisition reporting under the Act.

Furthermore, parties entering into licensing arrangements should carefully consider both the threat of substantial civil penalties for non-compliance with the Act and the FTC's current enforcement posture. This article provides a general overview of the Act, Rules, and FTC interpretations relating to intellectual property transfers.

## GENERAL REQUIREMENTS UNDER THE ACT

The Act generally provides that no person may acquire the assets of another person exceeding the statutorily-specified criteria unless both the "acquiring" and "acquired" persons simultaneously notify the FTC and U.S. Department of Justice of the proposed transaction and observe the applicable waiting periods. Information submitted to the FTC and DOJ by the parties pursuant to the Act is confidential and exempt from Freedom of Information Act requirements.<sup>2</sup>

The initial waiting period is 30

days. However, the FTC and DOJ may either earlier terminate such waiting period or extend such waiting period by issuing a "second request" for information concerning the parties' proposed transaction.<sup>3</sup> The issuance of a second request by one of the enforcement agencies extends the waiting period until 20 days after the parties provide the information requested by the second request.

The filing fee for pre-acquisition notification under the Act is \$25,000 per acquiring person. Penalties for failing to comply with the Act include civil penalties of up to \$10,000 a day for each day a person is in violation of the Act.

To date, the enforcement agencies have not announced either the imposition of a civil penalty action or a settlement involving a licensing arrangement that was subject to the Act but not notified to the agencies. However, it is most important to understand that the FTC has in recent years aggressively sought and obtained large civil penalty awards against non-complying parties generally.<sup>4</sup>

The purpose of the Act is to provide the federal enforcement agencies the opportunity to review a transaction before its consummation, thereby eliminating the need to seek post-transaction divestiture or rescission. Under the Act, however, both the FTC and DOJ have the right to challenge any acquisitions after expiration of the waiting period and/or consummation of the acquisition. In practice, there have been only a few instances in which the government has subsequently challenged a transaction that closed the Hart-Scott-Rodino process.

The FTC has taken the position since at least as early as July 1982 that certain licensing arrangements constitute the transfer of assets,

and, if the reporting thresholds (discussed below) are met, constitute reportable events under the Act. The FTC does not consider the grant of a nonexclusive patent or trademark license an acquisition of assets because the grantor retains the right to use the patent or trademark and/or to grant additional nonexclusive licenses.

The FTC also considers exclusive licenses to be subject to the Act as transfers of an asset to the licensee.<sup>5</sup> The FTC has also considered the grant of an exclusive geographic territory or exclusivity for specific uses as being akin to an acquisition of an asset.<sup>6</sup> Recently, the FTC indicated that the exclusive licensing of technology or know-how is a transfer of beneficial ownership of an asset subject to the Act.

## TREATMENT OF LICENSOR'S TECHNICAL SUPPORT AGREEMENT

The FTC, to date, has not specifically commented or analyzed the tangential arrangements that sometimes accompany the license of existing patents or know-how. Thus, the FTC has not issued any express public statements regarding how the FTC would treat a requirement that the licensee provide technical support for the development of improvements to the underlying patent. In such situations, the FTC would most likely analogize to consulting or employment agreements that are ancillary to the sale of a business, such consulting or employment agreements, if final file, are generally not subject to reporting under the Act.

As noted, the FTC considers how sub-consulting agreements (i.e. that

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reflect the value of services to be rendered and not a disguised portion of the purchase price for assets to be transferred as being exempt from the reporting requirements.<sup>18</sup> If the consulting or services agreements reflect the value of services actually to be performed in the future and are negotiated at arm's length in connection with the sale of the business or assets, the FTC has opined that their value need not be included in the acquisition price.<sup>19</sup> However, to the extent that such arrangements reflect present or future remuneration to the seller for its transfer of the assets, such payments must be included in the purchase price for the income arrangement.<sup>20</sup>

Recently, the FTC has taken the position that entry into a management agreement is not tantamount to an acquisition so long as there is no change in the beneficial ownership as a result of the entry into the agreement.<sup>21</sup> By analogy, to the extent that agreements involve future services for which the payments are commensurate with the services rather than additional consideration for the licensed intellectual property, that portion of the arrangements should not be subject to the Act.

#### TREATMENT OF JOINT RESEARCH AND DEVELOPMENT ARRANGEMENTS

High-technology companies frequently enter into joint research and development arrangements with third parties. To the extent that such arrangements are formalized through the formation of a joint venture corporation, the creation of the joint venture may be a reportable event under the Act.<sup>22</sup> However, where there is no transfer of assets in excess of \$5 million and no formation of a corporation,<sup>23</sup> such events are usually non-reportable.

#### REPORTING THRESHOLDS UNDER THE ACT AND RULES

The Act applies only to those transactions that satisfy three tests: (1) the Commerce test, (2) the Size of the Parties test, and (3) the Size of the Transaction test.

#### The Commerce Test

The Act applies only if either the acquiring person or the acquired person is engaged in commerce or its activity affecting commerce. This test is so broad as to give Congress power to legislate under the Commerce Clause of the Constitution. Accordingly, it will be very unusual for a proposed transfer not to satisfy this test.

#### The Size-of-the-Parties Test — \$5 Million/\$50 Million

The Act requires that the parties meet specified "size" considerations being subject to its requirements. The test can be satisfied in any of three different ways:

1. If the acquired person is engaged in manufacturing<sup>24</sup> and has annual net sales or total assets of \$5 million or more and the person making the acquisition has annual net sales or total assets of \$50 million or more.

2. If the acquired person is not engaged in manufacturing, and has total assets of \$50 million or more and the person making the acquisition has annual net sales or total assets of \$50 million or more.<sup>25</sup>

3. Regardless of whether the acquired person is engaged in manufacturing, it has annual net sales or total assets of \$50 million or more and the acquiring person has annual net sales or total assets of \$50 million or more.

In applying the "size of the parties" test, it is important to identify the acquiring and acquired parties properly. A "person" for purposes of the size of the parties test is not necessarily the actual acquiring or acquired entity, unless that entity is not "controlled" by any other entity.

The Rules require size computation for the "ultimate parent entity" of each party, i.e. for the person that "controls" the party to the transaction. Control is defined by the Rules as (a) holding 50% or more of the outstanding voting securities of an entity; (b) in the case of an entity with no voting securities, having the right to at least 50% of the profits of the entity, or the right to at least 50% of the profits of the entity; or upon dissolution the right to at least 50% of the assets of an entity; or (c) having the contractual

power to designate 50% or more of the directors of an entity.<sup>26</sup> Thus, to determine whether the size of parties test is met in a particular instance, the sales and assets of each ultimate parent entity, including all entities that parent "controls," must be considered.

#### The Size of the Transaction Test

In licensing arrangements, the "size of the transaction" criterion will often be the critical one for determining reportability under the Act. A transaction is reportable only if, as a result of the acquisition, the acquiring person will hold an aggregate total amount of assets of the acquired person in excess of \$5 million.<sup>27</sup> The rules define the "value of assets" to be the "fair market value of the assets, or, if determined and greater than the fair market value, the acquisition price."<sup>28</sup> The acquisition price "shall include the value of all consideration for such . . . assets to be acquired."<sup>29</sup>

The FTC does not permit installment payments to be reduced to reflect their present worth.<sup>30</sup> Instead, a licensee must aggregate the amounts of all determinable royalties payable over the life of the license.

The acquisition price, therefore, clearly includes the fixed royalty payments as well as any upfront payments made to the licensor.

It, however, the licensor designates a portion of future royalties as interest, the interest payments may be excluded.<sup>31</sup> The FTC will not permit an attempt to designate a portion of future royalties as "interest" if the license agreement itself does not identify the payments as such.

The presence of contingent payments may render the acquisition price undeterminable at the time the license agreement is negotiated and executed. For instance, it is not uncommon for licensing agreements to provide for the amount of future royalties to be derived as a percentage of license sales of the patented item. In such instances, the FTC requires the parties' boards of directors (or their designees) to determine in good faith the fair market value of the rights being acquired.<sup>32</sup>

The most appropriate formulation

