F.I. 15

[redacted]

March 22, 2002

VIA e-mail (mverne@ftc.gov)

B. Michael Verne, [redacted]
Compliance Specialist
Premerger Notification Office
Federal Trade Commission, Room 301
Sixth and Pennsylvania Avenue, N.W.
Washington, D.C. 20580

Re: Formal Interpretation 15 re Limited Liability Companies

Dear Mike:

We have a question under Formal Interpretation 15 that I think may be a recurring one, and are writing to ask whether the PNO agrees with our view that the formation of the LLC described below is not reportable under the Act.

A, B and C will form an LLC. Initially, A and B will each hold 48% ownership interests, and C will hold the remaining 4% interest. Initially, A, B and C will hold interests entitling them to 48, 48 and 4 percent, respectively, of the profits of the LLC. A is a wholesaler or products, and B is a remarketer of data obtained from retailers. C is a retailer, and hence a customer of A and a provider of sales data to B.

The parties contemplate that, over time, additional retailers (D, E, F, etc.) will become owner-participants in the LLC in the same manner as C, and at no more than the same 4% interests that C will hold. The interests of A and B will therefore be reduced as each new retailer comes on board. Six months after formation, for example, the ownership interests of A and B may have declined to, say, 42%, due to new retailers D, E and F joining and receiving 4% interests.

Formal Interpretation 15 provides:

> "The PNO will henceforth treat as reportable the formation of an LLC if (1) two or more pre-existing, separately controlled businesses will be contributed, and (2) at least one of the members will control the LLC (i.e., have an interest entitling it to 50 percent of the profits of the LLC *or 50 percent of the assets of the LLC upon dissolution*)."

A and B will contribute various "hard" assets to the LLC, such as leases and equipment. For

[redacted]

B. Michael Verne, Esq.

[redacted]

March 22, 2002
Page 2

purposes of this letter, you may assume that these assets will satisfy the "two businesses" proviso of condition (1) of Interpretation 15. As to condition (2), however, it is clear that no member will "have an interest entitling it to 50 percent of the profits of the LLC."

Accordingly, the only issue is one arising under the "assets" part of the definition of "control," a definition that I assume was borrowed from 16 C.F.R. § 801.1(b)(ii). In our example, however, C [and subsequent retailer-participants D, E and F] will contribute data and other things that the IRS regards as 'services," not "assets" for tax purposes. As is typical in the case of service-contributing members, C will not receive an initial "capital account," and hence will have no *immediate* right to a distribution of assets upon dissolution (since C did not contribute any assets), because all distributions are based ultimately on capital account balances. If the LLC dissolved *right after it was formed*, A and B would get their assets back and C would get nothing However, 4% of any profits will be allocated to C's capital account, so that if the LLC earns $100 of profit on it first day of existence, C will have a capital account of $4 and an interest in any dissolution distributions of that much, and A's and B's interests in dissolution proceeds will be reduced to that extent and will be less than 50% apiece.

As a matter of antitrust law, there would seem to be no reason to insist that the rights to dissolution proceeds be measured by reference to a hypothetical immediate dissolution of an LLC that has just been formed.. In the instant case, we know for a certainty as a matter of mathematics that if the LLC produces even one dollar of cumulative net profits, less than 50% of the dissolution proceeds will flow to a particular member.

If—in order to meet the "control" definition of condition (2) of the Interpretation—A and B simply gave C a capital account share of the hard assets they are contributing upon the formation of the LLC rather than giving C an interest only in future profits, the IRS in its wisdom would immediately declare that C has received ordinary, taxable income to the extent of the initial capital account given to C. Thus, C would prefer to receive only an interest in future profits.[1]

In light of the above, we think that a sensible reading of condition (2) of the Formal Interpretation is that it is met if the nature of the LLC is that the service-contributing "Cs" of this world will have a right to assets upon dissolution the moment the LLC begins to show profits, even if they do not technically have such a right on the day of formation of the LLC.

---

[1] The following simple example illustrates the point: If you and I formed a 50/50 LLC, you contributing $1000, and me agreeing to contribute hard work in exchange for my 50% equity, and we dissolved the LLC tomorrow, you would want your $1000 back, and wouldn't want to give me $500 in exchange for my having done nothing, yet. And if you were foolish enough to give me the $500, well, the IRS would pounce upon me right away, and demand its cut of my new-found "income."

[redacted]

B. Michael Verne, Esq.

[redacted]
ATTORNEYS AT LAW

March 22, 2002
Page 3

Put another way, we read the definition of "control" in 801.1(b)(ii) to be aimed at a "strawman" partner situation—employees of a partnership (sometimes called "profit-sharing" associates in the case of law firms) who have in a sense the right to receive a share of the net profits of the partnership, but who are not (and never will be) "partners" who have a right to the assets upon dissolution. The twin definition of "control" assures that the person having 50% or more of the rights to the assets cannot avoid being a UPE for HSR purposes by the device of cutting-in some employees and calling them "profit-sharers." However, an LLC organized in the manner described in this letter cannot be used in this strawman fashion.

We would therefore appreciate learning if the PNO concurs in this analysis, in which case the formation of the LLC described in this letter would not be reportable under the Act. I will, of course, be happy to discuss this inquiry with you at any time, and please feel free to telephone me in any event.

With best regards,

[redacted]

ADVISED THAT THE RETAINED PROFITS WHICH HAD NOT YET BEEN DISTRIBUTED WERE NOT PART OF THE DETERMINATION OF THE RIGHT TO 50% OF THE ASSETS upon DISSOLUTION. AT THE TIME OF THE FORMATION EACH OF A & B HAVE THE RIGHT AND WOULD BE DEEMED TO CONTROL THE LLC. ALSO ADVISED THAT THE MORE DIFFICULT QUESTION OF WHO (IF ANYONE) CONTROLS AT THE TIME OF SOME FUTURE ACQUISITION WAS STILL UNDER DELIBERATION BY THE PNO STAFF. N. OUUKA & J. SIDONOV (DOJ) CONCUR.

[redacted]

B. Michael Verne
4/8/02