October 2018

Liability for investee company cartels

Over the summer, EU judges reached an important decision which vindicates the European Commission's stance that even minority investors can be liable for the competition infringements of investee companies.

In 2014, the European Commission imposed fines of almost €302m on 11 producers of high voltage cables which were in a cartel between 1999 and 2009. That decision was of particular interest to private equity houses because Goldman Sachs (GS) was found liable for the conduct of Prysmian, an Italian manufacturer, acquired by GS private equity funds in 2005 (but divested by the time of the Commission decision). It was one of the first cases in which the Commission fined a private equity firm for the actions of a portfolio company.

GS appealed the decision, and on 12 July 2018, the EU General Court handed down its judgment, reaffirming the Commission's approach and leaving Goldman Sachs potentially liable for a fine of €37m. This was despite the fact that, for part of the period for which it was found liable, GS held under 32% of Prysmian's shares.

The Ruling

The Goldman Sachs appeal

In 2014, former GS portfolio company, Prysmian, was found to have been involved in a cartel and received a fine of over €104m. Between 2005 and 2009, Prysmian was owned, to varying degrees, by GS funds (see 'Case Chronology' box). On the basis that GS exercised "decisive influence" over the commercial policy of Prysmian, the Commission held GS jointly and severally liable for approximately €37m of Prysmian's fine, even though there was no suggestion that GS had any knowledge or involvement in the cartel.

GS appealed this decision on various grounds, including on the basis that, as a private equity firm which gradually sold down its funds' stake across the relevant period, it did not exercise "decisive influence" over Prysmian. None of GS's arguments were ultimately successful.

Whilst perhaps anathema to private equity houses (given their role as investment managers for third party funds), to EU competition lawyers it is not wholly surprising that the Commission held GS liable for Prysmian's conduct during the period it exercised, in effect, 100% of the voting rights in Prysmian (July 2005-May 2007).

However, of particular interest is the Court's conclusion that GS continued to be liable for Prysmian's conduct after the latter's 2007 IPO – even though, afterwards, GS held as little as 32% of Prysmian's shares.

Why was GS deemed to exercise "decisive influence"?

Pre IPO

Under EU law, in order for a parent to be held liable for the conduct of its subsidiary, it must have had "decisive influence" over its subsidiary at the relevant time, and therefore have formed part of the same "undertaking" (i.e. economic unit).

In its 2014 decision, for the period prior to Prysmian's IPO (see box right), the Commission tried to rely on a legal presumption which dictates that a parent will be *assumed* to exercise decisive influence over its subsidiary if it owns all/nearly all of the share capital – despite the fact that, prior to the IPO, GS had already sold down its funds' shareholding to 91.1% and then 84.4% (and despite GS funds, as distinct from GS, being the legal owners of these shares). The Commission relied on the fact that, even after these initial sell-downs, in practice GS continued to exercise 100% of the voting rights in Prysmian and therefore should be regarded as akin to a sole owner. GS appealed the extension of the legal presumption to this situation.

The Court agreed with the Commission's approach and considered that GS had failed to rebut the presumption that it exercised decisive influence during the pre-IPO period. What mattered was that, with (in effect) 100% of the voting rights and the other shareholders acting purely as passive investors, GS was in a position to exercise total control over Prysmian's commercial strategy. The Court held it was not sufficient to point to the fact that Prysmian's Board minutes made no reference to GS's interests, nor did it matter that the Prysmian Board declared its independence publicly (pursuant to Italian company law).

Post IPO

During 2007, due to Prysmian's IPO and a further sell down, GS sold down its stake to just under 32%.

From this period onwards, the Commission was unable to rely on the presumption above, so instead sought to demonstrate that GS maintained decisive influence on the basis of a range of economic, organisational and legal links between the companies. These included: 1) the power to appoint/remove members of Prysmian's boards of directors; 2) the power to call shareholder meetings and propose the revocation of Board directors; 3) GS's actual representation on Prysmian's Board and those directors' broad management powers; 4) regular updates and monthly reports; 5) measures to ensure GS maintained decisive control after the IPO; and 6) evidence that GS's behaviour was typical of an industrial owner.

The Court agreed that the Commission could rely on the factors above to demonstrate that GS exercised decisive influence both pre and post IPO. The last two factors are of particular interest in so far as they relate exclusively to the post IPO period, and demonstrate how a private equity investor can still be liable for behaviour of its portfolio company <u>even after</u> it has substantially sold-down its stake to a minority shareholding. In this respect of this post IPO period, the Court confirmed that, to demonstrate GS's decisive influence, the Commission could rely on the fact that:

- shortly prior to the IPO, GS (as sole controlling shareholder) re-appointed the Board of Directors and which would stand until 31 December 2009, ensuring GS continued to control the Board even after the IPO;
- in addition, GS also changed Prysmian's by-laws (in accordance with the relevant listing rules) which ensured that, post IPO, GS would continue to have the ability to appoint 5 of 6 Board Directors;

CASE CHRONOLOGY

- **July 2005**: Prysmian (formerly a division within Pirelli) acquired by GS Capital Partners V Fund L.P.
- **September 2005 & July 2006**: GS divested equity stakes to Apollo and management, taking its shareholding to between 91.1% and 84.4%.
- **May 2007**: Prysmian listed on the Milan stock exchange. Following the IPO, GS retained a 54% shareholding in the company.
- **November 2007:** GS divested its remaining interest in Prysmian in stages, by selling approx. 22%, leaving GS with just under 32%.
- **January 2009:** The Commission opened its investigation into Prysmian and the other cartelists, following a leniency application from one of the parties to the cartel (ABB).
- **November 2009 – March 2010:** GS sold a further 14% in November 2009, and sold its final 17% stake in March 2010.
- **April 2014:** The Commission hands down its decision against GS/Prysmian, finding a cartel between 1999 and 2009.
- **July 2018:** Following a number of appeals against the Commission's decision, the European General Court rules in support of the previous determination against GS.

- both pre and post IPO, over 50% of Prysmian's Board continued to be populated by GS employees or other directors with informal links to GS;
- immediately prior to the IPO, GS also introduced a 'Strategic Committee' which advised the Board, two of three members of which were GS employees. While this committee had no formal decision making powers, the Board systematically consulted it regarding key investments;
- both pre and post IPO, GS was the only shareholder which had the right to call a shareholders meeting to propose the revocation of directors; and
- post IPO, GS continued to act as an "industrial owner" (e.g. by acting as an interlocutor between Prysmian and potential customers).

The Implications

Responsibility to pay

Having established that GS exercised decisive influence over Prysmian (both pre and post IPO) on the basis of the above organisational and economic links, the Commission did not need to demonstrate how GS specifically exercised its control over Prysmian to make GS liable for the latter's cartel behaviour. Nor was it necessary to show GS was involved in, or even aware of, the cartel.

Prysmian was hit with the biggest fine at €104.6 million, which included a joint fine of €37.3 million with Goldman Sachs. Having been found to be jointly and severally liable with Prysmian, both GS and Prysmian will have a primary responsibility to pay the identified fine to the Commission. In other words, it is not the case that GS only has to step in to pay the fine where Prysmian is unable to do so.

Conduct of a portfolio company: mitigation steps

In almost all majority investments, a private equity house will be deemed to have decisive influence over its portfolio companies and will therefore be potentially liable for breaches of competition law by those companies. Even on minority investments the rights that the sponsor may have to appoint directors and control voting rights may mean that the sponsor becomes liable in the same way.

While there are a number of steps that private equity investors may take to mitigate this type of risk, fundamentally the most effective action is to minimise the risk of a portfolio company being involved in a competition law breach in the first place.

Private equity investors should consider whether their due diligence processes are sufficient to cover potential ongoing competition law breaches by prospective portfolio companies (and also that appropriate warranties and, where relevant, indemnities are secured on the acquisition). In relation to existing portfolio companies, private equity investors should assess, based on the industry and jurisdictions in which the group operates, the risk of a serious competition law breach, consider whether they have asked the right questions about competition law compliance and determine whether an appropriate compliance programme is in place.

FOR FURTHER INFORMATION, PLEASE CONTACT

10 Snow Hill
London EC1A 2AL
T: +44 (0)20 7295 3000
F: +44 (0)20 7295 3500
www.traverssmith.com

Paul Dolman
Partner, Head of Private Equity

E: paul.dolman@traverssmith.com
T: +44 (0)20 7295 3274

Nigel Seay
Partner, Head of Competition

E: nigel.seay@traverssmith.com
T: +44 (0)20 7295 3416

Stephen Whitfield
Partner, Competition

E: stephen.whitfield@traverssmith.com
T: +44 (0)20 7295 3261

Richard J Brown
Associate, Competition

E: richard.j.brown@traverssmith.com
T: +44 (0)20 7295 3249