TRAVERS SMITH

Competition law risks for private equity firms

April 2014

In this briefing, we focus on a recent decision of the European Commission finding Goldman Sachs liable for the cartel conduct of a former portfolio company. We also comment on a separate potential area of competition law exposure for private equity firms; their involvement in bid processes for acquisition targets.

Why should private equity firms be concerned about competition law?

Serious breaches of competition law by companies active in the EU are likely to result in enforcement action by the European Commission or EU member state competition authorities, such as the Competition and Markets Authority (**CMA**) in the UK. Where a competition regulator investigates and reaches a finding that there has been an infringement of competition law, the consequences can be very serious (see box opposite).

The most obvious competition law risk for private equity firms is the potential value impact on a portfolio company which has infringed competition law. However, liability may not stop with the portfolio company, it can attach to private equity firms as well.

- **Liability for the conduct of a portfolio company.** Under EU and UK competition law, liability for a competition law breach by a particular company attaches to the entire "economic unit" of which that company forms part. As a result the European Commission and the CMA in the UK are able to hold a parent liable for the competition law infringement of a subsidiary if the parent exercises "decisive influence" over the subsidiary, even if there was no involvement in or knowledge of the competition law breach. Such influence is presumed where the parent owns all, or nearly all, of the shares of a subsidiary. As has been demonstrated by the European Commission's finding against Goldman Sachs (**GS**) last week, on the same basis, private equity firms which exercise decisive influence over their portfolio companies may be in the frame for fines for a competition law breach by a portfolio company. This liability can even arise after the portfolio company has been sold.
- **Competition law risks in bid processes.** Separately, the conduct of and / or arrangements made by the private equity firm itself in bid processes may also fall within the scope of EU and UK competition law.

Liability for the conduct of a portfolio company

Goldman Sachs and Prysmian

On 2 April 2014, the European Commission announced its final decision in the Power cables case, imposing fines of almost €302m on 11 producers of high voltage cables which were involved in a cartel between 1999 and 2009. The case has been closely watched by the private equity industry given reports that one of the companies potentially in the frame for fines was GS, due to the involvement in the cartel of a former portfolio company of GS's private equity arm, GS Capital Partners.

The former portfolio company was Prysmian, an Italian cable manufacturer. Prysmian was found to have been involved in the cartel and received a fine of just over €104m. Between 2005 and 2009, Prysmian was owned, to varying degrees, by one of the GS Capital Partners funds (see box over page). On the basis that it exercised "decisive influence" over Prysmian for at least part of this period, GS has been held jointly and severally liable for the conduct of Prysmian during the period it exercised decisive influence and therefore for around €37m of Prysmian's fine. GS is liable on this basis even though there is no suggestion that GS had any knowledge of or involvement itself in

EU and UK competition law: key points

EU and UK competition law prohibit:

- **Anti-competitive agreements:** serious infringements include price-fixing, bid-rigging and market-sharing arrangements.
- **Abuse of dominance:** businesses which enjoy substantial market power may be prohibited from e.g. charging excessively high prices or refusing to supply a customer without good reason.

The consequences of infringement include:

- Fines up to 10% of worldwide turnover for the most serious infringements.
- Unenforceability of agreements.
- Third party damages claims.
- Director disqualification (UK only).
- Criminal prosecution of individuals implicated in cartel activity (UK only).

the alleged cartel conduct.

This is one of the first cases in which the European Commission has attributed liability to a private equity firm for the competition law infringements of a portfolio company. The Commission has previously held investment companies liable for the actions of their subsidiary businesses, however this case is arguably the first where they have done so in respect of a relatively standard private equity structure.

The full text of the European Commission’s decision is unlikely to be published for some time. However, based on the information currently made available by the Commission and the parties we highlight the following points:

- **Why did the European Commission find that GS exercised "decisive influence" over Prysmian?** In making a finding of the exercise of "decisive influence", the European Commission may rely on evidence of economic, organisational and legal links between the companies. Joaquin Almunia, the European Commissioner for competition, is reported as noting that the Commission believes that GS had been involved in the management decisions of Prysmian, through its voting rights and also board representation. In particular, Almunia noted that for the period between 2005 and 2007, GS was able to exercise 100% of the voting rights in Prysmian, and could revoke the board of directors and appoint a new board at any time. There were also GS representatives on the board of Prysmian, and GS was regularly updated on Prysmian business through monthly reports. While the full decision will no doubt further illustrate the Commission’s reasoning, clearly none of these factors are unusual in a private equity context.

- **Is the European Commission sending a message to private equity firms?** It has always been the European Commission's position that parent or holding companies can be held responsible for the conduct of their subsidiaries and in imposing this fine on GS, arguably all the Commission is doing is confirming that private equity or other financial owners who exercise decisive influence, whether by ownership or other means, will not be viewed in a different light. However it is interesting to note that in announcing the decision, Almunia emphasised "*the responsibility of groups of companies, up to the highest level of the corporate structure, to make sure that they fully comply with competition rules. This responsibility is the same for investment companies, who should take a careful look at the compliance culture of the companies they invest in*".

Responsibility to pay

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 European Commission. In other words, it is not the case that GS will only have to step in to pay the fine where Prysmian is unable to do so.

Conduct of a portfolio company: mitigation steps

Private equity firms should revisit their fund documentation and equity documents to try to ensure they are indemnified so far as possible for these risks both in the period of control of the portfolio company and thereafter. However, clearly the most effective action a private equity firm can take is to minimise the risk of a portfolio company being involved in a competition law breach.

Private equity firms should consider whether their due diligence processes are sufficient to cover potential competition law breaches by prospective portfolio companies and that appropriate warranties and indemnities are secured on the acquisition. In relation to existing portfolio companies, private equity firms should consider whether they have asked the right questions about compliance with competition law and whether an appropriate compliance programme is in place.

Competition law risks in bid processes

Other cases brought before the courts in non-EU jurisdictions in recent years illustrate that competition law risks can also arise for private equity firms when dealing with other actual or potential bidders for acquisition targets.

The competition law allegations made in these recent cases have included:

- private equity firms clubbing together (a "**club deal**") to put forward a single bid for an acquisition target with the alleged aim of reducing the number of competitors for the acquisition target, and therefore the likely purchase price; and / or

- an agreement between potential bidders that one bidder will not bid, or will bid an uncompetitive price for, an acquisition target, usually in return for a benefit provided by the other. The benefit in return may take one of several forms, including: a general understanding or specific reciprocal arrangement that the winning bidder will not bid on

The investment in Prysmian and the European Commission investigation

- In July 2005, Prysmian (formerly a division within Pirelli) was acquired by GS Capital Partners V Fund L.P.
- In May 2007, Prysmian was listed on the Milan stock exchange. Following the IPO, GS retained a 54% shareholding in the company. It then divested its remaining interest in Prysmian in stages, by selling approximately 22% in November 2007, 14% in November 2009, and finally 17% in March 2010.
- The European Commission’s investigation into Prysmian and the other cartelists began in January 2009, following a leniency application from one of the parties to the cartel (ABB).
- The investigation ran for 5 years concluding on 2 April 2014. Some of the parties have already indicated they intend to appeal the decision. In a statement issued last week, GS noted that it is currently considering whether to appeal.

other acquisition targets; compensation for the losing bidder.

Bid processes: mitigation steps

Some of the issues under consideration by the courts in these recent cases are specific to the relevant national competition and other laws in question. Nonetheless, there is significant overlap with the relevant principles under EU and UK competition law. The following key points should be borne in mind in any dealings with other actual or potential bidders for an acquisition target:

- **Club deals.** A decision by a private equity firm to enter into a club to jointly bid for an acquisition target to diversify the risk of the transaction across the club members / minimise investment commitment should not of itself raise EU / UK competition law concerns. However, discussions relating to the potential establishment of a club should be approached carefully and in accordance with legal advice, particularly in respect of the exchange of "competitively sensitive information" (see box opposite) between the parties. In addition, club involvement should always be clearly disclosed to the vendor at an early stage.
- **Agreements not to bid.** Outside of the context of a club deal any form of arrangement or understanding between private equity firms to refrain from bidding for a particular acquisition target is unlikely to be permissible under EU / UK competition law. This is also likely to extend to an agreement with a trade bidder not to bid.
- **Forming a club after initially participating independently.** Particular sensitivities arise in circumstances where private equity firms initially participate in a bid process independently, but later decide to form a club. In such cases, private equity firms should always seek legal advice prior to making any approach to another bidder.
- **Documentary evidence.** Almost any correspondence – for instance, in relation to structuring a transaction in the context of involving other private equity firms – may be reviewed subsequently by a court or a competition regulator. Firms should be particularly careful, where they are considering involvement with other bidders, to evidence the reasoning behind / justification for their independent decisions to adopt a particular transaction structure.

For more information, or if we can assist further in relation to any of the matters raised in this briefing, please contact Nigel Seay, Helen Croke or your usual contact at Travers Smith.

"Travers Smith LLP gives 'responsive and commercially savvy advice'. The firm has a strong reputation in merger control and a solid following for behavioural work."

Legal 500, 2013

Competitively sensitive information

Under EU competition law, the exchange of "competitively sensitive" information between competitors could, in itself, be deemed to constitute a breach of the prohibition on anti-competitive agreements.

The risk involved in the disclosure of such information is that, once a company has an understanding of, for example, its competitor's pricing and other strategic business intentions, it will be able to align its conduct on the market with that of its competitors.

In the context of bidding processes, and particularly when considering entering into a club deal, a private equity firm should ensure it limits discussions to information which is strictly necessary for the purposes of evaluating the proposed bid, and that broader issues are not discussed, such as:

- the price each actual or potential bidder might offer on an independent basis (e.g. if the club proposal is not progressed) and their degree of willingness to make a bid for the acquisition target on their own;
- bids in the context of other, unrelated, transactions; or
- information relating to the private equity firm's / other bidder's businesses more generally (i.e. unrelated to the proposed bid).

Travers Smith LLP
10 Snow Hill
London
EC1A 2AL

T: +44 20 7295 3000
F: +44 20 7295 3500

www.traverssmith.com

Nigel Seay
Partner, Head of Competition
+44 (0)20 7295 3416
nigel.seay@traverssmith.com

Stephen Whitfield
Senior Associate, Competition Department
+44 (0)20 7295 3261
stephen.whitfield@traverssmith.com

Philip Sanderson
Partner, Head of Private Equity Group
+44 (0)20 7295 3367
philip.sanderson@traverssmith.com

Helen Croke
Partner, Corporate Department
+44 (0)20 7295 3389
helen.croke@traverssmith.com

Travers Smith LLP
10 Snow Hill
London EC1A 2AL
T +44 (0)20 7295 3000
F +44 (0)20 7295 3500

www.traverssmith.com