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New antitrust risks for private equity firms?

The European Commission has targeted a private equity house for potential fines for antitrust breaches allegedly committed by one of its portfolio companies

The market intelligence agency Mlex has reported that Goldman Sachs ("GS") has received a "statement of objections" from the European Commission (the "Commission") in connection with allegations that the Milan-based company Prysmian participated in a cartel for submarine and underground power cables and related products and services. In doing so, it has identified GS as a potential recipient of a fine for the activities of Prysmian, which was owned by certain GS Capital Partners funds for at least some of the period during which this cartel activity was alleged to have taken place.

GS has reportedly confirmed that there is no allegation that GS or any of its personnel participated in, or were aware of, the alleged cartel. If a fine is imposed on GS, it would therefore be purely on the basis of parental liability for the activities of Prysmian. While the Commission has, in recent years, made increasing use of its powers to fine parent companies for the actions of their subsidiaries, this is one of the first instances - and certainly the most high profile - in which a private equity firm has been targeted in this way. It highlights the need for private equity ("PE") houses to take an active interest in ensuring that antitrust compliance systems are rigorously implemented by their portfolio companies.

Background

Under EU competition rules, liability for an antitrust breach attaches not to the individual legal entities that committed the infringement, but rather to the entire "undertaking" or "economic unit" of which they form part. Following this logic, the EU courts allow the Commission to hold a parent company liable for the antitrust infringements of a subsidiary if the parent exerts "decisive influence" over it. In practice, such influence need only relate to the high level strategy and commercial policy of the subsidiary, so that a parent company's liability can be triggered even if it had no involvement in or awareness of the breach and did not in any way encourage the subsidiary to commit it.

Moreover, such influence is *presumed* where a parent company owns all or almost all of the subsidiary's shares. Rebutting that presumption – i.e. proving a negative, that no such influence was ever exercised – is extremely difficult. To date, there have been only three instances in which the EU courts have ruled that a parent company presented evidence that was at least capable of rebutting the presumption. In all three cases there was significant documentary evidence and testimony that the subsidiary in question was given unfettered freedom to determine its own commercial conduct and that neither the parent company nor its representatives had ever intervened to influence such conduct, even on matters of high level strategy.

Parental liability can arise even if the infringing subsidiary has been sold. For example, the fact that GS Capital Partners no longer owns Prysmian is no obstacle to the Commission pursuing GS, as it was the owner during the period of the alleged breach.

Key Issues

Potential fine for Goldman Sachs on the basis of pure parental liability for antitrust breach of a portfolio company

EU antitrust law allows for easy piercing of the corporate veil

Does this herald a shift in policy of the European Commission towards greater targeting of private equity owners?

Lack of involvement in or awareness of the breach is no defence

What are the risks for private equity firms and how can they be mitigated?

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Attributing liability to parent companies in this way allows the Commission to increase the fine that it imposes, often substantially. This is not only because the maximum fine that can be imposed by the Commission (10% of worldwide turnover) will be calculated on the basis of consolidated group turnover, but also because it makes it more likely that the parent company will be found to be a repeat offender, and subject to a 100% increase in the fine for each past breach. In the Commission's eyes, it also creates incentives for the board and senior management of a corporate group to drive antitrust compliance from the top down, which tends to be more effective.

By allowing the corporate veil to be so readily pierced, EU law stands in stark contrast to that of the US, where parent companies are in most cases only liable for antitrust breaches of their subsidiaries if parent and subsidiary are deemed not to have separate corporate existences. Moreover, the approach under EU law is replicated in the national laws of most EU countries and, in some cases, taken further. In the UK, for example, the OFT can seek an order prohibiting an individual from assuming any board level responsibilities for a UK company (even if not formally appointed as a director), if it considers that he or she turned a blind eye to cartel conduct within their corporate group.

Implications for private equity

As with all legislation that seeks to 'pierce the corporate veil' and impose liabilities on parents, groups or controllers, the implementation of antitrust rules is complicated by the difficulties of applying typical parent/ group/ controller analyses to the wide range of highly sophisticated and bespoke fund structures seen across the industry. Nevertheless, the Commission's actions against GS show that these complexities will not deter antitrust regulators from seeking to attribute liability to PE houses.

This is not the first time that the Commission has sought to impose a fine on a PE house - for example, it imposed a €13.3 million fine on the German firm Arques Industries AG in 2009 for an infringement committed by one if its portfolio companies. Nor does it necessarily represent a new, more aggressive policy of the Commission towards PE houses. It may be, for example, that the paucity of proceedings against PE houses is indicative of a high level of antitrust compliance by portfolio companies in general. It is also by no means certain that GS or Prysmian will be fined in this case: the Commission's statement of objections is simply a procedural step to allow them to respond to the charges levelled against them. At a minimum, however, it is a reminder that private equity firms are not immune from antitrust liabilities in the EU, and that mitigation strategies can pay valuable dividends for PE houses and investors alike, by avoiding fines, associated antitrust damages claims and reputational harm.

In principle, there are two ways that a PE house can mitigate these antitrust risks.

The first and most effective mitigation strategy is prevention. After all, if portfolio companies are free of antitrust liabilities, then there is nothing that can be attributed to their PE parents. Moreover, some antitrust regulators, such as those in the UK, the US, Australia, Canada and the Netherlands offer discounts on antitrust fines for firms that can show the existence of a compliance regime which is not only effective on paper, but also rigorously implemented.

A possible second strategy would be to ensure that there is comprehensive and compelling evidence that the PE house and related staff exercise no commercial, strategic or operational influence over its portfolio companies. In practice however this may not be compatible with the management strategies of many PE houses, particularly as arguments relating to the absence of exercise of "decisive influence" are rarely successful. However in relation to particular portfolio companies in respect of which a firm is taking a very "hands-off" approach, it may well be worth ensuring that there is contemporaneous documentary evidence of that approach.

For fund investors, the risk is that fines imposed on fund managers are recouped from the underlying fund. Whether this is possible will depend on the contractual arrangements governing the rights and obligations of the manager. But most funds will grant a wide indemnity in favour of the management company provided it has not acted negligently or in breach of any of its duties. As such, depending on the wording of the indemnity, in many cases it is likely that the loss will ultimately be recovered from the fund itself.

This may well lead to a discussion over the extent to which PE houses are responsible for ensuring a compliance culture at portfolio company level - and whether they have been negligent if they fail to do so. Consequently, ensuring that an effective antitrust compliance regime is in place has the benefit of not only reducing the risk of any issues arising in the first place, but also helping to ensure that the PE house cannot be seen as culpable for the loss, thereby protecting not only its reputation but also its indemnity position under the fund documents.

Finally, while proceedings against PE houses may be rare, there are a number of examples of portfolio companies that have been subjected to antitrust fines in respect of the period before they were bought by a PE house. While issues of parental liability will not arise for the PE house, it still faces a loss of value in its portfolio company. That risk can be mitigated by thorough due diligence, and by securing appropriate antitrust warranties and indemnities when buying a new portfolio company, so that a claim for the amount of any subsequent fine can be brought against the seller. The Prysmian case also serves as a reminder that liability could occur after the disposal of the portfolio company: investors

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and managers alike should ensure that appropriate consideration needs to be given to clawback and escrow arrangements when devising and negotiating fund structures and implementing exit and distribution strategies.

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