CLIFFORD CHANCE

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Private equity liability for antitrust fines

The European Commission has imposed a €37 million fine on Goldman Sachs (GS) for antitrust breaches committed by a portfolio company that was formerly owned by its private equity arm, GS Capital Partners. The fine was joint and several on GS and the portfolio company. It was imposed on the basis that GS exercised decisive influence over the portfolio company, though GS is not alleged to have participated in, been aware of or facilitated the alleged cartel in any way. The risk of such parental liability for private equity houses is not new, but it is a timely reminder of the need to ensure that fund documents cover this possibility and that an antitrust compliance programme should be implemented at portfolio level.

Liability without wrongdoing?

The European Commission ("Commission") held GS jointly and severally liable for €37 million of a fine imposed on the Milan-based company Prysmian for its participation in a cartel for submarine and underground power cables.

GS' liability stems from the Commission's finding that its private equity arm – GS Capital Partners (GSCP) – owned a controlling stake in Prysmian between 2005 and at least 2007: part of the period in which Prysmian was involved in the cartel. Prysmian's previous owner, Pirelli, was held jointly and severally liable with Prysmian for a further €67 million in respect of the prior period of infringement.

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 arm has incurred liability in this way for the actions of a portfolio investment. It highlights the need for private equity ("PE") houses and other financial investors, such as sovereign wealth funds, 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

Key issues

- When can a private equity house be held liable for antitrust breaches of a portfolio company?
- Is liability affected by absence of involvement in the breach, or the sale of the infringing portfolio company?
- How can these risks be mitigated?
- What are the implications for private equity houses and fund investors?

"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 or portfolio company 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 portfolio company.

For example, the EU courts accepted that parents of a 50/50 joint venture could be liable for its conduct on the basis that they were able to veto strategic commercial decisions of the JV, such as approval of its budget and business plan, and had appointed some senior managers who participated in decision making bodies (see our September 2013 briefing). They also found that restructuring and recovery measures that a German investment company implemented in one of its investments were clear evidence that it had exercised decisive influence.

Consequently, 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 –as was the case for GS.

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, and no parent company has succeeded to date (although the EU courts have overturned some decisions in which they found the Commission had not properly considered parents' arguments in this respect).

Commission decisions finding an infringement of the EU antitrust rules are binding proof of a breach for the purpose of follow-on damages claims before national courts in the EU.

Liabilities that linger

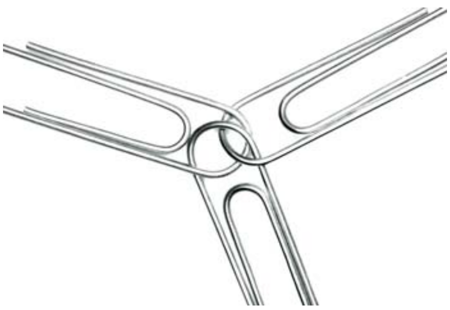
Parental liability can arise even if the infringing portfolio company has been sold. The fact that GSCP no longer owns Prysmian was no obstacle to the Commission fining GS, as it was the owner during part of the period of the alleged breach.

Attributing liability to parent companies in this way can allow the Commission to increase the fine that it imposes, often substantially.

This is partly 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. (This did not affect GS' fine, which was well below the maximum that could have been imposed even if its group turnover had been excluded.)

A finding of parental liability can also result in increased fines in the future, as companies that are deemed to be "repeat offenders" (including in respect of breaches committed by other portfolio companies) are subject to a 100% increase in the fine for each past breach.

In the Commission's eyes, imposing parental liability 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.



Piercing the corporate veil

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 Competition and Markets Authority 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.

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 portfolio companies if they are deemed not to have separate corporate existences. The EU approach is not widely followed in other non-EU countries either. However, this is often because the approach to parental liability has not yet been firmly established in those jurisdictions. When it is, the EU position could be influential.

GS's SEC filings indicate that it was Goldman Sachs, Inc. – the ultimate parent of the GS corporate group – that was the Commission's target and there is no public information on whether GSCP was also held jointly and severally liable. However, the Commission does have a discretion to fine intermediate holding companies, as well as ultimate parents, so liability in private equity structures could, depending on the circumstances and structures, attach to any of the general partner, registered shareholder of the portfolio company, intermediate holding companies or the PE manager/advisory company.

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 financial investor. Nor does it necessarily represent a new, more aggressive policy of the Commission towards PE houses. It may be that the paucity of proceedings against PE houses is indicative of a high level of antitrust compliance by portfolio companies in general.

However, it is a reminder that private equity firms are not immune from EU antitrust liabilities of their portfolio companies, and that mitigation strategies can pay valuable dividends for PE houses and investors alike, by avoiding fines, associated antitrust damages claims and reputational harm.

Mitigation strategies

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

The first and most effective mitigation strategy is prevention and detection. 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 theoretical second (but unattractive) strategy would require ensuring 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 will be incompatible with the management strategies of many PE houses (except possibly in relation to minority interests), particularly as arguments relating to the absence of exercise of "decisive influence" are rarely successful.

Third, contractual structures might be put in place so that in the event of a fine on the basis of parental liability, the ultimate financial burden rests within the portfolio company and, failing that, the underlying fund:

- The portfolio company. Fines are imposed jointly and severally on the parent and the infringing company, so if the portfolio company pays the entire fine, the PE house will have no liability. Judicial precedents for how liability should be allocated between infringers and jointly liable parents have not yet been established (although there are ongoing cases), but a contractual allocation may be possible. Such a mechanism would need to survive beyond exit by the PE house of its investment in the portfolio company.
- The underlying fund. Most funds will grant a wide indemnity in favour of the management company and its group provided it has not acted negligently or in breach of any of its duties. As such, depending on the wording of the indemnity, and assuming the portfolio company has been unable to pay, the management company may ultimately seek to recover the loss from the fund itself.

However, in certain circumstances indemnities and other risk-shifting contractual mechanisms (such as insurance) may be unenforceable in some jurisdictions, for public policy reasons.

In addition, the relevance of negligence for indemnity claims 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 mitigating risks not only to its reputation but also to its indemnity position under the fund documents.

Finally, 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. This highlights the importance of a thorough due diligence, and potential value of antitrust warranties and indemnities when buying a new portfolio company.

The Prysmian case also serves as a reminder that liability could occur after the disposal of the portfolio company. Investors and managers alike will need to give appropriate consideration to claw-back and escrow arrangements when devising and negotiating fund structures and implementing post-exit distribution strategies. However, once the fund has closed, and monies have been distributed, a PE house may have little choice but to bear the brunt of a fine.

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