PEI Alternative Insight
PE MANAGER
FOR PRIVATE FUND CFOs, COOs AND COMPLIANCE OFFICERS

Clearing competition concerns

Portfolio company violations of competition law can result in fines at the parent sponsor level, warn Squire Sanders antitrust lawyers Oliver Geiss and Will Sparks, who add that competition authorities have been more willing to look overseas to spot offenses.

posted - 28 Aug 2012
updated - 28 Aug 2012

To the private equity investor, concerns about antitrust – evoking illicit deals in smoky rooms – can seem a world away. The fact is most private equity firms pay less attention than they should to the risks to which they are exposed. Liability for breaking competition law can be traced to the parents of companies in breach even if they knew nothing of the infringements, meaning that parents themselves can face fines, litigation and significant disruption.

WHAT IS COMPETITION LAW?

Competition law is based on the principle that competitive markets deliver better value for consumers. The law aims to safeguard competition by prosecuting abuse of dominance and anti-competitive agreements, and monitoring mergers and acquisitions.

Abuse of dominance: Competition is restricted when a company is able to act independently of the market. This will often be the case if it holds a monopoly, but firms can achieve considerable market power (or 'dominance') even with competitors present. Being dominant is not prohibited in itself, but abusing that dominance is. Abuse of dominance falls into two categories: exclusionary abuses, which are aimed at shutting competitors out of the market, and exploitative abuses, whereby the dominant company takes unfair advantage of its customers.

Anti-competitive agreements: While abuse of dominance (usually) involves the conduct of a single company, anti-competitive agreements involve several. An example is the classic cartel, wherein rivals collude to distort the market. Price-fixing, market-sharing and bid-rigging are all grave offences, and companies can also find themselves under investigation for exchanging sensitive information. Specific competition rules also apply to vertical agreements, such as between a supplier and distributor.

Merger control: As well as monitoring companies' behaviour, competition authorities try to pre-empt changes in the market that could make it less competitive. This is the basis for merger control. When control over a company changes hands, it may be necessary to notify one or more competition authorities. If they deem the deal likely to reduce competition, for example by eliminating an important competitor, they can block it or apply remedies (such as the forced sale of a business) to address the concern.

HOW DOES THIS AFFECT MY FIRM?

Competition authorities have significant powers of enforcement, foremost of which are fines. The European Commission and most national competition authorities can impose eye-watering sanctions, with fines in the hundreds of millions not uncommon. Most importantly for GPs, exposure does not end with the company in breach but can extend to parents and shareholders: under EU law, a parent company is responsible for fines imposed on a subsidiary over which it has 'decisive influence'. Decisive influence is presumed if a subsidiary is wholly owned, but can exist where a subsidiary is owned jointly by multiple shareholders. Once decisive influence is established, the parent could face fines even if it had no knowledge of the anti-competitive behaviour in question.

Moreover, the authorities typically calculate fines based not just on the turnover of the company in breach, but on that of the 'single economic unit' of which it is part. A fine can therefore be set at 10 percent of the worldwide turnover of the ultimate parent company and every company in its group. An additional concern is recidivism, whereby separate breaches of competition law by different companies within a firm's portfolio could be treated as a repeat offence by the parent. In such cases, the European Commission can increase the fine by 100 percent.

ANY OTHER RISKS?

Parents of companies that breach competition law can also face actions for damages, based on claims by customers or competitors that have suffered harm. In addition, private equity firms should consider the reputational damage a competition investigation can cause and the cost and management time involved. Lastly, the director of a company that has been found guilty of violating competition law can be personally fined, disqualified from acting as a director, or even imprisoned. There is no reason why these penalties may not extend to non-executive directors representing a buyout firm with decisive influence over a subsidiary.

WHAT SHOULD I DO?

The good news is that private equity firms can minimise exposure to these risks before making a new investment and throughout their relationship with a subsidiary.

To avoid acquiring a company with existing exposure, competition issues should be factored into the due diligence process – for instance, reviewing key contracts for compliance, considering relevant relationships with competitors, and requesting disclosure of past or on-going dealings with competition authorities.

When drafting transactional documents, these should contain warranties and indemnities that allow the buyer to recover losses caused by the target's breach of competition law (such as fines). These could be sought from the company itself or from the seller, depending on the circumstances. Finally, establish whether the acquisition triggers any merger control filings and, if so, get all mandatory approvals in good time before completion.

For existing portfolio companies, ensure that mechanisms are in place to monitor and prevent anti-competitive behaviour. Used compliance programme to identify and address threats before they become liabilities, and take proactive steps if necessary. The European Commission and major national competition authorities offer whistle-blowers immunity or leniency, which should be conidered as soon as possible upon discovery of a potential breach. As well as implementing compliance among subsidiaries, consider the risks faced by your firm in a broader sense. A strategic review of your portfolio may reveal high exposure to competition risks, for example if you invest in highly concentrated sectors or those in which the competition authorities take a particularly close interest.

Finally, bear in mind that directors can face personal liability for antitrust penalties if they 'ought' to have known that a practice was unlawful, or suspected a breach but did nothing to prevent it. In their assessment, authorities assume a higher level of knowledge among directors than laymen. It is therefore essential that directors of private equity firms, and not just directors of their portfolio companies, receive adequate competition training.

GOING GLOBAL

In our experience, we are increasingly seeing competition authorities in the US and EU target antitrust offences taking place overseas. Notably, both the Department of Justice and the European Commission recently prosecuted manufacturers of LCD screens for a cartel where all the allegedly illicit behaviour took place in Taiwan. Similar investigations are on-going in the car parts sector involving mainly Japanese companies. This may be a sign not only of more aggressive enforcement by the authorities, but better compliance on the part of US and EU businesses. Either way, private equity managers should by no means assume that the risk of prosecution for competition infringements is lower if they invest outside established markets. In a globalised world, competition authorities cast their nets far and wide to seek out and punish companies that fail to comply rigorously with the law, wherever they are based.