Club dues

By Michael L. Keeley

As published in The Deal, Oct. 12, 2006, at 12

Recent revelations that the U.S. Department of Justice is conducting an informal antitrust investigation of private equity firms is a potent reminder that the conduct of private equity and other investment funds is subject to the antitrust laws.

From press accounts, it appears that DOJ is interested in the bidding practices of private equity firms, which frequently act cooperatively as "clubs" to take public companies private. DOJ may be concerned that the formation of clubs eliminates competition among private equity firms for targets, depressing the prices paid to public shareholders. DOJ likely is collecting information about how clubs function and what, if any, impact they have on the price ultimately paid to public shareholders.

Under the antitrust laws, private equity clubs should be defensible where cooperation is necessary for the club members to compete for a target. If, however, it turns out that private equity firms have been using clubs as a tool for depressing competition for targets (which seems unlikely given the number and variety of private equity firms), then participating private equity firms could face potential fines and civil suits for treble damages by aggrieved shareholders.

Although acquisitions by investment funds normally raise only procedural obligations, substantive antitrust issues exist where a single fund — or numerous funds under common control — acquire stakes in companies that compete with one another. For instance, if a fund attempted to acquire a 20% stake in two competing soft-drink manufacturers, the antitrust agencies would undertake a very serious and substantive review of the acquisition. The reviewing agency would evaluate whether management of the two soft-drink manufacturers would compete with each other less vigorously because of their common owner. Another concern would be that the investment fund might act as a conduit through which the competitors could collude.

It is common for investment funds to obtain one or more seats on the boards of directors of their portfolio companies in order to monitor and safeguard their investments. However, under a little-known antitrust law, Section 8 of the Clayton Act, it is in fact illegal for a fund to place representatives on the board of two competing companies. As recently as 2003, the Department of Justice intervened in a private litigation to support the enforcement of Section 8 against a private equity firm that held (through two funds that it managed) seats on the boards of two competing movie theater exhibitors.

Many, if not most, holdings by investment funds are minority stakes where the investment fund has little or no actual control over management. In many cases, despite this lack of control, an investment fund must file a Hart-Scott-Rodino form and observe a waiting period before completing an acquisition of more than $56.7 million of a company's stock.

An HSR form must contain various types of information about the acquiring person and any documents it prepared in evaluating the potential acquisition that discuss competition-related issues. The acquiring party also needs to pay a (nonrefundable) filing fee, ranging from $45,000 to $280,000, depending on the value of the acquisition.

Once the acquiring party files the HSR form, it must wait 30 days before consummating the acquisition. Acquiring stock before the end of the waiting period subjects the acquiring person to fines of $11,000 per day. The waiting period can be terminated early in the event that the agencies conclude early in the 30-day period that the acquisition raises no significant competition issues, but if early termination is granted, the agencies publish the identity of the acquiring and acquired persons in the Federal Register.

If during their initial 30-day review, one of the agencies identifies a competitive concern, that agency may issue a document and information request known as a second request. The vast majority of acquisitions made by investment funds raise no competitive concerns, so second requests generally are not an issue for investment funds. The issuance of a second request imposes a second waiting period, which expires 30 days after the acquiring and acquired parties provide the requested information. At that point, the agency must either allow the acquisition to close, seek an injunction in federal court or attempt to negotiate a settlement with the parties.

Because most acquisitions made for investment purposes (as opposed to control purposes) raise no competitive concerns, the HSR Act provides an exemption for acquisitions made "solely for the purposes of investment." Most investment funds rely on this exemption to avoid making an HSR filing.

The investment-only exemption provides that acquisitions of less than 10% of a company's stock are not subject to the HSR Act unless the acquiring person intends to attempt to influence the management decision of the company. The agencies have taken the position that most actions by an acquiring person beyond simply voting the shares (including writing to the board to suggest a course of action) constitute an attempt to influence management. There have been recent reports indicating that the agencies may be considering loosening these restrictions somewhat.

Antitrust enforcement in the private equity world is rare, but the potential downside of inadvertently violating the antitrust laws is significant. With a little knowledge, funds can avoid stumbling over the antitrust laws.

Michael L. Keeley is a partner with Axinn, Veltrop & Harkrider LLP.