

COMPETITION ALERT

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PRIVATE EQUITY COMES UNDER COMPETITION SCRUTINY

Recent investigations by both the US Department of Justice ("DOJ") and the US Federal Trade Commission ("FTC") into anticompetitive concerns around private equity investments signal that private equity's run of slipping under the radar of competition regulators may be at an end. This Alert considers the two US investigations and analyses how private equity may come under the scrutiny of the New Zealand Commerce Commission ("Commission").

DOJ investigation into "club deals"

The first sign of a shake-up for private equity came in October 2006 when the DOJ launched a preliminary inquiry into possible anticompetitive conduct between some of the world's largest private equity firms. Concerned by the conduct of consortiums of private equity firms which have been snapping up investments across the world, the DOJ sent letters to several of the largest US private equity firms. The letters are reported to have requested generic information on so-called "club deals" the firms had allegedly been involved in since January 2003. Club deals, in which two or more private equity firms join to buy a large company, have been increasingly popular as they give private equity the capital to go after otherwise out of reach heavyweight corporate targets.

Although preliminary, the investigation came as something of a shock to the private equity industry as, in 2006 alone, over 20 club buyouts took place globally. However, this commonplace arrangement is under scrutiny as the DOJ seeks to determine whether private equity consortiums have concluded anticompetitive agreements in the process of bidding for investment targets. In particular, the DOJ's investigation is focused on three allegations of anticompetitive conduct:

- Whether private equity firms shared information about their bids to ensure that they wouldn't outbid each other on certain deals - effectively "bid-rigging";
- Whether private equity firms agreed to form consortiums or clubs, resulting in less competition for the target. This is particularly relevant to scenarios in which a bidder withdrew its independent bid in an auction process to join the winning bidder in a final buying club; and
- Whether private equity firms made arrangements with financiers not to lend to other bidders, effectively excluding rival bidders from obtaining finance.

Under US antitrust law (the Sherman Act), the investigation will have to decide whether there exist legitimate reasons for private equity firms to exchange information with one another during the bidding process. Should the investigation fail to find legitimate reasons for this exchange of information, it may be considered a form of cartel conduct by the DOJ. Such a finding could have significant repercussions for the current private equity boom.

FTC investigation into a merger

Following the DOJ's investigation, the FTC has also recently put private equity under the spotlight in merger control.¹ On 24 January, the FTC moved to challenge the proposed acquisition of gas terminal company Kinder Morgan Inc ("KMI") by an investment group including private equity firms, The Carlyle Group ("Carlyle") and Riverstone Holdings ("Riverstone"). The FTC challenged the US\$22 billion acquisition due to concerns arising from Carlyle and Riverstone holding a 22.6% shareholding in Magellan Midstream ("Magellan"), a major competitor of KMI.

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1. The examination of private equity transactions in a merger context is not unusual in the EU, either. The EU has similarly examined, and, when the relevant overlap causes issues has refused to approve, investments by private equity eg *Industri Kapital I (Nordkem) / Dyno Comp/M.1813*.

The FTC alleged that the proposed acquisition would have violated section 7 of the Clayton Act and section 5 of the Federal Trade Commission Act, as it would have allowed Carlyle and Riverstone, through their interest in Magellan, to use their board representation rights in the two competitors to exercise unilateral market power. As KMI and Magellan operated terminals in eleven US cities with no real alternative competitors, the FTC alleged that the acquisition would result in higher gas prices for consumers in these eleven metropolitan markets. The FTC also indicated concern that board representation at both KMI and Magellan would give Carlyle and Riverstone access to competitively sensitive non-public information in both entities, enhancing prospects for coordinated conduct.

Following significant concessions made by Carlyle and Riverstone to remedy the competitive harm alleged by the FTC, the FTC approved the acquisition. In effect, Carlyle and Riverstone converted their investment in Magellan into a passive investment, with the FTC requiring the two firms to remove their representatives from Magellan's board and cede any control over the company's business operations to Magellan's other principal investor, Madison Dearborn Partners. Furthermore, the FTC consent order requires the parties to implement internal controls to ensure sensitive information is not shared between KMI and Magellan. With both Carlyle and Riverstone consenting to these remedies, the transaction was approved by the FTC. Interestingly, the remedies conceded in this case indicate that as private equity investments start to raise competition concerns in merger control, whilst divestiture remains an option for remedying anticompetitive effects, it is unlikely to be the most appropriate remedy for private equity participants.

Concerns for private equity in New Zealand?

While both the DOJ investigation and the FTC merger remedy indicate that competition regulators will exercise jurisdiction over private equity investments, it remains to be seen whether the Commission would take a similar stance. Key questions around private equity investments will be:

- Will a private equity acquisition result in a substantial lessening of competition, due to the private equity firm's investments or management rights in competing businesses?²
- Could forming a consortium of multiple private equity firms to bid for a target result in a substantial lessening of competition by reducing the number of potential bidders?³ Or conversely might such arrangements be pro-competitive by making viable an acquisition that would otherwise have been out of reach?
- Similarly, in reaching an agreement or understanding to bid jointly, will private equity firms expose themselves to liability under the price fixing prohibitions contained in section 30 of the Act? And if so, will the joint buying or joint venture exemptions apply?

What does this mean for private equity?

Both the DOJ investigation into private equity 'clubs' and the FTC challenge to the KMI acquisition indicate that regulators are at least contemplating extending the scope of their jurisdiction to private equity firms, who have up until now largely avoided the focus of competition regulators. In principle, if there is economic harm identified in the DOJ and FTC investigations, then the NZCC could well also seek to avoid similar harms occurring in New Zealand. It is an open question whether, and if so how, they would go about this, given the relative complexity of how the Commerce Act could apply to equally complex private equity structured transactions. The message is that investors need to be vigilant when dealing with private equity transactions as these developments evolve.

2. Sections 47(3) and (4) of the Act specify when two or more persons are "associated", and are therefore to be regarded as forming part of the "group" of companies (or persons, including trusts) effecting the relevant acquisition. The loose concept of "association" allows the potential aggregation of a number of investments which may fall short of being "controlled" by the fund. See also: <http://www.russellmcveagh.com/doclibrary/public/Competitionlaw/CompLawJun05.pdf>

3. Section 46 exempts from Part 2 of the Act arrangements and understandings insofar as they "provide for the acquisition of assets or shares of a business". This section has received little judicial consideration but the attention it has received suggests that it will be construed narrowly (*Commerce Commission v Fletcher Challenge Ltd & Ors* (1999) 6 NZBLC 107,752).

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