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Antitrust Enforcement Hits Private Equity

Wednesday, March 14, 2007 --- Private equity investment is on the rise. This increase in the number and size of transactions is drawing attention not only from media outlets, but also from antitrust enforcement agencies.

Historically, private equity firms and other "financial" buyers have faced little antitrust scrutiny, certainly in comparison to strategic buyers, an advantage that financial buyers push with sellers in the M&A process.

The Federal Trade Commission's recent challenge of the Carlyle Group and Riverstone Holdings LLC investment in Kinder Morgan, however, confirms that even partial investments by financial buyers will not escape antitrust review if the combined holdings create significant competitive overlaps.

Indeed, financial investors need to be mindful of the full range of antitrust risks, not simply merger review under Section 7 of the Clayton Act, but possibly liability under Section 1 of the Sherman Act as well.

This article provides an overview of the issues and holding in the Kinder Morgan action, reviews similar enforcement actions concerning partial investments to place the Kinder Morgan action in context, and closes with some suggestions on how private equity firms and others can minimize Section 7 and Section 1 risks.

The FTC Complaint against Carlyle and Riverstone alleges that the effect of their proposed investment in Kinder Morgan Inc. (KMI) would be to substantially lessen competition in the market for gasoline and other light petroleum product terminals in eleven metropolitan areas throughout the Southeast.

Through the acquisition, Carlyle and Riverstone acquired approximately 22.6% of the equity of KMI and the right to appoint two directors on the eleven-member KMI board. At the time of the acquisition, Carlyle and Riverstone held interests in various energy firms, through a separate fund, including a 50% interest in the general partnership that controls Magellan Midstream Partners LP.

Along with its 50% stake, Carlyle/Riverstone had the right to designate two representatives on Magellan's four-member board of managers and the ability to veto actions by the board of managers. Magellan, a midstream terminal and pipeline company, competed directly with KMI in various terminaling and pipeline operations.

The FTC alleged that Carlyle/Riverstone's significant interests in both KMI

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and Magellan, the right to board representation at both firms, the right to exercise veto power over actions by Magellan, and the right to receive non-public competitively sensitive information could eliminate current, actual competition between KMI and Magellan.

The FTC also claimed that the acquisition would increase the likelihood of coordinated interaction between KMI and Magellan, and the ability of KMI and/or Magellan unilaterally to exercise market power.

Antitrust scrutiny of partial investments is not new, nor is it limited to the realm of financial investors. In fact, there is a long line of cases supporting the proposition that the Clayton Act reaches more than just acquisitions of controlling interests.

Section 7 prohibits acquiring: the whole or any part of the stock or other share capital … where…the effect of such acquisition, of such stock…may be substantially to lessen competition, or tend to create a monopoly. 15 U.S.C. § 18.

Over the years, the Department of Justice and the FTC have brought complaints and entered into consent orders limiting partial stock acquisitions. Several of the cases involved partial stock acquisitions of less than 30 percent. In fact, acquisitions of less than 25% of a company's stock have been found to violate Section 7 where there is competitive overlap.

There is an exemption under the Clayton Act that Section 7 "shall not apply to persons purchasing such stock solely for investment and not using the same by voting or otherwise to bring about, or in attempting to bring about, the substantial lessening of competition." Id.

However, the DOJ has articulated how competitive harm can arise even from passive, partial ownership interests, and when such interests do not satisfy the "investment only" exemption:

When a firm makes pricing decisions…it weighs two effects that its decision may produce. A higher price…will generate greater revenues from those customers who continue to purchase services from the firm. But a higher price…also is likely to cause some portion of current or potential new customers to purchase services from a competitor, thereby reducing the firm's revenues. Weighing these two countervailing factors, firms attempt to choose the price…level that will maximize their profits. A firm that acquires a full or partial equity interest in a competitor…will face a different calculation of its profit-maximizing price…after such an acquisition. After the acquisition, some portion of the customers who would turn to a competitor in response to a price increase…would likely purchase services from the firm being acquired; thus, the revenue generated by those customers' purchases will continue to be earned indirectly (through the competitor that has been acquired) by the firm raising its price…. Thus an acquisition can cause an individual firm, acting unilaterally, to raise its price more than it would have otherwise…because its profit-maximizing price will be higher…as a result of

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the acquisition. These adverse effects are greater to the extent that the service offered by the acquired firm is a particularly close substitute for the service offered by the acquiring firm. Under those conditions, a larger share of the customers who switch service providers as a result of a price increase…will switch to the acquired firm.
United States v. AT&T Corp. and Tele-Communications Inc. Competitive Impact Statement, www.usdoj.gov/atr/cases/f2100/2155.htm at 8.

In AT&T-TCI, the DOJ required AT&T to divest completely the 23.5% equity interest it acquired in Sprint PCS through its acquisition of TCI. The DOJ rejected a lesser remedy, such as imposing ongoing conduct restrictions, because it believed that "such restrictions will have limited efficacy as a long-term protection against anti-competitive effects, and may require ongoing oversight of the conduct of a corporation's internal affairs that neither the Department nor a Court is well-suited to perform on an ongoing basis." Id. at 14.

The DOJ's decision to challenge Northwest Airline's partial ownership in Continental Airlines is also instructive on this point.

In that matter, Northwest held a 14% equity position, which carried with it over 50% of the voting rights. However, there were various agreements between Northwest and Continental imposing certain restrictions on Northwest's voting rights for a period of years.

The DOJ identified four ways that competitive harm could occur even where the acquiring firm lacks the legal authority to control or influence a competitor. First, the acquiring firm gains a unilateral incentive to compete less vigorously with the acquired firm. Second, the acquired firm has a corresponding incentive to compete less vigorously against the acquiring firm.

Third, the acquisition weakens the acquired firm's ability to compete. Finally, the acquisition makes collusion or cooperation between the two firms more likely. See United States v. Northwest Airlines Corp., Civil Action No. 98-74611, Plaintiff United States of America's Memorandum in Opposition to Defendant Northwest Airline's Motion for Summary Judgment, at 10-11 (July 28, 2000).

The defendants in Northwest-Continental argued that the governance agreements, which put Continental's stock in trust for Northwest and limited Northwest's ability to exercise certain rights, should alleviate any competitive concerns.

The government, however, highlighted the competitive significance of the fact that Northwest retained the right to vote the stock "on the most strategic decisions facing Continental…including mergers and acquisitions, reorganizations, and recapitalizations." Id. at 5.

According to the government, retaining the right to vote on "major corporate

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issues like mergers and acquisitions" meant that Northwest's acquisition fell outside of the "solely for investment" exemption to Section 7.

Most recently, the Sixth Circuit affirmed the DOJ's position that even acquisitions of minority, passive financial interests in competitors could violate the Clayton Act.

In U.S. v. Dairy Farmers of America Inc., 423 F.3d 850 (6th Cir. 2005), the Sixth Circuit reversed a district court ruling that the acquisition of a non-controlling partial ownership generally does not raise antitrust issues, absent direct evidence to the contrary.

In that case, the DOJ challenged Dairy Farmers of America's (DFA) acquisition of non-controlling partial ownership interests in two competing dairy cooperatives in Kentucky, Southern Belle and Flav-O-Rich. Southern Belle and Flav-O-Rich owned the only two, or two of only a few, milk processing plants that competed in bidding to supply school milk cartons to school districts in parts of Kentucky and Tennessee.

In ruling in favor of the DOJ, the Court of Appeals held that:

The district court erred in its focus on control, as opposed to the effect on competition; because control was not present in DFA's relationship with Southern Belle, the district court reasoned that the effect of a lessening of competition was also not present. This logic ignores the possibility that there may be a mechanism that causes anticompetitive behavior other than control.
Dairy Farmers, 423 F.3d at 862.

The Sixth Circuit went on to focus on the ability of a very large participant in the industry (DFA), to use its financial heft and current sales and management contracts with the dairy, arising in part from the minority interest acquisition, as an effective mechanism to exercise control over the decisions of the dairy.

During the course of the litigation, DFA tried to cure any potential antitrust problems in its agreement with Southern Belle by giving all of its voting rights to AFLP [its co-owner], in essence, attempting to render its partial ownership into a "passive" interest.

The Court of Appeals held that "this cure…ignores the fact that AFLP and DFA have closely aligned interests to maximize profits via anticompetitive behavior." Id.
Ultimately, despite the proposed fix, the Sixth Circuit held that a genuine issue of material fact existed as to whether the revised agreement would substantially lessen competition.

The DOJ subsequently submitted a proposed final judgment, which remains pending, that would require DFA to divests all of its interests in Southern Belle.

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Interestingly, in its recent action against Carlyle/Riverstone, the FTC did not require divestiture of overlapping assets, the typical remedy for a merger of two direct competitors in a concentrated industry. The proposed consent agreement allows Carlyle and Riverstone to maintain their investments in both KMI and Magellan.

However, Carlyle and Riverstone representatives are prohibited from serving on any Magellan boards, and from exerting any control or influence over Magellan, as long as they hold any interest in KMI. The companies are also required to set up procedures to prevent the exchange of competitively sensitive, non-public information between KMI and Magellan.

The Kinder Morgan matter indicates that investment firms with significant holdings in a particular sector need to be mindful of the antitrust risks of future transactions. The increased level of governmental scrutiny will require financial investors to carefully assess potential overlaps created through even partial investments.

In addition to evaluating the potential increase in concentration, investment firms should consider the level of oversight, board representation, and day-to-day control necessary to properly manage the investment.

Finally, beyond regulatory approval issues under Section 7 of the Clayton Act, partial ownership in competing firms can create ongoing exposure to liability under Section 1 of the Sherman Act. While the ownership threshold and requisite level of control varies by jurisdiction, some courts have held that a majority interest in two competing firms is enough to establish that there are not separate economic actors necessary to establish Section 1 liability.

However, no courts have held that an interest below 50% is sufficient for immunity under Copperweld. Given the exposure to treble damages and criminal liability, there is an additional incentive for investment firms to implement appropriate guidelines and institute proper monitoring to avoid even the appearance that companies within an investment portfolio are colluding.

Such issues can be mitigated with the assistance of experienced antitrust counsel, who can assist in developing protocols dictating how the companies can and cannot interact, implementing firewalls to prevent the improper flow of competitively sensitive information, and through the use of training to help reduce risk.

Effective firewalls that prevent the improper exchange of competitively sensitive information, while perhaps helpful in the merger review process, are essential for compliance with Section 1 of the Sherman Act.

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