The DOJ's Probe Into Private Equity Firms

Wednesday, October 25, 2006 --- If you took a poll among antitrust lawyers to determine who gets the gold medal for the most cavalier comment by someone firmly in the crosshairs of antitrust enforcers, undoubtedly Bill Gates would win for his famed 1995 comment to Intel executives—"This antitrust thing will blow over."

Those same storm clouds that Gates thought would "blow over" are now gathering over the private equity community, many members of which seem unfazed. The betting money, however, is not predicting sunny skies for long.

* What do we know about the Department of Justice investigation? *

Here's what has been stated publicly. The New York field office of the DOJ's Antitrust Division has launched an investigation into possible collusion among private equity firms. The "big dog" firms seem to be the initial focus, with Kohlberg Kravis Roberts, Silver Lake Partners, the Carlyle Group and Clayton, Dubilier & Rice among the reported recipients of letters from the DOJ.

The prices paid for public companies may be of particular concern to the DOJ, for obvious reasons. The letters ask for a range of information and documents related to deals and business practices, and the time period covered by the letters dates from 2003.

Of course, the fact that any firm receives a DOJ inquiry does not suggest that it (or any other firm, for that matter) has been involved in collusion; the DOJ has very broad investigative powers that it can use merely to reassure itself that firms have been complying with the law.

The investigation appears to be an outgrowth of the increasing rancor between private equity firms and sellers. The firms believe that the sellers are greedy for wanting even higher prices than the astronomical amounts paid in some recent deals (courtesy of the private equity industry, according to the firms).

The sellers counter with suspicion that the firms are colluding to keep prices well below what a competitive market would produce. Disgruntled sellers who feel that they got "clubbed" and took an anti-competitive haircut logically would have dialed up the DOJ.

* What is the DOJ looking for? *

The DOJ is looking for evidence showing that private equity firms have been
"clubbing up" on deals in order to diminish rivalry and drive down the prices paid to sellers. It is no secret that club deals have become increasingly popular, and there are good (as well as bad) reasons to assemble a club.

Some facets of the investigation suggest that the DOJ is pursuing a low key approach here, at least initially. For example, the DOJ is using the lowest caliber weapon in its arsenal (informal letter requests) to obtain information, rather than the heavy weapons (like civil investigative demands, civil subpoenas, and grand jury subpoenas) more customarily used when collusion is suspected.

In addition, the investigation is being conducted by a DOJ field office, as opposed to its Washington headquarters. As a result, some in the private equity community have surmised that the DOJ may not be terribly serious about this investigation, and only the biggest firms need to be concerned.

But not so fast – the DOJ may be using letter requests for procedural or strategic reasons unrelated to their level of concern, as well as for bureaucratic convenience, and the New York field office is neither a paper tiger nor an illogical base from which to investigate private equity firms. And the "big dog" firms may be just the opening salvo; the DOJ often targets firms in waves, starting with the industry leaders.

Later requests will inform the DOJ as to the initial industry reaction to the investigation. From the perspective of an experienced antitrust lawyer, indications are that the DOJ is not just going through the motions here, nor figuring things out as it goes along, but rather has particular issues and behaviors on its mind.

* How does the law apply? *

The antitrust statute that the DOJ is enforcing in its investigation is Section One of the Sherman Act, 15 U.S.C. §15. That law, essentially unchanged since its passage in 1890, prohibits “contracts, combinations and conspiracies in restraint of trade.”

Antitrust lawyers typically summarize this statute as prohibiting agreements that restrict or eliminate competition, although not all agreements are prohibited. The antitrust laws forbid only unreasonable agreements, which are defined as those agreements that are, on the whole, anti-competitive.

* What does this mean in the context of private equity collusion? *

While there is little or no case law applying the antitrust laws in the private equity context, there is a great deal of case law on collusion in other markets. The legal exercise in the private equity context will be to separate "good" (reasonable/procompetitive) collaboration among firms from "bad" (unreasonable/collusive) cooperation.

“Good” club deals will be those formed in order to enhance competition,
provide additional buyers, and take advantage of any number of firm-specific benefits that are compounded when private equity firms bid as a team. “Bad” club deals occur where the predominant purpose of the teaming arrangement is to eliminate rivalry in the hope that the winning bidder will get the deal at a lower price.

There is one time-tested way to tell the “good” club deal from the “bad” club deal – stand in the seller’s shoes. If the net result of clubbing up is to the seller’s benefit, it will undoubtedly be lawful under the antitrust laws. However, had the seller known all the facts, the seller would have preferred that the club members bid independently, any collective bidding under those conditions is likely to be highly suspect.

* Where is the investigation headed? *

DOJ investigations typically are slow moving, methodical and thorough. The first order of business will be for the DOJ to obtain all communications between firms suggesting, commenting on, or implementing a collective bidding arrangement, as well as deal-specific documents for affected deals.

Having made a first cut of the data and documents that it receives in this first round of letter requests, the DOJ will circle back and do a deeper dive in any location of concern. It will vacuum up all e-mails and electronic documents, it may conduct interviews and depositions of the private equity firms and the sellers, and it will incorporate everything into a sizable electronic database which can be sorted any number of ways.

By the end of the data and document gathering phase (typically six months or more in an investigation of this type), the DOJ will have developed a comprehensive picture of the communications among rival firms, the internal thought processes of each firm, and the economic effects of any joint conduct.

Then one of two things will happen. Either the DOJ will conclude that every firm has complied with the antitrust laws, in which case all firms will get their documents and data back and the investigation will be closed, or the DOJ will conclude that the sales price in one or more deals has been reduced through collusion, in which case the suspect firms will be invited down to the station house for a talk.

Many investigations are resolved through a consent decree, which occurs where the DOJ sues the firms and firms agree to an injunction prohibiting further collusion. In the private equity context it might be hard to establish defined boundaries in which good clubbing is permitted and bad clubbing is prohibited, but the DOJ economists are an able group and likely would be able to devise a workable set of standards.

Of course if the defendants feel that the standards are punitive or unworkable, they might litigate the case to the bitter end, but that is the exception rather than the norm.
* The 800-pound gorillas *

The process described above sounds prolonged and expensive, which it is, but the ending would be tolerable to the affected firms and provide guidance to the industry. Then life would go on. But there are two nightmare scenarios in which things could get ugly.

The first nightmare scenario would be if the DOJ uncovered evidence of blatant collusion between firms, such as a smoking gun e-mail between senior executives at rival firms who want to drive down price by reducing competition.

A development like that might cause the DOJ to seriously consider upgrading the investigation from a civil investigation to a criminal one, which would dramatically increase the stakes. A civil investigation typically targets the firm, but a criminal investigation typically targets individuals. And a criminal investigation changes the "we're all in this together" dynamic among the defendants, swiftly turning it into "every man for himself."

The DOJ has an amnesty program in the antitrust area which it exploits these tensions to the fullest in order to get potential defendants to turn on one another; the first defendant in the door gets a pass for telling on his co-conspirators, while the latecomers get prosecuted to the max. The first antitrust lawyer who uncovers evidence of hard-core collusion almost always calls the DOJ as soon as possible – there is no prize for being second.

There has been no public suggestion that hardcore collusion has occurred in the private equity context, but in imagining worst-case scenarios, that would be it.

The second nightmare scenario involves the DOJ only peripherally, but in some ways it is worse than a government enforcement action. The antitrust laws enable a seller victimized by collusion to sue the colluders, and if the seller wins the law requires that the colluders pay three times the damages, plus attorneys fees.

This puts the triple whammy upon defendants in collusion cases. First, because of the mandatory award of attorneys fees there is an experienced group of lawyers willing to take these cases at no charge to the plaintiffs. Second, because of the mandatory award of treble damages, victims have an enormous incentive to bring these cases and their settlement value is high.

And third, a prevailing plaintiff can collect 100% of its damages from any losing defendant, even one that is only 1% responsible for the collusion – that defendant, even though only a marginal player, cannot force its co-defendants to ante up.

If the DOJ investigation concludes in a way that suggests collusion has been
found, given the enormous amounts of money involved in club deals it is virtually certain that every seller who feels victimized will sue for three times the amount of the haircut, which would be an enormous sum.

* A word to the wise *

No private equity firm wants to get sucked into the vortex of an antitrust case, and there are some simple precautions that can be taken in order to minimize the risk of a very bad day. First, it helps to remind everybody in the house that competition is the law of the land, with direct cooperation among rivals being viewed with skepticism.

Documents and e-mails should be written with an understanding of that skepticism. Any documents or conversation that suggest that two or more rivals share in interest in reducing competition are highly problematic. If firms do decide to form a club, documents describing the purpose and effect of the club should highlight the procompetitive reasons for joint conduct – enhancing efficiency, expanding capacity, merging complementary skills or expertise, and the like.

Procompetitive justifications that are recorded at the outset of a deal are much more compelling than after-the-fact justifications, which enforcers and adversaries commonly discount as nothing more than the product of creative lawyering.

Finally, when in doubt, seek legal advice before rather than after the conduct occurs. All things considered, these precautions are easy, relatively inexpensive, and highly effective in ensuring that if litigation occurs, you are sitting in the bleachers, rather than struggling on the field.

--By Thane D. Scott, Edwards Angell Palmer & Dodge LLP

Attorney Thane D. Scott is a partner and co-chair of the Antitrust practice group with the 500-attorney national law firm of Edwards Angell Palmer & Dodge LLP. He may be reached at: tscott@eapdlaw.com.