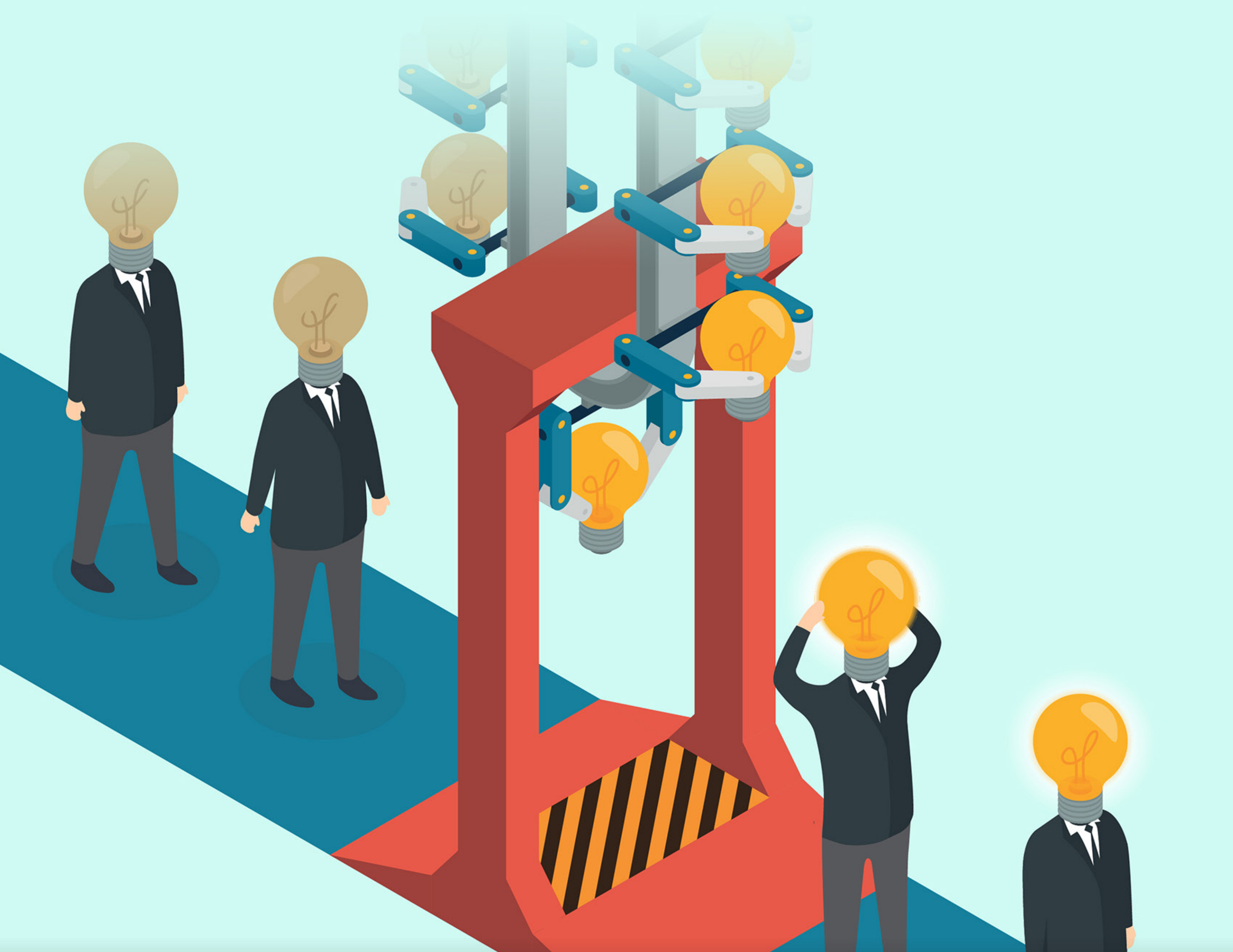
# PRIVATE EQUITY AND MERGER CONTROL – THE RULES OF THE GAME ARE CHANGING



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# I. INTRODUCTION

The merger control assessment for transactions involving private equity firms ("PE firms") has become increasingly complex as, over the years, they have grown to become industry giants, controlling a large number of portfolio companies with a well-established industry presence.

As to the establishment of filing requirements, in most cases this requires a thorough assessment of the control structure of the fund involved in the transaction in order to identify the relevant turnover for the merger filing analysis.

As to the substantive assessment, the main complexity derives from the need to cover any potential horizontal overlap, but also vertical relationship between the PE portfolio companies and the target. In fact, PE firms typically control a large number of portfolio companies and there is a tendency to focus investments in clusters or specific sectors. Moreover, PE transactions often have a clear industrial rationale driven by pre-existing portfolio companies, and do not constitute a mere financial investment.

For well-established PE firms, an upfront merger filing analysis, including the substantive review, has become an essential part of the overall deal, including – in certain cases – to establish whether (and to what extent) remedies will be needed to obtain timely clearance.

# II. THE RELEVANT ENTITIES TO ASSESS MERGER CONTROL FILINGS

Transactions involving PE firms are often subject to merger control requirements because their turnover exceeds the relevant thresholds and normally result in a change of control over a target, which triggers filings.

In most of the cases, to establish whether a competition authority has jurisdiction over a transaction the relevant turnover to be taken into account will be the financial income of the PE firm and the revenue generated by all its controlled portfolio companies, which are deemed to be part of the same "group."

The EU Commission's Jurisdictional Notice describes control as the "power to determine strategic commercial decisions"[2] of another undertaking, so-called "positive control," or the power to veto such decisions, i.e. "negative control." In this regard, the Jurisdictional Notice provides guidance on transactions involving investment funds.

As a general remark, the Jurisdictional Notice notes that "[i]nvestment funds are often set up in the legal form of limited partnerships, in which the investors participate as limited partners and normally do not exercise control, either individually or collectively."[3] As such, investment funds tend to acquire shares and voting rights that confer control over portfolio companies in their capacity as mere investment vehicles. Control as such is then ordinarily exercised by the investment company that has set up the fund, not the fund itself, through the investment group's organizational structure, e.g. by controlling the general partner of the funds and/or by contractual agreements, such as advisory agreements. In that way, the investment company generally acquires at least indirect control over the portfolio companies held by the investment funds.[4]

# III. IS EACH PE FIRM DIFFERENT?

Although the Jurisdictional Notice provides some general guidance, the structures that involve investment funds will be assessed on a case-by-case basis.

- First, PE firms are often organized through different funds, and each of these funds controls a number of portfolio companies. In some cases, it could be argued that the fund involved in the transaction is not part of the same "group" of the other funds, and that therefore these should not be taken into account both for turnover purposes and for the substantive assessment. To support such a position, it may be helpful to show that funds within the same PE firm are managed by different general partners. However, this may not be sufficient to persuade the EU Commission (and other competition authorities) if, for instance, the same managers are board members of

2 Commission Consolidated Jurisdictional Notice under Council Regulation (EC) No 139/2004 on the control of concentrations between undertakings, OJ C 95 of 16.04.2008, ("Jurisdictional Notice"), para. 54.

3 Jurisdictional Notice, para. 15.

4 Jurisdictional Notice, paras. 189 to 191.

different general partners established by the PE firm or if the general partners are supported (or supervised), for instance, by the same investment committee or advisory committee. Also, we note that by structuring each fund independently, and by taking this position before competition authorities, PE firms would have to carefully implement effective safeguards to avoid any coordination and exchange of competitively sensitive information between the funds and portfolio companies controlled by the different funds. This may increase the risk of Article 101 TFEU infringements.

- Second, in a few cases there may be a limited partner holding more than half of the limited partnership of the fund. This may be the case for a large institutional investor. Although it is unlikely that the limited partner exercises any controlling rights over the investment fund, its turnover would still be relevant to establish merger filing requirements.

- Third, there is an increased tendency in the public sector – for instance in China and in the Gulf area – to establish investment funds acquiring controlling stakes in European companies. Although these investment funds may be set up in the legal form of limited partnerships, public authorities may still exercise (indirect) control over the fund. Any link between the management of the fund and the public authorities may raise questions as to the possibility for the State to exercise decisive influence over the fund. In addition, having a public entity (alone or together with other public entities) acting as a limited partner – especially in cases with a large shareholding in the limited partnership – may also raise questions as to the independent exercise of investment and other strategic decisions by the fund. In short, a case-by-case analysis is needed to establish whether the investment fund shall be viewed as a State-Owned Entity, to which specific merger control rules may apply.

These examples show that considering all funds (and their respective portfolio companies) as part of a single economic entity for merger control purposes may not necessarily reflect the actual structure of a PE firm. That said, there are a few jurisdictions (e.g. United States and Canada) diverging from this approach: in these jurisdictions merger control rules are applied to the fund(s) involved in the transaction being assessed, rather than to the PE "group."

## IV. ACQUISITION OF CONTROL

The notion of control encompasses rights, contracts or any other means which, either separately or combined, confer decisive influence on an undertaking. Under Article 3(2) of the EUMR,[5] this is particularly the case when the possibility of exercising decisive influence is the result of (a) ownership or right to use all or part of the assets of an undertaking, or (b) rights or contracts that confer decisive influence on the composition, voting or decisions of the organs of an undertaking.

The PE firm will typically acquire sole control over a target by acquiring (a) the entire capital, (b) a majority interest, or (c) a minority shareholding, which confers veto rights over the target's strategic decisions. Veto rights resulting in (negative) joint control relate to decisions on matters such as the target's budget, business plan, major investments or appointment of senior management.

In other cases, the PE firm will acquire joint control over the target, either together with another PE firm or institutional investor or together with pre-existing shareholders or the founders of the target. First, the acquisition of joint control increases the likelihood of merger filing requirements. Second, the assessment of whether the PE firm will be acquiring joint control requires a case-by-case analysis, which would be conducted both on a *de jure* basis and a *de facto* basis, in particular when the founders are still involved – as shareholders and/or as managers – in the business of the target.

Finally, we note that even the acquisition of a minority stake above a certain percentage, without any controlling rights, may trigger filings in EU Member States (e.g. Germany and Austria) and in extra-EU jurisdictions.

5 Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings, OJ L 24, 29.1.2004, ("EUMR"), pp. 1–22.

# V. RECENT PROCEDURAL DEVELOPMENTS

### *A. The EU Commission's Consultation on EU Merger Control*

In October 2016 the EU Commission launched a public consultation on Evaluation of procedural and jurisdictional aspects of EU merger control, seeking stakeholders' feedback on procedural and jurisdictional aspects of EU merger control.[6] Two aspects of this consultation are of particular interest for PE transactions.

- The EU Commission is contemplating the introduction of a deal size threshold, complementary to the current turnover thresholds. A likely consequence of the additional threshold is that more transactions would be caught at the EU level, resulting in additional burdens for PE firms, especially for those investing in new technology businesses.

- The EU Commission is also considering extending the scope of application of the EU merger control simplified procedure. Broadening its application to transactions involving a vertical relationship and to acquisitions of joint control over a target with no activities within the EEA territory would contribute to a reduction of the burden on PE firms involved in transactions which do not present substantive issues.

### *B. Enforcement Against Procedural Violations of Merger Control Rules*

Under the EUMR, as in most jurisdictions, the parties acquiring control in a transaction which meets the jurisdictional thresholds, are required to notify the EU Commission, and are subject to a standstill obligation, i.e. must not implement the transaction before clearance.[7] The EU Commission can impose fines of up to 10 percent of worldwide group turnover for intentional or negligent breaches of such obligation.[8] With the EU Commission (and other competition authorities in Member States and worldwide) cracking down on breaches of gun-jumping rules and of the standstill obligation (see e.g. the ongoing investigations in Case M.7993, *Altice/PT Portugal* and Case M.8179, *Canon/Toshiba Medical*), PE firms must carefully assess their filing obligations and ensure they obtain clearances prior to completing their transactions or exercise any control over the target companies.

Moreover, the EU Commission can also impose fines of up to one percent of worldwide group turnover for intentionally or negligently supplying incorrect or misleading information in the context of merger control filings, regardless of whether the information had any impact on the EU Commission's decision.[9] The EU Commission is also actively enforcing its powers in this context (see e.g. the fining decision in Case M.8228, *Facebook/WhatsApp* and the ongoing investigations in Case M.8181, *Merck/Sigma-Aldrich* and Case M.8436, *General Electric/LM Wind*), and it recently stressed the importance of complying with the obligation to provide correct information, in order for the EU Commission to be able to take decisions "in full knowledge of accurate facts."[10] Therefore, it is crucial for PE firms, as notifying parties, to ensure that information provided by all the parties involved in the transaction, including the portfolio companies and the target, is accurate and complete.

6 Invest Europe, the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors, submitted its observations.

7 EUMR, Articles 4(1) and 7(1).

8 EUMR, Article 14(2).

9 EUMR, Article 14(1).

10 European Commission Press Release, IP/17/1369.

## VI. THE SUBSTANTIVE ASSESSMENT AND POTENTIAL REMEDIES

The EU Commission's Guidelines on the assessment of horizontal mergers[11] and Guidelines on the assessment of non-horizontal mergers[12] provide a useful framework for the assessment of substantive competition issues. The same principles and tests apply to PE transactions.

The large majority of PE transactions still do not present substantive issues, i.e. with no (or limited) overlaps with the target's activities. However, PE firms' increasingly large portfolios may trigger competition issues. The rules of the game have changed for PE firms involved in controlled auctions: in the past, the absence of any competition issues was often an advantage for PE buyers, while today, overlaps with other portfolio companies are more frequent, and industrial bidders may have an advantage.

This evolution requires PE firms to conduct an in-depth assessment of the potential horizontal overlaps and vertical links between the target and the portfolio companies. In cases where the PE firm controls a large number of portfolio companies active in the sector of the transaction, the data gathering process may prove to be very burdensome. Moreover, in cases in which a PE firm is contemplating joint control together with a co-investor (for instance, another PE firm), the assessment of horizontal overlaps and vertical links must be extended to the co-investor's activities and its portfolio companies.

Therefore, it is recommended that this analysis be conducted up front, leading – in case of competition concerns – to the possibility to propose upfront remedies, especially in deals where time is of the essence. Competition authorities usually welcome informal remedies discussions at the early stage of the notification process (and even during the pre-notification phase, where applicable). Such early discussions increase the chances of obtaining a conditional clearance (i.e. subject to remedies) in Phase I and mitigate the risk of competition authorities opening lengthy in-depth (Phase II) investigations. We note that negotiating a remedy package in Phase II may also increase the risk for PE firms of having to divest certain assets, or an entire business, under time pressure and with limited bargaining power, without getting the full value of the remedy package.

In transactions with a clear rationale to consolidate the business of one of the portfolio companies, it could in theory trigger a "conflicting interest" between the PE firm and the portfolio company, with the PE firm being typically more risk adverse on competition issues than its portfolio company.

## VII. CONCLUSION

PE firms now need to take a more strategic approach to merger control issues. In the past, PE transactions typically did not raise any competition issues, but now – due to their increasingly large portfolios – PE firms need to be pro-active in conducting merger control analysis prior to initiating a transaction. Having a good understanding of filing requirements and substantive issues (if any) is crucial in coming up with a plan to fix these issues up front, in order to avoid falling into lengthy Phase II investigations and to be able to close transactions without undue delay.

11 Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings, OJ C 31, 5.2.2004, pp. 5–18.

12 Guidelines on the assessment of non-horizontal mergers under the Council Regulation on the control of concentrations between undertakings, OJ C 265, 18.10.2008, pp. 6–25.