

INTERLOCKING DIRECTORATE AND PRICE FIXING EXPOSURE FOR PRIVATE EQUITY FIRMS WITH MULTIPLE PORTFOLIO COMPANIES IN THE SAME INDUSTRY

This alert describes the legal risk where a private equity or other firm with two or more portfolio companies in the same industry has a fund executive on the boards of these companies, even where different fund executives serve on the boards and the executives make no effort to coordinate.

The AFL-CIO complained to the Federal Trade Commission (FTC) that two competitors in the niche category of specialty ingredients for the paper-making industry were violating a federal law prohibiting a “person” (including two different individuals representing the same firm) from serving simultaneously as a director or officer of two or more competing firms: Section 8 of the Clayton Act (15 U.S.C. §19).

Section 8 was enacted in 1914 to remove any temptation for corporations to coordinate their activities through a shared board member. It has not been an enforcement priority for the FTC or the Department of Justice (DOJ). BUT an FTC or DOJ investigation of shared officers or directors could uncover evidence of actual price fixing, which, in contrast to Section 8, is the number one priority of the DOJ and the FTC. Price fixing, a violation of Section 1 of the Sherman Act, is vigorously prosecuted, criminally by the DOJ; and the DOJ, FTC, and private plaintiffs also pursue civil actions.

Notably, in that regard, recently a judge denied a motion to dismiss in a case where a firm had board membership on two competing movie chains, although different firm executives served on the two boards, finding that a conspiracy between them to eliminate competition was plausible. *Reading Int'l Inc. v. Oaktree Capital LLC*, 317 F. Supp. 2d 301 (S.D. N.Y. 2003). The Oaktree individuals that served on the boards were also sued in their individual capacities. Thus, if prices of competing companies increase in tandem, interlocking directorates may be seen as the vehicle or facilitating device for collusion, potentially subjecting the firm to an investigation by the government and civil damage suits.

A. What Is a Section 8 Interlocking Directorate?

Section 8 prohibits a “person” from serving as an officer or director of competing companies. A “person” can include two different individuals that represent the same corporation. Thus, for example, a private equity firm that has two different representatives on boards of competing portfolio companies can violate the law.

Because Section 8 is a “prophylactic” statute, a violation exists even without evidence of any intent or effort to coordinate prices, output, or other business decisions. The mere fact of an “overlap” in directors or officers between two competitors is sufficient, provided that certain minimal size thresholds are met. Currently each company need only have assets of **\$20 million** with competing sales of **\$2 million**—much less than the \$50 million threshold for FTC or DOJ review of an acquisition under the Hart-Scott-Rodino Act (HSR).

Section 8 is also a “*per se*” statute, meaning that unlike a Section 7, HSR acquisition analysis, the fact that competition will not be harmed is *not* a defense. There are two statutory “safe harbors”—but they involve **very** low amounts—where the competitive sales of either corporation is less than 2% of the corporation’s total sales, or where the competitive sales of each corporation is less than 4% of that corporation’s total sales.

B. What Is the Lesson?

The *Penfield/Hercules* investigation and the *Oaktree Capital* case are reminders of the need to be wary of having representatives on the boards of two competing companies. This is particularly true for private equity firms with multiple portfolio companies that could overlap in niche product areas.

The facts of the *Penfield/Hercules* case point out how easily the law can be implicated. The AFL-CIO asked the FTC to investigate the simultaneous service of John C. Hunter III as a member of the Executive Committee of Penfield Corporation and as a member of Hercules

Corporation's Audit and other committees. See <http://www.fastaficio.org/index2.html>.

Anyone can be the source of a "whistleblowing" complaint to the authorities. In *Penfield/Hercules*, it was a disgruntled labor union. In *Oaktree Capital*, it was a small competitor that was being forced out of the market, because it could not get first run movies. Often—it has been our experience—the "whistleblowing complainant" is an unhappy or recently fired employee.

C. When Do Firms Compete for Section 8 Purposes?

It is settled antitrust law that a parent and its 100%, wholly-owned subsidiaries are *not* legally capable of conspiring with each other to violate the Sherman Act because their economic interests are the same. *Copperweld Corp. v. Independence Tube Co.* 467 U.S. 752 (1984).

What is not clear, however, is what ownership of "affiliated companies" **below 100%** confers "antitrust immunity" for Section 8 purposes or for conspiracies among competitors. The law is quite unsettled except that ownership below 50% each is most likely to result in liability, and ownership of less than 100% involves risks of liability that increase as the ownership drops below 100%. The risk is enhanced if the two "affiliates" have a history of competing against each other and other shareholders have a voice in the management of either company

D. What Are the Consequences of a Section 8 Violation or a Conspiracy to Fix Prices?

There is a private right of action for a Section 8 claim and the FTC and DOJ also enforce it. Private plaintiffs have been successful in securing injunctions to stop overlapping directors from serving. To date, no court has awarded damages under Section 8, in large measure because no actual price fixing or other competitive injury has been demonstrated to have resulted from the interlocking directorates. There are no civil penalties assessed by the government for Section 8 violations, nor is it a criminal violation.

The same is not true for Section 1 of the Sherman Act or "price fixing," i.e., any agreement or understanding between the affiliated companies to refrain from price competition, to allocate customers, territories, or products, or to reduce output. A "Section 1" violation can result in serious criminal fines, jail terms, and civil damage liability. The antitrust laws were recently amended to make any price fixing violation subject to up to a **\$100 Million** fine, or twice the amount of actual loss or gain, whichever is *larger*. A plea of guilty or a

conviction generally creates automatic civil liability to victims that can sue for three times the actual (or "treble") damages. Individuals involved in the illegal conduct—or, e.g., a director who "should have known" of it (there is a "willful ignorance" standard)—can be **imprisoned for up to ten years**.

In any event, no company should want to be the subject of a government antitrust investigation or lawsuit. They are expensive, time consuming, and they also damage a firm's reputation with its customers and provoke collateral SEC and treble damage litigation. The FTC and DOJ keep their investigations secret, but public exposure can occur from a variety of sources, e.g., a complaining labor union, a need to disclose for SEC or other reasons. Antitrust violations are deemed to raise issues of "management integrity" that are not subject to the accountants' "materiality" tests.

Public notice invariably results in private litigation. There is a large, active—and very hungry—group of private antitrust lawyers who compete to file the first case in any antitrust matter, particularly those involving potential price fixing or other horizontal agreements to limit competition with their treble damage remedy and right to recover attorneys' fees if any relief is obtained.

E. How Can Section 8 and Price Fixing Risks Be Minimized?

First, be aware of the dangers of interlocking directorates and the potential exposure to a price fixing or other investigation involving coordinated activity. To that end, have a written company policy alerting all employees—particularly those in senior management and in sales and marketing—to the dangers of price fixing and the company's policy against any communications with competitors without legal clearance. That should include a specific warning that even the appearance of coordinating with competitors will result in severe sanctions, including termination.

Second, identify whether any of your less than 100% owned subsidiaries, affiliates or portfolio companies have competing sales before placing representatives on their respective boards.

Third, if board membership is approved—after consultation with counsel knowledgeable about antitrust issues—provide written instructions to any board representatives *not* to share *any* competitively sensitive information and to avoid actions that would coordinate the conduct of the two businesses or lessen competition between them.

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