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Client Alert

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# Consortium Deals May Move Forward: US Federal District Court Dismisses Antitrust Challenge to Private Equity Funds' Consortium Deal

In February 2008, in *Pennsylvania Avenue Funds v. Borey*, No. C06-1737RAJ (W.D. Wa. Feb. 21, 2008), a US federal district court in the Western District of Washington dismissed an antitrust action against two private equity firms (Vector and FP) that jointly acquired WatchGuard Technologies Incorporated (WatchGuard). While parties contemplating acquisitions should continue to seek counsel as to the antitrust implications of particular joint-bidding arrangements, the decision represents another favorable legal development for private equity firms and other financial institutions that enter into bidding consortia.

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Private equity consortia are generally comprised of two or more private equity funds and may include strategic partners. Bidding consortia enable private equity firms to share the risks associated with acquiring a large target company and facilitate the funding of the required equity financing. Indeed, recent consortium deals have been instrumental in executing multibillion-dollar acquisitions in cases where no single private equity fund could have funded the entire equity required for the transaction or was willing to risk doing so.

Subject to the terms of the confidentiality agreement negotiated with the target in any given auction, private equity firms can create consortia at different points during the bidding process and under various circumstances: (i) firms can join together at the beginning of the auction process; (ii) firms can form consortia shortly before or after the bid is submitted, but before executing definitive documentation; (iii) firms can join a winning bidder which is seeking to syndicate a portion of its equity commitment after executing definitive documentation; or (iv) occasionally, sellers may select which firms can join together to bid and acquire a target.

Bidding consortia recently have been subject to heightened public scrutiny as a result of lawsuits that have questioned the legality of their joint-bidding practices under the United States antitrust laws. At issue in these cases, in part, is whether consortium bidding may harm the sellers in competitive auctions by reducing the number of participants in the auction and the ultimate price to the seller.

In *Pennsylvania Avenue Funds*, the plaintiff—a former shareholder of Watchguard, the target company—alleged that the interrelated activity by Vector and FP constituted an illegal bid-rigging scheme. Vector and FP were originally just two of numerous potential purchasers that expressed an interest in acquiring WatchGuard. Indeed, the "[p]laintiff admitted at oral argument that as many as 50 suitors expressed some level of interest" in the transaction. However, as the WatchGuard auction proceeded, the field narrowed considerably.

According to the complaint, although both Vector and FP initially submitted competitive bids to acquire WatchGuard, the competitive bidding process came to a halt when Vector and FP allegedly "entered into a contract, combination, or conspiracy to artificially fix the price, refrain from bidding, or rig the tender offer bids for WatchGuard shares." The plaintiff alleged that the conspiracy played out in three phases: first, "Vector agreed to stop pursuing WatchGuard, and stand aside while FP made a lower bid." Next, FP lowered its bid from $4.60 per share to $4.25 per share. Finally, less than one month after WatchGuard's Board of Directors accepted FP's lowered bid, Vector announced an agreement to fund half of FP's acquisition of WatchGuard in exchange for a 50 percent interest in WatchGuard after the merger.

The complaint alleged that FP and Vector entered into a horizontal agreement to "rig the tender offer bids for WatchGuard shares." The plaintiff alleged that such an agreement was *per se* illegal under Section 1 of the Sherman Act, 15 U.S.C. § 1. Under that standard, the joint bidding arrangement, whereby FP and Vector allegedly agreed not to bid against one another and to reduce the price being offered, would be illegal irrespective of its purpose or effects. In the alternative, the plaintiff alleged that the purported agreement violated Section 1 of the Sherman Act under the rule of reason, which deems unlawful only those agreements whose adverse effects on competition outweigh any potential procompetitive justification. The court disagreed with the plaintiff on both scores.

First, as to plaintiff's *per se* claim, the court held that "[a]nalysis of Defendants' agreement to acquire WatchGuard under the *per se* rule is presumptively inappropriate." As the court explained, "*[p]er se* liability applies to 'agreements that are so plainly anticompetitive that no elaborate study of the industry is needed to establish their illegality.'" The court noted that "no court has applied the *[per se]* rule to a price-fixing agreement in a contest for corporate control," and that, in any event, it would be inappropriate to apply the rule given that "[p]rice fixing among rival bidders in a contest for corporate control is not, in general, anticompetitive." The court observed that joint-bidding by private equity firms plausibly has several pro-competitive aspects, including (1) allowing "poorer contestants" to "gain access to the contest" by "combining resources" with "well-heeled bidders," and (2) allowing "bidders who join forces" to "spread risk between themselves . . . ." The court concluded that joint bidding encourages bids that might otherwise exceed a sole bidder's "resources or risk tolerance" and dismissed the plaintiff's *per se* claim.

Second, the court likewise rejected the plaintiff's rule of reason argument. Under the rule of reason, the court explained, the "plaintiff must allege both the existence of a relevant market and 'that the defendant has power within that market.'" Beyond that the plaintiff also "must show that the defendants control enough of the market that their anticompetitive conduct actually injures competitors or consumers." It is well established that without market power arising from control over a substantial part of the relevant market, any anticompetitive impact of the complained of action is improbable.

The court stated that it was not pursuaded by the plaintiff's claim that "the market for corporate control of WatchGuard" constituted a "relevant market" because the market for control of a single target company appeared to be an inappropriately narrow market definition as a matter of law. However, even if the plaintiff's proposed market definition was sufficient, the court rejected the plaintiff's rule-of-reason claim because the plaintiff's allegations failed to demonstrate that Vector and FP possessed market power. Although the plaintiff argued that Vector and FP had market power because they were the only bidders left standing at the auction's end, the court found this characterization of the bidders as having market power misleading: Vector and FP's role as the two remaining bidders did not prove that they had market power, but instead, the court opined, indicated that WatchGuard "was not an attractive asset." In other words, "Vector and FP had an apparent stranglehold on this submarket… but only because dozens of other suitors who expressed interest in WatchGuard refused to make bids."

The court found the reality to be that "[a]ny acquirer who believed that WatchGuard was worth more than FP's bid could have made a topping bid" and that the WatchGuard shareholders retained the power to vote down the merger if they believed that the bid was too low. Thus, because the plaintiff failed to establish that the defendants in fact possessed market power, the court held that the plaintiff could not survive a rule-of-reason analysis and dismissed the Section 1 claim. Inasmuch as virtually all acquisition agreements involving the sale of a public company contain "fiduciary outs" which enable the target company to entertain competing bids until the required shareholder vote is conducted, the court's reasoning suggests that joint-bidding arrangements with respect to auctions for public companies should survive a rule of reason analysis. Of course, there can be no assurance that other courts will adopt the court's approach to the rule of reason analysis.

*Pennsylvania Avenue Funds* represents another positive development in antitrust law for private equity firms that participate in bidding consortia.[1]

Nonetheless, it is important to recognize that the court's analysis in *Pennsylvania Avenue Funds* was fact-specific and, standing alone, this decision does not create a bright-line rule that all consortium deals are immune from antitrust challenges. Instead, the decision supplies participants in consortium deals with yet another compelling precedent that they can use to ward off future antitrust challenges to their agreements.

**Endnote**

[1] *See, e.g., Finnegan v. Campeau Corp.*, 915 F.2d 824, 827-32 (2d Cir. 1990) (in a case presenting facts similar to Pennsylvania Avenue Funds, the Second Circuit held that the federal securities law (specifically, the Williams Act) precludes application of the antitrust laws to rival bidders that ultimately joined forces to acquire a target company); *Kalmonivitz v. G. Heileman Brewing Co., Inc.*, 769 F.2d 152, 156-57 (3d Cir. 1985) (affirming grant of partial summary judgment against antitrust plaintiffs in similar circumstances because "the sale of stock of a single company within the context of a takeover battle for that one company does not fall within…" the definition of "trade or commerce" and, therefore, "[t]he antitrust laws simply were not designed to regulate this type of corporate power struggle…").

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