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A legal update from Dechert's Antitrust and White Collar and Securities Litigation Groups

Private Equity Firms Escape Antitrust Liability for Joint Bidding Activity

Key Highlights and Implications:

The court dismissed a lawsuit challenging a joint bidding agreement among private equity bidders, even where the collaboration directly lowered the sale price.

Firms considering collaborative bids should continue to take precautions going forward, as these agreements may still be subject to antitrust review on a case-by-case basis. For instance, a firm should attempt to enter into the collaboration earlier in the bidding process (when the universe of potential bidders is large) to minimize the potential for antitrust scrutiny.

Sellers should continue to take precautions when establishing the auction process by specifically prohibiting bidder communications.

Introduction

A purported antitrust class action suit against two private equity firms over their joint bid to purchase WatchGuard Technologies Incorporated ("WatchGuard") was dismissed by a federal district court on February 21, 2008. *Pennsylvania Avenue Funds v. Borey*.[1] Plaintiffs in the suit—former shareholders of WatchGuard—claimed they were harmed by the joint bidding activity, which they alleged had the direct effect of lowering the sale price. The district court granted defendants' motion to dismiss, with prejudice, finding (a) the joint bidding conduct was not *per se* unlawful under the antitrust laws and (b) the joint bidding activity did not violate the antitrust laws under the "rule of reason."

The Activity Giving Rise to the Lawsuit

In late 2005, WatchGuard's board of directors set up an auction process for a potential sale of the company, and interested parties were solicited to participate. As many as 50 potential suitors expressed some level of interest during the bidding process, including the defendants—private equity firms Francisco Partners ("FP") and Vector Capital ("Vector"). As the auction process progressed, both FP and Vector submitted formal bids, with each refining its bid over the course of the due diligence process. As of late June 2006, FP's bid was at $4.60 per share, and Vector's bid was at $4.65 per share.

On June 26, 2006, Vector withdrew from the bidding, and FP soon after lowered its bid to $4.25 per share. WatchGuard's board ultimately accepted this bid on July 25, 2006. On August 16, 2006, Vector announced that it had an agreement with FP for a 50 percent ownership stake in WatchGuard following the acquisition and would pay 50 percent of the acquisition price accordingly.

Plaintiffs thereafter filed suit alleging that the agreement between FP and Vector to jointly purchase WatchGuard violated §1 of the Sherman Act, which prohibits certain anticompetitive agreements and conspiracies among competitors. Plaintiffs alleged that FP and Vector were competitors in the bidding process for WatchGuard, and that they agreed to end that competition in order to lower the purchase price paid to WatchGuard's shareholders. According to plaintiffs, this conduct was *per se* unlawful under the Sherman Act or, in the alternative, was unlawful under a Sherman Act rule of reason analysis.

[1] No. C06-1737RAJ (W.D. WA Feb. 21, 2008).

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Rejection of the *Per Se* Standard for Private Equity Joint Bidding Activity

The issue was before the court on defendants' motion to dismiss; therefore, the court construed all allegations in the light most favorable to the plaintiffs.

The court first considered whether the joint bidding activity should be deemed *per se* unlawful under the Sherman Act, a classification reserved only for those narrow categories of agreements that are "so plainly anticompetitive that no elaborate study of the industry is needed to establish their illegality." Finding no prior precedent mandating the *per se* standard for private equity joint bidding activity, the court considered the issue in the first instance and quickly determined that joint bidding was not *per se* unlawful under the Sherman Act.

The court reasoned that a number of legitimate and pro-competitive reasons exist for private equity firms to join forces when bidding for control of a company—even where the parties began the auction process as rivals. For instance, joining forces may allow smaller, less wealthy firms to better compete with larger rivals, thereby increasing competition. Joint bidding may also increase competition in instances where the risks would be too great for a single potential acquirer to bear on its own. In light of the potential pro-competitive justifications, the court concluded that joint bidding in the private equity context was "not invariably anticompetitive" and held that "[p]rice agreements between competitors in a corporate control context are not *per se* illegal."

No Violation under the Rule of Reason Due to Lack of Market Power

The court next considered whether the challenged conduct violated the antitrust laws under the "rule of reason," which requires a case-specific analysis to determine if the challenged conduct resulted in an unreasonable restraint on competition.

As a threshold matter, an antitrust plaintiff must properly allege that the defendants possessed market power within a "relevant market." The court found the complaint deficient in this respect because the defendants did not possess power in plaintiff's alleged market—"the market for corporate control of WatchGuard and other technology companies." The court referenced the nearly $159 billion poured into private equity funds in 2006 alone and noted that "Plaintiff offers no allegations from which the court could infer that the combined resources of FP and Vector are more than a minuscule fraction of this market."

The court found the same deficiency would exist even if the market were narrowed to simply "corporate control of WatchGuard." The court noted the large universe of interested suitors that *could* have bid for WatchGuard and refused to focus merely on the actual or final bidders. The court explained: "Any acquirer who believed WatchGuard was worth more than FP's bid could have made a topping bid. The agreement between FP and Vector would have had no effect on such a bid." The court added that WatchGuard's shareholders could have rejected the bid had they believed it to be too low.

Challenges to Joint Bidding Activity May Continue Notwithstanding the *Borey* Decision

Group bids and "club deals" by private equity firms have become increasingly more popular in recent years. These deals are typically pro-competitive and often work to the benefit of shareholders of the target companies. As this case demonstrates, however, more and more private equity firms could be forced to defend their decisions to bid (or not bid), either in defense of a class action lawsuit or, potentially, as part of a Department of Justice inquiry. And given the continued focus on these types of deals by the plaintiffs' bar, this area of law could see significant developments in the coming months.

Just recently, for instance, a complaint was filed in a federal court in *Boston, Dahl v. Bain Capital Partners LLC*, No. 08-10254, Complaint (D. Mass.), naming sixteen firms as defendants, including some of the largest private equity firms in the United States. The plaintiffs, former shareholders of Freescale Semiconductor Inc. ("Freescale"), allege that a number of the defendants conspired to suppress the price ultimately paid to acquire Freescale shares in a leveraged buyout.

The complaint alleges further that this transaction was part of a much larger conspiracy among the defendants to eliminate competitive bidding and "rig" the purchase price of a number of other target companies. The complaint alleges that bidding clubs were formed by the private equity firms in order to set prices and control which firms would bid for which target companies. According to plaintiffs, "sham" bids were submitted by club members in order to make the selected bidder's offer appear more desirable to the target. The plaintiffs further allege that target company management and investment banking firms were included in the conspiracy in exchange for financial stakes in the deals and underwriting and other fees.

Implications of the *Borey* Decision

- The *Borey* decision is a significant first-step in defense of challenges to the legitimate joint bidding activity of private equity firms. This decision could be appealed, however, so private equity firms would be wise to closely monitor future developments.

- Rejection of the per se rule. Not surprisingly, the court declined to label joint bidding activity as *per se* illegal under the antitrust laws. *Per se* treatment is reserved for only those narrow categories of conduct deemed so plainly anticompetitive that no elaborate study of the industry is needed to establish their illegality. As the court properly explained, joint bidding by private equity firms is often pro-competitive, and the *per se* rule is simply inappropriate in this context.

- Joint bidding behavior is still subject to rule of reason review. It is important to understand that rejection of the *per se* standard does not render joint bidding activities *per se lawful*. One potential landmine relates to which firms should be included in the analysis of defendants' market power. In *Borey*, the court included all firms expressing *any* interest in the bidding process. But the result may be different if only "serious" or "bona fide" bidders are included in the analysis.

- Sellers should be mindful to prohibit bidder communications or collaborations as part of the auction process—as is common practice—in order to avoid this situation from occurring.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/antitrust or www.dechert.com/securities.

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