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"All in favor of a cap on our liability?"

Wearing "Two Hats": Best Practices for PE Sponsor Representatives Serving on Portfolio Company Boards

In January, a federal court in California allowed federal securities law claims to go forward against a private equity sponsor based on the statements of one of its Managing Directors who was serving as Chairman of the Board of a portfolio company.[1] This holding serves as a cautionary tale for private equity sponsors whose employees wear "two hats" by serving both the sponsor and the portfolio company simultaneously.

Background

In 2011, a private equity fund purchased Rural/Metro, a provider of ambulance and medical transportation services, and funded the acquisition in part through a private placement offering of $200 million in senior notes. A sponsor representative was named Chairman of Rural/Metro's Board. Rural/Metro subsequently issued additional senior notes in connection with its purchase of several other ambulance companies.

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1. *Oaktree Principal Fund V, LP v. Warburg Pincus LLC*, 2:15 Civ. 08574 (C.D. Cal. Jan. 17, 2017).

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Plaintiffs, a group of funds collectively holding 92% of the outstanding senior notes, alleged that in early 2012, Rural/Metro executives learned of problems with the company's revenue-recognition system, which potentially meant that the company's revenues and EBITDA were overstated. Plaintiffs further alleged that on a series of quarterly note holder calls in late 2012 and early 2013, Rural/Metro's CEO, the sponsor representative and a representative of a business advisory firm (which was brought in to resolve the portfolio company's accounting issues) made false representations about the financial health of the company, downplayed the significance of a series of write-downs related to the revenue-recognition issue despite real uncertainty as to the extent of the problems, and fudged the company's EBITDA to suggest financial health when in fact the company may have been in significant distress.

The sponsor representative eventually fired the company's CEO, and in August 2013, Rural/Metro declared bankruptcy. Plaintiffs filed a complaint against the sponsor, the business advisory firm and the sponsor representative, claiming damages for purchasing the senior notes based on the representations and omissions of the defendants at prices far in excess of what they were worth. The complaint alleged that the sponsor violated federal securities law when its representative and the portfolio company's CEO made false statements to the note holders, both as a "maker" of the statements by the sponsor representative and as the "control person" responsible for statements of the CEO and sponsor representative.

> "The complaint alleged that the sponsor violated federal securities law when its representative and the portfolio company's CEO made false statements to the note holders, both as a 'maker' of the statements by the sponsor representative and as the 'control person' responsible for statements of the CEO and sponsor representative."

A Sponsor's Potential Liability as "Maker" of Statements by Its Representative

Under Rule 10b-5, defendants are liable for federal securities violations if they are the "makers" of false statements made in connection with the purchase or sale of securities. Plaintiffs alleged that the sponsor representative made false and misleading statements on a May 2013 note holder call, shortly after he had fired the CEO. On the May 2013 call, the sponsor representative:

- Introduced himself as "a partner at [the sponsor] and also the Chairman of the Rural/Metro Board."
- Announced a $35 million write-down (following two previous "one-time" write-downs announced on note holder calls by the company's CEO) and told investors that the EBITDA from the previous 12 months was $70.1 million (just slightly above the $70 million EBITDA threshold the company's analysts predicted would signal serious financial distress and inconsistent with the $64 million figure that the independent business advisory firm had previously calculated).
- Stated, when asked whether he would comment on whether the sponsor would contribute additional equity to Rural/Metro, "No reason to. The company's in perfectly good liquidity position."

The court found that the sponsor representative could be liable for all of the allegedly false statements he made on the May 2013 note holder call. The sponsor, however, could be liable only for the statement by its representative that Rural/Metro was "in perfectly good liquidity position."

The court's reasoning was based on *United States v. Bestfoods*, a 1998 U.S. Supreme Court decision that created a presumption that directors wear their "subsidiary hats" and not their "parent hats" when acting for the subsidiary.[2] The fact that the sponsor representative introduced himself as "a partner at [the PE sponsor] and also the Chairman of the Rural/Metro Board" was not enough to overcome

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2. *United States v. Bestfoods*, 524 U.S. 51, 69 (1998).

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this presumption when he spoke about Rural/Metro's financial condition on the call. Therefore, the PE sponsor was not directly liable for each statement its representative made.

However, the court found that when the sponsor representative was asked whether the sponsor would contribute additional equity to Rural/Metro, he was clearly responding as a representative of the sponsor. Because he was wearing his sponsor hat when he made the statement that the portfolio company was "in perfectly good liquidity position," the court found that the sponsor could be held liable for that statement if proven to be false.

A Sponsor's and Sponsor Representative's Potential Liability as Controlling Persons for CEO Statements

Under Section 20(a) of the Exchange Act, a company may be liable for a securities law violation committed by someone under its "control." The requirements for liability vary to some extent among the federal circuits, but generally, a plaintiff claiming a Section 20(a) violation must allege (i) a primary violation of Rule 10b-5 by the maker of the statement and (ii) control by the defendant over the primary violator.

The court found that the plaintiffs adequately pled primary violations of Rule 10b-5 by the portfolio company's CEO and the sponsor representative. Because the sponsor owned and controlled 100% of the common stock of Rural/Metro, the sponsor representative was the Chairman of the Board of the portfolio company, and the representative ultimately fired the company's CEO, the court stated that it is plausible that the sponsor and its representative had "control" over the company's CEO. Thus, the court found that the sponsor and its representative could be liable under Section 20(a) for the CEO's allegedly misleading statements on the note holder calls. In addition, since the sponsor was the sponsor representative's employer, it could be liable under Section 20(a) for his allegedly misleading statements on the May 2013 call.

A control person may take advantage of an "escape hatch" from liability under Section 20(a) if the controlling person acts in "good faith" and does not "directly or indirectly induce" the securities law violation.[3] The court found this defense to be unavailable to the sponsor given allegations of intentional misstatements by its representative.

Best Practices for Reducing Risk

To reduce the risk of liability as "maker" of statements to portfolio company investors in violation of Rule 10b-5, private equity sponsors and their employees should be mindful of any affirmative statements made by those employees while wearing "two hats." In order to reduce the risk of potential liability:

> "To reduce the risk of liability as 'maker' of statements to portfolio company investors in violation of Rule 10b-5, private equity sponsors and their employees should be mindful of any affirmative statements made by those employees while wearing 'two hats.'"

- **Silence is golden.** Avoid making statements directly to investors or potential investors in connection with the purchase or sale of securities. Silence is not actionable under Rule 10b-5 unless plaintiffs can overcome an extremely high bar set for non-speakers—that they had the "ultimate authority over the statement, including its content and whether and how to communicate it."[4]
- **Speak only for the portfolio company.** When public statements by sponsor employees on behalf of a portfolio company are necessary, the speaker should make clear that she is speaking only in her capacity as a member of the portfolio company. To that end, she should

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3. *Oaktree*, at *33 n.1.
4. *Id.* at *20, quoting *Fulton Cty. Employees Ret. Sys. v. MGIC Inv. Corp.*, 675 F.3d 1047, 1051-52 (7th Cir. 2012).

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avoid answering questions directed to the sponsor or that would draw on knowledge obtained solely by virtue of her employment by the sponsor. That may, in some circumstances, mean expressly stating that she is speaking as a board member of the subsidiary and declining to speak on behalf of the sponsor.

- **Nothing but the truth.** Perhaps most obviously, avoid making potentially misleading statements on either entity's behalf.

A sponsor can also mitigate risk of "controlling person" liability under Section 20(a) by ensuring proper management and supervision of the portfolio company, but avoiding involvement in the company's day-to-day operations.

- **Don't micromanage.** Avoid direct involvement in the day-to-day operations of the portfolio company. Being a controlling stockholder and having employees serve on the board of a portfolio company is not enough for a sponsor to be considered a "controlling person" for purposes of Section 20(a). Indeed, a federal court in California recently found that a sponsor did not act as a "controlling person" of a portfolio company, even with a 72% ownership stake and two employees on the board, because plaintiffs failed to allege the sponsor's involvement in day-to-day affairs of the company or specific control over the preparation and release of the allegedly false statements.[5] However, in the Rural/Metro case, the court found that plaintiffs alleged that both the sponsor representative and sponsor exercised sufficient control over the portfolio company's CEO and the operations of the portfolio company such that they could be liable for the CEO's statements.[6]

- **Good faith, supervision and internal controls.** Although a sponsor should not involve itself in day-to-day operations of a portfolio company, it should—in the ordinary course of managing a portfolio company—act in good faith and properly supervise the portfolio company. Section 20(a) does not apply if a controlling person can show that it acted in good faith and that it "did not directly or indirectly induce the act or acts constituting the violation" underlying the Section 20(a) claim.[7] The Rural/Metro court largely brushed aside the "good faith" defense with little elaboration because plaintiffs sufficiently alleged the sponsor representative's intentional misstatements. Other courts, however, have stated that to meet the burden of establishing good faith, the controlling person must prove that it exercised due care in its supervision of the violator's activities in that it "maintained and enforced a reasonable and proper system of supervision and internal controls."[8]

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5. *Welgus v. TriNet Grp., Inc.*, No. 15 Civ. 03625, 2017 WL 167708, at *12 (N.D. Cal. Jan. 17, 2017).
6. Observing corporate formalities and staying out of the portfolio company's day-to-day affairs should also help insulate the sponsor from liability for other types of alleged violations, should plaintiffs seek to "pierce the corporate veil" and hold the parent liable for the wrongful acts of the subsidiary.
7. 15 U.S.C. § 78(t).
8. *Marbury Mgmt., Inc. v. Kohn*, 629 F.2d 705, 716 (2d Cir. 1980).

Learning from the Past: What Anti-Corruption Compliance Can Teach Fund Sponsors and Their Portfolio Companies about Human Rights and Corporate Responsibility

"For portfolio companies, building a human rights compliance program by leveraging an existing anti-corruption compliance programs provides a powerful, practical and efficient approach for seeking to address evolving human rights risks."

Corporate risk continues to evolve, particularly in the field of human rights and corporate responsibility. Increasingly, human rights obligations are viewed as corporate obligations. Drivers of this shift include the UN Guiding Principles on Business and Human Rights, transnational civil litigation, investor disclosure expectations and an array of domestic regulations.

For fund sponsors, the private funds they manage and the investors in those funds, human rights and corporate responsibility compliance at the level of the portfolio company increasingly is becoming more important, from both a legal and a reputational perspective.

By managing a private fund that invests in, or provides financing to, a portfolio company that fails to satisfy its human rights and corporate responsibility obligations, a fund sponsor is exposed to liability. It is important for the fund sponsor to understand, and monitor, its portfolio companies' approaches to human rights compliance and corporate risk matters.

By committing to a private fund that invests in, or provides financing to, a portfolio company that fails to satisfy its human rights and corporate responsibility obligations, an investor may be deemed to be directly linked to an adverse human rights impact. As such, it is becoming increasingly more common for human rights and corporate responsibility issues to factor in the fund sponsor due diligence process in a similar way to anti-corruption compliance matters.

Changes in the corporate risk landscape are not unprecedented. Over the last decade, corporate anti-corruption laws have multiplied, along with increasingly vigorous enforcement, even sometimes in unexpected places. This has promoted the creation of robust anti-corruption compliance programs requiring businesses to set clear statements of policy, establish due diligence processes, monitor and test for compliance and provide mechanisms for remediation.

Substantively, there is much overlap: heat maps of countries with high corruption risk often mirror those of countries with high human rights risk. Corruption can fuel or at least facilitate human rights abuses, such as human trafficking, and vice versa. For portfolio companies, building a human rights

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compliance program by leveraging an existing anti-corruption compliance programs provides a powerful, practical and efficient approach for seeking to address evolving human rights risks.

1. Portfolio Companies Can Meet Human Rights Responsibilities by Adopting Processes for Addressing Adverse Human Rights Impacts

As a matter of international human rights law, the responsibility to address human rights abuses has largely been seen as a matter of state competence. This legal obligation rests on individual states to comply, which in turn can act domestically through criminal and administrative law provisions.

The UN Guiding Principles on Business and Human Rights (the "Guiding Principles"), which were unanimously endorsed by the UN Human Rights Council in 2011, are an innovation to that basic approach. They seek to address—on an international level—the individual responsibility of companies, advancing a voluntary, systems-based approach to corporate human rights obligations. The Guiding Principles largely have been lauded in policy and academic circles, as well as by civil society organizations, and have taken a central role in shaping transnational civil liability, investor disclosure expectations and relevant domestic regulations.

The Guiding Principles distinguish between public- and private-sector human rights responsibilities. States must *protect* human rights. Businesses must *respect* human rights. Respect is systems-focused. That is, businesses respect human rights by adopting policies and implementing processes to address adverse human rights impacts with which they are involved.

2. Compliance Programs Can Be Built on Existing Models

Before legal corporate human rights emerged as a more formalized risk, businesses witnessed a similar evolution in anti-corruption laws.

> "Of course, there are no 'one-size-fits-all' effective compliance programs. Each program should be fashioned to meet an organization's specific needs and risks."

In response to a growing number of scandals and concerns regarding corporate bribery, the U.S. Congress enacted the Foreign Corrupt Practices Act (FCPA) in 1977, outlawing the bribery of foreign officials. But anti-corruption enforcement in the United States remained relatively limited for decades: for 1977 through 1997, the websites of the U.S. Department of Justice ("DOJ") and the Securities and Exchange Commission ("SEC") reflect only 39 FCPA-related enforcement actions.

Outside the United States, efforts to combat transnational corruption progressed more slowly. Until the late 1990s, the German, French and Swedish governments, among others, still deemed bribes paid to foreign officials by local companies to be tax-deductible. The attitude shifted markedly with the adoption of the OECD Anti-Bribery Convention in 1997. The Convention requires signatory countries to criminalize offering or giving bribes to foreign public officials under their domestic laws. One by one, the OECD signatory nations have implemented national legislation proscribing the bribery of foreign officials.

Meanwhile, the enforcement of anti-corruption legislation has ballooned. Over the last decade, the DOJ and SEC websites recount 350 FCPA-related enforcement actions, roughly nine times as many as in the first 20 years the statute was in force. And anti-corruption enforcement is no longer the exclusive province of U.S. regulators. Recent years have witnessed a growing intensity of anti-corruption enforcement throughout the world, including in South America, Europe and Asia.

In seeking to enhance anti-corruption compliance, regulators around the world increasingly have articulated standards for what constitutes an effective compliance program. The broad strokes are often largely the same. For example, the UK Ministry of Justice has underscored the importance of proportionate procedures, committed management,

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risk assessment, communications (including training), due diligence and monitoring. Likewise, DOJ's and SEC's 2012 Resource Guide, as well as DOJ's April 2016 Guidance unveiling its new FCPA pilot program, have emphasized: (1) an established culture of compliance; (2) effective policies and procedures, including a code of conduct; (3) sufficient oversight, autonomy and resources for the compliance program, including qualified and experienced personnel; (4) risk assessment; (5) adequate training and continuing advice; (6) positive incentives and disciplinary measures; (7) the mitigation of third-party risks through due diligence; (8) a confidential reporting mechanism and an efficient and reliable internal investigation process; (9) continuous improvement through periodic testing and review; and (10) adequate due diligence on acquisition targets. The Decree implementing the so-called Brazilian Clean Company Act sets out similar parameters for assessing the effectiveness of a compliance program.

As a further incentive to adopt compliance programs, regulators may consider such programs in determining whether to charge a corporate violation or at least in deciding what penalty to impose (or seek). Indeed, the sole defense against the corporate offense of failing to prevent bribery under the UK Bribery Act is that the company had "adequate procedures" in place designed to prevent bribery by associated persons. In the United States, although not a formal defense, both DOJ and SEC routinely consider a company's compliance program as part of their investigations. Last year, DOJ hired a compliance consultant to help with this important task. As reflected in the U.S. Sentencing Guidelines, a company's failure to prevent a particular violation does not necessarily mean that the entity's compliance program is ineffective. Regulators therefore focus on a compliance program's good faith design, implementation and enforcement.

Of course, there are no "one-size-fits-all" effective compliance programs. Each program should be fashioned to meet an organization's specific needs and risks. In general, regulators' measures of an effective anti-corruption compliance program, as laid out above, are instructive for fashioning programs that are likewise effective for demonstrating respect for human rights. The Guiding Principles add to this mix an expectation of public reporting. The cornerstone of each of these expectations is for the business to prioritize risks from the perspective of those whose rights might be negatively impacted.

> "The evolution of anti-corruption compliance not only helps us understand trend lines for human rights compliance, but also provides a practical model that companies can leverage to meet the expectations of regulators, courts, and investors."

3. The Regulatory Landscape Is Evolving

The Guiding Principles are reshaping corporate risk in a way similar to that of the OECD Anti-Bribery Convention. First, they provide a benchmark against which consumers, investors, courts and activists can assess corporate respect for human rights. Second, just as the OECD Convention led to national regulation of extraterritorial corruption, the Guiding Principles have inspired legislation to enforce business respect for human rights.

The trend is most apparent in the context of human trafficking (or modern slavery), which corruption can facilitate. Recent anti-trafficking legislation includes the California Transparency in Supply Chains Act, the UK Modern Slavery Act and the U.S. Federal Acquisition Regulation on Ending Trafficking in Persons. The risks created by each of these regulations differ.

The California and UK Acts, for instance, focus on disclosure.

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Thus, the California Transparency in Supply Chains Act requires that businesses disclose any measures they take relating to verification, audits, certification, internal accountability and training; it does not mandate that businesses adopt particular processes regarding their supply chains. Similarly, the UK Modern Slavery Act focuses on disclosure, though it broadens the set of relevant business activities. Companies can comply with both regulations by reporting that they have done nothing to prevent human trafficking. When a company reports that it has taken measures to address human trafficking, those representations must of course be true, and litigation risk may ensue if they are not.

The U.S. Federal Acquisition Regulation on Ending Trafficking in Persons goes further. Issued in March 2015, the regulation significantly expands the responsibility of federal contractors sourcing over $500,000 in overseas goods or services to adopt measures to prevent human trafficking and forced labor. In particular, contractors must now develop, and annually certify, detailed Human Trafficking Compliance Plans evidencing: (1) policies and procedures related to recruitment, wages and housing; (2) employee training and awareness-raising; (3) due diligence measures to monitor, detect and terminate subcontractors; and (4) confidential grievance mechanisms to report violations.

Modern slavery legislation is just one aspect of emerging corporate human rights risk. The trend, however, is clear. As with anti-corruption two decades ago, corporate human rights risks are quickly multiplying. At the same time, the expectations of businesses are becoming more certain and practical.

Even as the breadth of these risks evolves, we can clearly discern regulatory focus on compliance program design. Against this backdrop, lessons internalized from anti-corruption efforts—regarding codes of conduct, due diligence, internal investigations, etc.—are invaluable for businesses seeking to navigate modern human rights risk.

4. Integrated Risk Management Can Bring Substantial Benefits in Efficiency and Effectiveness

The evolution of anti-corruption compliance not only helps us understand trend lines for human rights compliance, but also provides a practical model that companies can leverage to meet the expectations of regulators, courts, and investors. The fundamental compliance structure is the same: businesses must set clear statements of policy, establish due diligence processes, monitor and test for compliance and provide mechanisms for remediation. In addition, compliance functions require sufficient resources and autonomy. The foundation of both anti-corruption and human rights compliance is risk- and context-sensitive, including obligations that extend to agents and subcontractors.

As corporate risks evolve, portfolio companies need not start afresh in designing and implementing compliance strategies. To navigate effectively the changing human rights landscape, companies should mine their anti-corruption experiences, deploying lessons learned and considering the possible benefits of integrated risk management.

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Breaking Up Is Hard to Do: The Tax Treatment of Break-Up Fees

"Given the potential magnitude of the amounts at stake, the manner in which such fees are treated for U.S federal income tax purposes can have a material impact on the actual value of the payment to the parties."

Acquisition agreements often provide for the payment of a termination or "break-up" fee where one party seeks to abandon the transaction without due cause under the agreement. For example, a target company may be required to pay the buyer a termination fee in the event the target wishes to terminate the transaction to pursue another, superior offer. A buyer, on the other hand, may be required to pay a "reverse termination fee" in the event the buyer is unable to obtain sufficient financing or requisite regulatory approvals to complete the transaction. Depending on the transaction and the type of fee, these fees can be in the range of 3-7% of the equity value of the target company. Given the potential magnitude of the amounts at stake, the manner in which such fees are treated for U.S federal income tax purposes can have a material impact on the actual value of the payment to the parties.

Two separate internal IRS documents suggest that, from a buyer's perspective, the IRS would currently view a customary break-up fee payable upon a failed acquisition of target company as giving rise to capital gain or loss under current law. These documents contrast with earlier documents in which the IRS specifically permitted a buyer to recognize an ordinary loss on the payment of a break-up fee resulting from an abandoned transaction. The appropriate tax character of a break-up fee is a critical factor in analyzing the income tax impact associated with the receipt or payment of the fee, where parties' desired tax treatment of a break-up may not necessarily be aligned.

What's at Stake?

As a general matter, a recipient of a break-up fee will often prefer that the receipt of such fee be treated as giving rise to capital gain rather than ordinary income. For non-corporate taxpayers, capital gains attract a preferential rate of tax (currently 20%). While corporate taxpayers do not currently benefit from preferential rates of tax on capital gains, a corporate recipient of a break-up fee may nevertheless prefer capital gains treatment if such recipient has capital losses. In addition, a foreign recipient of a break-up fee from a U.S. payor generally would not be subject to withholding tax if that fee is treated as capital, but may be subject to withholding tax if the fee is treated as ordinary.

Conversely, a party required to pay a break-up fee in connection with a failed transaction generally will prefer such payment to result in an ordinary loss for tax purposes. This is because ordinary losses can be used to offset both ordinary income as well as capital gain.

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Recent Memoranda

Last fall, the IRS released two internal memoranda regarding the tax treatment of break-up fees in the context of an M&A transaction. The first memorandum (*FAA 20163701F*), released in September 2016, involves a terminated inversion transaction in which a merger partner's board of directors withdrew its shareholder recommendation for the transaction. As a result, the transaction was terminated and the merger partner was required to pay a break-up fee to the target company. The IRS concludes in the memorandum that the payment of the break-up fee resulted in a capital loss to the recipient pursuant to Section 1234A of the Code.

The second internal memorandum publicly released by the IRS in October 2016 (*CCA 201642035*) similarly concluded that the receipt of a break-up fee by a buyer in a merger transaction resulted in a capital gain to the buyer pursuant to Section 1234A rather than ordinary income. The break-up fee described in this second memorandum was triggered when a public company target received a superior purchase offer from a third party and terminated the merger agreement with the buyer to pursue a transaction with the third party.

Under Section 1234A, gain or loss that is attributable to the cancellation, lapse, expiration or other termination of a right or obligation with respect to property which is (or would be) a capital asset in the hands of the relevant taxpayer generally is treated as a capital gain or loss. In each of the memoranda, the IRS concluded that the applicable break-up fee was payable in connection with the termination of rights with respect to a target company's stock, which would have been a capital asset in the hands of the applicable buyer. Therefore, from the buyer's perspective, the IRS determined that the tax character of the break-up fee was capital in nature,

> "The memoranda recently made public by the IRS provide some clarity for buyers in stock acquisitions that payment or receipt of a break-up fee can be treated as capital gains rather than ordinary income."

Prior IRS Analysis

The recent memoranda reach a contrary conclusion to that reached by the IRS in an earlier 2004 internal memorandum as well as a 2008 private letter ruling. In the earlier releases, the IRS concluded that the receipt by a buyer of a termination fee in a failed M&A transaction resulted in ordinary income for the buyer, in one release specifically ruling that Section 1234A did not apply to the transaction, which is inconsistent with current IRS thinking. This inconsistency is specifically acknowledged by the IRS in CCA 201642305.

Final Thoughts

The memoranda recently made public by the IRS provide some clarity for buyers in stock acquisitions that payment or receipt of a break-up fee can be treated as capital gains rather than ordinary income. However, there are still a number of questions facing buyers and sellers in this area. For instance, the memoranda do not address the taxation of the target or sellers. While one might think that sellers and buyers should be treated the same in these circumstances, this parity isn't certain and there are some arguments for treating sellers differently. Moreover, the memoranda do not address the buyer's treatment in certain transactions, such as when the acquired assets are not capital assets in their entirety. While we do not believe that the documents recently released by the IRS are likely to impact broader market practice with respect to break-up fees, these documents serve as a reminder that parties to an M&A transaction that includes a break-up fee should factor in the potential tax impact of any such fee when evaluating the transaction.

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Spotlight on Europe

Sins of the Children: EU Antitrust Authorities Toughen Stance on Parental Liability

"The European Commission (the 'Commission') and courts are taking an increasingly strict approach to the interpretation of the principle of 'parental liability,' making it factually very difficult to rebut."

Two recent decisions and one ongoing appeal against cartel fines in Europe serve as a reminder that the European antitrust authorities take a strict approach to the issue of parental liability in an antitrust context. That differs markedly from the United States, where regulators generally do not impose equivalent parental liability for criminal antitrust fines.

This article explains the extent of parental liability under EU competition law and discusses the implications for private equity sponsors and financial investors when a portfolio company has committed an infringement. In summary:

- There is a low threshold for being considered an "active" investor for the purposes of a parent company being found *personally* liable (as opposed to being liable solely on a derivative basis) for the antitrust violations of a portfolio investment under EU antitrust law.
- The European Commission (the "Commission") and courts are taking an increasingly strict approach to the interpretation of the principle of "parental liability," making it factually very difficult to rebut.
- Consequently, the associated risk for a PE firm of being held personally liable for the unlawful conduct of a portfolio company is high and continues even after exiting the investment.

Legal Basis for Parental Liability under EU Competition Law

EU competition law provides that the parent company of a group may be held jointly and severally liable and fined for the anti-competitive conduct of another member of its group. The focus on economic rather than legal identity means that a parent and its subsidiaries are treated as a single corporate group for the purposes of competition law. The rationale for holding the parent jointly and severally liable with the portfolio company is two-fold. *First*, it takes the "true" economic strength of the wider business into account. *Second*, it prevents companies from avoiding payment by restructuring or transferring assets intra-group. This approach allows the Commission to address an infringement decision at the parent company level as well as at the level of the subsidiary where the violation was actually committed, and it also increases the amount of the fine that can be imposed because the amount may be calculated on a group basis, not by reference soley to the infringing subsidiary's turnover.

"Decisive Influence": The Test for Imputing a Portfolio Company's Conduct to the Sponsor

The test for imputing a subsidiary's infringing conduct is whether the parent company is in a position to exercise "decisive influence" over the subsidiary's

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conduct during the period of the infringement, and not whether it actually exercised that power.[1]

Presumption of Control in the Context of a >95% Share Capital Holding. Under EU competition law, there is a presumption that a parent has decisive influence over a subsidiary where a parent company holds 100%—or nearly 100%—of the infringing entity's share capital. The Commission has notably never applied the presumption where a parent company has held less than a 96% interest.

Rebutting the Presumption. When the presumption is found to apply, the onus shifts to the parent company to show that the subsidiary acted autonomously on the market and did not form part of the same economic unit as the parent.[2] However, case law shows that the bar for rebutting the presumption of influence is very high and the vast majority of appeals on this point have not succeeded. To rebut the presumption, the parent must demonstrate the subsidiary decided independently on its own conduct on the market. In essence, the question is whether the facts indicate that the parent company did not exert sufficient influence that the two must be regarded as one economic unit. As an example of the difficulties involved, a parent has been found to exercise decisive influence over a wholly owned subsidiary despite the fact that the parent had not adopted any formal management decisions during the period of the infringement, had never exercised its voting rights, and had only limited, minority board representation.[3]

"In essence, the question is whether the facts indicate that the parent company did not exert sufficient influence that the two must be regarded as one economic unit."

Parental Liability in the Context of a <95% Share Capital Holding. If the presumption of influence does not apply, the Commission must show that the parent exercised control. It is, however, not necessary to show influence was *actually* exercised. Organizational, legal, and/or structural links can be taken as sufficient. For example, a 30% minority investor has been held jointly liable based on the fact that it had board representation as well as certain governance rights over the portfolio company's activities.[4]

Heat Stabilisers: Parent Company Can Be Treated Differently than the Subsidiary for the Subsidiary's Unlawful Action

Most recently in the *Heat Stabilisers* case, the EU's higher European Court of Justice (the "ECJ") took a strict approach to parental liability, with the result that the parent was ultimately treated more harshly than the infringing subsidiaries in relation to the same unlawful action. Specifically, the parent company was not only found jointly and severally liable for the unlawful conduct of two of its subsidiaries, but it continued to be held liable even after the fines owed by the subsidiaries themselves were found to be time-barred.

Background

In April 2017, the ECJ dismissed an appeal by Akzo Nobel N.V. ("Akzo Nobel") against fines imposed on it for infringements by two of its subsidiaries, Akzo Nobel Chemicals GmbH and Akzo Nobel Chemicals B.V., both of which took part in a cartel during the first of three periods. In an earlier appeal, the lower-tier EU General Court had overturned the fine on the subsidiaries because the limitation period had expired, but had confirmed that the Commission could still find Akzo Nobel liable as their parent company. The ECJ had been expected to annul the parental fine because of a recommendation that it do so from the Attorney General based on the established

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1. *See, e.g.,* Case T-352/94 *Stora Kopparbergs* [1998] ECR II-2111.
2. Case C-97/08P *Akzo Nobel v. Commission* [2009] ECR I-8237.
3. Joined Cases T-208 & 209/08 *Gosselin Group v. Commission* [2011] ECR II-03639, [2013] 4 CMLR 671.
4. Case T-132/07 *Fuji Electric Co Ltd v. Commission* [2011] ECR II-4091.

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principle that the liability of a parent company cannot exceed that of its subsidiary. Instead, the ECJ agreed with the Commission's approach and rejected the appeal in its entirety.

There were two main reasons for the ECJ's decision. *First*, the fact that the subsidiaries could no longer be fined was considered essentially irrelevant. Akzo Nobel and the two infringing subsidiaries "*formed one and the same undertaking for the purposes of EU competition law*" and Akzo Nobel was therefore "*considered* personally *responsible and severally liable with those companies for the same anti-competitive conduct*" (emphasis added). *Second*, the ECJ confirmed that a parent company can be treated differently than its subsidiaries—even if its liability is based exclusively on the unlawful conduct of those same subsidiaries.

Key Takeaway:

- Parental liability is personal to the parent rather than derivative, which can result in differences in treatment.

International Flour Cartel: Ability to Appoint Supervisory Board Members Amounts to Decisive Influence

Earlier this year, Bencis Capital Partners lost its appeal against a fine imposed by the Dutch Authority for Consumers and Markets (the "ACM"). The Rotterdam District Court held that the principles of parental liability could be extended to the private equity firm for the unlawful conduct of one of its portfolio companies, Meneba, and explained that that the key question was whether the portfolio company acted autonomously. The Court found that the sponsor had effectively controlled the decision-making process at Meneba based on its ability to appoint members to the supervisory board.

Background

In 2010, the ACM fined 14 flour producers from Germany, Belgium and The Netherlands more than €81 million for their involvement in a market-sharing cartel. In a later decision, the ultimate parent companies of one of the infringing entities, Meneba, were also fined. Bencis Capital Partners ("BCP") and Bencis Buyout Fund II General Partner ("BBOF II GP") (together, "Bencis") held over 90% of the shares in Meneba between 2004 and 2007 and were held jointly and severally liable for a fine of approximately €1 million, the statutory maximum that could be imposed under Dutch law at the time.

The appeal court confirmed the regulator's decision to impose a fine on Bencis, noting that absence of knowledge of the anti-competitive conduct on the part of the controlling entity was no defense. The court reiterated that the powers Bencis held—specifically, the ability to appoint members to the supervisory board (including the chairman with the casting vote) which, in turn, took decisions on the appointment of management and the business plan—gave it decisive influence over the decisions of the company.

Key Takeaways:

- Absence of knowledge of anti-competitive conduct is no defense.
- Ability to appoint members to the supervisory board may amount to "decisive influence" and, consequently, give rise to parental liability.

Ongoing *Power Cables* Cartel Appeal

The final example is the ongoing appeal by Goldman Sachs ("GS") before the lower-tier EU General Court against the finding that it was jointly and severally liable for an antitrust infringement committed by Prysmian, a former investment made by a fund managed by the bank. Leave to intervene was sought by the European Private Equity and Venture Capital Association ("EVCA") on the basis that the contested decision raised an issue of principle of particular application to investments made by private equity and venture capital firms, but was rejected.

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Background

The GS appeal relates to a 2014 decision by the Commission that held GS jointly and severally liable for antitrust violations by one of its former portfolio companies, Prysmian, for that company's role in the *Power Cables* cartel. The Commission imposed fines totaling just over €301 million for the anti-competitive conduct of 11 cable producers over a 10-year period, assigning €104.6 million to Prysmian, of which GS was held to be jointly and severally liable for €37.3 million. GS has appealed on a number of grounds, including that the Commission failed to demonstrate that it actually exercised "decisive influence" over Prysmian over the relevant period.[5]

The Commission's Position

The Commission's position is that GS had exercised decisive influence over Prysmian for several years after it acquired the company from Pirelli in 2005. Prysmian was subsequently listed on the Milan stock exchange in 2007 and GS sold the entirety of its interest by 2010. The Commission reasoned that GS was more than merely a financial investor during that time because it indirectly held all the voting power for two years, could and did nominate individuals to the board of Prysmian, and participated in strategic decision-making. There was no suggestion, however, that GS had been aware of any anti-competitive conduct.

"EU case law on joint and several parental liability treats PE firms and other financial investors no differently in imputing the conduct of subsidiaries to their parents and, if anything, is becoming broader in application."

It is, however, unclear whether the Commission's case relies on a (rebuttable) presumption of decisive influence on account of GS owning 100% of the voting shares—an extension of the existing line of case law—or whether it is another example of decisive influence being shown to have existed based on the facts of the relationship between investor and portfolio company at the time.

Key Takeaway:

- Liability can still arise for the period the investment was held, even after an investor has exited.

Conclusion and Further Issues Relevant for PE Firms and Other Financial Investors

Overall it is clear that EU case law on joint and several parental liability treats PE firms and other financial investors no differently in imputing the conduct of subsidiaries to their parents and, if anything, is becoming broader in application. From the Commission's perspective, this is a matter of financial investors being held responsible both for up-front due diligence on their investments and for promoting compliance at the portfolio company level to prevent and detect anti-competitive conduct that could lead to liability.[6]

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5. Pirelli, which owned Prysmian during the first six years of the infringement, was also fined jointly and severally by the Commission and is also appealing the decision, and there are various other appeals outstanding on behalf of other parties.

6. As a further complexity, one question that has not yet had to be decided by the courts is how the Commission would behave in the event of an imputed repeat infringement by a PE firm. Recidivism is treated as an aggravating factor, so a PE firm could face punitive fines even where the anti-competitive activity is by a different portfolio company and on a different market. That may be one for a future decision.

Spotlight on Europe

Countdown to GDPR: 12 Months to Go and 10 Steps You Should Consider Now

"Like the Directive, the GDPR will apply to all organizations that have a presence in the European Union, but it also significantly expands the territorial scope of the EU data protection regime."

There is just one year to go until the General Data Protection Regulation (the "GDPR") comes into full force on May 25, 2018, replacing the existing EU Data Protection Directive (the "Directive"). Data privacy and cybersecurity have been increasingly in the news and on regulators' agendas, and there is no reason to believe this trend will diminish.

Below we set out 10 key issues private equity sponsors should consider now to prepare for the changes the GDPR will bring.

1. Determine if You or Your Portfolio Companies Are Subject to the GDPR

Like the Directive, the GDPR will apply to all organizations that have a presence in the European Union, but it will also significantly expand the territorial scope of the EU data protection regime. Specifically, even businesses with no EU presence will have to comply with the GDPR if they process personal data of "data subjects" who are in the EU in connection with (1) "offering of goods or services" to data subjects (no payment required); or (2) "monitoring" of the data subjects' behavior online, for example, for purposes of subsequent profiling. The "offering of goods or services" prong of the GDPR's territorial scope is very fact-specific and requires careful consideration of a non-EU company's business model vis-à-vis customers located in the EU, including whether that company's online presence is likely to be perceived as envisaging serving individuals located in the EU.

2. Consider Hiring a Data Protection Officer

The GDPR will require businesses whose core activities require large-scale "regular and systematic monitoring" of data subjects or large-scale processing of their sensitive data to appoint data protection officers ("DPOs"). Some EU data protection authorities, such as the CNIL in France, have gone even further and strongly recommend that all businesses that process EU personal data appoint DPOs to ensure GDPR compliance. Identifying a qualified person to serve as a DPO may be a challenging task, given the extensive expertise and capabilities expected of this role. A 2016 study estimated that the GDPR would create 28,000 vacant DPO positions, and businesses that must (or want to) appoint a DPO should begin the recruitment process without delay. Businesses that are not obliged to appoint a DPO, but wish to appoint a person responsible for data protection compliance, should consider creating a position with a title other than a "DPO" to avoid unnecessarily imposing mandatory obligations of the DPO on that individual.

3. Update Fair Processing and Privacy Notices

The GDPR aims to increase transparency about how personal data is handled, expanding the types of information that organizations have to provide to

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individuals to ensure fair and transparent processing of their data. Privacy notices or policies published on websites and elsewhere may need to be updated to include information about, among other things: (1) data retention periods; (2) safeguards relating to data transfers outside the EU; (3) contractual or statutory consequences of refusal to provide personal data; and (4) contact information of the company's DPO, where applicable. That information must be provided in "concise … and easily accessible form, using clear and plain language"; data protection jargon and overly technical language should be avoided. Although providing additional information may not be overly onerous in and of itself, identifying existing deficient notices that require updating may be a significant task for some businesses.

"Data protection impact assessments will become mandatory under the GDPR where large-scale processing of sensitive personal data or data subjects' profiling is involved."

4. Assess Consent

Consent is one of the bases for legitimately processing personal data under the Directive and will remain one under the GDPR. The GDPR, in contrast to some Member States' existing regulations, toughens the definition of a valid consent and casts doubt on whether much of pre-GDPR consent-based personal data processing will remain valid.[1] If a business relies on data subjects' consent for processing their data, it needs to make sure that those consents remain valid post-GDPR, including that they are (1) specific to the particular processing activity; (2) voluntary; and (3) active (requiring a positive step rather than inaction on the data subjects' part).

5. Consider Conducting a Data Protection Impact Assessment

Data protection impact assessments will become mandatory under the GDPR where large-scale processing of sensitive personal data or data subjects' profiling is involved. These are, in essence, data privacy risk assessments, aimed to determine whether a company is adequately addressing its data protection risks and to remediate as warranted. As with the appointment of DPOs, organizations should consider whether conducting an impact assessment is advisable as a tool for ensuring GDPR compliance even if it is not strictly required under the GDPR. Such assessments will help ensure GDPR compliance and protect sponsors' investments in their portfolio companies.

6. Implement an Incident Response Plan

The GDPR introduces, for the first time, a pan-EU data breach notification obligation, requiring organizations that suffer qualifying personal data breaches to notify relevant EU supervisory authorities and, in some cases, affected individuals. Notifications must be made without undue delay and in any event within 72 hours, a time frame that, practically speaking, means that companies subject to the GDPR need to have a cyber incident response plan ("IRP") in place before a breach occurs. Organizations subject to the GDPR should also set out in their IRPs the process for determining whether a notification of the breach has to be made and, if so, the procedure for making the notifications. Sponsors with portfolio companies subject to the GDPR may wish to liaise with those companies to ensure that they have appropriate policies and procedures in place. Fines for failing to notify the relevant supervisory authority and/or affected individuals can be up to the higher of 2% of annual worldwide turnover or €10 million, even if the affected business was not at fault for the underlying data breach.

7. Review and Update Data Processing Agreements

Businesses should review existing contracts with third parties that process personal data on their behalf to ensure that they are valid

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1. *See, e.g.*, D&P Client Update, *UK Information Commissioner's Office Issues GDPR Consent Guidance: What Business Should Know and Do*, March 7, 2017, *available at* http://www.debevoise.com/insights/publications/2017/03/uk-information-commissioners-office-issues?wb48617274=4A20E446.

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post-GDPR. Such contracts should include a range of requirements on data processors, including assistance with and reporting of data breaches, technical and organizational measures the data processor must undertake to safeguard the data, and audit rights.

8. Be Prepared to Comply with New and Enhanced Individual Rights

The GDPR enshrines a host of new individual rights—including the rights to data erasure ("right to be forgotten") and data portability and the right not to be subject to automated decision-making (for example, profiling)—and expands existing rights, for example the right to receive, on request, information about the processing of an individual's personal data. Many of the new and expanded individual rights aim to increase individuals' ability to control the way in which their personal data is handled. As such, businesses should be prepared for the possibility that they would be receiving a significantly higher number of requests and complaints from data subjects. It is most prudent to prepare for that ahead of time by setting out policies and procedures for responding to such requests and complaints (or reviewing policies and procedures already in place).

9. Identify Your Lead Supervisory Authority

Under the GDPR, one data protection supervisory authority will take the lead on investigating data protection issues that implicate several EU Member States for businesses established in the EU. Although more guidance on this subject is anticipated, it is likely that, for businesses operating in more than one EU Member State, the lead supervisory authority would be the one covering the jurisdiction of the company's headquarters and/or the centre of the corporate decision-making. EU data protection authorities have explicitly discouraged "forum-shopping" for lead supervisory authorities, but it remains worthwhile for businesses to consider who its lead supervisory authority would be and whether more than one supervisory authority could credibly claim that title. For businesses that are at higher risk of scrutiny (*e.g.*, those that process large quantities of personal data), it is then prudent to establish good working relationships with the lead supervisory authorities and ensure that they keep up to date with those authorities' guidance and expectations.

10. Train Staff

With all the new provisions that GDPR introduces, it is essential to ensure that company staff—and in particular the employees dealing with individuals' personal data—are appropriately trained. In most cases, that training must extend not just to the DPO or the employees specifically tasked with data protection compliance functions, but also IT, Legal, Human Resources, Marketing and other functions whose activities inadvertently can put companies at risk of violating the GDPR.

Conclusion

While the GDPR is still 12 months away from coming into force, organizations that are or may be subject to its jurisdictions should spend that time to prepare, including by implementing the steps outlined above. We expect regulators to be unsympathetic to those who are not compliant by May 25, 2018, given that the final text of the GDPR has been available since 2016 and has been widely discussed and analyzed since then. The time to consider GDPR's impact on your business and your portfolio companies, and take the appropriate steps, is now.

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Spotlight on Europe

The UK Private Fund Limited Partnership: A New Fund Vehicle

> "It is clear that the new regime will significantly enhance the flexibility and attractiveness of English and Scottish limited partnerships, the UK's principal fund vehicles."

European private funds often choose to domicile in the United Kingdom, and successive UK governments have expressed a strong desire to maintain that leading position. As anticipated in a previous edition of the Private Equity Report,[1] recent and long-awaited reforms to UK limited partnership law,[2] which will have the effect of creating a new vehicle for private fund managers, have been designed with that objective in mind—and it is clear that the new regime will significantly enhance the flexibility and attractiveness of English and Scottish limited partnerships, the UK's principal fund vehicles. The final form of the changes is, in fact, even better than those previously suggested in a 2015 consultation.

The Private Fund Limited Partnership ("PFLP")

English and Scottish limited partnerships (referred to herein as "UK limited partnerships") have been a popular choice for private fund managers since 1987, when the government and the tax authority jointly confirmed certain aspects of their tax, legal and regulatory treatment. But, since then, other European jurisdictions have sought to erode the UK's competitive advantage by reforming their own existing fund vehicle structures, or by introducing new ones.

That means there is now a range of partnership and partnership-like vehicles that can be used by European fund managers, and the choice of vehicle is usually an important question to be addressed up-front on any new fund raising. That question will inevitably be asked afresh in light of the UK's impending departure from the European Union and, for many managers who do not need an EU fund, an English or Scottish "Private Fund Limited Partnership" (as this new vehicle is called) will be the right choice.

For managers with existing UK limited partnerships, it will be possible to opt them into the new regime, and most fund managers will probably decide to take up that option. However, it is important to note that the new regime is entirely voluntary: managers can continue to create new limited partnerships, or operate existing ones, under the old rules if they wish.

Key Features of the New Regime

Paradoxically, the most important feature of the new regime is that it is not very different from the old one: the fundamental features of the existing limited partnership vehicle—which is familiar to investors and their advisers, and sits upon a body of well-understood law—are preserved. In particular, the

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1. *See* http://privateequityreport.debevoise.com/the-private-equity-report-fall-2015-vol-15-no-2/consultation-on-uk-limited-partnership-law-reform.
2. The final form of the Order which brings these changes into effect is available at: http://www.legislation.gov.uk/uksi/2017/514/contents/made.

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changes have no impact on the tax status of the UK limited partnership, nor do they interfere with the contractual freedom that has been a hugely important reason for the limited partnership's dominance.

Instead, the changes make some small but important changes to the detailed rules, all of which are designed to make the regime more flexible, and therefore more able to accommodate the negotiated outcomes desired by the parties, or easier to administer.

"PFLPs will also be easier to administer, with some requirements to register or advertise information abolished."

For example, the UK has adopted an approach familiar in other popular fund vehicle jurisdictions and provided a non-exhaustive "white list" of activities that investors can safely engage in without risking their limited liability status. Furthermore, the UK white list is extensive and, for example, allows the investor to take part in a decision about the acquisition or disposal of a particular investment, or the exercise of the partnership's rights in relation to an investment. Of course, whether a limited partner has the right to be involved in such decisions will be a matter determined by the limited partnership agreement—and it will often not be consistent with the overall relationship among the fund sponsor and its investors—but if that is the negotiated outcome (as it may be in a pledge fund or separately managed account), the legal barriers to using a UK limited partnership have gone.

Another very important change is the abolition of the requirement for a limited partner in a PFLP to make a capital contribution, and a provision enabling any previously contributed capital to be returned to investors before the end of the life of the partnership. That will simplify the accounting and closing process and eradicates the risk that a small administrative error might jeopardize an investor's limited liability status.

PFLPs will also be easier to administer, with some requirements to register or advertise information abolished (on the basis that they offered no useful protections for third parties). There are also changes to make it easier for limited partners to arrange the winding up of a partnership, and certain default duties of partners are dis-applied (but could be re-applied by contract if desired).

Legal Personality: No Change (Yet)

Scottish partnerships have separate legal personality, whereas those established elsewhere in the UK do not. The government has previously said that it will explore whether to allow limited partnerships to elect whether they would like to have legal personality wherever in the UK they are established, in order to give all partnerships that option. However, such a change would require primary legislation and is therefore not included in this round of reforms. The government is also looking at the rules relating to Scottish limited partnerships more generally because there have been concerns that these have been subject to abuse by criminals. Further change to the rules may therefore be expected in future.

Conclusion

Alongside the British Private Equity and Venture Capital Association, members of the Debevoise & Plimpton Investment Management Group have worked hard over many years to secure these changes and they represent an important step forward for European fund structures. We expect the new regime to be widely adopted.

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