The Bankruptcy Wildcard in Cartel Cases

by

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Abstract: Where fines are the only available sanction against cartels there is a trade-off between increased deterrence and the increased risk of insolvency. Higher fines are unacceptable to the European Commission because of the costs and uncertainties associated with bankruptcy. These concerns have led to the emergence of a 'financial constraints' discount which is applied with a lack of transparency and may be strongly influenced by the EC treaty objectives of protecting employment and social justice. Such bankruptcy discounts encourage infringing firms to paint as gloomy a picture of their financial situation as possible to reduce their cost of collusion. They also provoke cartel members into raising prices further, safe in the knowledge that they will never incur fines high enough to threaten their financial viability. The existence in the US of a parallel 'loose' bankruptcy discount allows international infringing firms to cite sanctions previously incurred in the US as grounds for 'financial constraints' in Europe. The effect is lower fines to the detriment of EC deterrence and international enforcement.

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Introduction

Cartel policy in the EC currently suffers from an enforcement problem: In order to achieve some level of effective deterrence, the sanctions incurred by infringing firms, given their probability of being detected, must outweigh the illegal profits enjoyed from the cartel. However the current regime falls well short of this and, neither the probability of detection, nor the sanctions imposed can be significantly increased to make up for the shortfall. Increasing investigations would be too costly, and an effective leniency policy requires sanctions to be substantial enough to induce an infringing firm into revealing a cartel to the Commission in return for immunity. The problem is that fines are the only Community wide sanction available in the EC, and higher fines would mean an increased risk of the infringing firm becoming insolvent. This trade-off is unacceptable to the European Commission because of the costs and uncertainties associated with bankruptcy. To ensure against them, the European Commission has developed a 'financial constraints' consideration in cartel cases that discounts fines already subject to the 10% annual turnover cap, legislated for the protection of undertakings. The purpose of this paper is to address a gap in existing research by assessing how such bankruptcy discounts are applied by the European Commission and what their policy implications are for the EC cartel enforcement regime in its pursuit of effective deterrence.

Ostensibly the 'financial constraints' consideration reflects a concern that high fines might force an offending firm into insolvency. However, the Commission's wide discretion and apparent lack of transparency in exercising these discounts are such that factors external to competition policy, in particular the social objectives of the EC treaty, may determine how they are granted. The US Department of Justice appears to invoke the 'ability to pay' exception of the US Sentencing Guidelines in cartel cases with a similar lack of transparency, even where the 'continued viability of an organisation' is not 'substantially jeopardized' as required by the guidelines. There is evidence to suggest that international infringing firms can take advantage of these 'loose' bankruptcy considerations to play competition authorities against each other in order to lower the sanctions they incur. In particular, as US investigations of international cartels normally precede those of the EC, by the time an international firm faces punishment from the

European Commission, it is in a better position to argue a danger of bankruptcy by making reference to fines and settlements for private damages already incurred in the US.

These findings have three serious implications for deterrence of cartels in Europe: Firstly, the lack of transparency and clear criteria for qualification of bankruptcy discounts makes them open to abuse by firms who exaggerate their financial difficulties. Secondly, bankruptcy discounts essentially guarantee the continued existence of an infringing firm regardless of the severity of its offence. This provokes a cartel into increasing its overcharge and committing to spend its illegal cartel profits without putting any aside for the payment of fines – safe in the knowledge that a competition authority will never fine them out of business. Thirdly, as fines are the only sanction available to the European Commission, bankruptcy discounts have the effect of reducing the cost of collusion, widening the shortfall in deterrence and worsening the EC enforcement problem. This is not the case in the US where other sanctions, such as treble damages in private action cases and imprisonment, exist which can be strengthened instead of fines.

The paper is split into six sections. Section 1 looks at the European enforcement problem outlined above in more detail, explaining why it is difficult to raise the probability of detection, the effect of a leniency programme and the need to raise fines. Section 2 looks at what bankruptcy actually involves for a firm. Section 3 outlines why the European Commission does not want infringing firms to become bankrupt. Section 4 gives a recent example of the EC 'financial constraints' discount being exercised. Section 5 discusses the discretion behind the 'financial constraints' consideration; identifying how it is applied with a lack of transparency and consistency, as well as considering the importance of the social objectives of the EC treaty and how these may influence the Commission's exercise of cartel policy. Section 6 identifies how the Antitrust Division of the US Department of Justice exercises its own bankruptcy discount with a similar lack of transparency, this time under the veil of the plea-bargaining system, and the implications this has for deterrence and for the abuse of bankruptcy discounts in Europe. Throughout this paper I refer to the treatment of the German company, **SGL Carbon A.G.** and its US subsidiary, by both the EC and US, as a means of illustrating how bankruptcy discounts worsen the European cartel enforcement problem.

1. The Enforcement Problem: Deterrence

Deterrence is a central aim of cartel policy. It is important that as well as punishing firms guilty of collusion in the present, the formation of new cartels in the future is prevented and the harm they would cause avoided. This is because the cost of collusion that has already occurred can never be fully recovered and so it is preferable for that cost to be averted in the first place. On the assumption that the industry concerned is well informed about cartel policy and of convictions[1], the deterrence of a crime depends on the level of sanctions faced by a guilty party and the probability of detection (Wils 2005 Ch.8; Landes 1983; Polinsky & Shavell 1998; Becker 1968). Optimal deterrence is achieved where the cost of collusion (the magnitude of the sanction and the likelihood of being caught) outweighs the benefits of collusion (the illegal cartel profits).[2] Assuming that current cartel policy falls short of optimal deterrence (e.g. Hüschelrath 2002), it is strengthened when either sanctions or the probability of detection are increased. The problem facing cartel enforcement in the EC is that both of these are effectively capped and cannot be increased.

The probability of detection can be raised by either increasing the antitrust authority's resources, allowing it to carry out more investigations, or by introducing an effective leniency policy. Increasing the money spent on cartel investigations is difficult as a competition authority has to allocate limited resources between different areas of its competition enforcement. Investigations also tend to be costly and time consuming (ICN 2005 p4). The cost of the extra investigations necessary in order to achieve a substantial increase in detection rates might very well outweigh the harm caused by the cartels that would otherwise go uncaught. The cost of antitrust enforcement is often overlooked, and it is important to bear in mind that increasing deterrence will only be worthwhile if the marginal cartel harm averted is greater than the marginal cost of increasing deterrence

[1] In a situation where there is little information available about cartel policy, deterrence can only be achieved through high probability of detection. This is because it is only when companies get caught that they and others operating in their industry become informed about policy (Ben-Shahar 1997), or start believing that policy is being implemented.

[2] *Theory of the firm* assumes that a firm's primary aim is to maximise profit. The volume of corporate law and antitrust prosecutions in the US and EU over the last ten years confirms that corporations will not necessarily avoid an activity that is profitable simply because it is illegal. Instead, they will internalise the sanction imposed as a result of that illegality as a cost. (Posner 1998 p421; Hammond 2000) Hence this cost must be high enough to make the illegality unprofitable if a firm is to desist from engaging in it.

(Block & Sidak 1980). Introducing an effective leniency policy is a way of increasing the probability of detection without requiring an increase in spending. Indeed, inviting firms to step forward with evidence of an infringement in return for immunity or a fine discount should *save* investigation time and resources. An effective leniency programme will: provide immunity to the first member of a cartel to step forward and reveal the infringement; allow the availability of leniency even after an investigation into an industry has been opened; provide clear criteria for leniency applicants; and be applied consistently by the competition authority (Hammond 2004; Motta & Polo 2003; Spagnolo 2003). However a leniency programme will only be effective in raising the rate of detection if the full sanctions incurred by the cartel members beaten in the 'race to the Commission' for leniency are sufficiently high. This is because the incentive to come forward must be substantial enough to induce a cartel member into breaking the trust of the collusive agreement and exposing the infringement (Spagnolo 2003; Hinloopen 2003). Where the full sanction is low, a firm will prefer to continue colluding and either risk being caught or only take advantage of the leniency programme once an investigation into its industry has been opened, or where the cartel has failed.[3] It is for this reason that a leniency programme in a cartel regime that imposes low sanctions is likely to increase the probability of prosecution substantially (firms apply for leniency once investigation into their industry has opened) but will not have much of an affect on the probability of detection (Hüschelrath 2002). Hence without the ability to increase sanctions, the probability of detection is effectively capped, even with the existence of a leniency programme.[4]

Sanctions available in cartel policy include corporate fines, criminal fines and imprisonment of individuals, and private enforcement. These can be increased either by raising a sanction (such as imposing higher fines), or by introducing more sanctions (such as the adoption of a criminal offence against individuals). In order to achieve optimal deterrence, sanctions must be increased to compensate for the fact that not every cartel is caught and to ensure that the cost of the collusion outweighs the benefits. In the

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[3] This is backed by a recent empirical study of the 1996 Leniency Notice (Stephan 2005) which reveals how most cartels revealed through leniency in the EC have either failed before they were revealed, or are international cartels that were uncovered and prosecuted in the US first.

[4] Spagnolo (2003) suggests that an alternative may be to provide monetary rewards to revealing firms as well as providing immunity from sanctions. These would be financed using the fines collected from the remaining cartel members. However, such a policy is unlikely to be politically feasible, and will leave the firm receiving the reward with a substantial and unfair competitive advantage.

US cartel policy, a number of strong sanctions exist: as well as substantial fines there is the imprisonment of individuals and the availability of damages to buyers of up to treble the overcharge of the cartel. Connor (2005) found that despite the *potential* in the US for firms to pay between six and ten times the 'illegal cartel profits' in fines and damages, there is still under-deterrence in US cartel policy. This is partly because plea-bargains, amnesty (leniency) applications and out of court settlements reduce sanctions substantially, but is also because Connor's assessment does not include the effect of imprisonment because it is difficult to place a monetary value on its impact as a sanction. A criminal cartel offence involving jail time is important because it forces individuals within a company to put their own interests before those of their employer. It is also different from monetary sanctions because, whereas firms can indemnify personal fines, imprisonment is not so easy to compensate for. It is possible that the deterrent effect of sending company directors and senior management to jail fills the shortfall in deterrence that Connor identifies in his paper. The fact that company executives who are non-US nationals have voluntarily flown to the US to serve jail sentences as part of plea-bargain agreements would certainly support this (Hammond 2001).

In the EC fines are the only available sanction. There is very limited private enforcement[5] and no criminal cartel offence exists on the Community level. Some member states such as Ireland and the UK have adopted criminal offences on the national level and others may be in the process of doing so. However these are subject to different legal tests and procedures, and the majority of EU member states have no such sanction at all (OECD 2005). Recent evidence even suggests that most member states, particularly the new members in the east, are moving away from criminal sanctions and instead focusing on leniency programmes and administrative fines (Reynolds & Anderson 2006). Increasing fines is thus central to achieving some level of effective deterrence in EC cartel policy. In order for optimal deterrence to be achieved in the EC enforcement regime, fines would need to equal the net harm caused by a cartel, increased[6] according to how much less

[5] Although the Commission intends to make efforts to improve this – see for example Monti (2004) and DG Comp's Green Paper 'Actions for damages' (Dec 2005) available at: http://europa.eu.int/comm/competition/antitrust/others/actions_for_damages/index_en.html (visited 10 January 2006)

[6] Fines have the advantage of being relatively costless to increase, with the exception of the increased cost of type 1 errors (the wrongful punishment of innocent parties – Strandburg 2003). This might include abuse of a leniency programme by firms wishing to harm their competitors. Where other sanctions exist, it has been argued that the use of fines should be exhausted before more costly sanctions like imprisonment are

than one the probability of detection is (Landes 1983), or put another way, by how much the shortfall in detection rates is. However the affect that these increased fines might have on firms and the industries in which they operate is a concern for the European Commission.

Bryant & Eckard (1991) provide the only empirical study of the probability of a cartel being detected and estimate it to be as low as 0.13 a year (meaning that only 13% of cartels are detected). This study is widely referenced, appearing in a number of policy documents including the White Paper that preceded the introduction of a criminal offence against individuals in the UK. Based on Bryant & Eckard's findings, Wils (2002 p39) points out that where a cartel has achieved a 10% mark-up, has lasted for five years, and there is a 0.16 probability of detection, deterrence could not be achieved with fines below 150% of an undertaking's annual turnover. Bryant & Eckard's paper is quite old and should not be relied upon too much by virtue of the fact that it is the only empirical paper of its kind. It is also important to allow for the positive effect of a leniency programme as the sanction increases. However, even if we assume that the unlawful profits from the entire duration of the cartel only amount to 20% of an undertaking's annual turnover and that the probability of detection is 0.30, deterrence would require a fine of over 60% of annual turnover. The current cap on fines in the EC is 10% of annual turnover.[7] Fines of the level outlined by Wils will be necessary to compensate for the fact that the

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implemented (Polinsky & Shavell 1998). For example, the criminal prosecution of company directors will involve the costs of incarceration and the legal costs of securing convictions in court.

[7] Buccirossi & Spagnolo (2005) suggest that fines of this magnitude based on deterrence models that started with Becker (1968) overlook the 'incentive compatibility constraint' in modern theory of oligopoly and collusion which states that "to achieve cartel enforcement the expected loss from being punished by partner cartel members in the future if detected cheating [by them], must be higher than the gain from cheating/undercutting the cartel today" (p26). In order for illegal multi-agent agreements like cartels to be sustainable, this and the simple Becker type profitability must be satisfied simultaneously for every member of the cartel. Currently, the incentive compatibility constraint is not utilised by cartel policy because firms that undercut their cartel (forcing it to break up) broadly face the same sanctions as those which do not. Buccirossi & Spagnolo model a policy where, in addition to an effective leniency policy and monetary rewards for firms revealing cartels through the leniency programme, fines imposed on firms that have cheated the cartel are reduced in relation to those imposed on firms that have not cheated, thus disrupting the incentive compatibility constraint and making cartels unsustainable. They estimate that such a policy would require optimal deterrent fines that are less than 10% of the traditional Becker inspired levels outlined in this paper, and there would be no need for criminal sanctions. However, as already mentioned monetary rewards are unlikely to be politically feasible, and there are problems with providing fine discounts to cheating firms as the time between a firm cheating and a cartel ending may be short, making it difficult to determine which firms cheated and which did not – clearly if there is an additional fine discount to be had, all firms will try to argue they left the cartel early. This problem is compounded by the fact that firms remaining in the cartel will start destroying evidence as soon as a firm is detected cheating, in the knowledge that the cheating firm will be eligible for a fine discount, should they be caught. Moreover, despite their findings Buccirossi & Spagnolo concede that fines in the EU and US need to be "substantially increased" because they currently fall short of the optimum given current cartel policy.

probability of detection, even if boosted by a leniency programme, will be significantly less than 100%. The sanction imposed (in the EC's case, the fine) must thus go over and beyond the harm caused in order to make up for this shortfall in detection. This was recognised in Chapter 7 of the White Paper that preceded the Enterprise Act 2002 in the UK and which makes reference to Bryant & Eckard. Like the US, the UK opted for a criminal offence (now in force) to make up for the gap in deterrence.

In the absence of other sanctions such as the imprisonment of individuals, empirical evidence suggests that if fines were increased to optimal levels (such as those outlined above), they would cause long term damage to an infringing firm's financial viability or undermine it altogether resulting in bankruptcy and a more concentrated market (Craycraft *et al* 1997, Polinsky & Shavell 2000). Moreover, if fines become too high, they can have an adverse affect on deterrence as, having entered a cartel, firms might be induced to incur excessive costs in an attempt avoid the high fines (Kobayashi 2001). High fines might also be in conflict with EC principles of proportionality.

The central enforcement problem facing EC competition policy is that both the probability of detection and the sanction (fines) are effectively capped, preventing the strengthening of deterrence to bring it closer to the optimum. The detection rate is capped by limited resources and the fact that effective leniency programs require high sanctions. Fines are the only available sanction to the Commission and these are limited by a 10% annual turnover ceiling and by a 'financial constraints' discount (identified later in this paper) because imposing higher fines on infringing firms increases the likelihood of insolvency. Bankruptcy does not necessarily spell the end of a firm and its consequences will vary depending on the circumstances of a particular undertaking and of the industry in which it operates. However, there a number of costs associated with bankruptcy which make it an undesirable outcome for competition authorities.

2. What does bankruptcy involve?

The US and the member states of the European Union typically have two distinct levels of bankruptcy in recognition of the fact that a 'one-size-fits-all' bankruptcy procedure cannot be optimal because the circumstances of each bankrupt firm will vary widely (Povel 1999). The first and more severe procedure involves the dissolution of the firm, with its assets liquidated under the supervision of a trustee – in the US this is known as 'Chapter 7' of the Federal Bankruptcy Code. The second and less severe procedure involves the firm being reorganised and is based on an expectation that it has a viable future – in the US this is known as 'Chapter 11' bankruptcy.

When firms liquidate under Chapter 7 bankruptcy, the proceeds from the liquidated assets of the bankrupt firm are distributed between creditors first and foremost. According to the *absolute priority rule* creditors must be paid before the firm's owners, the shareholders, receive any of these proceeds. Many creditors are likely to be left out of pocket and there are rarely any proceeds left for the shareholders (White 2005 p2). However under the doctrine of limited liability the most that shareholders can lose is the value of the shares that they hold in the bankrupt firm, not their personal assets or shares in other firms. Where Chapter 11 bankruptcy is filed, the creditors are paid with the firm's future profits and shareholders retain some of their equity in the company – this is normally negotiated with the creditors as part of the firm's reorganisation (White 2005 p2). The 'US Trustee' of the Justice Department will appoint committees representing the interests of the creditors and shareholders. Working with the company itself, a reorganisation plan is arrived at that must be approved by the creditors, the shareholders and by the court. However, the court has the power to overrule either party and impose a reorganisation plan it feels is equitable.

With regard to the repercussions of Chapter 11 bankruptcy for senior management, a serious divergence exists between the US and key members of the EU such as the UK and Germany. Whereas the US bankruptcy code here tends to favour the debtor, bankruptcy codes in the UK and Germany tend to favour the creditor. The US code is pro-debtor in that the pre-bankruptcy senior management usually retain substantial control over the company after Chapter 11 bankruptcy, as 'debtors-in-possession'.

Hypothetically, this might include individuals directly involved in the cartel offence that resulted in the firm being fined into bankruptcy in the first place. The management supervises the firm's reorganisation, subject to some oversight by the courts. Moreover, these managers are normally given substantial bargaining power in the bankruptcy procedure and are, for example, allowed to retain profitable pre-bankruptcy contracts, and (unlike firms not in bankruptcy) reject unprofitable contracts (White 2005 p8). They can also force the renegotiation of lease contracts, do not pay interest on the firm's debts and even have access to new financing from lenders who get priority over the existing creditors (Bower 2003). The rationale behind granting management so much power in US Chapter 11 bankruptcy is that nobody has a stronger incentive to make sure that a firm has a future, than the directors who are unlikely to find employment in another firm, should their current firm fail (Cheffins 1997 p523). By contrast, in the UK and Germany this 'soft' bankruptcy (known as 'Administration' and 'Vergleichsordnung') is pro-creditor and does not allow the management to retain so much power. The pre-bankruptcy management is usually removed and a new management is employed which retains very little control of the company's day to day running. The running of the company is supervised by an administrator appointed by the court who must approve any reorganisation plans. These 'soft' bankruptcy proceedings are rarely pursued in these jurisdictions because they are complicated and expensive – this discourages creditors from favouring them – and so they usually push for liquidation instead, particularly where a firm is not very large (Gladstone & Lee 1995). These differences between Chapter 11 type bankruptcy procedures create difficulties when multinational firms file for bankruptcy, as their interests and creditors exist in many different jurisdictions (see Bliss 2003).

The aim of Chapter 11 bankruptcy is to keep firms that are fundamentally sound in business, so as to avoid the costs associated with total liquidation. However, there have been cases of firms attempting to abuse the generous provisions of US Chapter 11 bankruptcy. Following the imposition of a $135 million fine by the US Department of Justice in spring 1998 for price-fixing in the graphite electrodes industry, the German company, SGL Carbon AG, faced substantial private actions for treble damages. In December 1998, SGL Carbon ordered its US subsidiary to file a voluntary Chapter 11 bankruptcy petition in the United States District Court for Delaware. SGL made no secret

of the fact that it was using Chapter 11 bankruptcy to shield itself from civil antitrust actions, citing it as the only factor leading to its filing and, singling out antitrust plaintiffs as the only creditors who would not receive full payment. Shortly afterwards, SGL Carbon Corp's president, Wayne T. Burgess said in a press release, "SGL CARBON Corporation is financially healthy… If we did not face [antitrust] claims for such excessive amounts, we would not have had to file for Chapter 11. We expect to continue our normal business operations." It was also noted by the court that:

> [c]ontemporaneous with the press release, SGL AG Chairman Robert Koehler conducted a telephone conference call with securities analysts, stating that SGL Carbon was "financially healthier" than before and denying the antitrust litigation was "starting to have a material impact on [SGL Carbon's] ongoing operations in the sense that . . . [it was] starting to lose market share." He also stated that SGL Carbon's Chapter 11 petition was "fairly innovative [and] creative" because "usually Chapter 11 is used as protection against serious insolvency or credit problems, which is not the case [with SGL Carbon's petition]."'[8]

Strongly influenced by these public statements, the 3rd Circuit Court of Appeal dismissed SGL Carbon's petition for Chapter 11 bankruptcy, stating that it was unnecessary, given the healthy state of the firm and lack of 'good faith' in clearly using the filing to protect itself from civil antitrust action. At this stage at least, SGL Carbon was not facing fines and civil action of such magnitude as to threaten the entire company's solvency. What remains to be seen is whether this SGL bankruptcy case is a one-off attempt that has been overtly rejected by US courts, or whether less blatant attempts to use Chapter 11 bankruptcy as a shield from private actions for damages will be entertained in the future. If the latter proves to be the case, then firms can potentially use Chapter 11 bankruptcy to deflect private damage actions, while largely continuing business as usual.

Thus bankruptcy does not necessarily result in the closure of a firm. Usually, a 'soft' form of bankruptcy involving the reorganisation of the firm and its debts is also available. However, the provisions of this soft bankruptcy are far more generous in the US where Chapter 11 of the Federal Bankruptcy Code usually allows the existing management to retain considerable power over the operating of the company and in the

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[8] RE: SGL CARBON CORPORATION, Debtor. U.S. 3rd Circuit Court of Appeals. 12.29.1999 Nos. 99-5319 & 99-5382.

renegotiation of the company's debts. The example of SGL raises the question of whether Chapter 11 bankruptcy in the US can ever be successfully used as a shield against cartel sanctions – for example by filing for reorganisation on the basis of a number of debts, hidden amongst which are corporate fines and damage claims. If this is possible then the competition authority and injured parties simply become another creditor renegotiating a debt.

3. European Commission: the worry of making firms go bust

The imposition of fines that risk driving companies out of business is not acceptable to competition authorities for four main reasons. First, anything that increases the risk of bankruptcy imposes a social cost (see for example, Branch 2002). According to Posner (1998 p405), this consists mainly of the transfer of wealth away from shareholders, managers, employees and some creditors; the resulting necessary use of lawyers and bankers; reductions in efficiency of asset use; cost to those creditors who will not be paid, and the cost to other firms who relied on the bankrupt firm as a customer. The fees of professionals 'needed' for bankruptcy proceedings alone can run into hundreds of millions of dollars (Bower 2003).

Secondly, if a company is forced out of business, the industry in which it operates becomes more concentrated and so the risk of collusion in the future may actually increase as a result. There may also be the coordinated effect of fewer companies causing prices in the industry to rise (that is, by virtue of the fact that the market is more concentrated, firms can enjoy benefits from their collective market power through parallel behaviour that does not necessitate an explicit cartel agreement).

Thirdly, the imposition of fines causing bankruptcy would be politically unpopular. Management, shareholders and individuals made unemployed as a result of a firm being fined out of business could all be expected to lobby government to legislate against such high fines. There is a particular injustice in employees suffering as a result of decisions made by senior management when they are unlikely to have directly benefited from collusion, unlike their employers and shareholders (Cheffins 1997 ch14). As discussed in Section 5, promoting employment and social protection are two tasks that are central to

the EC treaty and which play a role in shaping how all areas of policy including competition are applied. Unlike most national competition authorities, the European Commission is not entirely independent of the legislature.

Lastly, if a firm is allowed to go bankrupt, then parties injured by the collusion will not be able to recover damages. In the US the sentencing guidelines (s.8.C.3.3) specifically allow for a discount in fines where there is a danger that the full fine will jeopardise a firm's ability to pay restitution to injured parties. After bankruptcy the firm is liable first and foremost to its corporate creditors, and – as outlined above by reference to the SGL case – firms may try to use Chapter 11 bankruptcy in the US as a shield against civil antitrust action.

The European Commission's fear that fines might jeopardise a firm's financial viability is reflected in the 1998 'Guidelines on the method of setting fines imposed'[9] (henceforth '1998 guidelines') which state that fines should be adjusted according to a firm's "real ability to pay" (para. 6b). It is also reflected in the longstanding 10% annual turnover cap on fines originally contained in Article 15(2) of Regulation 17/62:

"[Fines must not exceed] …10% of the turnover in the preceding business year of each of the undertakings participating in the infringement"

In 1983 the Commission confirmed that "the figure of 10 per cent [contained in Article 15(2)] represents a maximum fixed for the protection of the undertaking" (Pioneer ECJ appeal at 265).[10] This cap on fines has persisted over the years, contained in both the 1998 guidelines and in Article 23(2) of the Modernisation Regulation[11] which replaced Regulation 17/62. In the United States a cap on fines also exists, of up to 80% of affected commerce, however this is less of an issue as other sanctions exist which can be increased instead of fines, if necessary. The problem with any cap on fines (where fines are the only sanction) is that it can actually provoke cartels into raising prices further and even prolong their duration. This is because, if a firm knows that the magnitude of its

[9] Guidelines on the method of setting fines imposed pursuant to Article 15 (2) of Regulation No 17 and Article 65 (5) of the ECSC Treaty (98/C 9/03)
[10] *Musique Diffusion Francaise SA, C. Melchers & Co., Pioneer Electronic (Europe) NV and Pioneer High Fidelity (GB) Limited v. E.C. Commission* (Cases 100-103/80) [1983] 3 C.M.L.R. 221 – For a general discussion of Article 15(2) of Regulation 17/62, see Furse 1995.
[11] Regulation 1/2003, OJ [2002] L1/1

infringement has (in Europe) reached the equivalent of 10% of its annual turnover, anything beyond that will not increase its liability in fines (Connor 2005 p15). The bankruptcy considerations identified in this paper may serve to strengthen this effect.

Empirical studies (Craycraft *et al* 1997, Thompson & Kaserman 2001) show that optimal fines, those that fully punish and deter given probabilities of detection and absence of other sanctions, would in most cases be well in excess of the 10% annual turnover cap. Indeed, the Commission's fears would be realised as such fines would cause some firms to go out of business. Unlike torts, a firm cannot insure against antitrust fines imposed by a competition authority and is forced to internalise the fine as a cost. This cost may have to be substantial enough to drive some firms out of business to convince other firms that the cost of collusion is too high (because the probability of detection is low, as discussed in the first section of this paper). The costs of bankruptcy have already been outlined.

However, fines that cause a firm to go out of business may also be beneficial to competition policy. Evidence contained in the text of European Commission decisions reveal that some uncovered cartels operated in industries that suffered from overcapacity and inefficiencies.[12] A cartel may simply serve to prolong the life of a firm that should have been driven out of the industry by competition from more efficient companies. It may also be the case that collusion leads to higher prices which attracts over-entry into the market, in which case exit from the market will be a natural consequence of breaking the cartel down. Bankruptcy is important to the economics of competition policy in this respect. As less efficient firms are driven out of the industry, average efficiency is increased resulting in lower production costs and lower prices for consumers (White 2005 p1). Furthermore, if a firm has a viable future but simply cannot pay its debts after the imposition of a high fine, it can always file for the lesser Chapter 11 type bankruptcy under which the firm is simply reorganised with its debt repayments renegotiated, rather than actually being liquidated (Posner 1998 p403). As discussed in section 2, most jurisdictions including Germany and the UK have two levels of bankruptcy, with the 'softer' procedure allowing the company to continue operating. Such softer procedures exist in most European Jurisdictions as well as in the US Despite these advantages, the

[12] e.g Case COMP/C37.370 – *Sorbates* [2005/493/EC] – two firms pulled out of the industry in the years following the collapse of the cartel. See Stephan 2005

potential costs of bankruptcy and the unpredictability of its outcome makes it an unacceptable trade-off to increase in order to close the gap in deterrence.

4. ‘Financial Constraints’ consideration: a recent example

The Commission’s worry of firms going out of business is real enough to warrant discounts on the grounds of financial constraints even where the full fine is within the 10% cap. The Commission’s recent treatment of SGL Carbon AG, provides a good example of the application of a ‘financial constraints’ consideration. SGL was fined for its involvement in three different cartels: *Graphite Electrodes* (2001)[13], *Specialty Graphites*[14] (2002), and *Carbon & Graphite*[15] (2003).

In the *Graphite Electrodes* decision, the Commission rejected arguments from SGL and other companies concerning their ability to pay the fine, stating that “to take account of the mere fact of an undertaking’s loss-making financial situation… would be tantamount to conferring an unjustified competitive advantage on undertakings least well adapted to the conditions of the market”. In refusing to give a discount and in setting a fine of €80.2 million[16] the Commission demonstrated a desire for effective punishment and deterrence.

In both the 2002 *Specialty Graphites* cartel and 2003 *Carbon & Graphite* cartel decisions, however, the Commission granted a 33% discount. In the latter case, it stated that it “granted a 33% reduction of its fine for the reason that SGL is both undergoing serious financial constraints and has relatively recently been imposed two significant fines by the Commission for participation in simultaneous cartel activities”. The final fines were €27.7[17] million and €23.6 million respectively.

This “financial constraints” discount was granted twice despite the fact that SGL was a founding member of all three cartels, was the only company in the graphite industry to be involved in all three cartels, had been given a 50% fine *increase* in *Specialty Graphites* for being the ringleader and had been a member of the *Carbon & Graphite* cartel for its

[13] Commission Decision of 18 July 2001 – Case C.36.490 OJ [2002] L 100/1
[14] Commission Decision of 17 December 2002 – IP/02/1906
[15] Commission Decision of 3 December 2003 – Case C.38.359 OJ [2004] L 125/45
[16] Reduced to €69.1 million on appeal
[17] Reduced to €18.45 million on appeal

full duration of 11 years and 2 months. Furthermore, the decision to grant the 33% discount cannot be said to be influenced by any great co-operation by SGL with the Commission's investigation; SGL did not reveal any of the three cartels, was not the first firm to cooperate, and in *Carbon & Graphites* was one of the last.

The three cartels were broadly contemporaneous and so none were formed after the first Commission fines were imposed. However in *Graphite Electrodes*, SGL and others continued colluding until 1998 despite the fact that they were already under investigation in the US and Canada. Furthermore, all three cartels constituted very serious infringements of Article 81, involving industries worth over €1 billion per year in total by the late 1990s. In the most serious of the three, *Graphite Electrodes*, SGL and UCAR formed the cartel in the early 1990s at a time when they controlled more than two thirds of the industry. All three cartels were sophisticated and managed by the top level of the companies. Yet, despite all this, the Commission felt it necessary to discount the fines by a third in two out of three cases involving SGL because of its financial constraints.[18]

5. The Discretion behind 'Financial Constraints'

The Commission's ability to grant a discount for 'financial constraints' with very little explanation as to how a figure like 33% is arrived at is possible because of the very wide discretion that it enjoys when making a decision. This wide discretion leads to a lack of consistency and transparency in the way such considerations are applied. The availability of a bankruptcy discount undermines the effectiveness of a cartel policy as actual levels of fines are reduced, making it more likely that collusion is profitable. Companies will be tempted to abuse this discount so as to reduce the cost of sanctions; in particular, where a firm knows that the sanction will never be high enough to threaten its financial viability, there is an incentive for it to make the infringement larger (raise prices further) as the cost of collusion (the sanctions) is effectively capped in such a way as to guarantee the undertaking's continued existence.

[18] See also Hviid & Stephan 2005

This serves to strengthen Conner's (2005) observation that any ceiling on fines will provoke a worse infringement because the liability is effectively limited to the cap and so it is in the interest of a cartel to increase the size of its infringement, as this will make the capped fine (the cost of collusion) lower relative to the cartel profits, making the infringement itself more profitable. Moreover, the individuals organising the cartel, the company directors and senior management, stand to gain from making as much money out of the cartel as possible mainly due to the so called 'control mechanisms' which are in place to ensure their interests coincide with those of the shareholders, such as linking their salaries to the performance of the company (Cheffins 1997 p552).

Paragraph 1(b) of the 1998 guidelines states that fines should reflect the gravity and duration of the cartel and should be set to "a level which ensures that it has a sufficiently deterrent effect". What constitutes a "deterrent effect" is not based on a mathematical formula or an economic model; instead, it rests entirely on the Commission's judgment. This is illustrated by Garcia Bermudez (of DG COMP) when he noted that the Commission granted a discount because of 'financial constraints' to SGL in the *Specialty Graphites* cartel because "…imposing the full amount of the fine did not *appear* necessary in order to ensure effective deterrence..." (emphasis added). The problem is that what *appears* necessary to the Commission may be influenced by factors that have nothing to do with competition policy. The Commission, as a competition authority, is not independent of the legislature and so political considerations may inform the way in which the Commission arrives at its decisions, as reflected in language like "specific social context" included in the 1998 Guidelines and discussed below.

Although the Commission can increase the basic fine amount where there are 'aggravating circumstances' such as the "repeated infringement of the same type by the same undertaking(s)", it also has very wide discretion to reduce fines. For example, the guidelines provide for fines to be reduced where there are 'attenuating circumstances'. However the list of such circumstances contained in the guidelines is not exhaustive and ends with "other factors". Financial difficulties of a company is not listed in the guidelines as an attenuating circumstance. However, paragraph 5(b) states that "depending on the circumstances, account should be taken of… the specific characteristics of the undertakings in question and their ability to pay in a *specific social context*, and the fines should be adjusted accordingly" (emphasis added).

To understand the importance of the 'social context' one must go back to the Treaty establishing the European Community (Treaty of Rome). Article 3 sets out the activities of the EC which includes "a system ensuring that competition in the Common Market is not distorted". However Article 2 states that, in implementing the policies outlined in Art 3, the Community shall have as its task (among others) "to promote throughout the Community… a high level of employment and of social protection". The Commission is a central EU institution, and though decisions made by DG Comp may have the protection of competition as their main aim, in exercising policy it must also negotiate, and take account of the other objectives of the European Union. For example, the Merger Control Regulation[19] states that the Commission must apply policy "within the general framework of the achievement of the fundamental objectives referred to in Article 2" and it was recognised by the Court of First Instance in Nestlé/Perrier[20] (27 April 1995 Case T-96/92) that this could include the Commission taking into consideration "the social effects [of merger decisions] if they are liable to affect adversely the social objectives referred to in Article 2 of the Treaty. The Commission may therefore have to ascertain whether the concentration is liable to have consequences, even if only indirectly, for the position of the employees in the undertakings in question, such as to affect the level or conditions of employment in the Community or a substantial part of it" (par. 28 – see also McGowan & Cini 1999).

The importance of social objectives in EC cartel policy was confirmed by the Court of First Instance last year in the *Graphite Electrodes* appeal.[21] After stating that the Commission is not *required* to take into account the financial situation of an infringing firm (par. 370), the CFI went on to say that the 'ability to pay' attenuating circumstance contained in paragraph 5(b) of the 1998 guidelines "applies only in a specific social context consisting of the consequences which payment of the fine would have, in particular, by leading to an increase in unemployment or deterioration in the economic sectors upstream and downstream of the undertaking concerned" (recital 371).

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[19] Regulation 4064/89, now superseded by Regulation 139/2004

[20] Judgment of the Court of First Instance (Second Chamber, extended composition) of 27 April 1995 . *Comitı Central d'Entreprise de la Socitıtı Gınırale des Grandes Sources and others v Commission of the European Communities.* Case T-96/92.

[21] Judgement of the Court of First Instance of 29 April 2004. *Tokai Carbon and Others v Commission of European Communities.* Joined Cases T-236/01, T-239/01, T-244/01, T-251/01 and T-252/01

In setting fines, as well as having this mandate to consider the ‘social context’, the Commission also has strong incentives to listen to the arguments of lobbyists and member state governments. J. From (2002) explains that this is due to the Commission’s long standing crisis of legitimacy. Unlike the Department of Justice which is a strong institution within a nation, the Commission’s legitimacy is derived from treaties and agreements that exist between governments. He suggests that the Commission tries to enhance its legitimacy by carefully allocating resources to cases that will have the most impact and also by “allowing all relevant actors access to the decision making process” by taking their concerns into account (p223). These actors might include interest groups, governments, and even European Commissioners looking to further the interests of their native member states (McGowan & Cini 1999, p188). The involvement of these actors inevitably forces the Commission to play closer attention to the social objectives of the EC, when exercising competition policy.

The wide discretion driven by “other factors” and the “social context” has two effects. First, it facilitates a lack of transparency in that the Commission makes fine discounts on vague and unclear grounds such as “financial constraints”, without giving a satisfactory explanation of the grounds for those discounts. Thus, in both its *Specialty Graphites* and *Carbon & Graphites* decisions the Commission failed to explain why ‘financial constraints’ discounts were given even after SGL’s arguments that it was *unable to pay* under paragraph 5(b) of the guidelines were rejected. Secondly, the wide discretion leads to a lack of consistency between decisions, as can be seen in the following examples which all concern attempts by firms to gain fine discounts on the grounds of financial constraints:

Table 1 – Apparent Inconsistencies in Commission Decisions

ALLOY SURCHARGE (1998)	The Commission accepted the deep crisis in which the industry found itself as being a mitigating circumstance, granting a 30% discount of the basic amount to one firm and a 10% discount to the others.
FETTCSA (2000)	The Commission rejected arguments of financial constraints, stating, "The individual financial situation of a participant in an infringement cannot entail a diminution in the amount of its fine"[22]. "…DSR-Senator argues that its actual financial situation limits its ability to pay. In particular DSR-Senator argues that the imposition of a fine of 13.75 million in the TACA decision has caused serious damage to an already precarious position. The imposition of a further fine would increase the risk of bankruptcy with all the attendant negative consequences" – Commission rejected this, saying that fines did not threaten company's financial viability. DSR-Senator survived the fine without going out of business.
AMINO ACIDS (2001)	Sewon was allowed to pay the fine in instalments because it had demonstrated an inability to pay the fines all at once (par 438).
INTERBREW & ALKEN-MAES (2001)	The Commission rejected arguments of financial constraints, stating "The fact that an undertaking suffers a loss, moreover, does not mean that it has derived no advantage from an infringement of the competition rules, since that advantage may consist in a reduction of its losses"
GRAPHITE ELECTRODES (2001)	The Commission rejected arguments from SGL for a reduced fine because of financial constraints
AUSTRIAN BANKS (2002)	The Commission rejected arguments from companies asking that fines be reduced because of serious difficulties in their industry and the fact that the cartel never actually made any money.
SPECIALTY GRAPHITES (2002)	SGL receives 33% discount because of 'financial constraints' and previous fine
CARBON & GRAPHITE (2003)	SGL receives 33% discount because of 'financial constraints' and previous fines

In the first two cases, it appears that the Commission is willing to grant fine discounts where an industry is in crisis, but not where an individual firm is in crisis because this would confer an unfair advantage on that individual firm regardless of its financial status. This is supported by its findings in Interbrew Alken-Maes, Graphite Electrodes and Austrian Banks and is a view that has thus far been upheld by the Court of First Instance and the Court of Justice:

[22] In response to arguments from Cho Yang in 2000/627/EC: Commission Decision 20th October 2000 Case C34.018 - *Far East Trade Tariff Charges and Surcharges Agreement* (FETTCSA) OJ [2000] L268

"It is settled case law that the Commission is not required, when determining the amount of the fine, to take into account the poor financial situation of an undertaking concerned, since recognition of such an obligation would be tantamount to giving an unjustified competitive advantage to undertakings least well adapted to market conditions.*"[23]*

However, the Commission seems to take a different view in Amino Acids, Specialty Graphites and Carbon & Graphites where discounts on the grounds of financial constraints were granted to individual firms. The problem is that it is not easy to reconcile the statement made in *Interbrew & Alken Maes* with the 33% discount given twice to one of the worst offenders in the graphite cartels. These inconsistencies between the Commission's treatment of infringing firms claiming to be experiencing financial difficulties may simply be a symptom of the exercise of wide discretion, as the Commission responds to particular circumstances on a case by case basis. However, this does not justify the lack of transparency in the decisions to grant discounts on such grounds. Even if these decisions are purely driven by concerns over employment and social protection, giving detailed reasoning to this effect would at least limit the scope for abuse of such discounts by firms exaggerating their financial difficulties behind the scenes in the knowledge that such discounts will be granted without detailed justifications being published in final Commission decisions.

The 'financial constraints' discounts as applied by the European Commission, with its wide discretion and obligation to consider the social objectives of the EC treaty, has two important implications for cartel policy in Europe: Firstly, this discount further reduces fines already below the 10% annual turnover cap, weakening the deterrent effect of cartel policy because it has the effect of reducing the sanction. This widens the enforcement problem in EC cartel policy as, unlike in the United States, there is no other sanction on a community level that can be strengthened to compensate for the loss of sanction that occurs as a result 'financial constraints' discounts. Secondly, the lack of transparency and absence of clear criteria for firms wishing to take advantage of 'financial constraints' in principle makes abuse of the Commission's discretion by infringing firms more likely.

[23] Case T-9/99 *HFB v Commission* [2002] ECR II-1487 recital 596 – (Joined Cases 96/82-102/82, 104/82, 108/82 and 110/82 IA2 *and Others v Commission* [1983] ECR 3369, par 54 and 55; Case T-319/94 *Fiskeby Board v Commission* [1998] ECR II-1331, Par 75 and 76; and *Enso Española v Commission*, par 316)

6. Playing Competition Authorities against each other

The fear of imposing fines that lead to bankruptcy is one that every competition authority in the world has to contend with, especially as fines become stiffer in an attempt to strengthen deterrence. As a result, exceptions in fining policy exist to safeguard against insolvency by reducing fines imposed on firms claiming to be undergoing financial difficulties. This includes the US which arguably has one of the most sophisticated competition policies in the world. As with the European 'financial constraints' discounts, the US Department of Justice grants discounts in a manner that lacks transparency, cloaked by the secretive nature of the plea-bargain system, and which is sometimes invoked for the benefit of firms that would not otherwise become insolvent. The combination of loose bankruptcy discounts in the EC and the US have the effect of reducing fines imposed on infringing firms and making them open to abuse by international firms. This is particularly detrimental to deterrence in Europe.

The Department of Justice and the US courts follow the United States Sentencing Commission Guidelines. These have minimum fine requirements for organisations involved in offences such as collusion. However, according to U.S.C. §8C3.3(a)(b), the court can agree to reduce a fine below this minimum level where there is a danger that imposing such a high fine would impair the firm's ability to make restitution to victims or if the firm demonstrates an inability to pay that fine,

"*Provided*, that the reduction… shall not be more than necessary to avoid substantially jeopardizing the continued viability of the organization"

On the 11th June 1999[24], as part of the plea bargain reached with SGL for its involvement in *Graphite Electrodes*, the DOJ told the court "the agreed upon fine [$135 million] is below the minimum of the United States Sentencing Guidelines (USSG) fine range due to SGL AG's inability to pay a higher fine". In addition, the DOJ allowed SGL to pay its fine in five yearly instalments and "…respectfully [requested] that the court waive the requirement for interest due to SGL AG's inability to pay". Similar deals invoking the 'inability to pay' exception were reached with UCAR[25] ($110 million), DUCOA[26]

[24] *U.S.A. v SGL Carbon Aktiengesellschaft*, Criminal No. 99-244, US District Court, Pennsylvania
[25] *U.S.A v UCAR International Inc*, Criminal No 98-177 13th April 1999, US District Court, Pennsylvania; *U.S.A. v MITSUBISHI Corporation*, Criminal No 00-033, 19th April 2001

($500,000) and TOKAI ($110 million)[27]. Shortly after incurring the US fine, SGL Carbon AG's US subsidiary unsuccessfully filed for Chapter 11 bankruptcy. (as discussed in Section 2). In dismissing the petition, the 3rd Circuit Court of Appeals noted that it was unnecessary as the firm was not in imminent danger of becoming insolvent despite the impending civil antitrust actions. It also noted that there was no evidence that the criminal and civil action had caused damage to the company's business relations.[28] Thus SGL was granted an 'ability to pay' discount even though the failed bankruptcy petition suggests that the firm's 'continued viability' was not otherwise 'substantially jeopardised' by the fines and civil action claims it was incurring, contrary to the criteria necessary for such a discount to be granted according to the Sentencing Guidelines.[29]

A more recent example illustrates how competition lawyers have picked up on the loose application of this bankruptcy discount. In May 2005 a plea-bargain was reached by the DOJ in which Hynix Semiconductor Inc pleaded guilty to the price fixing of DRAM computer chips and agreed to pay $185 million. Due to 'inability to pay', the fine was reduced and is to be paid over five years interest free. This is despite the fact that Hynix is about to spend $250 million on a business venture in China (Mutchnik & Casamassima 2005 at p4). As with the SGL case, the DOJ does not provide details of why the 'inability to pay' concession was granted and "signals that the Division might be more flexible and tolerant of creative solutions to reduce financial burdens on slow-poke defendants" sending the message to antitrust lawyers that "clouding your client's financial picture may just have a silver lining" (Mutchnik & Casamassima 2005 at p4).

The loose application of the 'ability to pay' discount and its lack of transparency may be due to two reasons. Firstly, the DOJ may be showing increasing flexibility in the discounts' application to encourage more firms to come forward and claim amnesty

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[26] *U.S.A v DUCOA, L.P.,* Criminal No 3-02CR0029IN, 30th September 1999, US District Court, Texas
[27] *U.S.A v TOKAI Carbon Co. Ltd.,* Criminal No 99-233 18th May 1999, US District Court. Pennsylvania
[28] Re SGL Carbon Corporation 3rd Cir., 12.29.1999 at 19
[29] In addition to its failed petition for Ch11 bankruptcy, further doubt is cast over SGL's alleged financial difficulties by the fact when the company was sanctioned by the European Commission a few years later, in *Graphite Electrodes* (2001), *Specialty Graphites* (2002) and *Carbon & Graphite* (2003) – it faced a total fine of €131.5 million (before appeals) and in allthree cases the Commission found SGL was not *unable* to pay under paragraph 5(b) of the 1998 fine guidelines - the two 33% discounts for 'financial constraints' were instead granted to SGL under "other factors". Furthermore, SGL, as well as UCAR and TOKAI (who received lower fines) were by virtue of Article 4 of the Commission decisions required to pay the fines **in full** within three months of the decision.

(leniency). So where a firm is not the first to come forward and misses out on immunity, it can still rely on an extra discount or flexibility in the payment of a fine through 'ability to pay' interest free payments. However making it easier for fines to be reduced, lowers the expected cost of collusion making the endgame less severe for infringing firms and making collusion more likely. As discussed in Section 1 a leniency programme will only be effective where the full sanction imposed is high enough to entice firms to breach the trust of the cartel. Indeed the minimum fine set by the Sentencing Guidelines serves this purpose, but the 'ability to pay' exception allows it to be ignored. Secondly, it may be that the 'ability to pay' exception is used by the DOJ as a bargaining tool in its plea-bargain process – after all it is argued behind closed doors during plea-bargain negotiations and then announced before a District Court for approval without a detailed explanation of why it is justified. This would suggest that the extent to which the DOJ is willing to recommend that a company has an 'inability to pay' (resulting in it paying fines that are below the minimum required by the fine guidelines) may simply depend on that company's bargaining skills or on how much money it has spent on the lawyers and negotiators sent to the DOJ to strike a deal (Guidorizzi 1998).[30]

As with the EC 'financial constraints' consideration, the fact that the 'ability to pay' discount is granted even where a firm is not in real danger of bankruptcy, and without any transparency as to how the discount is calculated or qualified, leaves it open to abuse by infringing firms wishing to lower the cost of collusion. This issue is particularly significant given that a big unexpected item to be written off (such as a fine) can always be presented as bringing a firm within the bounds of insolvency if it is not provided for in advance. Thus the existence of a loosely applied bankruptcy discount actually creates an incentive for firms not to put money aside when forming a cartel for the purposes of paying fines and restitution if caught, but rather the less prepared a firm can present itself as being financially, the greater the scope for discounted fines.

[30] It remains to be seen what impact, if any, the US Supreme Court decision in *United States v Booker* [124 U.S. Supreme Court 2531, Jan 12 2005] will have on this procedure. Prior to this decision, the US Sentencing Guidelines (despite their name) were binding on courts. In Booker they were declared advisory; giving judges the discretion to challenge sentences determined from the Guidelines. The Department of Justice is hoping that sentencing matters will remain business as usual (Hammond 2005). However, it is possible that courts' ability to reduce fines below the minimum set by the Guidelines will encourage infringing firms to take their chances with a judge sentencing them, rather than reaching a plea bargain with the DOJ.

The real significance of these uncertain bankruptcy discounts in different jurisdictions is that international firms guilty of collusion, can take advantage of these and use them to play competition authorities against each other with the result that the fines incurred are further reduced, as illustrated by the example of SGL. It is noted in the European Commission's *Graphite Electrodes* decision that,

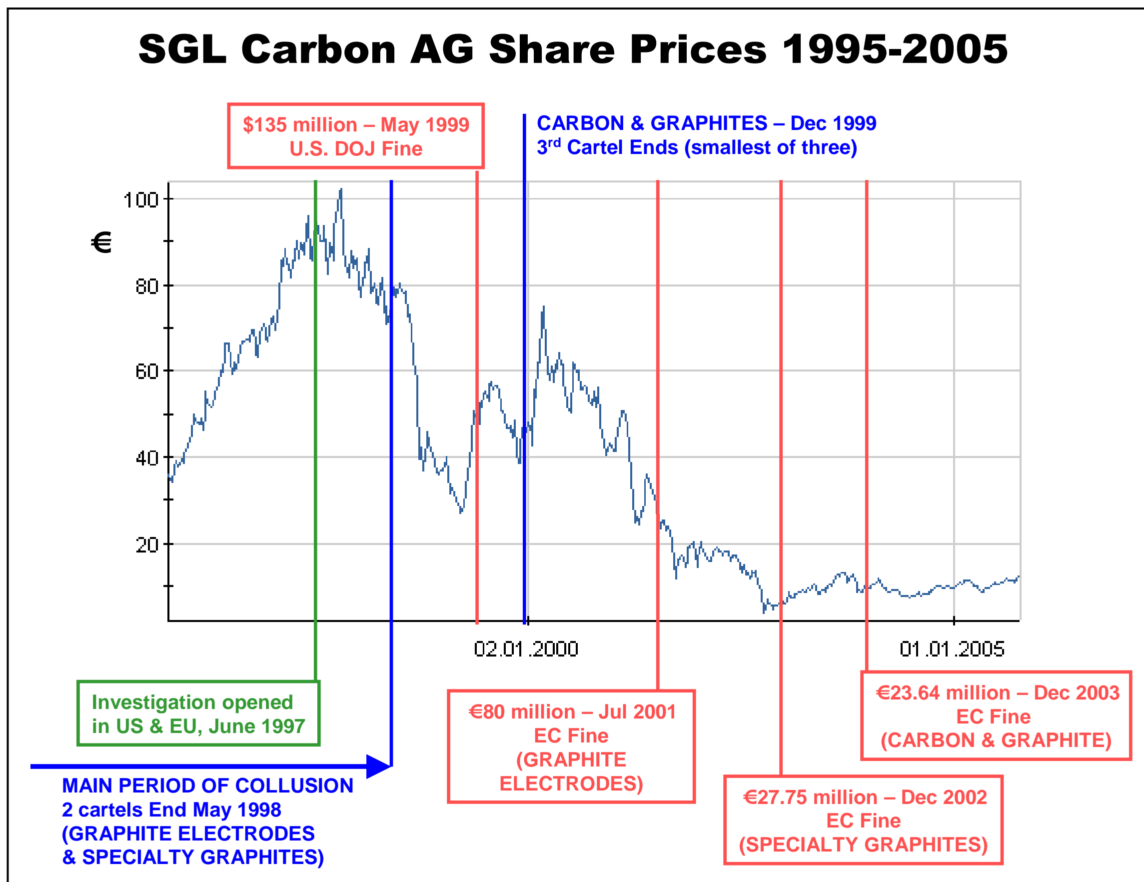
"SGL had negotiated a very substantial reduction in the U.S. criminal fine… [and is] acting in a contradictory manner in securing a reduction in the appropriate fine in the United States by reference to likely penalties in the Community and then claiming in the latter jurisdiction that it should not be subject to any fine at all" [31].

However, SGL was apparently successful in taking advantage of the discretion that exists in both jurisdictions to reduce fines on the grounds of financial difficulty with the result that it paid fines in the US that were below the minimum required by the US guidelines and by receiving a 33% discount from the European Commission twice.

Figure 2 below shows SGL's share prices between October 1995 and October 2005. During the period of collusion share prices increased substantially reaching a high of €102 on the 21st October 1997. Following the opening of investigations by US and EU authorities, the collapse of the *Graphite Electrodes* and *Specialty Graphites* cartels, and the imminent agreement to pay $135 million to the US in fines, share prices dropped to €27 by 18th March 1999. A recovery in share prices in 2000 may have been helped by the final stages of collusion in the *Carbon & Graphites* cartel before its collapse and may also reflect an underestimation of how high European Commission fines would be (for this was pre-*Vitamins* and coincided with a substantial increase in the number of cartel investigations and levels of fines imposed). Following the €80 million *Graphite Electrode* fine by the Commission, along with the other two ongoing investigations, share prices dropped to a low of €5.50 on 25/11/2002, perhaps suggesting that concerns about SGL's financial situation were by this stage well-founded. Share prices have settled at around €10 since the end of collusion and the end of periods of investigation and fines.

[31] *Supra,* FN 13, Par. 181

Figure 2[32]



The example of SGL exemplifies how the availability of these bankruptcy considerations worsens the EC enforcement problem and is also detrimental to international enforcement against hardcore cartels. Firstly, the SGL case is typical of international cartels prosecuted in the last ten years in that the US has a first mover advantage usually opening its investigation and imposing fines before the European Commission (Stephan 2005). This leaves the EC enforcement regime with a serious problem of political economy: by the time an international firm faces punishment by the Commission it will already have incurred fines and civil action for damages in the US and sometimes Canada. This makes it easier for that firm to present itself as undergoing financial difficulties, playing on concerns about unemployment and social justice within the EU, perhaps by scaremongering about factories closing with resulting mass redundancies. Consequently, it is easier for an international firm to gain discounts on the grounds of financial constraints even where the full fines would not seriously threaten their financial

[32] Share price data acquired from SGL's website: http://www.sglcarbon.de (visited 10 December 2005)

viability or even exceed the illegal profits enjoyed during the period of collusion. Secondly, lower fines resulting from bankruptcy considerations are not a problem in the US where other sanctions exist, but widen the gap in deterrence in the EC by reducing the only sanction available to the Commission, and effectively reducing the cost of collusion. Lastly, hard-core international cartels only face serious sanctions in a handful of jurisdictions. Thus the potential for bankruptcy considerations to be used in those few jurisdictions to reduce the levels of fines imposed, widens the more serious problem of punishing and deterring international cartels.

Concluding Remarks

EC cartel policy currently faces an enforcement problem: deterrence cannot be strengthened because the probability of detection and levels of sanctions are effectively capped. Detecting more infringements through increased investigations is costly and an effective leniency programme requires a high sanction with which to entice cartel members into providing evidence of an infringement to the Commission in return for immunity. Fines are the only EC sanction available on the Community level and these cannot be increased because of fears that higher fines will cause bankruptcy, with the costs and uncertainties associated with it. The enforcement problem is made worse by the existence of bankruptcy discounts in the EC and the US which ostensibly have the purpose of protecting firms from fines that would otherwise threaten their continued financial viability, averting the costs of bankruptcy. In practice however such discounts are detrimental to enforcement in three respects:

Firstly the wide discretion and lack of transparency with which the European Commission grants ‘financial constraints’ discounts leaves them open to abuse with the result that fines, already within the 10% annual turnover cap, are reduced even where there is no real danger of bankruptcy. Moreover, the importance of the social objectives of the European Treaty as well as the Commission’s desire to increase its credibility as an institution, raises concerns as to whether the ‘financial constraints’ discount can be applied equally or fairly to all infringing firms. This is because the protection of employment and social justice dictates that firms with larger operations and work forces

within the European Union are more likely to receive a fine discount on the grounds of financial constraints because it is easier for them to argue that fines will have an adverse effect in a 'social context'. The similarly flexible and unclear manner in which the US Department of Justice applies the 'ability to pay' exception to the Sentencing Guidelines allows international firms to reduce fines in the EC further by attempting to play competition authorities against each other. As US investigations of international cartels normally precede those of the EC, by the time an international firm faces punishment from the European Commission, it is in a better position to argue the danger of bankruptcy by making reference to fines and settlements for private damages already incurred in the US, as demonstrated by the example of SGL.

The scope for international firms to play competition authorities against each other and lower fines is of particular significance to a much larger enforcement problem than that faced by the EC. Many hardcore cartels operate internationally yet only a handful of jurisdictions impose significant sanctions for cartel offences (the strongest enforcement regimes exist in the US, EC, and Canada). This only compounds the problem that international cartels face proportionately far smaller sanctions relative to their offence than those incurred by cartels which only operate within the EU or US making them more profitable and thus more likely (OECD 2002). This is particularly so because such behaviour goes unpunished in most parts of the world.

Secondly the existence of any safeguards against bankruptcy create a strong incentive for firms to prepare as poorly as they can for potential fines when committing a cartel infringement, safe in the knowledge that a competition authority will never impose fines upon them that will drive them out of business. Indeed the gloomier the financial picture they paint, the lower the fines they are likely to incur. Such safeguards essentially amount to an even lower cap on fines, compounding Connor's (2005) observation (made in reference to the 10% annual turnover cap) that such limits to fines may provoke cartels into increasing their infringement so that their cartel profits are greater in proportion to their (effectively) capped liability.

Thirdly, by reducing fines already within the 10% annual turnover cap, bankruptcy discounts have the effect of lowering the sanctions faced by infringing firms and widening the EC enforcement problem outlined in Section 1 of this paper. As fines are

the only Community wide sanction, anything that reduces them essentially lowers the cost of collusion to an infringing party (relative to potential cartel profits) and so makes an infringement more likely.[33] This is not the case in the US where, unlike the European Commission, the DOJ has other sanctions in its arsenal that can be increased to compensate for any reduction in fines. As well as the availability of treble damages in civil antitrust actions, a particularly strong sanction in the US is the imprisonment of individuals. Fox (2005) points out that imprisonment has such a deterrent effect on company directors that many executives of colluding firms approach the DOJ and say "Fine me as much as you want, but don't send me to jail" – however, they never walk through the door and say "send me to jail for as long as you want but don't fine me". As part of the DOJ's *Graphite Electrodes* investigations two UCAR executives were jailed for seventeen months and nine months respectively and a total of seven other executives were prosecuted and personally fined. This may have compensated for the fact UCAR received a fine discount and so deterrence for the purposes of US cartel policy was not undermined in the way that it might have been in the EC.

The findings of this paper have important policy implications for the EC cartel enforcement regime. Whereas fines need to be increased in order to achieve effective deterrence, bankruptcy discounts have the effect of eroding deterrence in Europe by lowering them, reducing the cost of collusion. In order to overcome this obstacle, the European Commission needs to strengthen private enforcement and consider introducing community wide criminal fines and imprisonment of individuals directly involved in cartel infringements. Currently private antitrust actions are still weak[34] in the EC and criminal cartel offences only exist on a member state level in a few jurisdictions. They are not harmonised or fully coordinated and not every member state has one. Moreover, Article 23(5) of Regulation 1/2003 specifically states that decisions regarding Article 81 are not to be of a criminal nature. The effective use of a criminal offence in the EC would require harmonisation of the offences on the national level as well as the coordination of leniency policies and the availability of a "one-stop-shop" for leniency applicants. If private enforcement remains weak and a community wide criminal cartel offence is not

[33] The infringement may actually have been profitable if the fine does not reflect the harm caused (in particular the illegal cartel profits enjoyed during the infringement) and the low probability of detection. If this is the case then there is no deterrence, as the formation of new cartels in the future remains worthwhile despite the existence of cartel policy (Chemtob 2000).

[34] *Supra,* FN5

possible, then the Commission should at least set clear and strict criteria for the application of bankruptcy discounts, explaining where the protection of employment and social justice has influenced their decision and only granting such discounts where there is a strong justification. Fines need to be increased by as much as possible in order to strengthen deterrence and a strong first step would be to remove the statutory 10% of annual turnover cap on fines.

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