CPI COMPETITION POLICY INTERNATIONAL

CPI Antitrust Chronicle
January 2012 (1)

Minority Shareholdings, Material Effects?

Bojana Ignjatovic & Derek Ridyard
RBB Economics

www.competitionpolicyinternational.com
Competition Policy International, Inc. 2012© Copying, reprinting, or distributing this article is forbidden by anyone other than the publisher or author.

Minority Shareholdings, Material Effects?

Bojana Ignjatovic & Derek Ridyard[1]

I. INTRODUCTION

In a speech delivered in March 2011, Commissioner Almunia indicated a concern that EU merger control, in contrast to some national merger control regimes, is unable to investigate minority equity stakes as mergers.[2] He has instructed Commission staff to consider this "gap" in enforcement and whether it needs to be closed. As a result, the European Commission, in November 2011, announced its intention to conduct a study on the economic importance of minority shareholdings in the EC economy and on the need for the Commission to have the power to review the purchase of minority shareholdings.[3]

The interest in this topic appears to have been ignited by the Ryanair/Aer Lingus merger case, which was blocked by the Commission in 2007, a decision subsequently upheld by the General Court in July 2010. However, the Court also agreed that the Commission was powerless to investigate the 29 percent equity stake that Ryanair continues to hold in Aer Lingus. In contrast, the Office of Fair Trading ("OFT") in the United Kingdom (which, along with Germany, is a Member State with powers to consider acquisitions that fall short of control) has announced an intention to investigate that situation—though currently its attempts to do so have been held up by a legal challenge concerning the long time delay that has elapsed since the Commission Decision. The OFT's desire to review the minority stake in Ryanair/Aer Lingus has nevertheless raised important issues about both jurisdictional and substantive analysis in such acquisitions.

It is clear that, in theory, minority shareholdings that fall short of conferring control are capable of reducing the incentives of the parties to behave independently of their competitors and can thereby harm consumer welfare. There are three quite separate mechanisms whereby this might occur:

- First, acquiring a shareholding of a competitor may change the competitive incentives of the acquiring firm. Absent such a shareholding, an increase in the price by the acquiring firm that resulted in a loss of sales to the target would be one of the factors that would discourage such an increase in price. After the acquisition, however, some of that customer loss will be re-captured by the acquirer ("internalized" in its price setting decisions) through its shareholding in the target firm. As a result, the acquiring firm might choose to raise its prices unilaterally.
- Second, the acquisition of a minority shareholding may, even absent control over the target, enable the acquiring firm to influence materially the decisions of the target company in relation to key competitive parameters such as price, quality, or strategic expansion so as to confer a competitive advantage on the acquirer's other interests in the

[1] Bojana Ignjatovic is Principal & Derek Ridyard is Partner in the London office of RBB Economics.

[2] http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/11/166&format=HTML&aged=0&language=EN&guiLanguage=en

[3] http://ec.europa.eu/competition/calls/2011_016_tender_specifications_en.pdf

market. As a result, the acquiring firm might succeed in forcing the target firm to harm its own commercial interests by competing less effectively, to the benefit of the acquiring firm.

- Third, cross-shareholdings across companies could also, in principle, facilitate coordination between competing firms if they enable information sharing in respect of confidential market information, or increase the ability of the acquirer to influence the target's competitive strategy. The potential adverse outcome in such cases would be a general (collusive) increase in the prices of both firms.

However, the mere fact that minority shareholdings could give rise to such effects is not sufficient to establish that the EU merger regime ("EUMR") must be changed to fill this gap. Rather, the justification for closing any enforcement gap should be informed by a practical judgment that the potential concerns identified are sufficiently material to warrant intervention, when set against the costs of so doing. These costs will include increased resource implications for competition authorities and regulatory burdens on businesses, which will be necessarily higher under the EUMR's system of mandatory notifications than, for example, the U.K.'s system of voluntary notification. In addition to the additional resource costs, extending jurisdiction beyond the clear-cut threshold of control to rather more nebulous "material influence" tests would add substantially to the regulatory uncertainties in merger assessment.

Given this background, this paper discusses the economic framework for assessing acquisitions of minority shareholdings and its implications for the appropriateness of widening the Commission's powers to intervene in acquisitions falling short of control. Since minority shareholdings are substantially less likely to give rise to competition concerns than fully-fledged mergers, and since the assessment of such concerns is likely to involve a high degree of subjectivity and create substantial uncertainty, we are skeptical that any such extension of EUMR powers will create a more effective EU mergers regime.

II. UNILATERAL EFFECTS—INCENTIVES FOR THE ACQUIRING FIRM TO RAISE PRICE

The theory of minority shareholdings that fits most easily into the existing merger review framework is the risk that a firm that acquires a non-controlling equity stake in a rival may have an incentive to increase its own price or reduce quality. The mechanism for this change in incentives is the fact that some of the customer losses associated with a price increase by the acquiring firm would be "internalized" following its acquisition of a claim on the competitor firm's profits.

Extending the unilateral effects framework to acquisitions of minority shareholdings is conceptually straightforward; however, doing so clearly highlights that the likelihood of unilateral effects arising in this way is substantially reduced under minority shareholdings, relative to full-fledged mergers. In particular, assessing minority shareholding differs from the standard merger analysis in two significant respects.

First, the analysis of incentive effects is one sided, with the effects of the transaction on price, quality, or service being relevant only in respect of the acquiring firm. This is because the profit-maximizing choice of the target firm is unaffected by the fact that a rival has taken a minority stake.

Second, and more importantly, since a minority shareholding by definition implies the acquisition of only a certain proportion of the target shares, this weakens the extent to which the transaction will "internalize" the loss of sales between the merging parties. In the framework of "upward pricing pressure" tests, this is no more than to say that the diversion ratio between the parties—namely the proportion of sales lost by one firm following a price increase that is diverted to the other merging party—is effectively "diluted" by the degree of shareholding.

In fact, the diversion ratio is diluted in direct proportion to the shareholding in question. By way of example, consider a merger between firm A and firm B, where the diversion ratio between A and B is 30 percent. If A were to increase prices, 30 percent of the customers that it loses would switch to firm B. If firm A then purchases 33 percent of the shares in B, it would benefit from only one third of the profit contributed by those diverted sales, with the effect that the diversion ratio between firm A and its holding in firm B would be equal to only 10 percent. Since upward pricing pressure tests (regardless of the precise formula used) all predict that the expected impact of a merger on price is linked to the diversion ratio between the parties, all else being equal this means that the likelihood that acquiring a minority stake in a competitor will lead to increases in price is necessarily lower than is the case with full-fledged mergers.

This point can be illustrated by reference to the Commission's findings in the Ryanair/Aer Lingus merger. A key piece of evidence relied on by the Commission's SIEC decision in that case was that entry by Ryanair on an Aer Lingus route (which generally doubled route capacity in the process) was associated with a reduction in Aer Lingus' prices by 7-8 percent. Even if one were to take that result at face value, and to adopt the (highly questionable) assumption that this result estimated the likely impact of a full merger on the fares charged by the merging firms on overlap routes, it would remain unclear whether Ryanair's continued equity stake in Aer Lingus created a significant likelihood of higher Ryanair fares on those overlap routes. For example, a simple dilution of the 7-8 percent result by the 29 percent equity stake that Ryanair holds in Aer Lingus might well reduce any expected impact below the normal thresholds for economic significance.

To summarize, minority shareholdings that do not confer a substantial influence over the target company are considerably less likely to give rise to unilateral effects than full acquisitions. A robust case for intervention against minority stakes would therefore only exist in those rare cases where it is known that very serious competition concerns would arise in an equivalent "full merger" scenario.

III. UNILATERAL EFFECTS—DEGRADING THE TARGET OFFERING

Of course, if a minority shareholding does enable the acquirer to influence the decisions of the target firm, that also raises the possibility that such influence could be used to make the target compete less aggressively against the acquirer. Therefore, the substantive analysis must be extended to assess the effect of the transaction on the ability of the acquirer to impose increases in price or reductions in service quality of the target.

In this case, the acquirer's incentives to increase prices of the target company may well be *higher* than is the case in a full-fledged merger. This arises because the incidence of the commercial damage that is done to the target firm as a result of such influence (in terms of customer losses by the target) is diluted by its minority shareholding, while it gains the full benefit of any customer losses that are diverted to the acquiring firm in the same market. Indeed, the smaller the equity stake required to exert this commercially damaging influence on the target

firm the better, since that also minimizes the extent to which the acquiring firm bears the adverse commercial consequences of any such damage.

By way of example, consider firm A that purchases 20 percent of firm B, but by so doing acquires control over B's strategic decisions. If the diversion ratio from firm B to firm A is 30 percent, this means that firm A would gain 30 percent of all the sales lost by firm B if B increased price (as would be the case in a merger). On the other hand, firm A would bear only 20 percent of the commercial damage that firm B suffers as a result of sales losses that arise from increasing its price (as opposed to 100% in the event that firms A and B engaged in a full merger). In other words, firm A benefits from any switching of purchasers that occurs from firm B to firm A in exactly the same way that would apply in a full merger situation, while firm A would feel the revenue loss from sales that are lost due to higher prices for firm B only in proportion to its shareholding in the target.

However, the extent to which this raises concerns will still depend on the level of pre-merger competition between the parties to the transaction. If the diversion ratio from the target to the acquirer is very small, the incentive to degrade the target offering will necessarily be more limited.

Moreover, while the *incentives* of the acquirer to degrade the target's competitive offering may well be higher than in the merger, its *ability* to do so must necessarily be limited in those cases where it does not have full control.

Experience in jurisdictions where lower levels of control are subject to intervention suggests that it is frequently the case that a minority shareholding may allow certain levers of control (for example, the ability to restrict expansions or acquisitions that require funds to be raised through special resolutions) but not others (for example, the ability to set price). This implies that any levers of influence available to the acquirer often may not correspond to those aspects of the competition offering that would be of greatest concern in the substantive analysis.

Crucially, the remaining (majority) shareholders in the target will have a clear incentive to actively resist policies that degrade the target's offering and damage its commercial interests in order to benefit minority shareholders' other industry assets. Implicitly, therefore, concerns about the acquirer being able to affect the target's offering below the level of control are based on the notion that a minority shareholder can harm the interests of the majority for its own private gain. Any such situation would appear contrary to all notions of good corporate governance, and, if it arises, raises public policy and welfare concerns beyond those arising in a competition context.

The jurisdictional tests for "material influence" that is used by the OFT in the U.K. mergers regime, and that the Commission may consider as a template for its gap-closing objectives, appear to us to be too broad to delineate appropriately those cases where minority shareholding will genuinely give rise to substantial competition concerns. For example, the OFT has considered that a seat on the board of directors may be sufficient to grant material influence, even when other shareholdings and directorships are held by entities with non-aligned interests to those of the acquirer. In its BSkyB/ITV investigation, the U.K. Competition Commission found that BSkyB's 17.9 percent stake in ITV would allow it to block special resolutions given historic ITV shareholder attendance levels and voting patterns. It appeared not to deem likely that the increased BSkyB shareholding might, in fact, alter the incentives of the remaining shareholders to vote, encouraging them to resist any attempts by the minority equity shareholder to influence conduct that would harm the commercial interests of the majority. The OFT has also suggested

that the mere existence of a shareholding may be sufficient to exert material influence, as the target Board may not be willing to pursue policies that are in conflict with one of its minority shareholders.[4]

Not only do such tests cast the net of "material influence" too broadly—absent severe failures in corporate governance—but they are extremely case-specific and time-consuming to evaluate. Moreover, such a nebulous analysis of jurisdiction is by its nature more subjective, and subject to greater regulatory uncertainty than a straight-forward assessment of "control."

As a result, although there may be a theoretical risk that acquisitions of minority stakes may give rise to this category of competition concerns, well-governed companies should not enable minority shareholders to influence company policy in a manner contrary to the interests of all other shareholders. Even if some such concerns do exist, we doubt that they would arise with sufficient frequency to justify the additional regulatory burden of extending the Commission's jurisdiction to these transactions, and the U.K. merger control experience with such cases does not necessarily provide a model of clarity on how such concerns can be addressed.

IV. STRUCTURAL LINKS AND COORDINATED EFFECTS

The third and final argument for investigation of minority shareholdings may be that they create "structural links" between companies and thereby give rise to a greater risk of coordinated effects. Of course, the terminology of "structural links" is to some extent an historic legacy of the old "dominance" criterion for European merger control: At a time when doubts existed as to the legal power of the Commission to investigate coordinated effects concerns, identifying "structural links" between the parties provided a convenient rationale to relate such concerns to the single firm dominance. Today, however, the SIEC framework allows for an analysis of coordinated effects that is based on the effects of mergers on competitive behavior, without the need to evidence changes to structure. To the extent that any coordinated effects concerns may arise from minority shareholdings, they would do so because they allow the acquirer to have greater influence over, or access to, the company strategy of the target firm.

In considering whether there is a "coordinated effects" case for extending jurisdiction to minority shareholdings, it must first be noted that the number of merger decisions that turn on coordinated effects is extremely small. Moreover, minority shareholdings are in most cases likely to only marginally affect the incentive and ability to engage in coordinated effects.

It is often argued that structural links created through minority shareholdings may render it easier to reach a coordinated agreement (on price)—and hence pass the first of the *Airtour*s criteria for assessing coordinated effects. Proponents of this theory may point to the shareholding conferring directorships that could enable the acquirer to influence target policy towards a coordinated outcome.

However, we question the degree to which the ability to reach an agreement is substantially enhanced by structural links. First, as discussed in relation to unilateral effects above, the extent of influence that a minority shareholder may be expected to wield over company policy would be limited. Moreover, unless structural links are widespread throughout the industry to aid coordination with any firms other than the parties to the transaction, or the

[4] Office of Fair Trading, Jurisdictional and Procedural Guidance, ¶ 3.22.

target is a "maverick" firm that has prevented effective coordination among the remaining competitors, enhancing the ability to reach a coordinated agreement between only two firms in the market is rarely likely to lead to effective coordination across the market as a whole.

In the alternative, structural links may be argued to provide for greater ease of monitoring adherence to a coordinated agreement, by allowing greater transparency to the acquirer over the target company's strategies. Even if this is the case, again it does little for the ability to monitor all other industry rivals. Further, monitoring would be asymmetric: the acquiring firm may obtain information on the target which is helpful to the assessment of deviations from collusion, but the target would not be expected to have any such information about the acquirer. Unless the target in question is a suspected industry maverick, the effects of the transaction on aiding monitoring are likely to be limited. In any event, such information sharing might be dealt with by a rigorous application of Article 101.

As a result, given the low likelihood of coordinated effects concerns arising in most merger cases, and the limited extent to which minority shareholdings may increase coordination in a way not caught by existing competition law instruments, coordinated effects do not seem to provide a convincing rationale for intervention in minority shareholdings.

V. CONCLUSIONS—IS THERE AN ENFORCEMENT GAP FOR NON-CONTROLLING STAKES IN THE EUMR?

Regulatory authorities rarely relish the idea of being powerless to act in an area in which there could be a valid rationale for intervention. When it comes to non-controlling equity stakes, it is understandable that the Commission should ask whether the gap in its powers might prevent it from worthwhile intervention, especially when some of the leading national authorities do have the ability to do so. Nevertheless, there are valid grounds for doubting whether this gap in the EUMR should be closed for any of the three areas where such concerns might, in principle, arise.

First, minority shareholdings imply substantially weaker incentives for firms to change their competitive offering unilaterally than is the case for full-fledged mergers, with the effect that, in all but the clearest cases of seriously anticompetitive mergers, the incentive for a firm to alter its competitive strategy because of its ownership of a minority stake in a competitor is likely to be very limited.

Second, while the acquirer may have a clear incentive to degrade the target's offering to benefit its other industry assets, the ability of minority shareholders to influence company policy in this way will generally be contrary to the commercial interests of the other (majority) shareholders, and such ability would exist only in the presence of some failure of corporate governance. Indeed, if such failures were found to be prevalent, this would raise public policy concerns that went beyond the functioning of competition policy, and may be more appropriately dealt with by reform to corporate governance rather than by tweaking merger control rules.

Third, given the small number of mergers on which the Commission has intervened on the basis of coordinated effects, extending the scope of enquiry to assess acquisitions of minority shareholdings on the basis of the (largely unproven) potential for coordinated effects concerns appears to us to be disproportionate.

It is, of course, difficult to know *a priori* the extent to which minority shareholdings in practice give rise to serious competition concerns. However, economic theory strongly suggests

that minority shareholdings are in general significantly less likely to give rise to the incentive or ability for unilateral or coordinated effects than would be the case for full-fledged mergers. As a result, we are skeptical as to whether these potential concerns, when weighed against the very real costs of investigating minority shareholdings, are sufficient to justify increasing the Commission's jurisdiction in this area.