Mergers and acquisition

Introduction into the European control of concentrations between undertakings

Sources

- Faull & Nikpay: The EC Law of Competition. 2nd Ed. Oxford University Press, 2007
- Bellamy, C., Child, G. European Community Law of Competiton. 6th Ed. London: Sweet & Maxwell, 2008.
- European Commission > Competition http://ec.europa.eu/competition/index_en.html

Introduction

- Combining the activities of different companies (combining forces) can bring **benefits to the economy**
  - e.g., the development of new products in more efficient way, the reduction of production or distribution costs, …
- Combination may lead to **increased competition** within the European single market and **globalization**
- Concentrations may be capable of **increasing the competitiveness of European industry**, **improving the conditions of growth** and **raising the standard of living in the EU**
- On the other hand, some combination **may reduce competition** in a market – usually by **creating or strengthening a dominant position**.
  - Consumers may be harmed through **higher prices**, **reduced choice** or **less innovation**

European legal documents on merger control

- Council regulation (EC) No 139/2004 on the control of concentration between undertakings (**Merger Regulation**)
- Commission Regulation (EC) No 802/2004 implementing Council Regulation (EC) No 139/2004 on the control of concentrations between undertakings (**Implementing regulation**)
- **Jurisdictional Notice** (2007)
- **Case Referral Notice** (2004)
- **Best Practice Guidelines** (2004)
- **Simplified Procedure Notice** (2004)
- **Remedies Notice** (2001)
- Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings (**Horizontal Merger Guidelines**) (2004)
- **Non-horizontal Merger Guidelines** (2007)
- **Ancillary Restraints Notice** (2004)

The purpose of Merger Control

- The focus is on the impact of mergers **on future competition** rather than on how competition has evolved in the past
  - The assessment must take into account of likely future industry changes in order to assess properly the impact of a particular transaction.
- Merger Control involves **a market forecast of how competition will develop in the future**
  - The Commission must consider whether a merger will lead to a critical increase in market power → the assessment is made in accordance with **substantive test** of the Merger Regulation (see below)

Allocation of Jurisdiction

- The Merger Regulation covers **Concentrations with a Community dimension** – they must be **notified** to **the Commission**
- The Commission has **exclusive jurisdiction to investigate** (without the NCAs being able to apply their national merger control rules)

  → **“one-stop shop principle”** – laid down in Art. 21 (2) and (3) of the Merger Regulation
- **Concentration without a Community** dimension falls within jurisdiction of NCAs
- **Reallocation of Jurisdiction →** Exemption from allocation of jurisdiction principles:
  - **Pre-notification reallocation of jurisdiction** – a proposed concentration may be reallocated at the initiative of the parties – only at the pre-notification stage (Art. 4/4 and 5)
  - **Post-notification reallocation of jurisdiction** – notified concentration may be referred from the Commission to the NCAs or vice versa at the request of Member States (Art. 9)

„Concentration“

- The concept is widely defined → many types of transactions are covered by the Merger Regulation
- **Concentration** may be defined as **a change of control** in form of:
  1. **Mergers** = two or more undertakings merge
  2. **Acquisitions of control** = one or more undertakings acquire direct or indirect control of the whole parts of one or more other undertakings – e.g., by purchase of securities or assets, by contract,...
  3. The creation of a **full-function joint venture** (“JV”) is also considered as a concentration

  x a mere internal restructuring within a group of companies cannot constitute a concentration

1) Mergers

- **Legal mergers**
  - at least two previously independent undertakings amalgamate into a new undertaking
  - one previously independent undertaking is absorbed into another → only the latter retains its legal identity
- **Mergers by contract or other arrangements**
  - a merger may be also effected by a contract if it results in the *de facto* creation of a single economic unit
  - e.g., the case *M.660 RTZ/CRA* (1995) – the merger was effected by a contract which led to an identity of economic interest for all shareholders by equalizing dividend and capital entitlements

2) Acquisitions of control (1)

- Definition of **„control“** under the Merger Regulation – Art. 3(2):

  *Control shall be constituted by rights, contracts or any other means which, either separately or in combination and having regard to the considerations of fact or law involved, confer the possibility of **exercising decisive influence** on an undertaking, in particular by:*

  (a) ownership or the right to use all or part of the assets of an undertaking;

  (b) rights or contracts which confer decisive influence on the composition, voting or decisions of the organs of an undertaking.

Acquisitions of control (2)

→ "control" relates to **the possibility** of exercising **decisive influence** over an undertaking **on the basis of rights, contracts or other means**

- the fact whether the control has been acquired is determined by the **possibility** of exercising decisive influence, rather than the actual exercise of such influence
- **"decisive influence"** may include:
  - positive rights to manage and determine the commercial policy of another undertaking,
  - the ability to veto decisions relating to the strategic commercial behavior of another undertaking

Acquisition of control (3)

- **Object** of control can be:
  - **undertakings that constitutes legal entities**
  - **the assets of such entities**
  - **only some of the assets**

    → concentration may arise where only some of the assets of an entity – such intellectual property rights – are acquired)
- **Forms** of control:
  - **Direct control** – *holders of the rights or entitled to rights under the contracts concerned* - Art. 3 (3) a) of the Merger Regulation
    - usually direct ownership of shares giving the right to cast sufficient votes to exercise decisive influence over the undertaking concerned
  - **Indirect control** - *while not being holders of such rights or entitled to rights under such contracts, have the power to exercise the rights deriving therefrom* – Art. 3 (3) b) of the Merger Regulation
    - e.g., an undertaking may use another person or undertaking as a vehicle for the acquisition of the shares necessary for a controlling interest, and my also exercise the rights through that person or undertaking

Acquisition of control (4)

- Control may be acquired
  a) by an undertaking acting alone → **sole control**
  b) by a number of undertakings acting jointly → **joint control**

a) **Sole control**

- De iure control
  - Is usually acquired by an undertaking acquiring the majority of the voting rights in a company
- De facto control
  - May occur through minority shareholding
  - Negative control – a minority shareholder that is able to veto strategic decision in an undertaking → ability to exercise negative control must be sufficient to confer decisive influence

Acquisition of control (5)

b) Joint control

- **Two or more undertakings or persons** have a decisive influence over another undertaking
- The shareholders must cooperate on a **lasting basis**

  → they must reach a common agreement or understanding on major decisions concerning the undertaking in question
- De facto control – may arise where:
  - two or more minority shareholders may acquire joint control if:
    - together they will hold a majority of voting rights
    - they will act together in the exercise of them
  - is a high degree of dependency of a majority shareholders on a minority shareholders

3) Full-function joint venture undertakings (1)

- **Joint ventures („JVs“)**
  - agreements by which two or more independent undertakings proceed to a partial integration of their business operations which are put under join control in order to achieve some commercial goal
  - **concentrative JVs →** fall within **<u>Merger Regulation</u>** (**x** co-operative JVs → may fall within the scope of <u>Art. 101/1)</u>

- It is necessary to identify whether the transaction gives rise to a JV which performs on **a lasting basis all the functions of an autonomous economic entity → Art. 3 (4) of the Merger Regulation**

Full-function joint venture undertakings (2)

- **Full functionality** → JV is full-functional (or autonomous) if:
  - it performs the usual functions of an undertaking operating on the same market (not only one specific function – e.g., research and development)
  - it has management for its day-to-day operations and access to sufficient resources (finance, personnel, assets) to be able to conduct its business activities within the area provided for in the JV agreement on a lasting basis
- **Lasting basis** (durability)
  - Can be demonstrated e.g., if the parent companies commit the necessary financial and other resources to the JV.

Specific operations which are not concentration

- **Temporary holdings by financial institutions**
  - acquisition of securities on temporary basis with a view of resale does not constitute a concentration if made by financial institutions (e.g., insurance companies) whose normal activities include transaction and dealing in securities for their own account or for the account of others
- **Liquidation and insolvency**
  - the acquisition of control by a liquidator or similar office-holder in accordance with insolvency law, winding-up or analogous proceedings, does not constitute a change of control on a lasting basis
- **Acquisition by financial holding companies**
  - for the purpose of managing their investments without being involved in the day-to-day management of the undertaking

„Community dimension“ of a concentration

- The merger Regulation is applicable to **concentrations of a significant size** that have **a cross border impact across more than one Member State**

  → they are more effectively assessed at a European level

- The concept of “Community dimension” depends on the respective **turnovers** of the undertakings concerned **→ the economic size** of the parties
- It is not considered whether the concentration has any effect within the Community
- Tests for the assessment of „Community dimension“:
  a) **the Original test**
  b) In case the original test is not satisfied **the Alternative test** may be used

a) Original test for the assessment of „Community dimension“

3 cumulative criteria:

1. **Worldwide threshold**
   - the combined aggregate worldwide turnover (from ordinary activities and after turnover taxes) of all the undertakings concerned is more than **EUR 5 000 million**
2. **Community-wide threshold**
   - the aggregate Community-wide turnover of each of at least two of the undertakings concerned is more than **EUR 250 million**
3. **Two-thirds rule**
   - each of the undertakings concerned achieves more than two-thirds of its aggregate Community-wide turnover within one and the same Member State

b) Alternative test for the assessment of „Community dimension“

1. **Lower worldwide threshold**
   - the combined aggregate world-wide turnover of all the undertakings concerned is more than **EUR 2 500 million**
2. **Lower Community-wide threshold**
   - in each of at least three Member States, the combined aggregate turnover of all the undertakings concerned is more than **EUR 100 million**
3. **Additional three Member States threshold**
   - in each of at least three Member States included for the purpose of the second point above, the aggregate turnover of each of at least two of the undertakings concerned is more than **EUR 25 million**
4. **Two-thirds rule**
   - the aggregate Community-wide turnover of each of at least two of the undertakings concerned is more than **EUR 100 million** unless each of the undertakings concerned achieves more than two-thirds of its aggregate Community-wide turnover within one and the same Member State

Turnover calculation (1)

- It referrers to turnover derived from ordinary activities with third parties.
- Turnover
  - *the amounts derived by the undertakings concerned in the preceding financial year from the sale of products and the provision of services falling within the undertakings´ ordinary activities after deduction of sales rebates and of value added tax and other taxes directly related to turnover* (Merger Regulation, Art. 5)
- The aggregate turnover shall not include the sale of products or the provision of services between the merging parties

- Calculation of Turnover:

1. **Turnover: an accounting and „Net“ Concept**
   - the entire turnover of the merging group is considered, not merely the proportion thereof which is achieved on markets that are affected by the transaction
     - The Commission decision is normally based on audited accounts for the last financial year

Turnover calculation (2)

2. **Group Turnover**
   - The application of Art. 5 (4) – the undertaking´s turnover is combined with that of all other companies in the same group – the turnover considered includes all parent and sister companies as well as subsidiaries (Art. 5 (4) of the Merger Regulation)
3. **Geographical Allocation of Turnover**
   - In some cases, it is necessary to assess geographical allocation of turnover in order to settle the jurisdictional test → the general principle is to attribute turnover to the location of the consumers – that provides the best indication of where competition to achieve the sales actually took place
4. **Credit and Other Financial Institutions and Insurance Undertakings**
   - The calculation of turnover of financial institutions will follow Council Directive (EEC) 86/635 on the annual accounts and consolidated accounts of banks and other financial institutions

Substantive assessment of Mergers

Assessment of mergers, substantive test, procedure

The test for assessing of Merger under the Merger Regulation

- Art. 2 (1) of the Merger Regulation → *the Commission shall take into account*
  - *(a) the need* ***to maintain and develop effective competition*** *within the common market in view of, among other things,* ***the structure of all the markets concerned*** *and the* ***actual or potential competition*** *from undertakings located either within or outwith the Community*
  - (b) ***the market position of the undertakings concerned and their economic and financial power****, the alternatives available to suppliers and users, their access to supplies or markets, any legal or other barriers to entry, supply and demand trends for the relevant goods and services, the interests of the intermediate and ultimate consumers, and the development of technical and economic progress provided that it is to consumers' advantage and does not form an obstacle to competition*

Substantive test for the assessment of Mergers

- Art. 2(2) and 2(3) of the Merger Regulation - set out the **substantive test** for **the assessment of the compatibility of mergers with the common market**

  *A concentration which **would significantly impede effective competition in the common market or in a substantial part of it, in particular as a result of the creation or strengthening of a dominant position, shall be declared incompatible with the common market.***

→<u>SIEC</u> („Significantly Impede Effective Competition") <u>test</u>

- Was introduced for the first time in the new Merger Regulation (2004)

The development of the tests for the assessment of Mergers (1)

- The Original "Dominance" test – under the original Merger Regulation – solely a test for dominance - "the creation or strengthening of **a dominant position as a result of which effective competition would be impeded in the Common market or a substantial part of it**"
- The reasons for the change to the SIEC Test – the development of the treatment of **collective (or oligopolistic) dominance**
- The Case *Airtours/First Choice* – the Commission prohibited a merger which it considered would have created a collective dominant position on the part of three firms.
  - This case led to a debate about whether there was a gap in the Merger Regulation in the sense of anticompetitive effect resulting from the non-coordinated behavior of undertaking in a n oligopolistic market
- Green Paper (2001) – the reform that led to the new Merger Regulation (2004)
- Now, anti-competitive effect resulting from **non-coordinated behavior in oligopolistic markets** are also effectively covered by EU merger control law

The assessment of Market Concentration

- **Market share** – the first step of the assessment of whether a concentration will significantly impede effective competition
  - **Post-merger market share** – is usually calculated based on the combined pre-merger current market shares of the parties – sometimes, post-merger market share forecast must be adjust - e.g., in highly dynamic markets characterized by significant innovation or growth, or where is a strong likelihood of new entry
  - **40% market share** – should be viewed as a potential indicator of dominance (but not a presumption of dominance)
- **HHI – the Herfindahl-Hirschman Index**
  - is calculated by summing the squares of the individual market shares of all the firms in the market
  - E.g., a market containing five firms with market shares of 40 %, 20 %, 15 %, 15 %, and 10 %, respectively, has an HHI of 2550 (402 + 202 + 152 + 152 + 102 = 2550). The HHI ranges from close to zero (in an atomistic market) to 10000 (in the case of a pure monopoly).
  - a market with a post-merger HHI below 1000 normally does not require extensive analysis

Types of cases and their anti-competitive effect

- The Commissions examines the change in the future conditions of competition that the merger creates
  - If there is no change – no significant impediment to effective competition – the merger should be approved
- The Commission considers:
  - the possible **anti-competitive effects** arising from mergers
  - the possible **pro-competitive effects** stemming from efficiencies substantiated by the parties

- **3 types of mergers may be distinguished:**

a) **Horizontal Mergers**

b) **Vertical Mergers**

c) **Conglomerate Mergers**

a) Horizontal Mergers

- Horizontal guidelines (2004)
- **„Horizontal Mergers“** - undertakings concerned are actual or potential competitors on **the same relevant market**.
- Two main types of **anti-competitive effect**:

1. **Non-coordinated effect** (unilateral effect)
   - Elimination *of important competitive constraints on one or more firms, which consequently would have increased market power, without resorting to coordinated behaviour.*
2. **Coordinated effect**
   - Change *of the nature of competition in such a way that firms that previously were not coordinating their behaviour, are now significantly **more likely to coordinate** and raise prices or otherwise harm effective competition. A merger may also make coordination easier, more stable or more effective for firms which were coordinating prior to the merger .*

Horizontal Mergers – Non-coordinated effect (1)

- This effect can arise where the merger results in **the removal of direct competitive constraints** on one or more sellers, who consequently have increased market power which enables them unilaterally (without the coordination) e.g., to raise prices above the pre-merger level.

  → Non-merging firms in the same market can also benefit from the merger → the merging firms' price increase may switch some demand to the rival firms, which, in turn, may find it profitable to increase their prices.

  → **The reduction in these competitive constraints could lead to significant price increases in the relevant market.**

- The merger may also result in **a reduction in the intensity of competition** (without changing the way in which the firms interact)

Horizontal Mergers – Non-coordinated effect (2)

- Factors that may influence, whether a merger has anticompetitive non-coordinated effect:
  - **Merging firms have large market shares**
  - **Merging firms are close competitors**
    - The higher the degree of substitutability between the merging firms' products, the more likely it is that the merging firms will raise prices significantly
  - **Customers have limited possibilities of switching supplier**
    - Reasons: (i) there are few alternative suppliers, (ii) customers face substantial switching costs
  - **Competitors are unlikely to increase supply if prices increase**
    - The merger would not impede effective competition when rival firms have enough capacity and find it profitable to expand output sufficiently,
  - **Merged entity able to hinder expansion by competitors**
    - E.g. the merged entity may have such a degree of control, or influence over, the supply of inputs or distribution possibilities that expansion or entry by rival firms may be more costly
  - **Merger eliminates an important competitive force**
    - E.g. effective competition may be significantly impeded by a merger between two important innovators, for instance between two companies with "pipeline" products related to a specific product market.

Horizontal Mergers – Coordinated effect (1)

- A merger in a concentrated market may have anti-competitive effect through **the creation or the strengthening of a collective dominant position**
  - it increases the likelihood that firms are able to coordinate their behaviour in this way and raise prices, even without entering into an agreement or resorting to a concerted practice within the meaning of Article 81 of the Treaty → **„Tacit Collusion“**
  - a merger may also **make coordination easier, more stable or more effective for firms, that were already coordinating before the merger**, either by making the coordination more robust or by permitting firms to coordinate on even higher prices
- Possible aims of coordination
  - Increase of price above competition level, limitation of production, dividing or allocation of the market
- Coordination is more likely in markets where it is **relatively simple to reach a common understanding** on the terms of coordination.

Horizontal Mergers – Coordinated effect (2)

- The European Court of Justice addressed **collective dominance** in a merger case in France v. Commission (Joined Cases C 68/94 and C 30/95)
  - *„In the case of an alleged **collective dominant position**, the Commission is therefore obliged to assess, using a prospective analysis of the reference market, **whether the concentration which has been referred to it leads to a situation in which effective competition in the relevant market is significantly impeded by the undertakings involved in the concentration** and one or more other undertakings which together, in particular because of correlative factors which exist between them, are able to adopt a common policy on the market and act to a considerable extent independently of their competitors, their customers, and also of consumers.“*

Horizontal Mergers – Coordinated effect (3)

- The Commission examines:
  a) whether it would be possible to reach terms of coordination
     - It may be easier to reach a common understanding on the terms of coordination if the parties are relatively symmetric – especially in terms of cost structures, market shares, capacity levels and levels of vertical integration

  b) whether the coordination is likely to be sustainable

     → 3 conditions necessary for the sustainability of coordination (the principles were set out by the Court of the First Instance in the case *Airtours v. Commission - T-342/99*)
     - the coordinating firms must be able **to monitor to a sufficient degree whether the terms of coordination are being adhered to**
     - discipline requires that there is some form of **credible deterrent mechanism** that can be activated if deviation is detected
     - **the reactions of outsiders** - current and future competitors not participating in the coordination as well as customers - **should not be able to jeopardise the results expected from the coordination**

b) Vertical Mergers (1)

- Non-horizontal guidelines (2008)
- **Vertical mergers** involve companies operating at **different levels of the supply chain**.
  - E.g., a manufacturer of a certain product (the "upstream firm") merges with one of its distributors (the "downstream firm")
- Negative effect on competition:
  - **Actual or potential rivals' access** to supplies or markets is **hampered or eliminated** as a result of the merger → reduction of these companies' ability and/or incentive to compete.
  - **Non-coordinated effect – foreclosure**
  - **Coordinated effect** (the same conditions as in the case of horizontal mergers)

Vertical Mergers – Non-coordinated effects

- **Non-coordinated effects:**
  - **Foreclosure**
    - may discourage entry or expansion of rivals or encourage their exit → it is sufficient that the rivals are disadvantaged and consequently they compete less effectively
    - is regarded as **anti-competitive** where the merging companies are as a result able to **profitably increase the price charged to consumers**
    - **Input foreclosure** – the merger is likely to raise the costs of downstream rivals by restricting their access to an important input
    - **Customer foreclosure** - the merger is likely to foreclose upstream rivals by restricting their access to a sufficient customer base
  - **Other effects**
    - The merged entity may gain access to **commercially sensitive information** regarding the upstream or downstream activities of rivals (e.g., a company may obtain critical information, which allows it to price less aggressively in the downstream market to the detriment of consumers), …

c) Conglomerate Mergers

- **Conglomerate mergers**
  - mergers between firms that are in a relationship which is **neither horizontal** (as competitors in the same relevant market) **nor vertical** (as suppliers or customers)
  - Usually, mergers between companies that are active in **closely related markets**
  - E.g., mergers involving suppliers of complementary products or products that belong to the same product range
- In the majority of circumstances conglomerate mergers do not lead to any competition problems.
- Possible anticompetitive effect:
  - **Non-coordinated effect – foreclosure**
  - **Co-ordinated effect**

Conglomerate Mergers – Non-coordinated effect

- The merged entity may have the ability and incentive to leverage a strong market position from one market to another by means of **tying** or **bundling** or other **exclusionary practices**.
- Commission examines:
  - whether the merged firm would have **the ability to foreclose its rivals**
    - usually by tying or bundling
  - whether it would have **the economic incentive to do so**
    - depends on the degree to which this strategy is profitable
  - whether a foreclosure strategy would have **a significant detrimental effect on competition**, thus causing harm to consumers – impact on prices and choice