


Overlapping Ownership by Institutional Investors: A Legal Perspective

By Allen Grunes and David L. Meyer

I. INTRODUCTION

Recent economic work summarized in this newsletter has generated considerable interest by suggesting that the minority ownership positions held by large institutional investors in multiple, competing companies in the same concentrated industry might lead to higher prices (the “AST Study”). The specific finding of the AST Study was that such ownership overlaps involving domestic airlines were associated with (and from AST’s perspective may have caused) higher airline prices. The Antitrust Division has reportedly expanded its investigation of alleged coordination among the major U.S. airlines to encompass CIDs directed to the major institutional investors in those airlines. And Professor Einer Elhauge has argued that the AST findings provide a sufficient basis for an antitrust challenge to such “horizontal” institutional shareholdings.

In this note we take the AST Study’s findings at face value, assuming them to be valid as an econometric matter at least to the extent they suggest that overlapping institutional investor ownership positions in “oligopoly” industries tend to co-exist with higher levels of pricing by the partially-owned firms. We resist the temptation to engage in the policy debate whether the AST Study should motivate some sort of legal or enforcement action, although we note that

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econometric studies have led to such actions in the past. Instead, we ask a (relatively) simpler question: how, if at all, does existing law apply to the “effects” AST purport to find?

Even if the findings of the AST Study are valid, and even assuming some plausible causal connection between the ownership overlaps and the identified effects, we are skeptical that all a plaintiff would need to do is present the study to a judge and rest its case. Economic “effects” alone do not make out a legal claim under the antitrust laws. Leaving aside the unsettled contours of Section 5 of the FTC Act, antitrust law continues to contain elements that must be proven even if the economic underpinnings of a case are sound.

From a legal perspective, we see three principal ways in which an antitrust cause of action might (conceivably) be lurking in the econometric results reported by AST: (a) the acquisition (or acquisitions) leading to the overlapping ownership interest might cause a “substantial lessening of competition” actionable under Section 7 of the Clayton Act, the antitrust provision that comes closest to a pure “effects-based” analysis; (b) the presence of overlapping ownership positions might inform analysis of the likely competitive effects associated with mergers in the markets in which the owned firms operate; and (c) the overlapping ownership positions might lead to or facilitate an actual agreement in restraint of trade in the market(s) in which the owned companies compete, potentially actionable under Section 1 of the Sherman Act. We briefly outline some of the important issues that would have to be considered in connection with a potential claim under any of these theories. We also examine the loosely analogous application of Section 8 of the Clayton Act, which prohibits interlocking directorates, as potentially instructive on some of the issues raised by the AST findings.

II. BRIEF SUMMARY OF THE AST STUDY

The AST Study looked at the airline industry as one example among many where pension funds, mutual funds, and other institutional investors hold a high and growing share of U.S. publicly traded firms. They observed that several of the largest investors own meaningful minority shares of the stock of multiple competing air carriers. For example, they note that “[o]ut of the largest seven shareholders of United Airlines, who hold 60% of the vote share, five are also among the largest 10 shareholders of Southwest and Delta Air Lines, the largest and second-largest carrier, respectively.” AST ask whether this overlapping or “common” ownership may result in less intense competition and higher prices. The theory is that, from the perspective of any one of these institutional investors with positions in multiple airlines, the best way to achieve maximum returns is when the industry as a whole does well, not when individual airlines compete aggressively to capture market share.

Both the NASDAQ cases from the 1990s and the more recent Libor cases were based, at least in part, on econometric studies.

AST Study at 14.
To test this, AST examined price and quantity data on individual routes as well as public information about institutional ownership. They model the impact of institutional ownership on concentration by using a “modified” version of the HHI developed by O’Brien and Salop. Their results purport to find that overlapping ownership has a positive effect on the level of airline ticket prices on concentrated airline city-pair routes. Stated differently, if a route already is highly concentrated without considering overlapping airline ownership, as the extent of overlapping ownership increases, so do ticket prices.

AST stop short of suggesting how overlapping ownership translates into higher prices as a factual matter. They suggest some ways in which the institutional investors might be having an influence on pricing, ranging from airline eagerness to please large shareholders to the potential that even “passive” investors might find various levers to pull to influence the behavior of managers at the companies in which they hold a stake. But AST note that these are only possibilities, and leave it to others to identify the actual conduct or otherwise make the causal connection.

III. How Might Antitrust Law Address the Purported Findings?

A. Section 7

We begin with Section 7 of the Clayton Act, which broadly prohibits acquisitions that are likely to “substantially lessen competition.” It is not hard to see how an acquisition of stock in one airline by an entity that already own stock in another might be challenged under Section 7 if the acquisition could be proven likely to cause net anticompetitive harm. Section 7 explicitly covers the acquisition of “any part of the stock” or “any part of the assets” of a company and thus applies to partial acquisitions as well as to full-fledged mergers. There is no statutory minimum quantum of ownership, nor is there any requirement that the acquirer obtain control of the target company. Moreover, Section 7 has routinely been applied to consummated transactions, and thus potentially could be applied to force the unwinding of an existing ownership overlap.

Consistent with the modest objectives of this note, we do not attempt a comprehensive analysis of the issues that would arise were a Section 7 claim brought against an acquisition that would lead (or has led) to an entity having minority ownership positions in multiple competitors in a concentrated industry. But we can summarize a few of the most important issues.

**Solely for Investment?**

Section 7 contains an explicit exemption for acquisitions that are “solely for investment.” However, this exemption only applies if the investor is “not using the [ownership stake] by voting or otherwise to bring about, or in attempting to bring about, the substantial lessening of competition.” 15 U.S.C. § 18.

Whether this exception is an obstacle to using Section 7 to address small (in percentage terms) overlapping positions taken by institutional investors may depend on the mechanism by which the overlap is alleged to lead to higher airline
fares. If the story (and proof) is that the institutional investor is “using” its position to influence behavior at the owned-company level, there would be a plausible argument that the exemption is inapplicable. But if the alleged anticompetitive effects stem solely from an indirect “incentive” effect – as might flow from airlines’ understanding of their major investors’ self-interest and acting to please them – the exemption might well apply.

Caused By the Acquisition?

Another important element of any Section 7 claim is causation: did the acquisition cause the anticompetitive effect? This element may pose a challenge to the application of Section 7 based on the AST findings in several respects.

First, without a persuasive story about how an acquisition leading to an ownership overlap caused the owned company to increase its prices, proving causation will be hard.

The Sixth Circuit’s decision in the Dairy Farmers of America7 case highlights the importance of providing the mechanism by which a transaction might lead to adverse effects. DFA had a 50% voting interest in Flav-O-Rich when it entered an agreement to acquire 50% of Flav-O-Rich’s competitor Southern Belle, both of which operated dairies in the same region of the country. The government produced evidence that DFA’s purchase agreement would give it the power to help set the salary of those running Southern Belle and veto power over certain expenditures by Southern Belle. Building on this evidence, the government produced expert testimony that the competing dairies had a strong incentive to reduce the competition between them when bidding on school milk contracts. The expert reports made many of the same points reflected in the AST Study, including the managers’ incentives to keep the large owner (i.e., DFA) happy by increasing joint profits. However, the government did not have evidence of direct communications between the dairies regarding pricing or where/how to bid.

After the litigation began, the parties revised DFA’s purchase agreement to eliminate DFA’s voting rights and thus remove any argument that DFA would “control” Southern Belle. Nonetheless, in reversing summary judgment for the defendants, the Sixth Circuit rejected the argument that a lack of control precludes a Section 7 violation. It wrote:

“In sum, even without control or influence, an acquisition may still lessen competition. As the Supreme Court stated, ‘A company need not acquire control of another company in order to violate the Clayton Act. Section 7 prescribes acquisition of “any part” of a company’s stock where the effect “may be substantially to lessen competition, or tend to create a monopoly.”’ Denver and Rio Grande W. R.R. Co. v. United States, 387 U.S. 485, 501 (1967) (quoting 15 U.S.C. § 18)

7 United States v. Dairy Farmers of America, 426 F.3d 850 (6th Cir. 2005).
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The Sixth Circuit held that the trial court should have considered the original agreement and the various means by which DFA exerted “some control” over the business activities of Southern Belle. But it also went on to say that even under the revised agreement, the trial court should have focused on the “effect on competition” rather than on “control”:

“As explained supra, the district court erred in its focus on control, as opposed to the effect on competition; because control was not present in DFA’s relationship with Southern Belle, the district court reasoned that the effect of a lessening of competition was also not present. This logic ignores the possibility that there may be a mechanism that causes anticompetitive behavior other than control.”9 (Emphasis added.)

As DFA suggests, it is necessary to identify the “mechanism” by which an acquisition of a partial ownership interest leads to supposed market effects. As noted earlier, AST identify a number of possibilities of what that “mechanism” might be, but leave the actual question open. They show correlation, but appropriately stop short of claiming causation.

In the arena of antitrust enforcement involving minority ownership stakes, three broad categories of potential “mechanisms” have been identified as warranting attention: (a) whether the ownership stake gives its holder an incentive to pull its competitive punches (or to use its influence to cause another company to do so); (b) whether the stake gives one firm the ability to influence the competitive decisions of a rival, or gives a common owner the ability to influence the actions of two competitors; and (c) whether the ownership stake creates meaningful avenues for the sharing of competitively sensitive information, which might in turn lead to coordination of marketplace conduct.10

Each of these inquiries is intimately bound up with the specific facts. It turns on such questions as what rights of influence flow from the specific terms of the investment?; by what mechanism might a firm “pull its punches” and does it actually have the incentive to do so in the posited manner?; how might confidential information be passed from one firm to the other through a common owner given the parties’ (proposed) safeguards against inappropriate information sharing?

As importantly, each of the inquiries is tied up with some sort of conduct or behavior. Pulling punches, exerting influence, and conveying information all

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8 Id. at 860.
9 Id. at 862.
10 See, e.g., Laura A. Wilkinson and Jeff L. White, Private Equity: Antitrust Concerns with Partial Acquisitions, Antitrust, vol. 21, no. 2 (Spring 2007) 28
involve something more than passively responding to economic incentives. As the Sixth Circuit put it in DFA, “closely aligned interests” was not enough. The interests had to be accompanied by “anticompetitive behavior.”

Many of these sorts of questions arise in the context studied by AST, and make it imprudent to jump to the conclusion that there is a viable theory of causation present here.

- If the mechanism were some form of “incentive” effect of the overlapping positions, as perhaps implied by AST’s reliance on the work of O’Brien and Salop, how would it function? Who is pulling what competitive punches?

  The airlines have no direct minority stake in their rivals (the normal situation in which the concern about pulling competitive punches arises). The common owners may, but how are they getting their airlines to act in a manner consistent with the incentives of these owners rather than the interests of shareholders as a whole?

- If “influence” is the mechanism, what tools are used and how are they exercised? Is the idea that firms “just know” what their large shareholders want? If so, why doesn’t every firm (with or without overlapping institutional investors) already know that shareholders will be better off if an oligopoly-style coordination breaks out instead of a price war? The term “influence” itself suggests some sort of conduct must be involved.

- Or is the mechanism something closer to one of information flow – with airline managers reassured by the recommendations offered by shareholders who have large stakes in both? Perhaps those recommendations send messages about the plans of rival airlines; or perhaps managers take comfort in the expectation that their rivals will be receiving similar recommendations, either or which might reduce the risks associated with interdependent rather than disruptive marketplace strategies?

These are all potentially interesting and important empirical questions on which we offer no opinion, except to suggest that viable Section 7 enforcement in this arena would have to be coupled with some showing of what mechanism actually causes the effects observed by AST. At bottom this is likely to be a very difficult empirical hurdle in any merger analysis.

A further set of causation-related hurdles likely would flow form the very small size (in percentage terms) of the individual minority stakes at issue, the lack of board positions, and the presumed absence of any agreement among institutional owners as to how their separate ownership rights would be exercised. Challenges to minority-ownership stakes has generally involved large-minority positions (above roughly 20%) or concrete contractual rights of influence, such as those at issue in DOJ’s settlement in the ATT/Dobson case requiring divestiture of ATT’s small (10%) stake in a carrier that competed with Dobson. As the

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11 426 F.3d at 862.
complaint in that case alleged, “[a]lthough the minority equity interest in each situation is small, AT&T has significant rights under the relevant partnership agreements to control core business decisions, obtain critical confidential competitive information, and share in profits at a rate significantly greater than the equity ownership share upon a sale of the partnership.”\footnote{Complaint, \textit{United States v. AT&T Inc. and Dobson Communications Corp.}, ¶22 (October 30, 2007), available at http://www.justice.gov/file/487566/download.} The challenge of proving causation would be compounded where there were no formal rights of influence and each individual shareholder’s stakes were too small to materially influence airline behavior.

\textbf{Lessening of Competition?}

In addition to a causal link between the acquisition(s) and the effects, of course, Section 7 also requires proof of a “substantial lessening of competition.” This element has been interpreted quite broadly to encompass coordinated effects, whereby a merger makes it more likely that tacit or explicit collusion will occur in the markets in which the merged firm operates, as well as unilateral effects, whereby the transaction leads the merged firm to compete less aggressively regardless of how others react. Section 7 has also occasionally been applied by the enforcement agencies in settings where the impact on “competition” is less obvious, such as where the transaction remove some external constraint on the competitive behavior of the merged firm, such as the allegation in Fresenius Medical Care/Daiichi-Sankyo (FTC Docket No. C-4236) that the proposed vertical transaction would allow the combined firm to evade certain Medicare-related constraints on pricing.

However creative agencies might try to get, applying Section 7 as a formal matter requires explaining how the transaction leads to a “lessening of competition,” not just a change in the company’s behavior post-merger. It is widely accepted, for example, that Section 7 does not prohibit transactions that lead to the surviving company raising its prices (or discontinuing some planned investment, etc.) simply because a new set of more-aggressive or differently-minded managers has taken over the reins.

Following this logic, the mere fact that higher prices were observed following a transaction should not be sufficient to invoke Section 7, unless the plaintiff could point to some mechanism relating to reduced competition by which prices went up. If the truth were that such effects resulted from nothing more than the market for corporate control steering investment to those owners who are relatively risk-averse and thus disinclined to invest in companies that make high-stakes bets on output expansion or share-shifting price warfare, a Section 7 case would be hard to win.

In his forthcoming article, Professor Elhauge suggests that the AST work by itself should be enough to satisfy Section 7’s requirements. His argument is that by factoring in common ownership into the HHI and the delta, a plaintiff could get the benefit of the “presumption” of \textit{Philadelphia National Bank} and the agency merger guidelines that an acquisition in concentrated markets is
anticompetitive, and the burden would be shifted to investors to offer another explanation.

We are quite skeptical that courts could be persuaded absent evidence in a long series of cases showing that anticompetitive effects actually do flow from the kinds of ownership overlaps AST studied. While the *Philadelphia National Bank* presumption still has vitality in litigated merger cases, the whole thrust of Section 7 law in recent decades (starting with *General Dynamics*) has been to erode the force of structural presumptions, and the lower courts would extend that presumption to the uncharted territory of minority overlaps at their peril.

They likely would be dissuaded from doing so not just because of the absence of a consistent pattern of judicial precedent for the existence of the effects AST posit, but also because of important countervailing policy arguments. If presumed liability turned on common investment in a concentrated industry, the movement of capital could be chilled as courts sought to regulate which sorts of investments by whom are entitled to a presumption of anticompetitiveness.

**B. IMPLICATIONS FOR SECTION 7 ANALYSIS OF TRANSACTIONS INVOLVING OWNED FIRMS**

Before turning to the potential application of Section 1, we pause to consider whether the effects found by AST might be relevant in assessing whether mergers in industries where there are meaningful overlaps in institutional ownership are themselves more likely to be anticompetitive. Stated simply, if such overlaps facilitate tacit coordination among the owned-firms where concentration is high, is the converse true: are merger-caused increases in underlying concentration more likely to result in such coordination, leading in turn to higher prices of other non-competitive equilibria, when there is a higher degree of overlapping ownership?

This may turn out to be an interesting empirical question, but it seems unlikely to be of particularly practical relevance in any given merger analysis. On the one hand, if there were a concrete mechanism by which coordination was thought likely to result (say, in the specific terms of a particular owner’s access to information, influence over management, etc.), it would seem conducive to a targeted remedy rather than being fatal to the deal. (Cf. *Graftech/Seadrift*, DOJ Press Release Nov. 29, 2010.) On the other hand, if the concern were the generalized one that overlaps might make it more likely that companies will understand the potential profitability of avoiding price wars or other aggressively competitive acts (*e.g.*, because they know what their owners want), it seems likely the same industry conditions driving owners to have that view would already lead managers to the same conclusion without any material overlap in ownership.

However, it may lead the agencies to look more closely at mergers where common ownership is involved and the markets are moderately or highly concentrated and, in addition, there is already some basis to worry about potential adverse competitive effects.
C. SECTION 1

Section 1 of the Sherman Act prohibits contracts, combinations, and conspiracies that unreasonably restrain trade. The central element of any Section 1 claim is proof of an actual agreement, meaning that two independent economic actors reached a “meeting of the minds” or a “conscious commitment to a common scheme.”

It is not inconceivable that overlapping ownership interests could lead to an actionable agreement between two competing firms, or among those firms and their common owner, but this element sets a high bar. The most plausibly speculated mechanisms for the effect observed by AST likely would not involve a Section 1 agreement, and scenarios that would involve such an agreement seemingly could arise in innumerable contexts having nothing to do with the ownership overlaps AST studied.

AST begin by noting that institutional asset managers, traditionally regarded as “passive” shareholders, in fact actively engage with their portfolio companies. They vote their shares and thus have a say in executive compensation, retention and election of directors. Such actions, they hypothesize, may incentivize managers to pay attention to the desires of these significant shareholders, even without any other communication. For example, a manager who is overly aggressive in gaining share from rivals faces the risk of being removed. We can call this the “send a message with your votes” scenario. However, if this were the only cause of less competitive conduct by the managers, it would arguably negate the need for any kind of “agreement,” even between the shareholder and the airline(s) in which it has a stake (much less between the airlines themselves), and might therefore make it more difficult for a plaintiff to establish a Section 1 claim.

AST posit a more specific scenario similar to the above involving price-setting by the airlines. When airlines set route level prices, they appear to take into account the identity of their competitors. Since the identities of the rival’s owners is public information, AST hypothesize that the airline might take into account its common ownership as a reason to charge somewhat higher prices. But again, if this were true, it would also potentially negate the need for any sort of input by the owners as well as any sort of horizontal agreement between the airlines, and thus could be an argument against liability under Section 1.

A third possibility discussed by AST involves managers being “active” in some sense other than through formal shareholder action. Investors may have communications with management as part of their “active” role. We can call this the “whisper in their ears” scenario. However, AST note that less is known about the content of such communications. And it would be necessary to investigate what asset managers do and say in order to understand “whether such communication aids the translation of anti-competitive incentives into anti-competitive outcomes.” In other words, AST recognize that, without more facts, there is still a critical element missing. It is not enough to simply allege that there are communications without knowing more about what those communications involve.
It is of course possible that investors could whisper into the ears of both companies about what they would like to see in particular markets. But AST actually distance themselves from this possibility, suggesting that it is “unlikely” that shareholders give their firms explicit directions with respect to the desired intensity of competition in particular markets.

Importantly, however, even if such direct one-way communication about particular markets were to take place, it would likely still fall short of the legal requirements under Section 1. An investor whispering in the ear of two companies regarding what the investor would like to see in the marketplace is still unlikely to be condemned as a price fixing agreement, even if the airlines took some action based on it. Without more, it would be an example of what the Ninth Circuit in the Guitars case (In re Musical Instruments and Equipment Antitrust Litigation, ___ F.3d ___ (2015)) recently called a “rimless” hub-and-spoke conspiracy, which does not rise to the level of a Section 1 agreement among competitors.

As the court noted in Guitars, a traditional hub-and-spoke conspiracy has three elements: (1) a hub, such as a dominant purchaser; (2) spokes, such as competing manufacturers or distributors that enter into vertical agreements with the hub; and (3) the rim of the wheel, which consists of horizontal agreements among the spokes.

In the Guitars case, plaintiffs alleged that Guitar Center (a major customer acting as the hub) pressured each of the manufacturer defendants (the spokes) to adopt minimum advertised pricing policies, and the manufacturers acquiesced. The question was whether there was evidence of an agreement between the competing manufacturers (the rim). The court wrote:

“Manufacturers’ decisions to heed similar demands made by a common, important customer do not suggest conspiracy or collusion. They support a different conclusion: self-interested independent parallel conduct in an interdependent market.”

The court thus required something more to demonstrate the “rim” beyond the fact that the manufacturers all went along.

More interesting questions would arise if the facts went farther toward establishing the existence of a “rim-like” understanding among the owned firms. If a common owner met jointly with multiple airlines, or in one-on-one communications made clear to each of its companies how the others saw the marketplace, and what actions would be rewarded with an accommodating rather than competitive response, it is easy to see how a viable Section 1 claim could emerge. But an appropriate level of sensitivity to potential Section 1 risks faced by companies in concentrated industries would ordinarily steer companies clear of this sort of dialogue.

IV. POSSIBLE LESSONS FROM SECTION 8

Section 8 of the Clayton Act is the statutory prohibition on “interlocking directorates.” It states that “no person” shall at the same time serve as an officer
or director of competing corporations (other than banks and trusts, which are separately regulated) if certain dollar thresholds are met.

Section 8 most clearly applies to preclude the same individual from simultaneously serving on the boards of two competing companies, but it has also been interpreted to prevent the a competing company from appointing a representative on the board of its rival. So long as the statutory thresholds are met, Section 8 create a per se bar on the board overlap.

Section 8 has also been enforced where a third party (such as an institutional investor) is entitled to a representative on the boards of two competing companies, and its application in that setting provides some insight on how the law might deal with the ownership overlaps studied by AST. In Cleveland Trust, the third party was a financial institution that held stock (in various fiduciary accounts) in competing corporations, and used its voting rights to elect bank executives to serve as directors of the corporations. In International Association of Machinists, it was a labor union that owned an equity interest in competing airlines and secured representation on the competing boards. And in Reading International, it was a private equity firm that held substantial minority interests in competing movie theater chains and had the right to name directors in both chains.

The common thread in these cases is that the third entity has, at least in theory, some possible or plausible interest in limiting competition between the rival corporations in order to maximize returns from its investments. DOJ explained its underlying concern in the International Association of Machinists case as involving the potential for the third party to serve as a conduit for the exchange of confidential information, or be in a position to take steps to coordinate the business decisions between them. DOJ’s Competitive Impact Statement put it this way:

“[T]he IAM representatives may be able to use their positions as directors to coordinate decisions by the two airlines on pricing or entry and exit of particular markets in such a way that competition between Northwest and TWA is reduced. The directors may also be in a position to exchange information on competitively sensitive subjects such as future pricing or marketing strategies.”

The important take-away from the Section 8 cases is that even when enforcing a per se statute (one, moreover, that seeks to “to nip in the bud incipient

violations of the antitrust laws by removing the opportunity or temptation to such violations through interlocking directorates***17), DOJ has addressed the reasons why an interlock plausibly could lead to anticompetitive effects. Section 7 and Section 1 require something more than mere plausibility.