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Competition and Governance: Minority Shareholdings in Small Countries

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I. INTRODUCTION

Competition and good governance are closely related. When competition law and corporate governance intersect, it is important to be sure that the overlap gives rise to consistent policies. This paper identifies two major areas of intersection concerning minority shareholdings. The paper finds that competition law yields outcomes consistent with corporate governance standards and, at limited times, may provide an alternative path to enforceable standards of good corporate governance. Corporate governance rules are likely a more complete way of addressing distortions of competition that arise from related-party transactions than competition law. Nonetheless, somewhat surprisingly, competition law may have some role to play in cases of related-party dealing to purchase at above-market prices. In some circumstances, competition law may even provide firmer guidance than laws on corporate governance.

The first overlap between competition law and shareholding structures occurs when a common owner has shareholdings in multiple competing companies. The second occurs when a company in a group purchases from a related company (often in the same group), even when better deals for supplies could be found outside the group. On the one hand, minority shareholdings, even at a level of less than 20 percent, can create positions of influence that can merit treatment under merger review for potential lessening of competition between competing companies that are linked via a minority shareholding in one of them. This treatment of minority shareholding emphasizes that some minority shareholders may influence important business decisions. Minority shareholding can be an important factor to consider when assessing whether a merger review situation exists.

On the other hand, minority shareholders may be penalized by holders of decisive influence (including by minority-shareholding management) via anticompetitive procurement practices. Procurement and disposition practices by corporations can be intended to favor some controlling parties to the disadvantage of any minority shareholders without material influence over procurement. That is, procurement and disposition by private enterprises may be designed to reallocate corporate profits or value away from one company towards another with a high ownership share by shareholder/managers of the first company. This procurement distortion is more severe in the presence of interlocking shareholdings across distinct business enterprises providing services and products to one another, as may be more common in small and less developed countries with few major economic actors.

This paper examines how minority shareholding interacts with competition and governance in one small emerging economy (Mauritius).² The paper seeks to identify those

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² Mauritius is an island country in the Indian Ocean with a population of about 1.3m and modest surface area of 2040 km². According to the Ibrahim Index of African Governance, Mauritius was ranked first for governance

competition policy problems that are related to minority shareholdings and merit competition law consideration. While the country experiences described are those of a small country, the issues outlined in this paper are nonetheless of broad relevance, reflective of behavior that can be found on occasion in the large, developed economies.

II. MERGER SITUATIONS

In deciding whether a merger situation exists in Mauritius, the competition law seeks to identify whether one party will have influence over actions of two competitors. Minority shareholdings are a frequent area of debate for deciding whether a merger situation exists.³ Minority shareholdings may have material influence on business decisions through a variety of mechanisms:

1. Minority shareholding held by an active competitor; and
2. Minority shareholding held by investors in competitors.

These cases will be treated in turn.

Minority shareholdings of concern can sometimes be accompanied by board representation but board representation is not a necessary condition for there to be material and common influence on business decisions by competitors.

A. *Minority Shareholding Held by Active Competitor*

At times, an enterprise may purchase a minority shareholding in a competitor. When an active competitor acquires such a shareholding, but does not increase the holding or merge with the competitor, the vigor of rivalry may be affected. Rivalry may be affected through a number of routes. These include the ability of a minority shareholder to unilaterally veto substantial changes in corporate structure or investment⁴ as well as the ability to have substantial influence over decisions for which shareholder approval is required. For those minority shareholders with board representation even more options are available to reduce rivalry, such as the ability to influence pricing policies, the ability to obtain access to information over future business plans of competitors, and the ability to influence mergers, acquisitions, and major contractual relationships.

B. *Minority Shareholding Held by Investors in Competitors*

Passive investors are generally not viewed as a mechanism for reducing rivalry.⁵ Large investment funds with diversified holding may, for example, own small stakes in competing companies. Active investors, however, at times may take positions in competing companies. Even without considering the possibility of reducing rivalry, taking positions in competing companies can be a rational investment strategy when an investor believes that a sector as a whole provides high opportunity for financial gain through restructuring of debt or other assets. An investor may

among African countries in Africa in 2011. (2011 Ibrahim Index of African Governance, 2011) The corporate governance situation of Mauritius is therefore generally quite strong.

³ See, for example, OECD (2008) *Minority Shareholdings*, Competition Policy Roundtable, DAF/COMP(2008)30.

⁴ For example, if a 75 percent or 90 percent shareholder approval is required for major transactions, a minority shareholding of 25 percent or 10 percent is sufficient to unilaterally reject a major transaction, such as a merger with a third competitor or an investment that would substantially increase production capacity or quality.

⁵ This assumption is open to question.

then seek out investment opportunities in the sector and end up with an equity or a convertible debt stake in one or more competitors.

Should such stakes raise concerns about potential material influence? If the minority investor has board representation in competitors, a direct route for exercise of material influence exists. Investors may seek in such instances to assign different directors to each enterprise and establish rules (or “screens”) that limit the exchange of information between the directors appointed to represent the common investor. Such limits may coincide with the fiduciary duty of investors to maximize the performance of the firm on which they are a director. However, such information barriers are of unproven effectiveness. Moreover, it is clear that directors who are representing a common investor may increase the profits of the investor by sharing information and jointly influencing decision-making.

Information barriers will not resolve the more fundamental problem that can arise when management has incentives tied to financial performance. Assuming the management is aware of a significant interest by a minority shareholder in one or more competitors, the managers may seek to satisfy this minority investor constituency by competing “weakly” rather than “aggressively.” That is, suppose that weak competition will yield slightly lower profits for a manager’s company, but substantially higher profits for the industry (and joint shareholders). Suppose further that all managers are aware of the investor benefits from “weak” competition. Managers who consider that their personal job prospects and tenure are related to their investor’s financial performance may choose, independently and without coordination with competitor managers, to compete “weakly.”

C. Cases

The Mauritian competition law has a material influence standard for determining whether enterprises are under common control. Under this provision, (47(3)) “Any person may be treated as bringing an enterprise under his control where—(a) he becomes able to control or materially to influence the policy of the enterprise but without having a controlling interest in it; (b) being already able to control or materially to influence the policy of the enterprise, he acquires a controlling interest in it; or (c) being already able materially to influence the policy of the enterprise, he becomes able to control that policy.”⁶

There are at least two occasions when the material influence standard has been used in Mauritius. Neither instance is currently public. However, some of the facts of the two cases may be illustrative of the benefits of having a material influence standard in small jurisdictions. Material influence has been seriously considered in an enquiry involving a 49 percent interest and in another involving an interest of 10-20 percent.

Ownership rules exist in many regulated sectors, such as telecommunications, media, and foreign investment. These rules are often more mechanical than the material influence rule. They may, for example, limit the shareholding that a foreign investor can acquire of a domestic company to a certain figure, like 49 percent. It is fully possible that a situation that would not result in control (from the entity that approves FDI) may result in obtaining material influence.

⁶ Note that control may exist with less than a 50 percent shareholding if, for example, many shareholders do not exercise their right to vote.

Evading the spirit of a regulation via careful use of mechanical regulatory rules of control may succeed, absent a material influence standard. For example, multiple competing companies may be owned by separate branches of family interests without actually having joint shareholding. This might allow, for example, one branch of a family to legitimately hold media interests of one type and another branch to hold interests of another media without breaching a prohibition of cross-media ownership. At times, such different ownership structures may not involve any joint management, as when there has been a falling out between different branches of a family. At other times, such different ownerships may be an attempt to evade the spirit of a regulation. Thus, broadening the media reach of a family interest may be possible from a media regulation perspective, particularly when media ownership rules are mechanistic and based on examining presence of overlapping majority interests of listed shareholders.

When mergers are assessed using a material influence standard, family interests that divide ownership of companies that compete with each other can be pierced. For example, if one family member contacts another and subsequently influences substantial policy decisions in the other's firm, this may establish material influence and permit treatment of material influence over multiple competing companies as merger situations.⁷

Mauritius is actively applying a material influence standard and this has permitted a wide and appropriate reach of merger control.

III. RELATED-PARTY TRANSACTIONS

According to the OECD:

Related party transactions are common and occur when a company conducts business transactions with parties that have potentially direct or indirect control over the terms of the transaction. As a result, the terms of the transaction might result in a loss to the company as compared with market prices. Related parties include management, board members and controlling shareholders and their associates and can be to the detriment of non-controlling shareholders. The problem might be particularly acute in jurisdictions characterised by concentrated ownership.⁸

Many small countries and developing countries are characterized by concentrated ownership structures and thus are at risk of such transactions. In large family enterprises that have multiple generations, there are often diffuse individual stakes between different branches of a family. Moreover, families may be present in related businesses but with different shareholding patterns in different companies. One branch of a family may control the management of a company, while holding a minority stake in it.⁹

⁷ It might not be a coincidence that in the years preceding the November 25, 2009 promulgation of the Competition Act (2007), there was a substantial simplification of family shareholdings among some major economic groups, including simplifications that eliminated common ownership stakes in competing companies.

⁸ See OECD, 2011, http://www.oecd.org/document/39/0,3746,en_2649_34813_49078503_1_1_1_1,00.html describing the forthcoming book, RELATED PARTY TRANSACTIONS AND MINORITY SHAREHOLDER RIGHTS.

⁹ According to *The Report on Corporate Governance for Mauritius*, "The private sector in Mauritius is slowly evolving from a business environment dominated by family companies. This has had significant implications for corporate governance. For instance, there are still companies where senior management are also major shareholders or related to major shareholders. The governance issue here is that the manager must run the business for the benefit of the company and consequently for all shareholders, not just his or her group of shareholders." (Committee on Corporate Governance (2004) p.8)

In such situations, the family branch with controlling interest may be tempted to distort procurement and other transactions to favor other family companies. If the shareholding structures of the two companies are identical, distortive procurement or disposition decisions (e.g., procurement by company A from company B) may eliminate procurement competition and, in many cases, result in payment of higher prices for goods or services than would be the case if company A simply held an open procurement.

Such procurement practices do constitute distortions of competition and result in reduced efficiency. This paper argues that such distortions are not generally violations of the competition law, but may violate the legal responsibilities of directors. The violation of fiduciary duty has a follow-on consequence of distorting competition for the supply of products and services.

A. Private Corporations Do Not Generally Have a Competition Law Responsibility to Procure at Market Prices

Given that a corporation's decision not to procure can be viewed as a distortion of the market process, some observers have questioned whether such decisions could constitute a violation of the competition law. Answering such a question requires a detailed consideration of the exact text of the competition law's provisions. Based on an analysis of the Mauritian competition law, there would generally be no obvious violation of the competition law from a decision to restrict competition for procurement. That is, related-party procurement is generally not a "restrictive business practice" from the perspective of competition law, though in specific circumstances this could be the case.

B. It is Not Generally an Abuse for a Private Corporation to Procure at Above-Market Prices, but Could Be an Abuse Under Limited Conditions

A common pre-condition for finding an abuse is that the firm engaged in potential abuse should have market power over the sale or purchase of the product in question. In the generic situation when a firm purchases from a related entity a product that could also be purchased from other parties, there is no presumption of market power. In the Mauritian law, the existence of a monopoly situation is defined as one where one company accounts for 30 percent or more of the goods supplied or acquired on the market, or three companies account for 70 percent of the goods or services that are supplied or acquired on the market. (Competition Act, Section 46 (1) (a) and (b)) Unless a clear showing of a monopoly situation can be shown on the part of the purchasing company, there would be no violation of the law.

The use of the word "acquired" in the monopoly situation definition is clearly intended to capture monopsony. Thus the act of purchasing, as well as selling, is clearly covered by the Act. If a monopoly situation is deemed to exist for purchasing, the purchasing of goods at above-market prices from related entities may constitute a violation of the Competition Act (2007). According to the law, a monopoly situation is subject to review by the Competition Commission where the Commission has reasonable grounds to believe that an enterprise has engaged in conduct that "has the object or effect of preventing, restricting or distorting competition" or "in any way constitutes exploitation of the monopoly situation."

In its evaluation, the Commission shall take into account, *inter alia*, the availability or non-availability of substitutable goods or services for consumers and nearby competitors to whom consumers could turn. The Commission shall also take into account "evidence of action or behaviour by an enterprise that is, or group of enterprises that are, a party to the monopoly situation where such actions or behaviour...are likely to have an adverse effect on the efficiency,

adaptability and competitiveness of the economy of Mauritius....” If a company is both a monopsony purchaser of a good or service and pays a higher price for the good than the market price, there is a potential violation of Section 46 of the Act. No such case has yet been brought by the Commission.

C. It is Not Collusion for a Private Corporation to Procure at Above-Market Prices

The decision by a private corporation to procure from a related party is not collusive activity as defined in the Act. The Act clearly focuses on cases of horizontal agreements as being collusive. The decision by a purchaser to choose a related-party supplier is not a horizontal agreement in the sense of the act, being neither horizontal nor, at the time the decision is made over how to procure, an agreement.

D. Even If Private Corporations Do Hold a Public Tender, They Generally Have No Competition Law Responsibility to Choose the Best Offer

The Act does not focus on the conditions of selection between competing offers in a tender. Rather, when focusing on tenders, the Act is focused on collusive agreements to rig a bid.

In the limited situation of monopsony purchasing, the Act may be interpreted to require that the best offer be chosen. This requirement would arise because a decision to pay higher than market price¹⁰ would be a clear “distortion of competition” (46 (2) (a)) and, absent a strong justification, would have an adverse effect on the efficiency of the economy (46(3)(d)).

E. It is a Violation of Fiduciary Duty of Directors/Managers to Approve Transactions That Constitute Clear Self-Dealing

While competition law may apply to related-party transactions in only limited circumstances in which the company effecting a purchase is in a monopsony position, the law governing corporate operation in Mauritius provides much wider applicability of limitations. According to the Companies Act (2001), interests and transactions must be notified unless they are “entered into in the ordinary course of the company’s business and on usual terms and conditions.” (148(2)b) Transactions can be cancelled if the company does not receive “fair value.” There is no provision that makes transactions not performed at “fair value” against the Companies Act, however. Nonetheless, the fiduciary duty owed by directors to act in the interest of the company for which they are a director, when evaluating a transaction for that company, suggests that transactions at a value outside the range of “fair value” should not be approved and should be voided.

Other countries have clearer prohibitions on related party transactions. In Australia, for example, Chapter 2E of the Corporations Act states that for a public company or its controlled entities to give a financial benefit to a related party, either shareholder approval must be obtained or the action must fall within an approved exemption, one of the most notable being that the financial benefit would be reasonable between parties dealing at arm’s length.

Given that board approvals of self-dealing, whether implicit or explicit, are likely violations of the law (e.g., whether as a result of the Companies Act (2001) or from fiduciary

¹⁰ The price referred to in this paper is the price-quality bundle.

duty), one reasonable way for board members to assure themselves of the absence of personal benefits from self-dealing is to hold open tenders for major procurements or dispositions.

F. Large Transactions in Private Enterprises, Such as Procurements or Dispositions, Should Pass Through Related-Entities Only After Due Consideration By the Board

Good governance principles generally say very little about the mechanics of how to ensure that related-entity procurement does not harm the interests of minority shareholders. One of the most obvious methods, and one often used to provide transparency in both public and private procurement, is to proceed via open procurement.

Procurement and dispositions can veer towards related-party transactions when the shareholding structures of the two transacting companies are different. That is, suppose that a family branch with management control has a small interest in the main company A, but a much larger or complete interest in company B. Then, when procuring from company B, the managing family branch will have an incentive to overpay B for its goods and services, thus transferring profits from the company with diffuse and small ownership stakes to that with a high ownership stake by management. Similarly, if company A is selling to company B, the managing family branch will have an incentive to understate prices.

When such risks exist, it is even more important that open procurement occur. Open procurement increases transparency to shareholders and directors, providing a stronger basis for assessing fair value.

The OECD Principles of Corporate Governance (2004) provide basic guidance in this regard. They state that “abusive self-dealing should be prohibited” (III(B), OECD (2004)). They also state, “Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation.” (III(C), OECD (2004)) Further they suggest that timely and accurate disclosure should be made on related party transactions (V(A)5, OECD (2004)) According to the OECD Principles, the Board should be engaged with “Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.” (VI(D)6, OECD (2004))

The Mauritian government set up a Committee on Corporate Governance that released a report in 2004. It states, “The personal interests of a director, or persons closely associated with the director, must not take precedence over those of the company and its shareholders, including minority shareholders.” (2.4.2, Committee on Corporate Governance (2004))

The report emphasizes that “Full and timely disclosure (preferably in writing) of any conflict, or potential conflict, must be made known to the board....The board should develop a corporate code of conduct that specifically addresses conflicts of interest, particularly relating to directors and management, which should be regularly reviewed and updated as necessary.” (2.4.4, Committee on Corporate Governance (2004))

G. Small Country

Mauritius exemplifies the challenges that can arise for good governance in small countries. These arise from limited human resources and from the limited pool of alternative suppliers. Mauritius has taken many actions to promote better governance.

“In a country as small as Mauritius, the pool of [good governance]...skills is small and true independence is very difficult to achieve.”¹¹ (Committee on Corporate Governance (2004), p. 7)

Moreover, the pool of alternative suppliers and buyers may be limited. That is, with a high level of concentration present in the market, alternative suppliers and buyers will be fewer than in larger economies. It is inherently more likely that transactions will involve related parties. This risk is not unique to Mauritius, as it arises from minimum efficient scale for corporate operations.

IV. CONCLUSION

This paper focuses on the relationship between healthy competition, good governance, and minority shareholding. Interlocking directorates and shareholdings are a common feature of many countries. While they are well-known in certain developed countries, such as Japan and Korea, they are also common in small developing economies. This paper has shown that in one small, developing economy, competition law can and does take account of material influence in evaluating overlapping shareholdings for merger review. Perhaps surprisingly, the paper has suggested that under certain very limited circumstances, competition law may apply to the decision by a company to procure from a related party.

The policy question is whether competition law tools should be used to protect minority shareholders.¹² In considering this question, which is beyond the scope of this paper, it would be important to consider not only whether competition law is an appropriate instrument for protecting minority shareholders but also whether competition authorities should be responsible for that protection. While one reaction might be that protecting minority shareholders should not be in the mission of competition authorities, another might acknowledge that competition authorities actually perform varied tasks around the world. If there is no regulator with a clear mission that would encompass protecting minority shareholders, the question of whether a competition authority should do so is relevant, particularly in the presence of market power.

Fiduciary duty and corporate governance standards and laws are broader tools to use in attacking decisions by a company to pay above-market prices for goods or services that they procure. These would seem to be both the most direct and appropriate tools to use in general for preventing related-party transactions that pay non-market prices. The overall point remains, though, that competition law is more related to good corporate governance than is typically acknowledged.

¹¹ While one solution to finding independent directors for Mauritian companies would be to appoint directors from abroad, “The isolation of Mauritius means that a director from overseas would have to devote 3 days for each board meeting when travelling is taken into account. If a company has 6 board meetings a year, an independent director from overseas would have to devote 18 days annually to his Mauritian directorship, without preparation time, which is a considerable commitment for a non-executive director.” (Committee on Corporate Governance (2004), p. 7)

¹² The Mauritius competition regime does not envision private action.