Divesting ownership in a rival

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We examine the consumer welfare effect of a firm’s partial ownership of a competitor and compare the implications of alternative forms of divestiture. We identify conditions under which turning voting shares into non-voting shares is preferable to selling the shares to the firm’s current shareholders (an option frequently chosen). We also show that selling the voting shares to a large independent shareholder is preferable to selling them to small shareholders. We provide additional theoretical results and apply them to the divestiture of Portugal Telecom’s holdings in PTM.

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1. Introduction

In 2006, British Sky Broadcasting Group (BSkyB), a UK pay-TV broadcaster, announced the acquisition of 17.9% of ITV, a UK free-to-air TV broadcaster. The UK Competition Commission concluded that such acquisition would lessen competition considerably, and ordered BSkyB to reduce its shareholding to below 7.5%. In a related example, until November 2007 Portugal Telecom (PT) held a 58% share of PT Multimedia (PTM), a combination of voting stock and non-voting stock. The two firms operated in several markets as the two main “competitors” (sometimes the sole competitors). Responding to government pressure that PT divests its share in PT Multimedia, PT’s share in PT Multimedia was distributed to PT’s shareholders.

These are just two of the many examples where a firm owns a share in a competitor. This situation raises a series of competition policy questions, including: (a) To what extent does partial ownership lessen competition and decrease consumer surplus? (b) What difference does it make whether the partial ownership consists of voting shares, as opposed to preferred (non-voting) stock? (c) If a divestiture of control rights is to take place, what is the best way to implement it: to sell the shares to a large shareholder, to sell the shares to small shareholders, to distribute the shares among the shareholders of the parent company in proportion to their holdings, or to turn the voting stock into preferred stock?

In this paper, we attempt to address question (c), and in the process shed some light on (a) and (b). We propose a basic framework whereby each shareholder cares for his financial interest, whereas each firm maximizes the combined interests of its controlling shareholders.

As a preliminary result, we establish a relation between consumer surplus under a price setting duopoly and the weights that each firm gives to its competitor’s profits. We then apply this general result to examine the impact of alternative forms of divestiture. First, we show that turning a partial ownership from voting stock to preferred stock increases consumer welfare. In other words, while a financial interest in a competitor may lessen competition, a controlling share is even worse.

Next, we compare the relative merits — in terms of consumer surplus — of alternative divestiture options. In various recent cases,
divestiture has been implemented by the so-called “proportional” method, whereby firm A’s controlling shares in firm B are transferred to the shareholders of firm A in proportion to shareholdings in firm A. We identify conditions under which this option performs worse — in terms of consumer surplus — than turning voting stock into preferred stock, which in turn performs worse than full divestiture (that is, selling the shares to a third party).

Regarding the option of full divestiture, we show that a sale to a large independent shareholder fares better than a sale to many small shareholders. Intuitively, a sale to a large shareholder increases the weight given to independent shareholders in the target firm; and this has the beneficial “countervailing” effect of increasing the weight given by the target firm to its own profit.

While these are our main results, we also provide additional sets of necessary and sufficient conditions to rank various divestiture options. Moreover, while our results are couched in terms of divestiture of partial competitor ownership, they also apply (with the appropriate sign change) to an increase in partial ownership.

1.1. Related literature

A number of authors have considered the impact of partial competitor ownership on the nature of oligopoly competition. In one of the earliest contributions, Reynolds and Snapp (1986) show that market output is lower when there is partial ownership. Bresnahan and Salop (1986) build on Reynolds and Snapp (1986) by introducing the distinction between financial interest and control. They consider a joint venture between two competitors and show that an independent joint venture is more competitive than any form of silent financial interest, which in turn is more competitive than limited joint control or full ownership or control by one parent.¹

Flath (1992) contributes to this literature by considering both direct (as in the above papers) and indirect financial shareholders. Firm A indirectly holds shares in firm C if it holds shares in firm B and, in turn, firm B holds shares in firm C. The anticompetitive effects are greater in this case than when only direct holdings are considered.²

In a recent contribution, Karle et al. (2011) consider a private investor who initially owns controlling stake in one of two competing firms and may acquire a (controlling or non-controlling) stake in the competitor, either directly (by making use of own funds) or indirectly (by inducing the controlled firm to do so). While there is some overlap with our analysis, their framework cannot be used to address the question we are interested in this paper, namely comparing various forms of divestiture.³

Although most of the literature focuses on unilateral effects of partial ownership, Gilo et al. (2006) look at the possibility of coordinated effects. Specifically, they analyze whether passive financial investments in rivals facilitate or hinder tacit collusion. Despite the fact that larger crossholdings may limit the punishment after deviation from a collusive agreement (Malieg, 1992), Gilo et al. (2006) establish that an increase in financial ownership by a rival firm never hampers collusion.

¹ Reitman (1994) considers the same ownership structure as Reynolds and Snapp (1986) in a conjectural variation model to discuss the incentives firms may have in participating in partial ownership arrangements. See also Alley (1997) for an application of a conjectural variation model with partial ownership arrangements and trade to the automobile industry.

² Dietzenbacher et al. (2000) extend these results to more than three firms and to Bertrand competition. They also provide an empirical application to the Dutch financial market. In related recent research, Nicola and Bunn (2008) conducted a series of simulations to analyze the effects of crossholdings on the outcome of sealed bid-offer auctions with capacity constraints.

³ Moreover, Karle et al. (2011) only consider two possible extreme cases regarding initial ownership structures in the target firm: one block holder or many small shareholders. In addition, all private investors are assumed not to have initially positions in more than one firm. Our present paper proposes a more general framework in both respects, which is important in terms of empirical application.

The paper that is closest to ours is O’Brien and Salop (2000). They study the case when there is partial ownership which may or may not correspond to control. They evaluate the impact of such cross shareholdings by computing each firm’s price pressure index (PPI): an increase in firm i’s PPI corresponds to an upward shift in its first-order condition; given constant rival prices, this leads to a higher price by firm i. Based on this methodology, they find the surprising result that obtaining control of a rival firm through partial ownership may be worse, in terms of welfare, than a complete merger between the two competitors.⁴ Some of our results are consistent with those of O’Brien and Salop (2000). However, our framework allows us to consider additional ownership comparative statics they did not consider.

O’Brien and Salop focus on partial acquisitions that lead to various scenarios. However, the relationship between financial interest and control is not modeled. By distinguishing between voting stock and preferred stock, our approach addresses this issue and derives a series of policy relevant results. Moreover, unlike O’Brien and Salop we allow explicitly for the distinction between individuals as owners and firms as owners, raising the issue of direct and indirect control or financial interest. As our empirical application shows, this distinction is of practical interest.

1.2. Road map

The remainder of the paper is structured as follows. In Section 2 we present our formal framework. Section 3 includes some preliminary results (lemmas) which we then use in Section 4, where we present our main results. An extension to our basic framework, considering the case of common shareholders, is included in Section 5. In Section 6, we apply our analysis to the case of Portugal Telecom’s (PT) divestiture of its share in PT Multimedia (PTM). Section 7 concludes the paper.

2. Formal approach

Consider an industry with two firms (A and B) and N relevant shareholders.⁵ We explicitly consider the distinction between voting stock (i.e., shares with control rights) and preferred (non-voting) stock. Firm i’s total stock (i = A, B) is composed of a percentage Vi of voting stock and a percentage 1 − Vi of preferred stock. Shareholder n holds a share vni of voting stock in firm i and a share sni of preferred stock in firm i. Hence, shareholder n holds a percentage nni(1 − Vi) of firm i’s total stock.

Each firm’s profit is distributed among shareholders proportionally to their total stock, regardless of whether it be voting stock or preferred stock. Hence, shareholder n receives a profit stream corresponding to a percentage rni of firm i’s aggregate profit, Πi. It follows that shareholder n’s payoff is given by \[ Πi_n = Πi rni + Πi sni. \]

In addition to individual shareholders, we also consider the possibility that firm A owns a share tA in firm B, which includes a share tB > 0 of voting stock.² It follows that, if n is firm i’s operating profit (i = A, B), then firm A’s aggregate profit (including cross-holdings) is given by \[ ΠA = nA + tAΠB, \] whereas for firm B we have simply \[ ΠB = nB. \]

We follow O’Brien and Salop (2000) in assuming that each firm’s objective function is a weighted sum of shareholders’ payoffs. Additionally, we assume that the weight given by firm i to shareholder n’s payoff, wi, is a function of shareholder n’s voting stock. In particular, let \[ wi = f(vni) \] where: \( f(0) = 0; \) \( f(\theta) = \theta f(\nu_\theta) \) for all \( \theta > 0 \) and \( \nu_\theta = 1 - \theta \frac{f(\theta)}{f(1)} \) for all \( \theta > 0 \). We thus assume that a firm gives no weight to a

⁴ In a recent contribution Foros et al. (2010) consider the case when the partial ownership of one firm in the other is endogenously determined.

⁵ We allow for two types of shareholders, relevant shareholders and infinitesimal shareholders. Only the former are able to influence the firms’ managers.

⁶ Strictly speaking, firm B has, at most, N + 1 shareholders, if we include the competing firm as a shareholder.
particular shareholder who does not own voting stock, that the weight given to a particular shareholder is increasing in his percentage of voting stock, that the ratio of weights corresponding to any two shareholders, \( n \) and \( n' \), does not change if the percentage of voting stock owned by each of them changes in the same proportion and that if a given shareholder’s stock is split between two shareholders, the weight given by firm \( i \) to these two shareholders is lower than the original weight.

Notice that in our setting, even if shareholder \( n \)’s percentage of voting stock is kept constant, if for some reason there is a change in the pattern of ownership of the remaining shareholders, this may affect the weight attributed by the firm to shareholder \( n \)’s payoff. Moreover, even if one shareholder has the majority of the votes we do not consider that the firm maximizes his payoff. As highlighted by O’Brien and Salop (2000) “the control exerted by shareholders with the majority of voting power is not absolute. If it were, the minority (or non-voting) shares would have little value…” (p. 571).

Formally, firm \( i \) maximizes \( \omega_i \) \((i = A, B)\), which are given as follows:

\[
\begin{align*}
\omega_A &= \sum_{n=1}^{N} w_{A_n} (\pi_{A_n} + \pi_B) \\
\omega_B &= \sum_{n=1}^{N} w_{B_n} (\pi_{A_n} + \pi_B) + w_{B_0} \omega_A.
\end{align*}
\]

(1)

Solving for \( \omega_A \) and \( \omega_B \) and expressing aggregate profits in terms of operational profits, we obtain:

\[
\begin{align*}
\omega_A &= \sum_{n=1}^{N} w_{A_n} (\pi_{A_n} + (\pi_B + \pi_{A_0} + \pi_{B_0})) \tau_B \\
\omega_B &= \sum_{n=1}^{N} (w_{B_0} + w_{B_n} w_{A_n})(\pi_{A_n} + (\pi_B + \pi_{A_0} + \pi_{B_0})) \tau_B.
\end{align*}
\]

(2)

Thus, an alternative way to think about firm \( i \)’s maximization problem is to consider that, ultimately, there are \( N \) shareholders with control rights (through \( w_{0n} \)) and financial interests (through \( \taujn \)) in firms \( A \) and \( B \), both direct and indirect interests. For instance, the direct financial interests of shareholder \( n \) in firm \( B \) correspond to \( \tau_{B0} \), whereas his indirect financial interests are given by \( \tau_{A_0B0} \). A similar reasoning can be applied to the control weights \( w_{0n} \).

Many of our results below are better expressed in terms of share correlation/concentration indexes. Specifically, we define

\[
K_{ij} \equiv \sum_{n=1}^{N} (w_{in} + w_{in} w_{B_n}) \tau_{jn}
\]

(3)

with \( i, j = A, B \) and \( i \neq h \). In words, \( K_{ij} \) measures the correlation between direct plus indirect control in firm \( i \) and financial interest in firm \( j \), as well as the concentration of such control/interest. In the limit, \( K_{ii} = 0 \) either because firm \( i \)’s control is separated from firm \( j \)’s ownership or because there are many infinitesimal shareholders. At the opposite extreme, \( K_{ij} = 1 \) if there is a single shareholder who controls the firm and is entitled to all its profit.

With this notation, both firms’ objective functions can be written as

\[
\begin{align*}
\omega_A &= K_{AA} \pi_A + (K_{AB} + K_{AB0}) \pi_B \\
\omega_B &= K_{BA} \pi_A + (K_{BB} + K_{BB0}) \pi_B.
\end{align*}
\]

(4)

Without loss of generality and assuming \( K_{ii} > 0 \), one can re-write the firms’ objective functions as

\[
\begin{align*}
\omega_A &= \pi_A + \gamma_A \pi_B \\
\omega_B &= \pi_B + \gamma_B \pi_A
\end{align*}
\]

(5)

where

\[
\begin{align*}
\gamma_A &= \frac{K_{AB} + K_{AB0}}{K_{AA}} \\
\gamma_B &= \frac{K_{BB} + K_{BB0}}{K_{BB}}
\end{align*}
\]

(6)
correspond to the weights each firm attributes to its competitor’s operating profit.

3. Preliminary results

We are interested in understanding how changes in ownership affect consumer welfare. For this purpose, we assume that firms compete in prices and that prices are strategic complements: \( \partial \pi_i/\partial \pi_j > 0 \). Moreover, we assume that an increase in firm \( i \)’s price increases firm \( j \)’s operating profit \( \pi_j \) and reduces consumer surplus. The following result then relates changes in \( \gamma_i \) to changes in consumer surplus.

Lemma 1. Consumer surplus is decreasing both in \( \gamma_A \) and \( \gamma_B \).

Although we focus our attention on price competition, the negative relation between \( \gamma_i \) and consumer surplus extends to other modes of market competition (for example, Cournot competition with linear demands). The idea is fairly intuitive: to the extent that firm \( i \) takes firm \( j \)’s profit into consideration when maximizing profits, we are closer to the perfect collusion extreme, which implies higher prices.

Although our focus is on changes in firm \( A \)’s holdings of firm \( B \), we first consider a series of comparative statics exercises with respect to infinitesimal changes in some key parameters.

Lemma 2. \( \gamma_B \) is increasing in \( K_{AB} \), non-increasing in \( K_{BB} \) and decreasing in \( \tau_{B0} \). Moreover, \( \gamma_A \) is increasing in \( \tau_{B0} \) and \( K_{AB} \) and non-increasing in \( K_{BB} \).

The weight placed by firm \( i \) on its rival’s profit decreases with \( \tau_{B0} \). Whenever control (measured by direct and indirect control weights) and financial interests become more aligned in firm \( i \), shareholders will use their control to make firm \( i \) maximize own profit and thus place a lower weight on the rival’s profit.\(^7\) For a similar reason, the weight placed by firm \( i \) on its rival’s profit increases with \( \tau_{B0} \). If shareholders with (direct or indirect) control of firm \( i \) have more financial interests on firm \( j \), then firm \( i \) will place a larger weight on its competitor.

As for firm \( A \)’s financial interests in firm \( B \), \( \tau_{B0} \) it affects both firms in different ways. An increase in \( \tau_{B0} \) makes firm \( A \) care more about firm \( B \)’s profits due to its larger financial interest in firm \( B \). How about firm \( B ? \) To the extent that \( K_{BB} > 0 \), i.e. that there is some correlation between control in firm \( B \) and financial interest in firm \( A \), a larger \( \tau_{B0} \) makes firm \( B \) place a higher weight on own profit and consequently a lower profit on rival’s profit. Everything else constant, the more firm \( A \) cares about firm \( B \) (as measured by \( \tau_{B0} \)), the more firm \( A \) will use its control over firm \( B \) to maximize firm \( B \)’s profits, which in turn leads to a lower \( \gamma_B \).

We now discuss in more detail the factors that drive \( K_{ij} \). For that purpose, we define

\[
K_{ij} \equiv \sum_{n=1}^{N} w_{in} \tau_{jn}
\]

(7)

\( i = A, B \), so that we can write

\[
K_{ij} \equiv \sum_{n=1}^{N} (w_{in} + w_{in} w_{B_n}) \tau_{jn} = k_{ij} + w_{0i} k_{ij}
\]

\(^7\) It should be noted that \( \partial \pi_i/\partial \pi_j \) is negative when \( K_{ii} > 0 \). Otherwise it is zero. Recall that when \( K_{ii} = 0 \), shareholders with control of firm \( i \) have no participation in firm \( j \)’s profit. As long as \( K_{ii} > 0 \), firm \( B \) will maximize own profit and as long as \( K_{ii} > 0 \), firm \( A \) will maximize its aggregate profit, which includes a percentage \( \tau_{B0} \) of firm \( B \)’s operating profit. Increases in \( K_{ii} \) or \( K_{ij} \) do not change this behavior.
with \( h_{ij} = AB \) and \( i \neq h \). Again, \( k_0 \) measures the correlation between control in firm \( i \) and financial interest in firm \( j \), as well as the concentration of such control/interest. But in this case, it refers exclusively to direct control.\(^8\)

With respect to firm \( A \), there is only direct control, and hence, \( k_A = k_{BA} \). There exist, however, two types of control regarding firm \( B \): direct control and indirect control (which is exerted via firm \( A \)). Hence, \( k_B \) is composed of two elements. The first one measures the extent to which direct control in firm \( B \) is correlated with financial interest in firm \( j \), \( k_{ja} \). The second one measures the extent to which control in firm \( B \) exerted via control in firm \( A \) is correlated with financial interest in firm \( j \), \( w_{ja}k_{BA} \). In what follows, we will assume that direct control in a given firm is more correlated with (direct) financial interest in the same firm than with financial interest in the rival firm, which implies that \( k_{A}k_{BB} - k_{A}k_{BA} > 0 \). Under this assumption, Lemma 2 can then be rewritten as:

**Lemma 2**: \( \gamma_B \) is increasing in \( k_{BB}, k_{BA} \) and \( v_{BB} \), and decreasing in \( k_{AB}, k_{BA} \) and \( t_{BB} \). Moreover, \( \gamma_A \) is increasing in \( t_{AA} \) and \( k_{AA} \), and non-increasing in \( k_{BA} \).

As far as \( \gamma_A \) is concerned, since \( k_{AA} = k_{BA} \) and \( k_{AB} = k_{BA} \) (see footnote 8), the results in Lemma 2 coincide with those in Lemma 2. With regard to the part that refers to \( \gamma_B \), however, this formulation allows us to highlight further effects, which we discuss in turn.

First, \( \gamma_B \) is increasing in \( k_{BB} \). Why would firm \( B \) care about firm \( A \)'s profits? For two reasons: (i) because some shareholders with control in firm \( B \)'s may have a financial interest in firm \( A \) (i.e. because there exist common shareholders); and/or (ii) because the shareholders with control and financial interest in firm \( A \) also have some control in firm \( B \) (through \( w_{ja} \)). The extent to which the shareholders who control firm \( A \) also have a financial interest in firm \( A \) is measured by \( k_{AA} \), thus \( \gamma_B \) is increasing in \( k_{AA} \).

Second, \( \gamma_B \) is decreasing in \( k_{AB} \). Recall that the indexes \( k_i \) measure both correlation and concentration. In this case, it is best to think of \( k_{BB} \) as a concentration index. In the limit when \( k_{BB} \) is small, all firm \( B \) shareholders (except firm \( A \)) are of infinitesimal size. This implies that firm \( A \)'s share in firm \( B \), even if less than 1, effectively gives firm \( A \) complete control over firm \( B \). To the extent that \( k_{AA} \) is greater than zero, so that firm \( A \)'s voting shareholders also have a financial interest in firm \( A \), this implies that the controlling share \( v_{BB} \) will induce firm \( B \) to care a lot for firm \( A \)'s profits. For this reason, an increase in \( k_{BB} \) will give a greater concentration of control by firm \( B \)'s "independent" shareholders — "counterweights" the effect of \( v_{BB} \). We will return to this "counterweighting" effect later.

Third, \( \gamma_B \) is increasing in \( v_{BB} \) (and in \( w_{ja} \)) if \( k_{A}k_{BB} - k_{A}k_{BA} > 0 \). Greater control of firm \( B \) by firm \( A \)'s shareholders leads firm \( B \) to place greater weight on firm \( A \)'s profits. There are two opposing effects in place: (i) A larger \( w_{ja} \) increases the correlation between control in firm \( B \) and financial interest in firm \( A \), \( k_{BB} \), via indirect control; and (ii) a larger \( w_{ja} \) increases the correlation between control in firm \( B \) and financial interest in firm \( A \), \( k_{BA} \), if \( k_{AB} \) is positive. The channel through which the first effect takes place is similar to that discussed above regarding the partial derivative \( \frac{\partial \gamma_B}{\partial k_{BA}} \). To the extent that \( k_{AA} > 0 \), the voting shareholders who have partial indirect control over firm \( B \) also have a financial interest in firm \( A \). Such control is used to influence firm \( B \) to give greater weight to firm \( A \)'s profits. And the greater \( v_{BB} \) is, everything else constant, the greater the control of firm \( B \) by firm \( A \), and the greater this effect is. The second effect results from the possible existence of common shareholders who control firm \( A \) and have a financial interest in firm \( B \). To the extent that \( k_{BB} > 0 \), some shareholders are interested in making firm \( B \) place a larger weight on own profit and an increase in \( w_{ja} \) makes their indirect control of firm \( B \) stronger.

Notice the contrast between two of the derivatives: \( \gamma_B \) is increasing in \( v_{BB} \), but decreasing in \( k_{BB} \). This shows that the nature of firm \( A \)'s holdings in firm \( B \) matters a great deal: control and financial interest are related but different forms of shareholding. In fact, for a given level of financial interest, greater control leads firm \( B \) to place greater weight on firm \( A \)'s profits; but for a given level of control, greater financial interest leads firm \( B \) to place a lower weight on firm \( A \)'s profits. In the next section we will discuss the importance of this distinction when comparing various forms of divestiture.\(^9\)

Discussing the effects of partial ownership, O'Brien and Salop (2000) also allude to the important distinction between active and passive ownership:

In analyzing the competitive effects of partial ownership, it is necessary to distinguish between two aspects of partial ownership, financial interest and corporate control ... These two factors have separate and distinct impacts on the competitive incentives of the acquired and acquiring firm. Financial interest affects the incentives of the acquiring firm, while corporate control affects the incentives of the acquired firm. (p. 568)

While we agree with this characterization, we also think that it is incomplete. We agree that a higher \( v_{BB} \) leads to a higher \( \gamma_B \) ("financial interest affects the incentives of the acquiring firm") and that a higher \( k_{BB} \) leads to a higher \( \gamma_A \) ("corporate control affects the incentives of the acquired firm"). But to this we add that, to the extent that firm \( A \) has some control over firm \( B \), financial interest also affects the incentives of the acquired firm (a higher \( v_{BB} \) leads to a lower \( \gamma_B \), as stated in Lemma 2).

In addition to the derivatives presented above, it is also relevant to discuss how \( \gamma_A \) and \( \gamma_B \) are affected by \( k_{BB} \) and \( k_{BA} \). With respect to \( k_{BB} \), a higher correlation between (direct) control in firm \( A \) and financial interest in firm \( B \) makes firm \( A \) place a higher weight on firm \( B \)'s profit and, to the extent that the shareholders who control firm \( A \) have an influence via \( w_{ja} \) on firm \( B \)'s decisions, will make firm \( B \) place a higher weight on itself, i.e. a lower weight on firm \( A \)'s profit. As for \( k_{BA} \), we have \( \partial \gamma_B/\partial k_{BA} > 0 \) and \( \partial \gamma_B/\partial k_{BA} = 0 \). The reasons are similar, with the exception that firm \( B \) has no voting shares in firm \( A \) and, hence, shareholders who control firm \( B \) have no way to instruct firm \( A \) to place a higher weight on its own profit. As a result of the above, the existence of common shareholders leads to a higher \( \gamma_A \), whereas the effect on \( \gamma_B \) is uncertain. If \( k_{A}k_{BB} - k_{A}k_{BA} > 0 \), the existence of common shareholders also leads to a higher \( \gamma_B \).

Since in the presence of common shareholders, changes in the ownership and control structure give rise to several effects going in opposite directions, it is difficult to establish general results. In the following section, we present our main results for the case in which there are no common shareholders before the divestiture. Section 5 then discusses the implications on the main results of the existence of common shareholders prior to the divestiture.

### 4. Main results: no common shareholders

Although our general notation allows for shareholders with holdings in both firms, in this section we will assume that this is not the case except for the share firm \( A \) holds in firm \( B \). Taking this into account, we have \( k_{BB} = k_{AA} = 0 \) and we may rewrite Eq. (6) as follows:

\[
\gamma_A = f_{BB} \\
\gamma_B = \frac{w_{BB}k_{AA}}{k_{BB} + w_{BB}f_{BB}k_{AA}}.
\]

\(^9\) As we will see, the two forms of shareholding are not independent: an increase in voting shares also leads to an increase in financial interest, except in the limit case when \( V_i = 0 \), so that voting shares correspond to no financial interest.
We now turn to the main results in the paper, where we consider the implications for consumer surplus of various alternative forms of divestiture of firm A’s control holding in firm B. Specifically, using Lemmas 1, 2 and other results, we now characterize the effect and compare the relative merits in terms of consumer surplus of the following alternative options:

1. The shares are distributed among the shareholders of the parent company in proportion to their holdings.
2. The shares are turned into preferred stock.
3. The shares are sold to infinitesimally small shareholders.
4. The shares are sold to a new large shareholder.

Note that there is an important distinction between Options 1 and 2, on the one hand, and Options 3 and 4 on the other hand: the latter two options require a sale of shares, whereas the first two do not. In other words, one would expect the transactions cost of Options 3 and 4 to be greater than that of Options 1 and 2. We will return to this issue when discussing the relative merits of each option.

Option 1 assumes that all shares (irrespective of being voting or preferred stock) that firm A owns in firm B are distributed to firm A’s shareholders in proportion to their total stock in the parent company. If there is only one type of shares, then there is only one type of proportional spin-off. If, however, there are various types of shares, then our assumption is not innocuous, as it is likely that different rules will lead to different outcomes. For example, each share might be distributed in proportion to the shares of the same type held in the parent company.

Option 2 directly addresses the issue of control. If the main concern is that firm A controls firm B, then the simplest way of addressing the issue is to remove such control by turning its voting shares into non-voting shares.

Option 3 is a natural benchmark. Just as the most competitive market structure corresponds to atom-sized firms, one may conjecture that atom-sized shareholders best correspond to the idea of a competitive structure. However, as we will later see, such shareholder structure does not necessarily maximize consumer surplus.

Finally, Option 4 is similar to Option 3 with the difference that the sale is made to one large shareholder.

We first consider the case of a proportional spin-off procedure (Option 1). In some sense, a proportional divestiture substitutes direct firm control for shareholder control. To the extent that these alternative forms of control are substitutes, a tantalizing possibility is that a proportional spin-off may increase or decrease consumer welfare depending on the particular patterns of ownership structure.

This is for two reasons. First, since the indirect voting shares are converted into direct shares in proportion to $\tau_{A_n}$ and not in proportion to $\nu_{A_n}$, the relative voting importance of each shareholder changes, thereby affecting the shareholder’s weight even if the latter is linear in voting stock. Second, even if $\nu_{A_n} = \tau_{A_n}$, as the weight assigned to each shareholder is not necessarily linear in the percentage of voting stock she holds, the importance of each shareholder may change: a given reduction in the indirect percentage of votes is not necessarily compensated by an equal increase in the direct percentage of votes held, as far as control weights are concerned.

This type of divestiture has several effects, which we discuss in turn.

First, it creates common shareholders. If $k_{AB} > 0$, some shareholders with control over firm A will, after the divestiture, have a financial interest in firm B (i.e. $k_{AB}$ becomes positive). This will lead firm A to attribute a higher weight to firm B’s profit (i.e. $\gamma_B$ increases). On the other hand, to the extent that, after the divestiture, firm A still retains some control over firm B, these common shareholders will use their control over firm A to make firm B more aggressive, thereby leading to a decrease in $\gamma_B$. Additionally, the shareholders who gain some direct control over firm B also have a financial interest in firm A (i.e. $k_{AB}$ becomes positive). Hence, these shareholders will make firm B behave less aggressively (i.e. a larger $\gamma_B$).

Second, the proportional divestiture leads to a reduction in both $\nu_{AB}$ and $\nu_{BB}$, where the corresponding induced effects on $\gamma_A$ and $\gamma_B$ are already discussed in the previous section (see Lemma 2 and Lemma 2').

Finally, the proportional divestiture also has an impact on $k_{AB}$. By redistributing shares that were previously concentrated in firm A to its own shareholders, this type of divestiture leads to an increase in the correlation between ownership and control in firm B, which has the positive effect of making this firm place a lower weight on firm A’s profit (i.e. $\gamma_A$ is reduced).

Before presenting our next result, which establishes a necessary and sufficient condition for the proportional divestiture to be good for consumers, some additional notation must be introduced: Define

$$S^P_B = \sum_{n=1}^{N} \Delta w_{AB} \cdot \tau_{An}$$

where $\Delta w_{AB}$ denotes the variation in $w_{AB}$ due to the implementation of Option $O = 1, \ldots, 4$; divestiture. In words, $S^P_B$ refers to the correlation between variations in control weights in firm B (resulting from divestiture $O$) and original ownership shares in firm B. One particular case is worth explaining. We have $S^P_B = 0$ when each shareholder who is given a different weight in firm B’s objective function did not own directly any stock in firm B before the divestiture (and hence had no direct claims over firm B’s profit). A large $S^P_B$ means that shareholders who gained more control over firm B are those who have, at the outset, a larger financial interest in firm B.

Proposition 1. Any complete or partial proportional divestiture (Option 1) increases consumer welfare if and only if

$$k_{AB}(S^P_B + k_{BB} \Delta w_{BB}) - S^P_{AB} w_{BB} k_{AB} < 0.$$
In order to illustrate in a simpler way the main mechanisms behind this result, consider the special case wherein the \( f(\cdot) \) function is linear. More specifically, assume now that \( f(v_{in}) = v_{in} \) and \( \sum_{i=1}^{N} t_{in} = 1 \). When this is the case, the condition in Proposition 1 boils down to

\[
\sum_{i=1}^{N} (t_{in} - v_{in}) t_{An} < 0.
\]

In this case, the condition for consumer welfare to increase will be verified if the largest shareholder in terms of financial interest are also the ones who have a lower percentage of total stock compared to their percentage of voting stock. Shareholders with \( t_{in} > v_{in} \) will be attributed a higher direct percentage of the divested voting shares, \( t_{An} v_{An} \), than their ex-ante indirect voting influence in firm \( B \), \( v_{An} v_{An} \). Now, if these shareholders, the ones whose relative voting power in firm \( B \) increases with the divestiture, also have a high financial interest in firm \( A \), a high \( t_{An} \) they will use their increased (voting) influence to instruct firm \( B \) to be less aggressive.

Consider the following illustrative example: two shareholders, 1 and 2, are each entitled to 40% and 60% of firm \( A \)'s profit, respectively, but one of them (say, shareholder 1) owns all voting stock. Further, firm \( A \) owns 20% of firm \( B \)'s voting stock. Before the divestiture, shareholder 1 has an indirect control over firm \( B \) that corresponds to 20% (i.e., firm \( B \) will give a weight of 20% to shareholder 1's payoff) and the remaining shareholder has no control over firm \( B \), i.e., it is given no weight by firm \( B \). After the proportional divestiture, 12% of firm \( A \)'s voting stock in firm \( B \) will be attributed to shareholder 2 and 8% to shareholder 1. In this case, the proportional divestiture will reduce consumer surplus. Shareholder 2 will see his control in firm \( B \) increase when compared to shareholder 1. This happens because shareholder 2 will be given a larger percentage of voting stock, 12%, than his original indirect holdings, 0%, while shareholder 1 will only receive 8% and previously held 20%. But, given that shareholder 2 is more interested in firm \( A \)'s profit than shareholder 1 was (because he has a larger financial interest) the increase in control will make firm \( B \) less aggressive.

It is worth remarking at this point that with \( f(v_{in}) = v_{in} \), if each shareholder \( n \) owns the same percentage of voting shares and preferred stock in firm \( A \) (i.e., \( v_{in} = s_{in} = t_{in} \)), then a proportional divestiture turns out to be neutral from a consumer welfare point of view.\(^{11}\) The intuition is straightforward: the proportional divestiture simply converts indirect voting power and financial interest into direct ones. The same is true if there is only one type of stock.

Next, we consider the possibility of turning firm \( A \)'s voting stock in firm \( B \) into preferred stock (Option 2).

**Proposition 2.** Any complete or partial divestiture that turns voting stock \( v_{An} \) into preferred stock (Option 2) leads to an increase in consumer surplus.\(^{12}\)

Turning voting stock into preferred stock does not completely separate the firms: the financial interest is kept at the same level. However, as far as consumer surplus is concerned, it represents a positive move. As shown by Lemma 2, a decrease in \( v_{An} \) leads to a decrease in \( \gamma_{B} \); and this in turn leads to an increase in consumer surplus, as shown in Lemma 1. Moreover, a decrease in \( v_{An} \) leads to an increase in \( k_{B} \). This happens because the independent voting shares \( v_{An} \) now have relatively greater value. And, by Lemma 2, an increase in \( k_{B} \) leads to a decrease in \( \gamma_{B} \).

Intuitively, the switch from voting stock to preferred stock has two effects on control: it weakens firm \( A \)'s control of firm \( B \) (the direct effect) and it also strengthens control by firm \( B \)'s independent shareholders. Both of these effects lead firm \( B \) to place a lower weight on firm \( A \)'s profit.

Currently competition policy in the EU and the U.S. seems roughly consistent with Proposition 2's characterization of the effects of partial ownership. In the EU, any partial interest that enables the purchaser to exercise control over the target company is subject to a merger filing. The same is true, however, if the acquisition does not change the degree of control. The U.S. guidelines also make a distinction between active and passive acquisitions, though they also recognize that even passive acquisitions may present competitive concerns (Hatton and Cardwell, 2000).

The following proposition considers the situation in which there is a divestiture of voting stock \( v_{An} \) that takes place by sale (Options 3, 4).

**Proposition 3.** A complete divestiture of voting stock \( v_{An} \) that takes place by sale (Options 3, 4) leads to an increase in consumer surplus.\(^{13}\)

The intuition behind this result is simple. When a complete divestiture of voting stock takes place by sale, then, after the sale, \( v_{An} = w_{An} = 0 \). From Eq. (8), this leads to firm \( B \) attributing no weight to firm \( A \)'s profits, \( \gamma_{B} = 0 \). In addition, \( t_{An} \) will decrease by \( v_{An} \), implying that also \( \gamma_{B} \) (the weight given by firm \( A \) to firm \( B \)'s profits) will decrease with the complete divestiture by sale (Lemma 2).\(^{14}\) Now, since both \( \gamma_{A} \) and \( \gamma_{B} \) decrease with the operation, Lemma 1 implies that consumer surplus will be enhanced after a complete divestiture by sale.\(^{15}\)

It should be noted, however, that the divestiture of a small fraction of \( v_{An} \) by means of a sale to an infinite number of small shareholders may lead to a decrease in consumer surplus. In order to illustrate this possibility, consider the following simple example in which (i) all shares are voting shares, (ii) there are no common shareholders and (iii) \( f(v_{An}) = v_{An} \). Following Singh and Vives (1984) and assuming firm symmetry, let the representative consumer maximize

\[
U(q_{A}, q_{B}) = a(q_{A} + q_{B}) - \frac{1}{2} (bq_{A}^{2} + bq_{B}^{2} + 2dq_{A} q_{B}) - p_{A} q_{A} - p_{B} q_{B}
\]

where \( a, b, d \) and \( q_{i} \) are positive parameters, with \( b > d \), and \( q_{i} \) denotes firm \( i \)'s output. This utility function leads to the following linear inverse demand function:

\[
q_{i} = \frac{a(b - d) - bp_{i} + dp_{j}}{b^{2} - d^{2}}
\]

Assuming that marginal costs are equal to zero, it is straightforward to obtain normalized equilibrium prices and outputs, which are presented in Appendix B.

**Consumer surplus**, if divided by \( a^{2}/b \), can be written as

\[
CS^{*} = (Q_{A} + Q_{B}) - \frac{1}{2} (Q_{A}^{2} + Q_{B}^{2} + 2xQ_{A}Q_{B}) - P_{A}Q_{A} - P_{B}Q_{B}
\]

where \( Q_{i} \) and \( P_{i} \) are normalizations of equilibrium quantities and prices and \( x = d/b < 1 \).

Now, the divestiture of a small fraction of \( v_{An} \) leads to a decrease in consumer surplus if

\[
\partial CS^{*} / \partial v_{An} = \frac{Q_{A} \partial Q_{A}}{Q_{An}} (1 - Q_{A} - xQ_{B} - P_{A}) - \frac{Q_{B} \partial Q_{B}}{Q_{An}} (1 - Q_{B} - xQ_{A} - P_{B}) + \frac{P_{A} \partial P_{A}}{Q_{An}} Q_{A} - \frac{P_{B} \partial P_{B}}{Q_{An}} Q_{B} > 0.
\]

\(^{12}\) Recall that with no common shareholders, firm \( A \) cares about firm \( B \)'s profits to the (precise) extent that it has a financial interest in firm \( B \); \( \gamma_{A} = t_{An} \), which follows from Eq. (8).

\(^{13}\) If the sale included all types of stock, and given that we are assuming no commons shareholders, it would separate firms completely: \( \gamma_{A} = \gamma_{B} = 0 \).
The following figure represents in the \((v_{\text{div}}X)\) space the area for which this derivative is positive, for small arbitrary values of \(k \equiv k_{\text{BB}}/k_{\text{AA}}\). For each of three arbitrary values of \(k\), the previous condition holds below the corresponding curve. Appendix B provides the details.

To understand this effect, note that after a divestiture of firm A’s holdings in firm B by means of a sale to an infinite number of small shareholders, the values of \(k_{\text{AA}}\) and \(k_{\text{BB}}\) remain constant.\(^{14}\) From Eq. (8), we conclude that the only effect in \(\gamma_{A}\) and \(\gamma_{B}\) is through \(v_{\text{old}}\) and \(t_{\text{old}}\) — or simply \(v_{\text{old}}\), since \(t_{\text{old}} = v_{\text{old}}\) given our assumption that all shares are voting shares.

When \(v_{\text{old}}\) (firm A’s share of firm B) decreases with the sale, so does the value of \(\gamma_{A}\) (the weight placed by firm A’s management on firm B’s profits). This is fairly intuitive and reflects the first equation in Eq. (8): the weight given by firm A to firm B’s profits is proportional to firm A’s financial interest in firm B. (This is also part of Lemma 2.)

What is perhaps not as intuitive is that a reduction in \(v_{\text{old}}\) leads to an increase in the weight given by firm B to firm A’s profits. In the limit, suppose that there is an infinite number of infinitesimal shareholders in firm B, except for firm A, which holds a strictly positive share, i.e. that \(k_{\text{BB}}\) is very small. This means that firm A has effective control of firm B, that is, firm B’s objective is effectively firm A’s objective. If we now reduce firm A’s holding in firm B to a low level, then firm A’s financial interest in firm B is also reduced. In the limit as this value becomes close to zero, firm A’s interest becomes identified with firm A’s profits. Since firm A has effective control over firm B, it follows that firm B’s management becomes more concerned with firm A’s profits, a change that corresponds to an increase in \(\gamma_{B}\). The areas identified in Fig. 1 illustrate that the above increasing effect in \(\gamma_{B}\) may be sufficiently strong to counteract the “natural” decreasing effect in \(\gamma_{A}\). Specifically, the condition that \(k\) is sufficiently small implies that firm A’s voting share in firm B, \(v_{\text{old}}\), effectively gives firm A control of firm B.

O’Brien and Salop’s (2000) comments on the effects of partial ownership echo the possible effects described in this example:

Partial investments can raise either larger or smaller concerns than complete mergers. This may seem surprising, since partial acquisition would appear to align the parties’ interests less in all cases than would a complete merger. The competitive effects of partial ownership depend critically on two separate and distinct elements: financial interest and corporate control. This distinction is absent in merger analysis, which assumes that the acquiring firm (or person) automatically controls the acquired entity after the merger. With partially ownership interests, however, these elements are separable. They can occur in ways that result in greater or lower harm to competition than a complete merger. (p. 562)

In fact, re-interpreting Proposition 3 as a result about acquisitions (that is, changing “signs”), we obtain a situation very much like the one characterized by O’Brien and Salop’s (2000). A full acquisition may not be as bad as a partial acquisition to the extent that the full merger does not increase control by much but, by increasing firm A’s financial interest in firm B, lowers the relative weight that firm B places on firm A’s profits. In other words, as O’Brien and Salop (2000) rightly point out, the effects of partial ownership depend critically on the balance between financial interest and corporate control. Notice moreover that, as suggested by O’Brien and Salop and stressed by Foros et al. (2010), the above line of argument implies that, under some conditions, there may be ownership structures worse than a full merger. In other words, starting from a full merger, the sale of some of firm B’s stock owned by firm A may lead to a decrease in consumer surplus. In our framework, this corresponds to starting with the case \(v_{\text{old}} = t_{\text{old}} = 1\) and \(k_{\text{BB}} = 0\) and considering a small reduction in \(t_{\text{old}}\).\(^{15}\)

How can one possibly go from full merger to something that is even worse than full merger? The idea is that when a firm has control over the prices of two substitutes, it has the incentive to increase one of them so as to increase the demand for the other one. In so doing, it will face a trade-off between higher profits in one of the firms and lower profits in the other one. To the extent that the controlling firm cares less for the profit of the target firm — because it does not completely own it — it has incentive to increase prices more than in the case of a complete merger.

Our final results in this section compare the relative merits, in terms of consumer surplus, of the four alternative divestiture options under consideration.

**Proposition 4.** The induced change in consumer surplus is more favorable as we move from Option 1 (proportional divestiture) to Option 2 (switch from voting stock to preferred stock), irrespective of being a complete or partial divestiture, if and only if

\[
k_{\text{AA}} \left( w_{B0}^1 - w_{B0}^2 - \frac{k_{\text{BB}} + S_{\text{BB}}}{k_{\text{BB}} + S_{\text{BB}}} \right) + S_{\text{BA}} > 0.
\]

When comparing Option 1 and Option 2, three differences are worth stressing. First, after a partial divestiture, firm A will retain some influence over firm B’s actions, i.e. firm B will still place some control weight on firm A’s payoff. However, for the same divestiture of voting rights, this remaining weight will be larger under Option 2: \(w_{B0}^1 < w_{B0}^2\). The proportional divestiture removes some voting shares and distributes them to new shareholders, while Option 2 merely eliminates the voting rights. Given the creation of new shareholders, this reduces the relative control weight of firm A on firm B more in the case of Option 1. The lower \(w_{B0}^1\) and the larger \(w_{B0}^2\) the more likely it is that Option 1 is better for consumers. Second, the effect on \(k_{\text{BB}}\) also differs across the two options. In fact, the original shareholders with control and financial interests in firm B will also be differently affected by the two options. For the same reason as above, Option 2 leads to larger relative weights because there are no new shareholders involved. The increase in correlation between control and financial interest makes firm B’s decisions more independent from firm A under this option. This independence is beneficial for consumers but, considering these two effects combined, the first term in the condition in Proposition 1 can be shown to be negative.

Finally, Option 1 creates common shareholders, i.e. shareholders with control of firm B who care for firm A’s profit, a factor that favors Option 2, in terms of its impact on consumers. This is represented by the term \(S_{\text{BA}}\) in the condition above. In case of a complete divestiture, we have \(w_{B0}^1 = w_{B0}^2 = 0\) and the condition above always holds (in the absence of common shareholders). Note, in particular, that if financial interest
in firm A is very diluted, which implies both $k_{AB}$ and $S^A_{AB}$ close to zero, the proportional divestiture will lead to the distribution of voting shares in firm B to a very high number of very small shareholders and, as a result, the two options would tend to be equivalent in terms of their induced change in consumer surplus.

Further, if $f(V_{B0}) = V_{B0}$ and $\sum_{n} \gamma_{Bn} = \sum_{n} \nu_{Bn} = t_{B0A} = 1$, the condition in Proposition 4 becomes $\alpha_{B0B} \sum_{n} \gamma_{Bn} \cdot t_{B0A} > 0$, which always holds. With this particular weight structure, turning voting shares into preferred stock is better than distributing shares proportionally both in the case of a complete and in the case of a partial divestiture (Option 2 is better than Option 1) because the induced effects on $\gamma_{B}$ are different. The only effect associated with the switch from voting stock to preferred stock (Option 2) is a reduction in $V_{B0}$ while the proportional divestiture (Option 1) leads to increases in $k_{B0}, k_{B0}, k_{BAB}$ and $k_{BBA}$. The two latter effects correspond to the creation of common shareholders, a situation that we describe in detail in Section 5. The dominant effect that makes the proportional divestiture perform worse in terms of impact on consumer surplus is then that this proportional divestiture creates shareholders with (direct) voting shares in firm B and financial interest in firm A. In fact, the higher the financial interest a shareholder has in firm A, the larger the percentage of voting shares that this shareholder will get with the proportional divestiture of voting stock initially owned by firm A, and this will lead to an increase in the weight firm B places in firm A’s profit.

Proposition 5. Consider the case of a partial divestiture. The induced change in consumer surplus is more favorable as we move from Option 3 (sale to small shareholders) to Option 4 (sale to one large shareholder). In the case of a complete divestiture both options are equivalent in terms of the induced change in consumer surplus.

The intuition that Option 4 (sale to one large shareholder) is better than Option 3 (sale to small shareholders) in the case of a partial divestiture is akin to part of Lemma 2, where we state that $\gamma_{B}$ is decreasing in $k_{B0}$: the greater the concentration of firm B’s sharesholdings, the less weight firm B places on firm A’s profits. In the limit, when $k_{B0} \rightarrow 0$, firm A’s voting share in firm B grants firm A effective control over firm B, that is, firm B maximizes firm A’s profits (assuming that firm A voting shareholders also have a financial interest in firm A). The difference between Option 3 and Option 4 is that $k_{B0}$ remains constant under the former, whereas $k_{B0}$ increases in the latter which, by Lemma 2, implies a lower $\gamma_{B}$ and a higher consumer surplus.

In other words, the contrast between the sale to small shareholders and the sale to one large shareholder corresponds to the countervailing effect of shareholder concentration: strong independent shareholders in firm B have the beneficial effect of counteringweighting the negative effect (from a consumer surplus perspective) of firm A’s partial ownership of firm B. There is an interesting analogy with the countervailing effect of buyer power in vertical relations (e.g., Dobson and Waterson, 1997). In general, market share concentration is bad for consumer welfare; but to the extent that there already is market power at one level of the value chain, an increase in concentration at a different level (e.g., downstream) may be welfare-enhancing.

While we show that a partial sale to one large shareholder is better than the sale to an infinite number of infinitesimal shareholders, these are not the only possibilities to consider. In fact, the highest consumer surplus corresponds to a sale pattern that maximizes the post-divestiture value of $k_{B0}$. If there is a perfect correlation between control and financial interest in firm B; this would correspond to selling $V_{B0}$ to the largest independent shareholder in firm B.

It should be highlighted that Options 3 and 4 are equivalent in terms of their impact on consumer surplus in the case of a complete divestiture of voting stock. Given the inexistence of common shareholders, such divestiture completely separates both firms with the exception of some remaining financial interest of firm A in firm B. Hence, after the divestiture, $\gamma_{A} = \gamma_{B}(1 - V_{B})$ and $\gamma_{A} = 0$.

Proposition 6. Consider the case of a complete divestiture. Then, the induced change in consumer surplus is more favorable: (i) as we move from Option 2 (switch from voting stock to preferred stock) to Option 3 (sale to small shareholders) or to Option 4 (sale to one large shareholder); (ii) as we move from Option 1 (proportional divestiture) to Option 3 (sale to small shareholders) or to Option 4 (sale to one large shareholder).

To understand why a complete sale to infinitesimal shareholders is better than turning voting stock into preferred stock (Option 3 is better than Option 2), it may help to think of a complete sale of $V_{B0}$ to an infinite number of infinitesimal shareholders (Option 3) as a two-step process: first $V_{B0}$ is turned into preferred stock (Option 2); and then this preferred stock is distributed to an infinite number of infinitesimal shareholders. Strictly speaking, the two steps lead to a different final arrangement than Option 3. However, to the extent that the stock is distributed to infinitesimal shareholders, it does not matter whether it is voting or preferred stock.

The crucial point is then to understand the impact of the second step above: transferring preferred stock from firm A to an infinite number of infinitesimal shareholders. From Eq. (8), a decrease in $v_{B0}$ leads to a decrease in $\gamma_{B}$. This makes sense: to the extent that firm A reduces its financial interest in firm B, it will place a lower weight on firm B’s profit. Having established that the transfer of $v_{B0}$ leads to a lower $\gamma_{B}$, we must now add that it has zero effect on $\gamma_{A}$. This may appear to contradict Lemma 2, where we stated that a decrease in $v_{B0}$ leads to an increase in $\gamma_{A}$; but in fact such result requires $w_{B0} > 0$. Since the first step above leads to $v_{B0} = v_{B0} = 0$, the subsequent transfer of preferred stock has no effect on $\gamma_{B}$. We thus conclude that the second step leads to a further decrease in $\gamma_{B}$, which by Lemma 1 corresponds to an increase in consumer surplus, and which finally proves that the complete sale of $V_{B0}$ leads to a greater increase in consumer surplus than the switch from voting stock to preferred stock.

A complete proportional divestiture is not as good as the sale to infinitesimal shareholders essentially because it creates common shareholders. In the limit case in which firm A’s shareholders were infinitesimal, the two divestitures would have the same effect.

4.1. Transaction costs

As mentioned at the beginning of the section, our results — and in particular Proposition 6 — do not take into account the transaction costs involved with each of the options. Turning voting stock into preferred stock, or transferring the ownership from firm A to firm A’s shareholders, does not require valuing the shares — and does not require any financial transaction to take place. By contrast, selling shares to a third party creates a host of potential problems. For example, if the time frame for the sale is too narrow then there may not be enough market demand; whereas if the time frame is too wide then the beneficial effects of divestiture may take too long to take place; and for a given time frame, potential buyers may delay strategically their purchases. Moreover, if the Competition Authority is to determine the price at which the shares are to be sold, then there is the obvious problem of share valuation.

For all these reasons, our results must be taken with a grain of salt: While Options 3 and 4 are better than Option 2 in terms of consumer surplus, the transactions costs they imply may warrant the simpler option of simply changing the nature of firm A’s shares in firm B.

5. Extension: common shareholders

The results in the previous section were based on the assumption that, initially, no shareholder owns shares of both firms. In some cases
(including the Portugal Telecom case described in the next section) there are indeed common shareholders. How does this change the analysis? In this section, we show that most results remain qualitatively the same. However, as Lemma 2 and 2’ illustrate, there are additional effects to consider, on the one hand and the math becomes considerably more complex, on the other hand.

For each of the Propositions in the previous section, the relevant condition with common shareholders is presented in the corresponding proofs in Appendix A. In what follows, we discuss the main implications of introducing common shareholders, for each of the divestiture options under analysis.

With common shareholders, Option 1, the proportional divestiture, increases consumer welfare if and only if $\gamma_B$ decreases,\textsuperscript{16} which occurs when

$$K_{BB} \left( S_{AA} + k_{BA}\Delta w_{BA} \right) < K_{BB} \left( S_{BB} + k_{AB}\Delta w_{BB} \right).$$

In other words, whether the proportional divestiture is good or bad for consumers depends on the interplay between four terms: (1) $K_{BB}$, (2) $(S_{AA} + k_{BA}\Delta w_{BA})$, (3) $K_{AA}$, and (4) $(S_{BB} + k_{AB}\Delta w_{BB})$.

Note that the first and third terms are positive, whereas the second and fourth terms can be either positive or negative.

The first term measures the extent to which, at the outset, the ownership of voting stock in firm $B$ is correlated with financial interest in the same firm, i.e., it measures the extent to which shareholders with the ability to influence firm $B$’s decisions are interested in firm $B$’s profit.

The second term, which can be written as $\sum_{i=1}^{N-1} (\Delta w_{Bi} + w_{Ai}\Delta w_{Bi})$ is positive if those shareholders who will have an increase in their direct control weight larger than the decrease in the indirect control weight in firm $B$ also have a large $\ell_{BA}$.\textsuperscript{17}

The third term, is similar to the first one and measures the correlation between shareholders initial direct and indirect voting rights in firm $B$ and their financial interest in firm $A$, and thus captures to what extent voters in firm $B$ are interested in firm $A$’s profit.

Finally, the fourth term, $\sum_{i=1}^{N-1} (\Delta w_{Bi} + w_{Ai}\Delta w_{Bi})\ell_{BA}$, is positive if those shareholders who will have an increase in their direct control weight larger than the decrease in indirect control weight in firm $B$ also have a high financial interest in firm $B$, $\ell_{BA}$.

If the second term is positive and the fourth term is negative, then the condition for consumer welfare to increase is never verified. This happens because if the shareholders to whom firm $B$ will attribute a larger weight care a lot for firm $A$’s profit and a little for firm $B$’s profit, then they will instruct firm $B$ to give a higher weight to firm $A$’s profit. As a result, $\gamma_B$ will increase and consumers will be worse off.

If the second term is negative and the fourth term is positive, then exactly the opposite effects take place and the condition for consumer welfare to increase is trivially satisfied.

If the second and fourth terms have the same sign, $\gamma_B$ is not affected by a proportional divestiture (see Proposition 1).

16 Recall that $\gamma_B$ is not affected by a proportional divestiture (see Proposition 1).

17 Note that the change in direct control weight is given by $\Delta w_{Bi}$, which is mitigated by the reduction in indirect control weight, $w_{Ai}\Delta w_{Bi} < 0$.

Finally, it should be noted that when common shareholders exist the complete sale option (for instance, Option 3, the sale to an infinite number of small shareholders) may no longer have a positive effect on consumer surplus. In fact, although, as before, $\gamma_B$ decreases inequically (because of the decrease in $\ell_{BA}$) the change in $\gamma_B$ has the same sign of

$$-w_{BB}(k_{AA} - k_{BA}) + \gamma_B^3 \left( S_{BB} - S_{BA} + w_{BB}k_{BB} - w_{BA}k_{BA} \right) + V_{BB}^{\delta} \gamma_B^3 \left( S_{BA}^2 - S_{AA} \right) \left( k_{BA} - w_{BB}k_{AA} \right)$$

which has an uncertain sign, if $k_{AA}^3 > k_{BA}^3$ it is positive (otherwise, it is negative if $k_{AA} > k_{BB} > k_{AB}$).

The reason is, as before, that such sale reduces $\ell_{BA}$ and $\ell_{BB}$, whose induced effects on $\gamma_B$ go in opposite directions. A positive $k_{BB}^3$ means that firm $B$ will still care for firm $A$’s profit even if firm $A$ loses its control shares in firm $B$. As the loss in control implies a loss in financial interest, firm $A$’s aggregate profits, which accrue to shareholders who have control in firm $B$, will include a lower percentage of firm $B$’s profit. Hence, firm $B$ will place a larger weight on firm $A$’s profit and a lower weight on its own profit.

6. Application: PT and PTM

As the starting paragraph in the paper suggests, the questions we examine are not of pure intellectual interest; they also correspond to actual situations where concrete regulatory decisions need to be made. In this section, we consider a retrospective application of our framework: the divestiture of Portugal Telecom’s, Portugal’s largest telecommunications operator, holdings in PTM. Until November 2007 Portugal Telecom (PT) held a 58% share of PT Multimedia (PTM). The two firms operated in several markets as the two main “competitors” (sometimes the sole competitors). Under pressure from the Portuguese government, PT agreed to divest its shares in PTM. PT management’s proposal was then to divest its share in PTM to PT’s shareholders, in proportion to their holdings.

Table 1 lists the main shareholders in PT and PTM before the divestiture. As can be seen, there were a few relatively large shareholders. Moreover, aside from the fact that PT owned a share in PTM, there was a significant overlap in ownership of both firms. In fact, three of the four larger shareholders in PTM, excluding PT, also owned a

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|c|}
\hline
Shareholder & Shares & Voting rights & \multicolumn{2}{c|}{PT} \\
\hline
 & & & PTM & PTM \\
\hline
PT & - & 58.43% & - & 10.00% \\
PTM & 0.00% & - & 0.00% & - \\
Teléfonica & 9.96% & 0.00% & 9.96% & 0.00% \\
Grup Espírito Santo & 7.77% & 6.96% & 7.77% & 6.96% \\
Bradesco Investments Partners & 7.41% & 0.00% & 7.41% & 0.00% \\
Ongoing Strategy Investments & 5.25% & 0.00% & 5.35% & 0.00% \\
Grupo Caixa Geral de Depósitos & 5.11% & 11.26% & 5.11% & 10.00% \\
Telmex & 3.41% & 0.00% & 3.41% & 0.00% \\
Paulson Co. Inc. & 0.00% & 2.34% & 0.00% & 2.34% \\
Merrill Lynch International & 2.20% & 0.00% & 2.20% & 0.00% \\
Fidelity & 2.09% & 0.00% & 2.09% & 0.00% \\
Grupo Barclays & 2.06% & 0.00% & 2.06% & 0.00% \\
Capital Group Companies & 2.04% & 0.00% & 2.04% & 0.00% \\
Grupo Visabeira & 2.01% & 0.00% & 2.01% & 0.00% \\
Controlinveste/Joaquim Oliveira & 2.00% & 3.77% & 2.00% & 3.77% \\
Grupo BPF & 0.00% & 5.16% & 0.00% & 5.16% \\
Cofina SGPS, S.A. & 0.00% & 2.23% & 0.00% & 2.23% \\
\hline
Total & 53.75% & 29.38% & 53.75% & 28.12% \\
\hline
\end{tabular}
\caption{Large shareholders in PT and PTM (as of May 2006).}
\end{table}
significant percentage of shares in PT. Fig. 2 presents the shareholder structure of both firms and identifies the shareholders present in both firms at the time.

In Section 2, we assumed the weight attributed by each firm (in its objective function) to a given shareholder is given by a function of the shareholder’s percentage of voting shares, that is, $v_{vin}$. Now, an important remark that should be made at this point is that, according to PTM’s statutes at the time, voting rights were capped at 10%. This means that a shareholder owning more than 10% of PTM’s shares was only entitled to 10% of the votes.

In what follows we consider as alternatives the four options considered in the previous section, namely:

1. Transfer of PT’s share in PTM to PT’s shareholders in proportion to their initial shares in PT. This was the option proposed by PT and actually implemented.
2. Change of PT’s share in PTM from voting stock to preferred stock.
3. Sale of PT’s share in PTM to small shareholders different from the current shareholders.
4. Sale of PT’s share in PTM to a new large shareholder.

In this application, we assume $f(v_{vin}) = (v_{vin})^z$ and consider three alternative arbitrary values for $z : z = 1; z = 2$ and $z = 3$. Further, we denote PT by firm A and PTM by firm B. In all cases, PTM holds no share in PT, that is, $\xi_{A} = 0$. Our focus is on the value of $\xi_{B}$, positive in the initial situation and zero in all other scenarios. Specifically, we proceed as follows. For each scenario, we compute the values of $\xi_{B}, v_{vin}, k_{AB}, k_{BA}, k_{AA}$ and $k_{BB}$. These values, together with the corresponding $\gamma_A$ and $\gamma_B$ for the three alternative values of $z$, are presented in Tables 2 and 3.

Table 2 assumes initially that there are no common shareholders, while Table 3 uses the shareholder structure presented in Table 1.

As most of PT’s shareholders would own a share in PTM below 10% after the proportional divestiture one can consider the proposed operation (Option 1) as a two-step operation. In a first step, the legal caps on voting rights are removed and, in a second step, the shares are distributed to PT’s shareholders in proportion to their initial shares in PT. The first step corresponds to turning some non-voting shares (those corresponding to holdings in excess of 10%) into voting shares. From Proposition 2, this has a negative effect on consumer welfare. The second step is neutral in terms of consumer welfare when $z = 1$. As discussed after Proposition 1, if there is only one type of shares and if shareholder weights are equal to their percentage of voting stock, the proportional divestiture merely turns indirect holdings into direct ones.\(^{18}\) Hence, if a shareholder’s weight is given by its voting rights, then PT’s proposal (Option 1) actually decreases consumer welfare, provided that $z$ is not much higher than 1. This can be seen at the bottom of

\(^{18}\) To be rigorous, the legal caps are not completely removed. This happens because one of the shareholders exceeds the 10% cap before the divestiture and another one exceeds it afterwards. The percentage of shares above 10% corresponds to only 5.75%. Therefore, the ensuing proportional distribution of shares is not completely neutral. The difference, however, is quite small. Moreover, proposition 1 is only neutral if $\sum_{n=0}^{\infty} \xi_{vin} = \sum_{n=0}^{\infty} k_{AD} = 1$, which does not hold in this example due to the inexistence of information about small shareholders.
each panel in Table 2, where the estimated values for the y's are reported. The reason for this is that, because of legal caps on voting rights, PT's voting rights in PTM (in the initial situation) are considerably lower than its shareholdings. Now, by transferring PT's shares in PTM to PT's large shareholders, PT is actually increasing the concentration of voting rights in PTM, since the shares it transfers correspond to greater voting rights than in the initial situation. In other words, by relinquishing 1% of voting rights, PT is increasing PT's shareholders' voting rights by more than 1%. However, when z is sufficiently large (in Table 2, when z = 3), Option 1 may lead to a reduction in $y_0$. The reason for this is that with a sufficiently convex $f(.)$ function, the distribution of voting stock among its own shareholders leads to a reduction in the (aggregate) weight given by firm B (PTM) to shareholders with financial interests in firm A (PT). Table 2 also illustrates the findings of Propositions 3 and 4. Without common shareholders, any of the sale options completely separates the firms and brings both $y_0$ and $y_0$ down to zero. Finally, Option 2 has no effect on $y_A$ and also brings $y_B$ to zero. In fact, in the absence of common shareholders, the removal of firm B voting rights in firm A (either by sale or simply by converting this shares into preferred stock) makes firm B completely immune to the influence of any shareholders with financial interests in firm A and, hence, firm B will give no weight to its competitor, i.e. $y_B$ becomes equal to zero in Options 2, 3 and 4.

Table 3 presents the same information but with common shareholders. The main qualitative difference is the fact that the sale to infinitesimal shareholders may have a negative effect on consumer surplus, as the two weights, $y_A$ and $y_B$, move in opposite directions, as mentioned at the end of Section 5. A complete sale reduces both $y_B$ and $y_B$ to zero and ends any (direct) control firm A's shareholders might have in firm B. However, given that some shareholders own stock in both firms, there will subsist shareholders with some (direct) control over firm B that also have a financial interest in firm A and that now care less for firm B's operational profit. Recall that after the divestiture, firm A's aggregate profit no longer depends on firm B's operational profit because the sale put an end to firm A's financial interest in firm B. Hence, these shareholders will instruct firm B to attribute a higher weight to firm A's profit.

The remaining alternatives confirm the expectations from Propositions 4, 5 and 6, which were obtained for the case of no common shareholders and therefore do not directly apply to Table 3. Namely that Option 4 is better than Option 3, and that Option 2 is better than Option 1 (the option actually implemented). As mentioned above, we should qualify this assertion by recognizing that the transactions costs of each option might differ. In particular, one advantage of Options 1 and 2 is that they do not require a market sale, with all the transactions costs this may imply.

7. Conclusion

We provided a series of necessary and sufficient conditions that allow us to rank alternative options for divestiture of firm A's holdings in firm B. Overall, three robust ideas stand out from our results: First, a participation that induces control is more damaging to consumer welfare than a passive participation (though both decrease consumer surplus). Second, the “proportional” method (which has been used in recent divestiture arrangements) generally performs worse than turning voting stock into preferred stock or selling shares to a third party. Third, the concentration of control among independent shareholders in the target firm is beneficial from a consumer surplus point of view (the “countervailing” effect).

Appendix A

Proof of Lemma 1. Firm i's first-order condition is given by

$$ f(p_i, p_j; y_i, y_j) = \frac{\partial f}{\partial p_i} + y_i \frac{\partial f}{\partial p_i} = 0. $$

Since $\frac{\partial f}{\partial p_i} > 0$, it follows that $\frac{\partial f}{\partial p_i} \frac{\partial f}{\partial p_j} = \frac{\partial f}{\partial p_i} \frac{\partial f}{\partial p_j} + y_i \frac{\partial f}{\partial p_i} > 0$. Since moreover $\frac{\partial f}{\partial p_i} \frac{\partial f}{\partial p_j} > 0$, standard supermodularity results (e.g., Theorems 2.3 in Vives, 2000) imply that equilibrium prices are increasing in $y_i$. Finally, since consumer surplus is decreasing in prices the result follows.

Proof of Lemma 2. Taking derivatives and simplifying, we get

$$ \frac{\partial \gamma_B}{\partial K_{BA}} = \frac{\partial \gamma_B}{\partial K_{BB}} > 0 $$

Proof of Lemma 2'. Taking derivatives and simplifying, we get

$$ \frac{\partial \gamma_B}{\partial K_{BA}} > 0 $$

In the proofs of all propositions, $\sigma = 0, 1, 2, 3, 4$ denotes the value taken by the relevant variables after divestiture $o$ took place. The superscript $o$ referring to the baseline case is omitted. Additionally, $\Delta x^o := x^o - x$. In all proofs, we start with the most complex case (general weight function for $w_o$, with common shareholders), then present the case of the general weight function for $w_o$ without common shareholders and, finally, the corresponding expression for the case of $f(v_n) = v_n$.

It should be noted that under all divestiture options considered, there are no changes in the distribution of firm A's shares, so $\theta_A = \theta_A$, $v_A = v_A$ and $w_A = w_A$ for $o = 1, 2, 3, 4$. Hence, $K_{AA} = 0$, $K_{AA} = 0$. With the exception of the proportional divestiture (Option 1) there are also no changes in $t_B$ for the original shareholders. Hence, $K_{AB} = 0$, $K_{AB} = 0$ for $o = 2, 3, 4$.

Given Lemma 1, the effects of the different divestiture options on consumer surplus depend on their effects on the weights each firm
Proof of Proposition 1. Assume a fraction $\alpha, 0 \leq \alpha \leq 1$, is being divested of both $v_{Bn}$ and $t_{Bn}$. With the divestiture, shares are distributed among the shareholders of the parent company, firm $A$, in proportion to their holdings, $t_{An}$, and we have:

$$
t_{Bn} = t_{Bn} + \alpha t_{An} \quad \forall n \in N_A
$$

$$
v_{Bn} = v_{Bn} + \alpha v_{An} \quad \forall n \in N_A
$$

As a result of these changes there will be a variation in the weights given by firm $B$ to each private shareholder $n = 1, \ldots, N$. This variation is given by

$$
\Delta w_{Bn} = w_{Bn} - w_{Bn} = f(v_{Bn} + \alpha v_{An}) - f((1 - \alpha)v_{Bn}) - f(v_{Bn}) + f((1 - \alpha)v_{Bn})
$$

Note that for some shareholders this variation may be positive while, for others, it may be negative. In general, the denominator of $w_{Bn}$ may either increase or decrease and the numerator increases only for those shareholders with $\alpha > 0$.

As for firm $A$: $\Delta w_{An} = w_{An} - w_{An} = f((1 - \alpha)v_{An}) - f(v_{An})$.

$$
\sum_{n=1}^N f(v_{An} + \alpha v_{An} t_{An}) + f((1 - \alpha)v_{An}) - f(v_{An}) + f((1 - \alpha)v_{An}) < 0.
$$

After the divestiture, we have:

$$
k_{An} = \sum_{n=1}^N w_{An} t_{An} = \sum_{n=1}^N w_{An} t_{An} + \alpha t_{An} + \alpha t_{An} k_{An} = k_{An} + \alpha t_{An} k_{An}
$$

$$
k_{An} = \sum_{n=1}^N w_{An} t_{An} + \sum_{n=1}^N \Delta w_{An} t_{An} = k_{An} + \sum_{n=1}^N \Delta w_{An} t_{An} + \alpha t_{An} k_{An} + \alpha t_{An} k_{An}
$$

$$
S_{Bn} = \sum_{n=1}^N \Delta w_{Bn} t_{Bn} = \sum_{n=1}^N \Delta w_{Bn} t_{Bn} + \alpha t_{An} k_{An} + \alpha k_{An} + \alpha t_{An} k_{An}
$$

Hence,

$$
k_{An} = k_{An} + \alpha t_{An} k_{An} = k_{An} + \alpha t_{An} k_{An}
$$

$$
k_{An} = k_{An} + \alpha t_{An} k_{An} = k_{An} + \alpha t_{An} k_{An} + \alpha t_{An} k_{An} + \alpha t_{An} k_{An}
$$

Inserting these expressions into Eqs. (11) and (13) we obtain:

$$
\gamma_i - \gamma_i = t_{Bn} - t_{Bn} + k_{An} - k_{An} = (1 - \alpha)t_{An} - t_{Bn} + \alpha t_{An} k_{An} - k_{An} = 0
$$

$$
\gamma_i - \gamma_i = t_{Bn} - t_{Bn} + k_{An} = \alpha t_{An} k_{An} - k_{An} = 0
$$

Therefore, Option 1 does not lead to any change in $\gamma_i$ and it leads to a reduction in $\gamma_i$ if and only if

$$
k_{BB} (S_{Bn} + \Delta w_{Bn} k_{An}) > 0.
$$

With no-common shareholders we have $k_{AB} = k_{AA} = 0$, $k_{BB} = k_{BA}$ and $k_{BB} = t_{Bn} k_{BB}$. Denote by $N$ the original set of firm $B$'s shareholders, with $N_A \cap N_B = \emptyset$. For firm $A$'s original shareholders, i.e. for $n \in N_A$, we have:

$$
\Delta w_{Bn} = \sum_{n=1}^N f(v_{Bn} + \alpha v_{An} t_{An}) - f(v_{Bn}) + f((1 - \alpha)v_{Bn}) > 0
$$

from where we have $S_{Bn} > 0$.

As for firm $B$'s original shareholders, i.e. for $n \in N_B$, we have

$$
\Delta w_{An} = \sum_{n=1}^N f(v_{An} + \alpha v_{An} t_{An}) + f((1 - \alpha)v_{An}) - f(v_{An}) + f((1 - \alpha)v_{An}) > 0
$$

which implies $S_{Bn} > 0$.

In case of no common shareholders, Eq. (14) becomes

$$
k_{BB} (S_{Bn} + \Delta w_{Bn} k_{An}) > 0
$$

Finally, if $f(v_{An}) = v_{An}$ and $\sum_{n=1}^N v_{An} t_{An} = \sum_{n=1}^N v_{An} t_{An} = 1$, we have

$$
\Delta w_{An} = \sum_{n=1}^N f(v_{An} + \alpha v_{An} t_{An}) - f(v_{An}) + f((1 - \alpha)v_{An}) = \alpha v_{An} t_{An} = \alpha v_{An} t_{An}
$$

$$
\Delta w_{An} = \sum_{n=1}^N f(v_{An} + \alpha v_{An} t_{An}) + f((1 - \alpha)v_{An}) = \alpha v_{An} t_{An}
$$

$$
S_{Bn} = \sum_{n=1}^N \Delta w_{Bn} t_{Bn} = \alpha v_{An} t_{An} t_{Bn}
$$

and Eq. (15) becomes

$$
\sum_{n=1}^N (t_{Bn} - v_{An} t_{An}) < 0.
$$

Proof of Proposition 2. Assume that a percentage $\alpha, 0 \leq \alpha \leq 1$, of voting stock $v_{Bn}$ is turned into preferred stock. As a result of the switch from voting stock to preferred stock, shareholder $n$ owning a
percentage of voting stock $v_{Bn}$ now owns a larger percentage, namely $v_{Bn}/(1 - \alpha v_{Bn})$. However, $t_{Bn}$ and $t_{B0}$ remain unchanged. Hence, after the divestiture:

$$v_{Bn}' = v_{Bn}/(1 - \alpha v_{Bn})$$
$$v_{B0}' = (1 - \alpha) v_{B0}/(1 - \alpha v_{B0})$$

As a result of these changes there will be a variation in the weights given by firm $B$ to each shareholder. This variation is given by

$$\Delta w_{bn} = \frac{f(v_{Bn} - (1 - \alpha v_{Bn})) - f(v_{Bn})}{\sum_{n=1}^{N} f(v_{Bn})} > 0$$

As for firm $A$:

$$\Delta w_{B0}' = \frac{f((1 - \alpha) v_{B0}/(1 - \alpha v_{B0})) - f(v_{B0})}{\sum_{n=1}^{N} f(v_{Bn})} < 0$$

where we have made use of the property: $f(v_{Bn})/f(v_{Bn}') = f((\alpha v_{Bn})/f((\alpha v_{Bn})')$.

Thus, we have

$$k_{BA}' = \sum_{n=1}^{N} w_{Bn} t_{An} = \sum_{n=1}^{N} (w_{Bn} + \Delta w_{Bn}') t_{An} = k_{BA} + S_{BA}'$$
$$k_{BB}' = \sum_{n=1}^{N} w_{Bn} t_{Bn}' = \sum_{n=1}^{N} (w_{Bn} + \Delta w_{Bn}') t_{Bn} = k_{BB} + S_{BB}'$$

with $S_{BA}'$ and $S_{BB}'$ non-negative. Hence,

$$K_{BA}' = k_{BA}' + w_{B0} k_{AB}' = k_{BA} + S_{BA}' + w_{B0} k_{AA}' = K_{BA} + S_{BA}' + \Delta w_{B0} k_{AA}'$$
$$K_{BB}' = k_{BB}' + w_{B0} k_{AB}' = k_{BB} + S_{BB}' + \Delta w_{B0} k_{AB}'$$

and Eqs. (11) and (13) become, respectively:

$$\gamma_{A} - \gamma_{B} = t_{B0} - t_{B0}' + \frac{K_{BB}' - K_{BA}}{K_{AA}'} = t_{B0} - t_{B0}' + \frac{K_{BB} - K_{BA}}{K_{AA}} = 0$$

sign $\gamma_{B} - \gamma_{B}'$ is $\text{sign} \left( (K_{BA} k_{AA}' - K_{BB} k_{BA}') + K_{BA} K_{AA}' (t_{B0} - (t_{B0} - v_{B0} v_{B})) \right) = \text{sign} \left( (K_{BA} k_{AA} - K_{BB} k_{BA}) + K_{BA} k_{AA} (t_{B0} - v_{B0} v_{B})) \right)$

Therefore, Option 2 does not lead to any change in $\gamma_{A}$ and it leads to a reduction in $\gamma_{B}$ if and only if

$$K_{BA}' - K_{BA} > 0$$

**Proof of Proposition 3.** After a complete divestiture of voting stock we will have $v_{B0}' = v_{B0} = v_{B0} = w_{B0}' = w_{B0} = 0$ in both Options 3 and 4. There will also be a decrease in $t_{B0}$ equal to $v_{B0} v_{B0}$, i.e., $t_{B0}' = t_{B0} - v_{B0} v_{B}$.

In Option 3 we have:

$$\Delta w_{B0}' = \frac{f(v_{B0}) - f(v_{B0} - \Delta w_{B0}')}{\sum_{n=1}^{N} f(v_{Bn})} < 0$$

and

$$k_{BA}' = \sum_{n=1}^{N} w_{Bn} t_{An}' = \sum_{n=1}^{N} (w_{Bn} + \Delta w_{Bn}') t_{An} = k_{BA} + S_{BA}'$$
$$k_{BB}' = \sum_{n=1}^{N} w_{Bn} t_{Bn}' = \sum_{n=1}^{N} (w_{Bn} + \Delta w_{Bn}') t_{Bn} = k_{BB} + S_{BB}'$$

where $S_{BA}'$ and $S_{BB}'$ are non-negative. Hence,

$$K_{BA}' = k_{BA}' + w_{B0} k_{AB}' = k_{BA} + S_{BA}' + w_{B0} k_{AA}' = K_{BA} + S_{BA}' + \Delta w_{B0} k_{AA}'$$

and Eq. (11) becomes

$$\gamma_{A}' - \gamma_{B} = t_{B0} - t_{B0}' + \frac{K_{BB} - K_{BA}}{K_{AA}} = (t_{B0} - v_{B0} v_{B}) - t_{B0} + \frac{K_{BA} - K_{AB}}{K_{AA}} = -v_{B0} v_{B}$$

while Eq. (13) becomes

$$\text{sign} \left( \gamma_{B} - \gamma_{B}' \right) = \text{sign} \left( (K_{BA} k_{AA}' - K_{BB} k_{BA}') + K_{BA} K_{AA}' (t_{B0} - (t_{B0} - v_{B0} v_{B})) \right) = \text{sign} \left( (K_{BA} k_{AA} - K_{BB} k_{BA}) + K_{BA} k_{AA} (t_{B0} - v_{B0} v_{B})) \right)$$

Givent that this is a complete divestiture we have $\Delta w_{B0}' = -w_{B0}$ and

$$\text{sign} \left( \gamma_{B} - \gamma_{B}' \right) = \text{sign} \left( K_{BA} k_{AA}' - K_{BB} k_{BA}' \right) = \text{sign} \left( K_{BA} k_{AA} - K_{BB} k_{BA} \right) + K_{BA} k_{AA} (t_{B0} - v_{B0} v_{B})$$

This is negative if and only if

$$-w_{B0} (k_{BA} k_{AB} - k_{BB} k_{BA}) + S_{BA}' (k_{BA} + w_{B0} k_{AB}) + v_{B0} v_{B} (S_{BA}' + k_{BA}) (k_{BA} + w_{B0} k_{AA}) < 0$$

In the absence of common shareholders $k_{AB} = k_{BA} = S_{BA}' = 0$ and Eq. (16) becomes

$$-k_{AA} w_{B0} (k_{AB} + S_{BB}') < 0$$

which is always true.

In Option 4 there will be a new shareholder, shareholder $N + 1$, which will take the role of firm $A$. Hence, $w_{B0}' = 0$ for the $N$ original shareholders and $\Delta w_{B0}' = -w_{B0} > 0$. This will only affect $k_{BB}$ which becomes:

$$k_{BB}' = \sum_{n=1}^{N+1} w_{Bn} t_{Bn}' = \sum_{n=1}^{N} (w_{Bn} + 0) t_{Bn} + (0 + \Delta w_{B0}' - 1) t_{B0} - v_{B0} v_{B}$$

Thus,

$$K_{BA}' = k_{BA}' + w_{B0} k_{AB}' = k_{BA} + w_{B0} v_{B0} v_{B}'$$

Hence, Eqs. (11) and (13) become

$$\gamma_{A}' - \gamma_{B} = t_{B0} - t_{B0}' + \frac{K_{BB} - K_{BA}}{K_{AA}} = (t_{B0} - v_{B0} v_{B}) - t_{B0} + \frac{K_{BA} - K_{AB}}{K_{AA}} = -v_{B0} v_{B}$$

\text{sign} \left( \gamma_{B} - \gamma_{B}' \right) = \text{sign} \left( (K_{BA} k_{AA}' - K_{BB} k_{BA}') + K_{BA} K_{AA}' (t_{B0} - (t_{B0} - v_{B0} v_{B})) \right) = \text{sign} \left( (K_{BA} k_{AA} - K_{BB} k_{BA}) + k_{BA} k_{AA} k_{BA} (t_{B0} - v_{B0} v_{B})) \right)$$
In the absence of common shareholders, $k_{AA} = k_{AB} = S_{BA} = 0$ and
\[
\text{sign}(\gamma_A^2 - \gamma_B^2) = -w_{BB}k_{AA}(k_{BB} + V_Bv_{BB}w_{BB}) < 0.
\]

**Proof of Proposition 4.** From Lemma 2, Option 2 is better than Option 1 if the two following conditions hold:

\[
\gamma_A^2 - \gamma_B^2 = \frac{k_{BB} - k_{AB} - \alpha_{AA}k_{AA}}{k_{AA}} \leq 0
\]

(17)

\[
\text{sign}(\gamma_A^2 - \gamma_B^2) = \text{sign}(k_{BB} + \kappa_{BB}k_{BB}k_{AA} + k_{BA}k_{AA}(\gamma_A^2 - \gamma_B^2)) \leq 0.
\]

(18)

Using the expressions for $K_B$ presented in the Proofs of Propositions 1 and 2 we have
\[
\gamma_A^2 - \gamma_B^2 = \frac{t_{BB} - t_{AB}}{t_{BB}} + K_{AB} - (K_{BB} + \alpha_{BB}k_{BB}) = 0
\]

and
\[
\text{sign}(\gamma_A^2 - \gamma_B^2) = \text{sign}\left((K_{BB} + S_{BB} + \Delta w_{BB}k_{BB})(K_{BA} + S_{BA} + \Delta w_{BA}k_{BB}) - (K_{BB} + S_{BB} + \Delta w_{BB}k_{AA}) (K_{BA} + S_{BA} + \Delta w_{BA}k_{AA})\right).
\]

In the particular case of no-common shareholders we have $k_{BB} = k_{AB}, k_{AA} = w_{BB}k_{AA}$ and $K_{BA} = K_{BB} = S_{BA} = 0$:
\[
\text{sign}(\gamma_A^2 - \gamma_B^2) = \text{sign}\left((K_{BB} + S_{BB} + \Delta w_{BB}k_{BB})^2 - w_{BB}^2K_{BB} - S_{BB}^2\right).
\]

We now show that the first term is positive, or that
\[
k_{BB} + S_{BB} = \frac{w_{BB}}{w_{BB} - w_{BB}}\rightarrow \frac{w_{BB}}{w_{BB} - w_{BB}}\rightarrow \sum_{N-1}^{\infty} w_{BB}^{-1} = \sum_{N-1}^{\infty} \frac{w_{BB}^2}{w_{BB}^2 + w_{BB}^2}.
\]

This is equivalent to
\[
\sum_{N-1}^{\infty} f(v_{BB} + \alpha_{BB}t_{BB}) = \sum_{N-1}^{\infty} f(v_{BB} + \alpha_{BB}t_{BB})
\]

After simplifying we obtain
\[
\sum_{n=1}^{N} f(v_{BB} + \alpha_{BB}t_{BB}) = \sum_{n=1}^{N} f(v_{BB} + \alpha_{BB}t_{BB})
\]

which is always true.

Finally, if $f(v_{BB}) = v_{BB}$ and $\sum_{n=1}^{N} v_{BB} = \sum_{n=1}^{N} t_{BB} = 1$, we have
\[
\Delta w_{BB}^2 = \alpha_{BB}v_{BB}
\]

\[
\Delta w_{BB}^2 = \alpha_{BB}v_{BB}
\]

\[
S_{BB} = \sum_{n=1}^{N} \Delta w_{BB}^2 v_{BB} = \alpha_{BB}v_{BB} \sum_{n=1}^{N} t_{BB} = 0
\]

and
\[
\Delta w_{BB}^2 = \frac{v_{BB} - \alpha_{BB}v_{BB}}{1-\alpha_{BB}} - v_{BB}
\]

\[
\Delta w_{BB}^2 = \frac{v_{BB} - \alpha_{BB}v_{BB}}{1-\alpha_{BB}} - v_{BB}
\]

\[
S_{BB} = \sum_{n=1}^{N} \Delta w_{BB}^2 v_{BB} = \frac{k_{BB}}{1-\alpha_{BB}} - k_{BB}.
\]

Therefore,
\[
\text{sign}(\gamma_A^2 - \gamma_B^2) = \text{sign}\left((K_{BB} + S_{BB} + \Delta w_{BB}k_{BB} - w_{BB})^2 - k_{BB} - S_{BB}^2\right).
\]

**Proof of Proposition 5.** After a partial divestiture of voting stock we will have $v_{BB} = v_{BB} = (1 - \alpha)v_{BB}$ in both Options 3 and 4. There will also be a decrease in $t_{BB}$ equal to $\alpha v_{BB}$, i.e., $t_{BB} = t_{BB} = t_{BB} - \alpha v_{BB}$.

In Option 3 we will have:
\[
\Delta w_{BB}^3 = \sum_{n=1}^{N} f(v_{BB} + \alpha_{BB}v_{BB}) - \sum_{n=1}^{N} f(v_{BB} + \alpha_{BB}v_{BB}) > 0
\]

\[
\Delta w_{BB}^4 = \sum_{n=1}^{N} f(v_{BB} + \alpha_{BB}v_{BB}) - \sum_{n=1}^{N} f(v_{BB} + \alpha_{BB}v_{BB}) < 0
\]

and $k_{BA}^3, k_{BB}^3$ and $k_{BB}^3$ have the same expressions as in the proof of Proposition 3, with $S_{BA}$ and $S_{BB}$ non-negative.

In Option 4 there will be a new shareholder, shareholder $N + 1$, and:
\[
\Delta w_{BB}^4 = \sum_{n=1}^{N} f(v_{BB} + \alpha_{BB}v_{BB}) - \sum_{n=1}^{N} f(v_{BB} + \alpha_{BB}v_{BB}) > 0
\]

\[
\Delta w_{BB}^4 = \sum_{n=1}^{N} f(v_{BB} + \alpha_{BB}v_{BB}) - \sum_{n=1}^{N} f(v_{BB} + \alpha_{BB}v_{BB}) < 0
\]

and
\[
k_{BA}^4 = \sum_{n=1}^{N} w_{BB}^2t_{BA} = \sum_{n=1}^{N} \left(v_{BB} + \Delta w_{BB}k_{BB}\right) t_{BA} + (0 + \Delta w_{BB}k_{BA}) t_{BA} = k_{BA} + S_{BA} + \Delta w_{BB}k_{BB} + z
\]

\[
k_{BB}^4 = \sum_{n=1}^{N} w_{BB}^2t_{BB} = \sum_{n=1}^{N} \left(v_{BB} + \Delta w_{BB}k_{BB}\right) t_{BB} + (0 + \Delta w_{BB}k_{BA}) t_{BB} = k_{BB} + S_{BB} + \Delta w_{BB}k_{BB} + z
\]

with $S_{BA} > 0$.

Hence,
\[
K_{AA}^4 = k_{BA} + w_{BB}^2K_{BA} = K_{BA} + S_{BA} + \Delta w_{BB}k_{BB}
\]

\[
K_{BB}^4 = k_{BB} + w_{BB}^2K_{BB} = K_{BB} + S_{BB} + \Delta w_{BB}k_{BB} + z
\]

with $z = \alpha v_{BB}^2 + v_{BB}^2$.

Using the expressions for the $K$'s presented above, we have
\[
\gamma_A^2 - \gamma_B^2 - \frac{t_{BB} - t_{BB}}{t_{BB} - t_{BB}} + \frac{K_{BB} - K_{BB}}{k_{AA}} = 0
\]

and
\[
\text{sign}(\gamma_A^2 - \gamma_B^2) = \text{sign}\left(K_{BB}^4 - K_{BB}^4 - K_{BB}^4 - K_{BB}^4 (t_{BB} - t_{BB})\right)
\]

\[
= \text{sign}\left(K_{BB}^4 - K_{BB}^4 - K_{BB}^4 - K_{BB}^4 (t_{BB} - t_{BB})\right)
\]

\[
= \text{sign}\left(K_{BB}^4 + S_{BB}^4 + \Delta w_{BB}k_{BB} + z\right) (K_{BA} + S_{BA} + \Delta w_{BB}k_{BB})
\]

\[
- (K_{BB} + S_{BB} + \Delta w_{BB}k_{BB}) (K_{BA} + S_{BA} + \Delta w_{BB}k_{BB})
\]

Without common shareholders we have $k_{BB} = k_{BA} = S_{BA} = S_{BB} = 0$ and, as long as it is not a complete sale:
\[
\text{sign}(\gamma_A^2 - \gamma_B^2) = \text{sign}\left(K_{BB}^4 + S_{BB}^4 + \Delta w_{BB}k_{BB} + z\right) (K_{BA} + S_{BA} + \Delta w_{BB}k_{BB} - 1) > 0.
\]
We now show that
\[ \frac{k_{BA} + S_{BA}^2 + z}{k_{BB} + S_{BB}^2} > \frac{w_{BA}}{w_{BB}}. \]

By definition, this is equivalent to
\[
\frac{\sum_{n=1}^{N} w_{BA}^n + z}{\sum_{n=1}^{N} w_{BB}^n + z} > \frac{w_{BA}}{w_{BB}} \iff \frac{\sum_{n=1}^{N} (f(v_{BA}) + f(1-\alpha)v_{BA})}{\sum_{n=1}^{N} (f(v_{BB}) + f(1-\alpha)v_{BB})} > \frac{w_{BA}}{w_{BB}}.
\]

which is always true.

In case of a complete sale, i.e., \( \Delta v_{BA} = \Delta w_{BA} = -w_{BA} \), even with common shareholders, one can show that \( \text{sign}(v_{BA} - v_{BB}) > 0 \):
\[
(K_{BB} + \Delta w_{BA}^2 k_{AB} + S_{BB}^2 + z) (K_{BB} + \Delta w_{BA} k_{AA} + S_{BB}^2) - (K_{BB} + \Delta w_{BB} k_{AB} + S_{BB}^2) (K_{BB} + \Delta w_{BB} k_{AA} + S_{BB}^2) = (k_{BB} + S_{BB}^2 + z) (k_{BB} + S_{BB}^2) - (k_{BB} + S_{BB}^2) (k_{BB} + S_{BB}^2) > 0.
\]

In fact, \( \frac{k_{BA} + z}{k_{BB} + S_{BB}^2} > \frac{k_{BA} + S_{BA}^2}{k_{BB} + S_{BB}^2} \), which is always true.

**Proof of Proposition 6.** After a partial divestiture of voting stock we will have \( v_{BA}^2 = (1 - \alpha) v_{BA} \) and \( t_{BA}^2 = t_{BA} - \alpha v_{BA} V_{BA} \) under Option 3 and \( v_{BB}^2 = (1 - \alpha) v_{BB} \) and \( t_{BB}^2 = t_{BB} \) under Option 2.

Before proceeding, note that
\[
w_{BA}^2 = \sum_{n=1}^{N} \frac{f(v_{BA})}{\sum_{n=1}^{N} f(1-\alpha)v_{BA}} = \sum_{n=1}^{N} \frac{f(v_{BA})}{\sum_{n=1}^{N} f(1-\alpha)v_{BA}} = w_{BA}.
\]

\[
w_{BB}^2 = \sum_{n=1}^{N} \frac{f(v_{BB})}{\sum_{n=1}^{N} f(1-\alpha)v_{BB}} = \sum_{n=1}^{N} \frac{f(v_{BB})}{\sum_{n=1}^{N} f(1-\alpha)v_{BB}} = w_{BB},
\]

which implies \( \Delta w_{BA}^2 = \Delta w_{BB}^2, S_{BA}^2 = S_{BB}^2 \) and \( S_{BA}^2 = S_{BB}^2 \).

From Eqs. (11) and (13) we have:
\[
\gamma_{A}^2 - \gamma_{A} = t_{BA} - t_{BB} + \frac{K_{BB} - K_{BA}^2}{K_{AA}} = \alpha v_{BA} V_{BB} > 0
\] (21)

and
\[
\text{sign}(\gamma_{B} - \gamma_{A}) = \text{sign}(K_{BA} k_{BA} - K_{BB} k_{BA} + K_{BB} k_{BA}^2 - K_{BA} k_{BA}^2) = -\text{sign}(K_{BA} + \Delta w_{BA} k_{AA} + S_{BA}^2)^2 (\alpha v_{BA} V_{BB}) \leq 0.
\]

In case of a complete divestiture, we have \( (K_{BB} + \Delta w_{BB} k_{AA} + S_{BB}^2)^2 = (K_{BB} - w_{BB} k_{AA} + S_{BB}^2)^2 = (K_{BB} + S_{BB}^2)^2 \).

Assuming no common shareholders, this is 0 and \( \gamma_{B} - \gamma_{A} = 0 \): Option 3 is better for consumers because it leads to a lower \( \gamma_{B} \). Otherwise, the weights each firm places on its rival always move in opposite directions.

Finally, after Option 1, we will have \( v_{BA}^0 = (1 - \alpha) v_{BA} \) and \( t_{BA}^0 = (1 - \alpha) t_{BA} \).

\[
\gamma_{A}^0 - \gamma_{A} = t_{BA}^0 - t_{BB}^0 + \frac{K_{BB}^0 - K_{BA}^0}{K_{AA}} = \alpha v_{BA} V_{BB}
\] (22)

and
\[
\text{sign}(\gamma_{B} - \gamma_{A}) = \text{sign}(K_{BA} k_{BA} - K_{BB} k_{BA} + K_{BB} k_{BA}^2 - K_{BA} k_{BA}^2) = -\text{sign}(K_{BA} + \Delta w_{BB} k_{AA} + S_{BB}^2)^2 (\alpha v_{BA} V_{BB})
\]

In the case of a complete divestiture \( \Delta w_{BB} = \Delta w_{BB} = -w_{BB} \) and this expression becomes:
\[
\text{sign}(\gamma_{B} - \gamma_{A}) = \text{sign}(K_{BA} + S_{BA}^2) (K_{BA} + S_{BA}^2) - (K_{BB} + S_{BB}^2) (K_{BB} + S_{BB}^2) - (K_{BB} + S_{BB}^2) \times (K_{BB} + S_{BB}^2 - \alpha v_{BA} V_{BB})).
\]

If there are no common shareholders, we have \( k_{BA} = S_{BA} = 0 \) and this simplifies to
\[
(K_{BB} + S_{BB}^2) S_{BA}^2 > 0.
\]

**Appendix B**

Following Singh and Vives (1984) and assuming firm symmetry, let the representative consumer maximize
\[
a(q_{A} + q_{B}) - \frac{1}{2} (b_{A} q_{A}^2 + b_{B} q_{B}^2 + 2d_{A} q_{A} q_{B}) - p_{A} q_{A} - p_{B} q_{B}
\]

with \( b > d \). This utility function leads to the following linear inverse demand functions:
\[
p_{A} = a - b q_{A} - d q_{B}
\]
\[
p_{B} = a - b q_{B} - d q_{A}
\]

or, equivalently, to the following direct demand functions:
\[
q_{A} = a(b-d) - b p_{A} + d p_{B}
\]
\[
q_{B} = \frac{a(b-d) - b p_{B} + d p_{A}}{b^2 - d^2}
\]

Assuming that marginal costs are equal to zero, it is straightforward to show that the equilibrium prices are given by:
\[
p_{A} = a(b-d)(2b + d(\gamma_{A} + 1))
\]
\[
4b^2 - d^2 (\gamma_{A} + 1)(\gamma_{A} + 1)
\]
\[
(a-b)(d(\gamma_{A} + 1))
\]

where
\[
\gamma_{A} = v_{BA} k_{BA}
\]
\[
\gamma_{B} = k_{BB} + k_{AA} w_{BB} v_{BA}
\]
After a partial divestiture in which a fraction $\alpha$ of firm A’s stock is sold to infinitesimal shareholders, we have

$$v_{PA}^3 = (1-\alpha)v_{BA} \quad \text{and} \quad w_{PA}^3 = \frac{\sum_{n=1}^{N} v_{n} + (1-\alpha)v_{BA}}{1-\alpha v_{BA}^3}$$

and therefore,

$$\gamma^3 = \frac{(1-\alpha)v_{BA}}{1-\alpha v_{BA}^3} = \frac{(1-\alpha)v_{BA}}{\frac{k}{k + ((1-\alpha)v_{BA})^2}}.$$

Writing $\nu = (1-\alpha)v_{BA}$ and inserting these expression into the equilibrium prices we obtain:

$$p_{PA} = \frac{(k + \nu^2)[(2b-d)(1) + (b-d)]}{4b^2(k + \nu^2) - d^2(1) + k(1 + \nu^2)}$$

$$p_{PA} = \frac{(2b^2(k + \nu^2) + db(1-v)(k + \nu^2) - d^2v(k + \nu^2))}{4b^2(k + \nu^2) - d^2v(1) + k(1 + \nu^2)}$$

or, letting $d = \nu < 1$ and normalizing prices and output

$$p_{PA} = \frac{2b^2(k + \nu^2) + db(1-v)(k + \nu^2)}{4b^2(k + \nu^2) - d^2v(1) + k(1 + \nu^2)}$$

In order to have non-negative prices and outputs we need that

$$g_1(k, \nu, x) = 4(k + \nu^2) - \nu^2(1) + k(1 + \nu^2) > 0$$

$$g_2(k, \nu, x) = 2(k + \nu^2) + \nu(1-v)(k + \nu^2) - \nu^2k(1 + \nu^2) > 0$$

$$g_3(k, \nu, x) = 2(k + \nu^2) + \nu(1-v)(k + \nu^2) - \nu^2v(1) > 0.$$

Notice that $g_2(k, \nu, x) > 0$ is always true because:

$$\frac{\partial g_2(k, \nu, x)}{\partial k} = (x + 1 - \nu v + 1 - \nu^2) > 0$$

and

$$g_2(0, v, x) = v^2(x + 1)(1 - \nu v + 1 - x) > 0.$$