Forum

The following two articles were prepared by Dr Martin Howe, who until recently was the Director of the Competition Division of the UK Office of Fair Trading and a prominent member of the OECD Competition Law and Policy Committee. He is a noted expert on competition law issues generally.

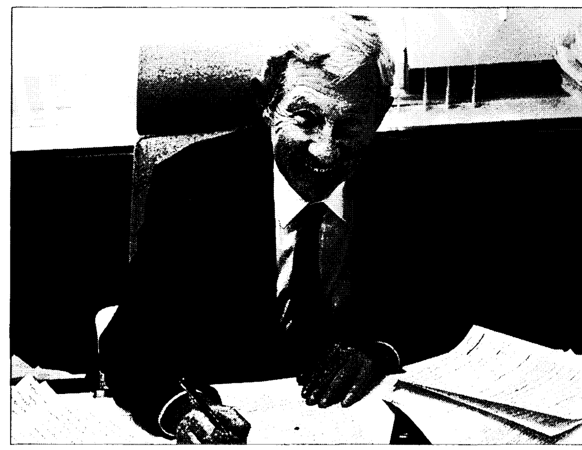
Dr Howe visited the Commission early this year for two months.

The first article is a discussion paper on the failing firm issue. It is an issue that is regularly raised in merger issues and a subject of some debate. The then Trade Practices Commission and the New Zealand Commerce Commission issued a joint discussion paper, Acquisitions and the Failing Company Argument, *in 1993. The issue was also covered in the TPC's merger guidelines. The Commission considered it was appropriate to update its thinking and issue a new discussion paper.*

Comments on the discussion paper are welcome and should be addressed to Hank Spier, General Manager, ACCC, PO Box 1199, Dickson ACT 2602.

The failing firm and the Trade Practices Act

The purpose of this paper it to suggest how the ACCC might approach the argument that a merger which in the normal way would be unlawful under s. 50 of the Trade Practices Act should be allowed because of the imminent failure of one of the merger parties, with a view to revision of the ACCC's *Merger Guidelines* or publication of a separate document to replace the October 1993 joint discussion paper.



Context

In most systems of merger control the fact that one of the merger parties is in danger of collapse and is likely to exit the market if the merger is prohibited will be taken into account by the competition authority in its assessment of the effects of the merger. How the usual assessment is modified in such circumstances will depend upon the substantive rules of the merger control and also upon the procedures of the system.

There is no reference in the Trade Practices Act to the failing firm issue, but it nevertheless can be taken into account in one of two ways.

- It may be argued that a merger which appears to lead to a substantial lessening of competition will not do so because one of the parties is failing and hence the merger cannot be blocked under s. 50 (this is the usual context in which the so-called 'failing firm defence' arises).

- Even where it is held that a merger involving a failing firm will lead to a substantial lessening of competition, it may be argued that the merger should be authorised on public benefit grounds under

s. 90 of the Act, for example because of the prospective loss of employment.

Although the case law on the failing firm issue is limited in Australia, both these arguments have been put forward in merger cases over the years.

As to the guidance issued by the Australian authorities, the joint paper proposes at section 7 the following test:

> The test is whether without the acquisition, the supply presently coming from the company would no longer come to the market and its resources would no longer be employed in that market as a result of the failure of the company. If these resources would not continue to provide an actual or potential constraint in the market, allowing their acquisition by another market participant **probably** will not enhance the market power of the acquiring company. In such a case, the acquisitions (sic) are unlikely to raise ... competition concerns. *(emphasis added)*

Despite the qualification that the acquisition of a failing firm will **probably** not enhance the market power of the acquiring company, there is a strong implication that the conclusion will be the same whatever the structure of the market. However, the paper does make clear that before the failing firm argument can be allowed, the authorities must be satisfied both that the firm will indeed fail and that it will exit the market. This means that there must be no way that the failing firm can be pulled round (not necessarily in its present form), and that there are no alternative buyers whose acquisition of the firm would raise no, or lesser, competition concerns.

The joint paper notes that the failure of a company might be judged to involve public benefits that will need to be considered in any application for authorisation, but adds that little can be said in a general sense about how any claimed benefits would be assessed.

The approach suggested in the current *Merger Guidelines* is rather different. The failing firm issue is referred to in chapter 5 of the guidelines which deals with the 'merger factors' that s. 50(3) requires the Commission to have regard to in assessing whether a merger is likely to have the effect of substantially lessening competition (see the section on the loss of a vigorous and effective competitor).

Paragraph 5.135 of the guidelines states:

> If the target firm is considered to be failing, the Commission will consider the likely effect of the acquisition on competition compared to the effect of the target's assets exiting the market. Under the latter circumstances, the distribution of the target's customer base among the remaining market participants would be determined by market forces, whereas an acquisition would tend to deliver those customers to the acquiring firm. If the competitive strength of remaining participants is evenly matched, the level of competition in the market may be better served by allowing the firm to fail. However, the loss of capacity will tend to reduce competitive pressures in the market. Depending on the effect of the acquisition on the relative strength of remaining participants, retaining the failed firm's capacity in the market may still be pro-competitive. Acquisition by a smaller player may result in more evenly matched rivals and an increased level of competition in the market. If the acquirer is the only other participant in the market, the acquisition is unlikely to have any effect on the level of competition.

This explicitly recognises that the effect upon competition of the acquisition of a failing firm may depend upon the structure of the market, with the argument that there can be no enhancement of market power being particularly questionable 'if the competitive strength of remaining participants is evenly matched'.

Paragraph 5.136 of the guidelines recognises that public benefits may be claimed in an authorisation application where a merger involves a failing firm. 'The claimed benefits may include retention of technical or productive assets, an avoidance of social dislocation and unemployment or the achievement of resource savings though rationalisation and economies of scale.' Chapter 6 of the guidelines spells out in some detail how the Commission assesses any authorisation application in a merger case, though with no specific reference to the failing firm issue.

The approach in the *Merger Guidelines* to the assessment of the effect on competition where one of the parties is failing is sounder than that of the joint paper, but it would be useful if the approach was spelt out more fully, probably in a revision of the joint paper. What follows could provide the basis for a more extended exposition.

Elaborating the approach

It will bear saying that the failing firm issue will only arise if the proposed merger breaches, or is likely to breach, the Commission's concentration thresholds — that is, if the merger will result in a combined market share of the four largest market participants post merger of 75 per cent or more and the merged firm will have a market share of at least 15 per cent, or if the market share of the merged firm is 40 per cent or more, and if the Commission's further examination of the merger suggests that it could lead to a substantial lessening of competition. Many mergers involving failing firms will raise no competition concerns either because the parties are not engaged in the same market(s) or, if they are, because their shares of that market are small.

Indeed, it would be useful in any publication on failing firms and merger control to emphasise that it is part of the competitive process that firms will fail and for a variety of reasons — some internal to the firm such as managerial inefficiency, some external such as a decline in demand and resulting excess capacity. Mergers can be welfare enhancing in such circumstances in putting resources promptly to alternative uses. They may also lead to improvements in efficiency through the rationalisation of capacity, changes in management or realisation of economies of scale. But where a merger seems likely to lead to a substantial lessening of competition in the terms of s. 50 of the Act, the question is how, if at all, the usual assessment should be modified because one of the parties is failing.

Prerequisites

It is relatively common for a firm to say that it is in financial difficulties and that a merger is imperative to save it from collapse. A competition authority, familiar with the tricks that are played to get and to exploit market power, is entitled to be sceptical about the failing firm argument.

As the joint paper makes clear, it is axiomatic that two prerequisites should be met before there can be any question of considering the argument that an apparently anti-competitive merger should be allowed because one of the parties is said to be failing.

The Commission must be satisfied, first, that failure is imminent and, second, that there are no alternative buyers whose acquisition of the failing firm would not raise competition concerns. These prerequisites ensure that, without the merger, the failing firm would indeed exit the market. It will invariably be difficult for a competition authority to establish that these two prerequisites are satisfied, and as far as possible the onus of proof should be put on the parties. If the prerequisites are not met, then the merger should be assessed in the normal way.

Failure means more than inefficient management or unsuccessful products. It should not be enough to show that sales or profits are declining or even that losses have been incurred. Nor should it be enough to show that the firm's owners are anxious to quit a market and sell a business. The test should be a strict one. The requirement should be that the firm is on the brink of collapse (the Canadian authority specifies within a period of six months) or is actually insolvent, and it should be required to demonstrate this with independent evidence such as bankers' or auditors' reports.

As to alternative buyers, documentary evidence should be produced that positive efforts have been made to identify any prospective purchaser, and that no reasonable alternative offer has been rejected. While the Canadian authority's requirement that the parties undertake an effective 'shop process' at the parties' expense (normally using an approved independent agent) may seem too demanding, some independent source of evidence on the search process is highly desirable.

As to what would be a reasonable price, any sum higher than the proceeds that follow liquidation of the firm should be considered acceptable. If the acquirer is willing to pay an amount significantly above this sum, then the implication is that the merger does promise an increase in market power or that there are strategic reasons for preventing the business being taken over by some other firm, now or in the future.

Effects on competition

The joint paper comes close to suggesting that if the prerequisites are met, that is the end of the matter: there can be no competition problem. This seems to be the position adopted in the United States. It is settled that if the likely alternative to a merger is the elimination of the firm and its assets from the market, then the merger will not violate section 7 of the Clayton Act which prohibits any merger that would substantially lessen competition in any line of US commerce. In *Citizen Publishing Co. v. United States* (1969) the Supreme Court held that an acquisition may be permissible under the failing firm doctrine if three requirements are satisfied: first, that the parties demonstrate that the company to be acquired is in imminent danger of failure; second, that there is no realistic prospect of a successful reorganisation of the failing firm (which arguably is subsumed in the first requirement); and third, that there is no viable alternative purchaser that poses less risk to competition. These requirements are reflected in the US authorities' 1992 *Merger Guidelines*.

In the European Community's merger regulation there is no provision for approving a merger that would create or strengthen a dominant position as a result of which effective competition would be significantly impeded, the test laid down in Article 2 of the regulation, on the ground that a party to the merger is failing. Yet the European Commission has developed the concept of a 'rescue merger'. In *Kali and Salz/MdK/Treuhand* (1993) the Commission concluded that a merger which would otherwise be prohibited on competition grounds can be allowed if three conditions are met: first, without the merger the failing firm would exit the market in the near future; second, acquisition by any other firm which would result in less damage to competition can be ruled out; third, there is evidence that if the failing firm were to exit the market virtually all its market share would go to the merger partner.

The third of these requirements is crucial and goes to the heart of the rationale of the failing firm argument. It is the effects of a merger which entitle the authority to take steps to prevent it. There needs to be a causal link between the merger and the effects on competition and ultimately on welfare. In contrast to the usual analysis where the comparison is of the market structure before and after the merger, in the failing firm case there will be a structural change even without the merger. Whether the merger is prohibited and the failing firm forced to exit the market, or the merger is approved, there will be the loss of one competitor in the market. If there are only two firms and one is failing, with or without the merger the remaining firm will finish up with 100 per cent of the market. It will, of course, be in a stronger position than before as it has no competitors and has acquired the failing firm's assets and any goodwill. But that is the effect of its competitor's failure rather than of the merger. Hence, the argument runs, given the need for a causal link between the merger and the effects on competition, there can be no substantial lessening of competition and no justification for blocking the merger.

The ACCC's *Merger Guidelines* are less dogmatic. 'If the acquirer is the only other participant in the market, the acquisition is **unlikely** to have any effect on the level of competition' (para 5.135, *emphasis added*). The qualification is justified. First, however thoroughly an authority has checked whether there are no alternative buyers, doubts may remain. Thus, in the Western Australian Newspapers application for authorisation (1990), the Trade Practices Commission (TPC) felt that the owners of the failing firm, publishers of a rival newspaper in Perth, had not given adequate consideration to the single alternative bid for the company and the TPC attributed Western Australian Newspapers' willingness to pay significantly more than the other bid to a desire to reinforce its position of dominance in the market. The TPC therefore contended that the merger did lead to a substantial lessening of competition and it was prepared (since it also rejected Western Australian Newspapers' application for authorisation on public benefit grounds) to contemplate the failing firm's exit from the market.

This decision suggests the second qualification that must be made to the proposition that if a firm is indeed failing, and it is acquired by the remaining firm in the market, there can be no competition problem. The proposition ignores the strategic possibilities in such an acquisition. These will be more pertinent, however, where the structure of the relevant market is oligopolistic. And this, of course, will be the more usual situation.

It follows from all this that, even where the two prerequisites appear to be met, a competition authority will still be wise to endeavour to assess the competition implications of the merger against all the other possibilities: liquidation but also retrenchment by the failing firm or acquisition by some other, even if as yet unknown, party. In a leading New Zealand failing firm case, *NZ Cooperative Dairy/Waikato Valley Cooperative Dairies* (1991), the Commerce Commission concluded that the supply channelled through Waikato Valley would continue to be placed in the market, should the merger be blocked, if not through Waikato Valley as it presently was then through a reorganised Waikato Valley or through other organisations.

While the possibility of a substantial lessening of competition will be less the more dominant is the acquiring firm, the outcome will be more problematic in more oligopolistic markets. Clearly, with a merger, the market share of the acquiring firm will increase by more than if the failing firm exits the market and the failing firm's share is picked up by the remaining firms. It will, of course, be impossible to predict how market shares will change in the latter circumstance. But the point (a fairly obvious one) can be illustrated by a simple example, assuming that the failing firm's share is redistributed among the remaining firms in proportion to their existing shares.

Beginning structure	A 50%	B 20%	C 20%	D 10% failing
A acquires D	A 60%	B 20%	C 20%	
D exits	A 55.6%	B 22.2%	C 22.2%	

Although the market structure after the exit of D may be preferable in competition terms to the structure after a merger, it may still be difficult to argue that competition is **substantially** lessened comparing the one situation with the other, and therefore that the merger should be blocked.

But aside from any uncertainty whether the failing firm would indeed exit the market this is to put too much emphasis upon arithmetical changes in market share. Market dynamics need to be taken into account and again the possibility of strategic motives for the acquisition of a failing firm explored. There are a number of ways in which it might still be concluded that a merger with a failing firm would reduce competition compared with the alternative of that firm's exit from the market. Assessment requires close consideration of the recent history of market conduct, of the reasons why the firm finds itself in financial difficulties, and of the particular bundle of assets that the merger will bring to the acquiring firm, to mention the more obvious.

One possibility is that coordinated conduct between the remaining firms would be easier after a merger. Bearing in mind that there would be the same number of firms with or without the merger, this scenario would require that the acquisition of a failing firm be seen as a signal of some sort to the rest of the industry. This could be the case where there has been excess capacity, a period of vigorous competition (price war) leading to losses, and where the merger would facilitate rationalisation and a return to 'more orderly' conditions. The objection might be made to this line of reasoning, however, that the very way it is put recognises the inherent instability of coordination among oligopolists.

A second line of reasoning might be that if the failing firm was to exit the market, competition would become more intense as the remaining firms battle for market share. For a pattern of settled, perhaps coordinated, conduct to be upset by the disruption of the exit of a failing firm, it would seem that the failure would need to be for managerial or other internal reasons rather than excess capacity — which itself would be expected to stimulate competition —

and that the failing firm had a significant share of the market.

A third line of reasoning would examine any strategic motives for the acquisition of a failing firm. Oligopolists endeavour to shape the market environment in which they operate to their advantage. Predatory pricing, pre-emptive advertising campaigns, investment in additional capacity can all be undertaken for strategic reasons at the cost of profits in the short term. A firm may see strategic opportunities in the acquisition of a failing firm. First, the acquisition may remove, or at least diminish, any immediate risk that the firm's exit would facilitate the entry of a new competitor. Second, the acquisition may strengthen the acquirer's strategic opportunities vis à vis its rivals. It is not the size of the additional market share acquired that counts so much as what it represents and how it might be used to increase the acquirer's strong position in the market. In the case of the Bristile Holdings application for authorisation (1997), the ACCC put considerable weight on the strategic advantages it saw to Bristile, the only supplier of clay tiles in the Western Australian roof tile market, in acquiring the concrete tile business of Pioneer Building Products. The Commission was satisfied that Pioneer would cease its tile manufacturing operation but was unable to come to a judgment on whether there might be an alternative buyer to Bristile. There were two other concrete tile producers with roughly similar shares to that of Pioneer. The Commission concluded that competition would increase in the short term if Pioneer exited the market, as the remaining firms competed for its share of the market. They also felt, and it appears to have been decisive, that if the merger was allowed, Bristile's acquisition of a concrete tile business alongside its clay tile business would give it such a strategic advantage over the two remaining concrete tile producers as to make effective competition from that quarter unlikely, and that its commanding position in tile marketing would further inhibit potential entrants.

In a failing firm case, a competition authority has to evaluate matters with which it will not normally be concerned, most obviously the failing firm's financial situation. But in the majority of failing firm cases the authority will need to proceed to a competitive assessment in the usual way. As always, it will have to make predictions about future conduct in a situation of considerable uncertainty, particularly in markets of an oligopolistic character. Only a fact intensive market analysis can serve to give credence to any argument that the acquisition of a failing firm will lead to a **substantial** lessening of competition compared with the alternative of the failure and exit of the firm.

Public benefits

Parties to any merger may apply for a s. 90 authorisation. Section 90 of the Act states that authorisations can only be granted if the Commission 'is satisfied in all the circumstances that the proposed acquisition would result, or be likely to result, in such a benefit to the public that the acquisition should be allowed to take place'. Among the circumstances that will be taken into account will be the detriments associated with the Commission's conclusion that the merger would lead to a substantial lessening of competition.

Chapter 6 of the ACCC's *Merger Guidelines* sets out at some length how this test is applied by the Commission, and a version of this should be included in any publication on the failing firm issue. Suffice it to note here that, while the term 'benefit to the public' is to be widely construed, the guidelines state (at para 6.39) that 'as emphasised by the (Competition) Tribunal, public benefits in the form of increased efficiency and better resource usage, resulting in lower unit costs, are most important in consideration of applications for the authorisation of mergers'. Failing firm mergers may give rise to efficiency gains but preserving capacity and employment are the benefits more likely to be claimed. Weight can be put on these types of public benefit only by weakening the effectiveness of merger control in promoting competitive market structures and the benefits that can be expected to flow from competition.

In fact, in both the Western Australian Newspapers case, where the claimed benefits focused on jobs saved, and in the Bristile case, where the emphasis was on cost savings, the public benefits were considered by the TPC and the ACCC respectively to be 'minimal'.

Conclusion

Much has been written about the failing firm defence argument though rarely is there mention of it in any competition law (Canada's Competition Act being a notable exception). Outside the United States, the number of decided cases where the failing firm issue has been a major feature is relatively small. Nevertheless, such cases raise important and difficult issues for the competition authority.

In Australia the failing firm argument may have to be considered under s. 50 to establish whether or not there is a substantial lessening of competition or under s. 90 in respect of an application for authorisation on public interest grounds.

Where the merger would, on normal s. 50 considerations, lead to a substantial lessening of competition, suggesting that the merger should be prohibited, the possibility that the failing firm may exit the market if the merger is prohibited requires a modification of the usual assessment.

It is suggested that two prerequisites have to be established if the failing firm argument is to be entertained, and that the onus of doing so should fall on the parties. These are that the failure of the failing firm is indeed imminent and that there are no alternative buyers whose acquisition of the failing firm would cause no, or a lesser, competition problem.

Although, where the prerequisites are met, the effects of a merger on the structure of the market may be little different in the short term from the structure that would emerge if the failing firm was allowed to exit — the less so, the more dominant in its market is the acquiring firm — there can still be reasons for concluding that competition may be more adversely affected if the merger takes place. The issue is whether competition is **substantially** lessened by the merger. For this to be likely, there will need to be a change in the dynamics of the market. To establish that the consequence is likely to be a substantial lessening of competition is likely to require close attention to the strategic opportunities open to the acquiring firm rather than to more traditional market shares, barriers to entry and the like.

As far as authorisation is concerned, the saving of jobs and capacity is a potential public benefit. Evaluation of such benefits in the context of a merger which has been found to be likely to lead to a substantial lessening of competition will always be difficult, as the Commission notes in its determination on the Western Australian Newspapers application. But the difficulties do not appear to be any greater than in any other authorisation application.

Reform of UK competition law

A Bill to reform United Kingdom (UK) competition law was introduced into Parliament in October 1997 and is expected to receive Royal Assent in July 1998. Reform is overdue. Indeed, the previous Government published its proposals as long ago as July 1989 but was unable thereafter to find a slot for them in any of its legislative programs. The present Competition Bill is more radical in the changes it will make both to the substantive provisions of the competition law and to the machinery with which the law will be enforced.

This article outlines the main changes and considers how likely they are to meet the objectives of the reform. The main objective is to improve the effectiveness of the law in dealing with anti-competitive business conduct. It is also intended that the changes will align UK competition law more closely to the law of the European Community as set out in Articles 85 and 86 of the Treaty of Rome. The objective here is to reduce compliance costs for UK business and the possibility of conflict between the two systems of law.

The new law

When enacted, the Competition Bill will introduce two prohibitions, one of anti-competitive agreements and the other of conduct amounting to the abuse of a dominant position. The first prohibition (called, in the