MERGER ANALYSIS OF FAILING OR EXITING FIRMS UNDER THE SUBSTANTIAL LESSENING OF COMPETITION THRESHOLD

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1. Introduction

The situation frequently arises, particularly in recessionary times such as the present, that one competitor may propose to acquire the assets or shares of a rival in circumstances where this rival will say that it is failing or otherwise inevitably proposing to exit the market.[1] The question arises as to whether such an acquisition is permissible under merger law.

Competition laws regulate mergers primarily because mergers have the potential to decrease competition and thus increase or facilitate the exercise of market power. Economically, market power is the ability of a firm (or a group of firms acting jointly) to decrease output and increase prices above the competitive level, without losing sufficient customers so as to make the price increase unprofitable.[2] If a firm can exercise market power by itself it has unilateral market power. If a group of firms acting jointly can exercise market power that is called co-ordinated market power or co-ordinated effects. Exercising market power can lead to increased prices, decreased output, inefficiency in production, the production of the wrong type and quantity of goods and services (allocative inefficiency) and decreased innovation.[3] The anti-competitive effects of a merger can be long-lasting as a merger can alter an industry's structure.

However, mergers do not only produce anti-competitive consequences. They may produce no effect. They can also produce beneficial outcomes. Combining two separate firms may not only increase the market power of the remaining firm, but may also have powerful efficiency consequences. This can result from allowing firms to harmonise product lines, co-ordinate production efforts from multiple-firm dealings, reduce duplicative costs and combine research and development programmes. Economic theory teaches that some of these efficiencies are passed on to consumers.

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1 This article focuses upon horizontal mergers, being mergers between competitors in the same market. The principles discussed here potentially also apply to other forms of merger being vertical mergers (where the merger parties are at different functional levels of a market) and conglomerate mergers (in which case the merger parties are in different markets), because the assessment of such mergers will similarly centre upon the likelihood of exit by the target firm, and how this may be accounted for under counterfactual analysis.

2 William Landes & Richard Posner "Market Power in Antitrust Cases" (1981) 94 Harv L Rev 937 at 937.

3 Frederic Scherer & David Ross *Industrial Market Structure and Economic Performance* (3rd ed, Houghton Mifflin, New York, 1990) at chapter 17.

Mergers that receive competition law attention usually have a combination of beneficial and deleterious effects. In such cases, the issue is whether the social losses from the anti-competitive effects outweigh the productive efficiencies.

Part III of the Commerce Act 1986 ("Act") governs mergers. Section 47(1) is the most important provision. It provides:

> A person must not acquire assets of a business or shares if the acquisition would have, or would be likely to have, the effect of substantially lessening competition in a market.

Parliament introduced this by the Commerce Amendment Act 2001. Prior to this, s 47 prohibited a person from acquiring assets of a business or shares if, as a result of the acquisition, that person or another person would be, or would be likely to be, in a dominant position in a market, or that person's or another person's dominant position in a market would be, or would be likely to be, strengthened. Commentators and courts referred to this as the "dominance" test.

Under the current s 47, a competitor cannot acquire the assets or shares of a rival if that acquisition would have the effect or likely effect of substantially lessening competition in a market. Commentators and courts refer to this as the "substantial lessening of competition" test.

The Commerce Act provides for a voluntary notification regime. Parties who are contemplating an acquisition may apply for a clearance or authorisation with the Commerce Commission ("Commission"). Under s 66 (3), the Commission is obliged to give a clearance if it is satisfied that an acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market. Also under s 67(3), the Commission must grant an authorisation if it is satisfied that, notwithstanding that the acquisition will have the effect or likely effect of substantially lessening competition in a market, the acquisition will result, or be likely to result, in such a benefit to the public that it should be permitted.

A particular problem for competition law analysis arises in the case of the acquisition of target firms which are about to fail. If the target firm is failing or inevitably likely to exit the market, then allowing the merger may not substantially lessen competition. If the target firm is insolvent or inevitably likely to exit, allowing another firm to acquire it will not alter the market structure and will have no effect on competition. This scenario is known in overseas jurisdictions as the failing firm defence, in the situation where the target company faces the grave probability of market failure. Such a defence permits a merger that would otherwise be illegal under s 47. If the target company is failing, a merger will not result in a substantial lessening of competition.

Intuitively, the failing firm defence appears to provide a common sense basis upon which to assess the competition law issues surrounding the acquisition of an exiting competitor. If the target firm is about to abandon the market, then why not allow the merger so that the target firm's productive capacity will at least be maintained, and its assets not confined to scrap? Also, shareholders of the target firm receive some return on their investment in the

business. Such an outcome may also have flow-on benefits to the target's creditors; and communities in which the target firm operates may benefit through continuation of local supply arrangements and employment.

In such circumstances, it is hard to say that the acquisition will substantially lessen competition. However, the situation is not always so clear cut. What if a preferable alternate purchaser of the target company exists from a competition law point of view? This alternate purchaser may not have as much market power as the intended purchaser. Further, what if such purchaser is offering a lower price (in some cases substantially lower) than the proposed acquirer? Should competition law concerns trump the interests of the target firm's shareholders and creditors?

Furthermore, what if exit of the target firm will be likely to provide the catalyst and opportunity for efficient new entry to occur? In this setting there will be competition for the target firm's customers from the incumbent and the new entrant.

A range of contradictory competition law and private goals therefore soon complicates intuition. Further complexity arises through the questionable legal foundation for the failing firm defence and the problem of formulating a rule for applying the defence. The particular difficulty in this context has been to fashion a stand-alone defence to overcome merger prohibitions which are expressed only by reference to broad standards of market power.

The defence has become important in recessionary times with more companies failing or otherwise facing circumstances of inevitable exit. Also, while courts had discussed the defence under the dominance test it, as yet, has had limited judicial scrutiny under the substantial lessening of competition test. Furthermore, the Commission has issued Supplementary Guidelines on Failing Firms.

One of the writers has discussed the failing firm defence under the dominance test.[4] This article discusses the failing firm defence under the substantial lessening of competition test. It draws upon the previous work in describing United States developments and the economic rationale for the defence.

The scheme of this article is as follows: Part 2 traces and critiques the foundations of the failing company defence. It suffices here just to cover the United States case-law developments, and to critique the rationale for such developments.[5] Part 3 traces New Zealand developments pertaining to the application of the defence under the old dominance threshold applying under the Act up to 2001. Part 4 discusses the development of principles under the substantial lessening of competition threshold which has applied

4 Mark N Berry "The State of the Failing Company Defence in New Zealand" (2000) 19 NZULR 58.

5 As it happens, the United States approach to the doctrine has served as the starting point for the framing of the defence in other jurisdictions, such as under Canadian and European Community law. See Michael Trebilcock, Ralph Winter, Paul Collins and Edward Iacobucci *The Law and Economics of Canadian Competition Policy* (University of Toronto Press, Toronto, 2002) at 264-265; Richard Whish *Competition Law* (5th ed, Oxford University Press, Oxford 2003) at 845.

to mergers since 2001. It undertakes five case studies under the substantial lessening of competition threshold. Part 5 briefly discusses public benefits and Part 6 advances conclusions.

II. Foundations of the Defence and Philosophical and Historical Background

A. United States Case-law

Section 7 of the Clayton Act deals with mergers under United States law. This provision renders unlawful mergers where the result may be to lessen competition substantially or to tend to create a monopoly. There is no legislative recognition of the failing company defence in the Clayton Act. Rather, case-law has created it.

Deciding whether a merger is likely to lessen competition substantially or tend to create a monopoly involves speculating as to the future. It also necessarily involves a comparison. A merger can only substantially lessen competition in comparison with something. The United States enforcement agencies compare what the market will be like in the future, with and without a merger. They compare what the market is like before the merger and what it will be like if the merger proceeds. Thus, they compare the market before and after the merger.[6] The status quo market situation is the point of comparison or counterfactual. The status quo contemplates a future market status quo. The failing firm defence is the only situation where the enforcement agencies do not use the status quo as the counterfactual.

The Supreme Court first recognised the defence as an alternative ground for its decision in *International Shoe Co v Federal Trade Commission*.[7] The Supreme Court upheld the merger of the nation's largest shoe manufacturer and another leading manufacturer that was on the verge of involuntary dissolution under Massachusetts law.[8] The target firm was failing and about to exit the market. The leading statement on point was as follows:[9]

> In the light of the case thus disclosed of a corporation with resources so depleted and the prospect of rehabilitation so remote that it faced the grave probability of a business failure with resulting loss to its stockholders and injury to the communities where its plants were operated, we hold that the purchase of its capital stock by a competitor (there being no other prospective purchaser), not with a purpose to lessen competition, but to facilitate the accumulated business of the purchaser and with the effect of mitigating seriously injurious consequences otherwise probable, is not in contemplation of law prejudicial to the public and does not substantially lessen competition or restrain commerce within the intent of the Clayton Act.

6 US Department of Justice and Federal Trade Commission *Horizontal Merger Guidelines* (1992, sec 201); Andrew Gavil, William Kovacic and Jonathan Baker *Antitrust Law in Perspective: Cases, Concepts and Problems in Competition Policy,* (Thomson West, St Paul,2002) at 418-561; *Chicago Board of Trade v US* 246 US 231 (1918) at 238.

7 *International Shoe Co v Federal Trade Commission* 280 US 291 (1930).

8 Ibid, at 299-300.

9 Ibid, at 302-03.

On the basis of this formulation, Courts have generally regarded the defence as an absolute defence[10] which applies where the two merger parties established two elements, namely: First, the parties must establish that the target firm faces the grave probability of business failure with remote prospects of rehabilitation.[11] Courts have strictly applied this limb of the defence in subsequent cases to require a high probability of failure. For example, the courts have variously required that the target company be "hopelessly insolvent"[12] or "irretrievably failing".[13] Courts may now apply the further inquiry into the target firm's prospect of rehabilitation less rigidly than the Supreme Court intended under its formulation in *International Shoe*. In *Citizen Publishing Co v United States*[14] the Supreme Court has since noted that, at the time it decided *International Shoe*, companies often emerged from bankruptcy.[15] Courts may be now less likely to speculate upon such outcomes, given that there is more recent data reflecting that fewer than 20 percent of firms filing for bankruptcy in the United States are likely to reorganise successfully.[16]

10 See Thomas J Campbell "The Efficiency of the Failing Company Defense" (1984) 63 Texas LR 251 at 252. For contrasting views on this point, see the materials cited in Mark N Berry, "The State of the Failing Company Defence in New Zealand" (2000) 19 NZULR 58 at footnote 47.

11 The application of the defence to failing subsidiaries or divisions is problematic, notwithstanding that the enforcement guidelines recognise that the defence can apply in such circumstances (US Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines*, 1992, sec 5.2). There may be dangers in admitting the defence in this setting, because parent companies can manipulate the capital structure of wholly owned subsidiaries. Nonetheless, there is the view that the defence should be available in the case of failing subsidiaries where the debt-equity ratio of the subsidiary is not materially higher than that of other firms in the subsidiaries market. See Phillip Areeda & Herbert Hovenkamp *Antitrust Law: An Analysis of Antitrust Principles and their Application* (2nd ed, Little Brown and Co, Boston 2000) at vol IV [953e and f].

12 *United States v Diebold Inc* 197 F Supp 902, 906 (SD Ohio 1961), reversed on other grounds, 369 US 654 (1962).

13 *United States v MPM, Inc* 397 F Supp 78, 98 (D Col 1975). For further case-law references on point, and references to United States enforcement agency guidelines, see Mark N Berry, above n 12 at 72. The most recent decisions continue to reflect problems in satisfying this element of the defence: see, e.g., *FTC v Arch Coal Inc*, 329 F Supp 2d 109, 124-36 (2004) (rejecting application of the defence on the basis that the target firm was not failing, notwithstanding that it was "a relatively weak competitor" with "no convincing prospects for improvement").

14 *Citizen Publishing Co v United States* 394 US 131 (1969).

15 Ibid at 138.

16 See, e.g., Robert K Rasmussen "The Efficiency of Chapter 11" (1991) 8 Bankruptcy Developments Journal 319 at 322.

Second, the parties must show that there is no other prospective purchaser. Courts have interpreted this limb of the defence to involve an inquiry into whether preferable alternative purchasers exist from a competition point of view. Courts have imposed requirements on targets to demonstrate that they have undertaken well conceived and thorough attempts to seek out viable alternative purchasers.[17] A problem arises in this context where the preferred purchaser's offer is substantially below the proposed acquirer's offer. It is difficult to fashion arbitrary rules in this setting.[18] However, recent authority is to the effect that if the preferred purchaser's offer is at above the liquidation price for the assets in question, then the failing firm defence is not available and the alternative sale should be allowed to proceed.[19]

B. Rationale for the Defence

One matter apparent from the *International Shoe* formulation of the defence in the United States is that the rationale for the defence is based upon private interests which assume that the defence should apply to limit losses to shareholders and injury to communities where plants are located. This is not a competition law or efficiency concern. Subsequent courts' continued adoption of the *International Shoe* formulation of the defence has meant that a more appropriate theoretical basis for the defence has not emerged under United States case-law.

The private interests justification for the defence is flawed for a number of reasons, including the following. First, shareholders and creditors of a failing firm will potentially benefit through application of the defence. Greater value will attach to the shares than would be the case should failure occur. Creditors will also benefit, even if only to save the costs associated with enforcement of their security interests. But it is open to argument that the protection of such interests results simply in distributional outcomes, which are not the proper domain of competition laws. Further, it is arguable that inappropriate interests are being protected because often reduction in shareholder wealth will result from poor management,[20] and creditors have the ability to secure their interests in any event.

Second, the divergent private interests of employees and the wider community are even more problematic. For example, the productive assets of a failed firm may well not disappear, but may be put to some other use by the acquirer. Indeed, relocation of the assets might even result in the more efficient use of them. In this example, employment and the related interests of suppliers lost in one community will be gained in another. Applying the defence in this situation would serve only to advance value choices around regional development options. This is not the domain of competition laws.

17 *United States v Pabst Brewing Co* 296 F Supp 994, 999-1000 (ED Wisc 1969).

18 See Areeda & Hovenkamp, above n 13 at [954e].

19 *AG (State of California) v Sutter Health*, US Court of Appeals, 9th Cir, No 00-15039, 30 March 2000 at 22, 29.

20 See Timothy Walthall "The Failing Company Defense and Corporate Collapse: Probing for a Rational Approach to Business Failure" (1982) 5 George Mason ULR 51at 67.

Third, some commentators have argued that the courts have fashioned the defence to protect small business.[21] This is not a legitimate goal under New Zealand competition law.[22]

Notwithstanding that the original private interests justification for the defence is flawed, a body of economic literature has emerged since the mid-1980s which points to a more credible basis for the defence. A leading contribution is the Shughart and Tollison model[23] which reviews the transition of merger to monopoly in the context where the target is a failing firm. This model assumes that:

- there is a two-firm competitive industry in which one of those firms is not viable in the long run;
- there is no alternative purchaser;
- each firm has one production plant;
- both firms are price-takers;
- one firm is more efficient than the other; and
- the more efficient firm enjoys rents for its superior efficiency while the other firm earns a normal rate of return.

Against this background, Shughart and Tollison advance the possibility of a permanent fall in market demand and a new market price under which the less efficient firm will not recover all of its costs. The less efficient firm will eventually fail. Whether or not the more efficient firm should be permitted to acquire the less efficient firm will involve a trade off of the welfare effects of either permitting the less efficient firm's assets to be acquired by the surviving firm or allowing this firm's assets to exit the market. Shughart and Tollison argue that the welfare loss will be smaller in the case of acquisition by the surviving firm essentially for two reasons. First, if failure occurs, the surviving firm will, in any event, choose the price-output combination which is consistent with profit maximisation. Second, the output of the merged firm will exceed the output of the surviving firm alone, resulting in a deadweight loss which will be less than would occur in the case of the failing firm's resources exiting the market.

21 See, e.g., Derek Bok "Section 7 of the Clayton Act and the Merging of Law and Economics" (1960) 74 Harvard LR 226 at 340.

22 Section 1A provides that the goal of the Act is to promote competition for the long-term benefit of consumers within New Zealand. This goal involves efficiency analysis. See Thomas Gault (ed) *Gault on Commercial Law* (online looseleaf ed, Brookers) at [CA1A.05].

23 William F Shughart & Robert D Tollison "The Welfare Basis of the 'Failing Company' Doctrine" (1985) 30 Antitrust Bull 357 359-63 (relying upon a model presented in A Koutsoyiannis *Modern Microeconomics* (2nd ed 1979) at 186-89). For further exploration of the economic justification for the defence, see Campbell, above n 12 (arguing that the defence is sometimes efficient); Fred S McChesney "Defending the Failing Firm Defense" (1986) 65 Nebraska LR 1 (disputing Campbell's analysis and arguing that the defence is always efficient); Richard D Friedman "Untangling the Failing Company Defense" (1986) 64 Texas LR 1375 at 1379-1404 (arguing that a merger will be of virtually unambiguous competitive benefit when it is the only way to keep the failing firm's assets in the industry).

As with all models, there are significant practical limitations with this model. As already noted, it assumes a two-firm market and no alternate purchaser. Further, in the pre-merger context, measurement problems arise in demonstrating the merged firm's output because the demand and marginal cost curves will be unknown over all possible relevant ranges of output. Nonetheless, this economic explanation of the defence provides the strongest case for its application, and intuitively it is sound to permit mergers where the output restriction will be smaller, and the welfare loss correspondingly less, if the failing firm's assets are acquired rather than scrapped or otherwise rendered non-productive.

III. New Zealand Developments

The courts and the Commission have considered failing company circumstances in New Zealand under two different merger thresholds.[24] As mentioned above, when first enacted in 1986, s 47 of the Act prohibited mergers which were likely to result in the acquisition or strengthening of a dominant position in a market. In 2001 Parliament amended s 47 and mergers are now assessed under the substantial lessening of competition test. This section of the article briefly traces relevant developments up to 2001 under the old dominance test. It then reviews the development of relevant principles since 2001 under the substantial lessening of competition test.

A. Dominance Test (1986-2001)

Under the old dominance threshold, the provisions applying to mergers were broadly as follows. First, s 47 prohibited mergers where they would, or would be likely to, result in the acquisition of a dominant position in a market. Courts interpreted this test for dominance as requiring the establishment of "more than 'high' market power".[25] However, such dominant position did not need to be "so controlling that it [was] impenetrable".[26] Accordingly, the dominance test was based on a prohibition triggered by the attainment of a high degree of market power. In the case of an acquiring firm already holding such a degree of market power, s 47 prohibited any acquisition that would be likely to result in a more than *de minimis* strengthening of the dominant position.[27]

24 For wider discussion of the historic application of the defence, see Mark N Berry, above n 10 at 76-85.

25 *Commerce Commission v Port Nelson Ltd* (1995) 6 TCLR 406 (CA) at 441.

26 *Port Nelson Ltd v Commerce Commission* (1996) 7 TCLR 217 (CA) at 242.

27 *NZ Co-operative Dairy Co Ltd v Commerce Commission* [1992] 1 NZLR 601 (HC) at 619-20.

Second, mergers which did not pass the dominance, or strengthening of dominance, tests could still be authorised on the grounds that the proposal involved countervailing public benefits which outweighed the detriments arising from the dominance concerns.[28] Efficiency considerations provided the primary basis for the assessment of such public benefits.[29]

From 1986 to 2001, there was only one case of any particular significance on the failing company defence. The *NZ Co-operative Dairy*[30] case involved the acquisition by NZ Co-operative Dairy Co Ltd of Waikato Valley Co-operative Dairies Ltd (Waikato Valley). The failing company defence was at issue in this case because, by the time of the appeal against the Commission's decision not to approve the merger, it was apparent that Waikato Valley would not survive and that its failure was "imminent".[31]

The High Court decision in *NZ Co-operative Dairy* is unsatisfactory in a number of respects. In terms of principles, the Court emphasised that there is no need or justification for the failing company doctrine. It based this conclusion on the perception that this doctrine emerged in a substantially different context to the New Zealand setting. In particular, it portrayed the doctrine as a special doctrinal rule engrafted upon different legislation.[32] The Court then proceeded to assert that s 47 was capable of dealing with failing company circumstances, without supplementary rules, in the following terms:[33]

> The tribunal's function is first to determine as a question of fact whether a participant, the subject of a merger proposal, has in practical terms already failed, or is in the process of failing so that its demise is imminent, or, if the process is not so far advanced, its failure can be foreseen as inevitable or even probable within a time span which will render what might otherwise be seen as a resulting dominance merely transitory. Second, having so determined the facts, to apply those facts as part of the overall circumstances of the particular case in determining whether dominance or a strengthening of dominance will, or is likely to, result, and if so, to proceed to the further stage of the tribunal's inquiry, in order to assess the impact those facts have on the overall assessment of public benefit to flow from the merger proposal. While the matters raised in other cases as a means of testing a failing company submission may provide useful guidelines or checklists in those cases, in the end each case must stand on its own facts.

The problem with this statement of principle is that it purports to offer guidance, but in reality provides none. In particular, on the question of dominance, or the strengthening of dominance, it is uninformative just to say that the facts are to be applied to "the overall circumstances of the particular case". Surely there was scope in this setting to enunciate further principles where, for example, it was evident that the assets of the failed firm would be likely to remain in the market and may be of interest to

28 Section 67(3) of the Act and *NZ Co-operative Dairy*, ibid, at 630-36.

29 Section 3A of the Act and *Telecom Corp of NZ Ltd v Commerce Commission* (1991) 4 TCLR 473, 528-30 (noting that allocative, production and dynamic efficiencies are relevant to assessing both public benefit and detriment). See Commerce Commission, Guidelines to the Analysis of Public Benefits and Detriments in the Context of the Commerce Act (October 1994) reprinted in *Gault on Commercial Law*, above n 22, vol 1, 1 App-77.

30 Above n 27.

31 Ibid, at 619.

32 Ibid, at 616.

33 Ibid, at 617-18.

an alternate buyer. In such circumstances, an inquiry into whether the acquisition of these assets by another buyer may not result in the acquisition or strengthening of dominance might be relevant. Merger decisions from the courts are not common. Parties seize upon what courts say and adjust their future behaviour accordingly. Furthermore, the Commission receives guidance from the courts. Simply to say that each case depends on the circumstances of the particular case is abdicating responsibility. High Court merger decisions should not be "restricted railroad ticket[s] good for this day and train only".[34]

Second, the reference just to "the overall assessment of public benefit" is similarly uninformative as a rule formulation in this context. For example, given the prevailing application of efficiency considerations to the public benefit test, it is open for courts to frame more specific rule formulations which explore the economic consequences of permitting a failing firm's assets to be acquired and remain productive, rather than to be confined to scrap or otherwise rendered non-productive. In the New Zealand setting there is in fact greater scope for the development of such rules than is the case under United States law, because of the additional application of our public benefit test. Whereas the issue of legislative difference led the Court to discount the application of the United States doctrine, it does in fact open up the scope for a more informed application of the rule in New Zealand.

The Court's failure in *NZ Co-operative Dairy* to articulate rules of greater specificity can also be seen to impact on the findings in that case. For example,[35] in the first of the two markets in which there were dominance concerns, namely the town milk market in Auckland and environs, NZ Co-operative Dairy conceded that it was in a dominant position. A matter of competitive significance was the proposal by Woolworths to sell Waikato Valley milk in these markets.[36] The Court concluded that (a) Waikato Valley's two plants would remain in the market and (b) that, but for Waikato Valley's failing circumstances, this removal of Waikato Valley's potential influence on the town milk market would have resulted in a strengthening of dominance. It is puzzling that the Court did not inquire into whether the proposed Woolworths venture was still possible with the new owners of Waikato Valley. Perhaps the Court's preoccupation with rejecting the United States doctrine, and its failure to articulate an informed framework on dominance issues involving failing firms, lead it into error in this analysis.

Turning to the second market of concern, that for the supply and acquisition of raw milk in overlapping catchment areas, the Court held that the merger would result in NZ Co-operative Dairy acquiring a dominant position. Therefore, an assessment was required as to whether the detriments flowing from this would be outweighed by countervailing public benefits. The Court did ultimately authorise this merger on public benefit grounds. But curiously, none of the claims were framed in failing company terms. Rather, the Court attached weight to other claims regarding likely increased payouts

34 *Smith v Allwright* 321 US 96 (1944) at 669.
35 For wider discussion of this case, see Berry, above n 4 at 82-85.
36 *NZ Co-operative Dairy*, above n 27 at 622-623.

to farmers, the viability of Waikato Valley farms and potential improved performance in export markets.[37] While this approach and outcome was potentially legitimate, it is curious that, in light of the Court's statement of principle that an overall assessment of failing company facts were relevant to the determination of public benefit in such cases, the Court made no attempt to put these facts into the public benefit context in this case.

Accordingly, there was no precedent of any particular pedigree on the failing company defence under the old dominance threshold.

B. Substantial Lessening of Competition Test (2001 – present)

In 2001, Parliament amended s 47 to prohibit mergers which would, or would be likely to, have the effect of substantially lessening competition in any market. This amendment sought to align New Zealand law with Australian law as the competition threshold is the same as that in s 50 of the Australian Trade Practices Act 1974 (now called the Consumer and Competition Act 2010 (Cth)). Other jurisdictions such as Canada and the United States also use a substantial lessening of competition test for merger control.

The reason for the change was that the Court of Appeal had interpreted dominance at a very high level. In *Telecom Corp of NZ Ltd v Commerce Commission* the Court of Appeal chided the High Court for equating dominance with a high degree of market power.[38] Furthermore, the Court of Appeal held dominance only covered single firm dominance. Richardson J said: "Only one person can be dominant in a particular aspect of a market at any one time."[39] Subsequently, both courts and the Commission rejected the notion that s 47 could deal with joint dominance concerns. Thus, only unilateral market power issues arose under the dominance test. The Commission made this explicit in the *Transalta Corp of Canada/ Contact Energy Ltd* clearance decision. There the Commission held it was irrelevant that a proposed merger could increase the possibility of collusion or oligopolistic co-ordination between rivals.[40] In short, co-ordinated effects were irrelevant under the dominance test.

As a result of *Transalta* the government changed the merger threshold from dominance to the substantial lessening of competition test. Thus, the primary goal of the reform was that merger analysis should extend to take account of the potential for tacit collusion or oligopolistic behaviour to occur as a result of mergers between competitors.[41] The High Court recognised this aspect of the legislative change in the following terms in *Brambles v Commerce Commission*:[42]

37 Ibid, at 634-36.
38 *Telecom Corp of NZ Ltd v Commerce Commission* [1992] 3 NZLR 429 (CA) at 434.
39 Ibid, at 442.
40 Commerce Commission Decision 340, 12 February 1999.
41 For further background on the amendment, see Mark N Berry & Morag Bond, "The Redirection of the Merger Threshold" in *Commercial Law Essays: A New Zealand Collection* (Rowe & Hawes eds, University of Canterbury Press, Christchurch, 2003) 119 at 122-123.
42 *Brambles NZ Ltd v Commerce Commission* (2003) 10 TCLR 868 (HC) at 189.

> The change in the Act's competition test for business acquisitions means that where markets are concentrated or will become so the Commission will consider both co-ordinated market power and unilateral market power. This contrasts with the approach under the previous dominance test where the analysis was, by definition, confined to questions of unilateral market power.

It was also apparent at the time of the amendment that the new substantial lessening of competition test was likely to introduce a different approach to the assessment of the market power threshold question under s 47. Whereas in the past the dominance test sought to identify a permissible level of market power, the new substantial lessening of competition threshold introduced a comparative assessment: was the merger likely to have a substantial impact on the market power continuum? It was predictable that such a comparative question had the potential to impact on failing firm situations.[43] In particular, commentators recognised that if exit of the target firm was accepted to be inevitable, this would preclude the application of comparative analysis based upon the status quo.[44] In simple terms, if a market had two firms A and B, and if B's exit was inevitable, then the acquisition of B by A or the exit by B would achieve the same competitive outcome. Therefore on a comparative assessment, the outcome under both scenarios would be the same, and for this reason there would be no substantial lessening of competition.

Matters have now advanced beyond these early predictions. There is now:

- judicial precedent on the substantial lessening of competition test and, in particular, the counterfactual assessment under this test. Also, there is precedent on what the effects of a substantial lessening of competition are. These principles impact significantly upon failing and related exiting firm analysis;
- new Commission guidelines on the subject of the failing company defence; and
- five cases in which failing or exiting company circumstances have been the subject of merger clearance applications.

The next part of this article discusses these developments.

43 Mark N Berry & Morag Bond, above n 41 at 125.
44 Ibid.

IV. The Emergence and Application of Substantial Lessening of Competition Principles

A. Counterfactual Principles

The substantial lessening of competition test by its very language begs a comparative assessment. The plain wording of s 47, pertaining to whether there may be a substantial lessening of competition, begs a with and without merger comparison. What will be the comparative competitive state of the market both with and without the merger?

This comparative test has come to be known as "counterfactual" analysis. It is now well entrenched in New Zealand as the prevailing basis for assessment of the substantial lessening of competition test. Indeed, the Court of Appeal recently referred to the counterfactual test as being "elementary" to analysis of the substantial lessening of competition test.[45] Courts have framed this test to require a comparison of the likely state of competition in a market if the proposed merger proceeds (the factual) with the likely state of competition if the proposed merger does not proceed (the counterfactual).

The Australian Trade Practices Tribunal introduced counterfactual analysis in its merger decision *Re Queensland Co-operative Milling Association Ltd (QCMA).*[46] However, it did not refer to "counterfactual analysis". Rather it referred to a "with and without analysis" (i.e. comparing the state of competition in the market with the merger and without the merger). The Full Federal Court of Australia extended this analysis to s 45 of the Trade Practices Act (the Consumer and Competition Act 2010 (Cth)) which prohibits contracts, arrangements and understandings that have the purpose, effect or likely effect of substantially lessening competition in a market in *Stirling Harbour Services Pty Ltd v Bunbury Port Authority.*[47] It considered the present state of competition against its projected state in the event the conduct occurs.

As with United States authority, Australian tribunals and courts used the status quo as the basis for comparison. However, this approach changed in New Zealand with the Commission's *Midland Health* authorisation decision.[48] This involved an application for authorisation of a restrictive trade practice under s 58 of the Act and in particular a ten year exclusive dealing contract for hospital and health services. In determining the counterfactual the Commission held that the most likely "without" scenario was not the status quo but rather either a five year exclusive dealing contract or a ten year contract with shorter term contracts for various health services. While the Commission used two "without" scenarios or counterfactuals in *Midland Health*, in practice it only relied on one. In all merger decisions from the 2001 s 47 amendment until 2007 the Commission only ever used one counterfactual for analyzing mergers. Indeed, its merger guidelines refer

45 *Commerce Commission v Woolworths Ltd* (2008) 12 TCLR 194 (CA) at [4].
46 *Re Queensland Co-operative Milling Association Ltd (QCMA)* (1976) 8 ALR 481.
47 *Stirling Harbour Services Pty Ltd v Bunbury Port Authority* (2000) ATPR 41-752; 41-267.
48 *Midland Regional Health Authority, Health Waikato Ltd*, Commerce Commission Decision 275, 1 August 1995.

to the counterfactual in the singular. The guidelines, however, note: "The status quo cannot necessarily be assumed to continue in the absence of the acquisition, although that may often be the case."[49]

There are two leading court cases on counterfactual principles under s 47. The first is *Air New Zealand and Qantas v Commerce Commission*.[50] This case is significant because it demonstrates the different application of the dominance and substantial lessening of competition tests under s 47.

The appellants argued that the Court could avoid applying the counterfactual test if it concluded that the merger would not result in the acquirer achieving market power in the sense of being sufficiently free from market pressures to be able to impose their own production and selling policies at their own discretion.[51] In essence the argument was that, absent a post-merger level of market power which enabled the merged entity to restrict output or raise price, it would inevitably follow that there would be no substantial lessening of competition. As it happens, such argument implicitly involves counterfactual analysis, because it is based on the assumption that there is no substantial competitive difference between the factual and the counterfactual. The Court concluded as follows:[52]

> We accept that an absence of market power would suggest that there had been no substantial lessening of competition in a market but do not see this as a reason to forsake an analysis of the counterfactual as well as the factual. A comparative judgment is implied by the statutory test which now focuses on a possible change along the spectrum of market power rather on whether or not a particular position on that spectrum, i.e. dominance has been attained. We consider, therefore, that a study of likely outcomes, with and without the proposed Alliance, provides a more rigorous framework for the comparative analysis required and is likely to lead to a more informed assessment of competitive conditions than would be permitted if the inquiry were limited to the existence or otherwise of market power in the factual.

A further problem with the appellant's argument is that it focuses solely on unilateral market power and ignores co-ordinated interaction. As mentioned above, the reason for the change in the merger threshold was to proscribe mergers where the acquisition was such that it is likely to facilitate collusion – whether express or tacit. With such mergers the remaining participants may not have gained any individual market power, but through co-ordinated interaction can increase price.[53]

49 Commerce Commission "Mergers and Acquisition Guidelines" 2004 at 21.

50 *Air NZ Ltd and Qantas Ltd v Commerce Commission (No 6)* (2004) 11 TCLR 347 (HC).

51 Ibid,at [41].

52 Ibid, at [42]. This approach has been endorsed and applied in subsequent merger decisions. See *Commerce Commission v NZ Bus Ltd* (2006) 11 TCLR 679 (HC) at 121; *NZ Bus Ltd v Commerce Commission* (2007) 12 TCLR 69 (CA) at 91; *Commerce Commission v Woolworths Ltd*, above n 47 at [63].

53 *Federal Trade Commission v HJ Heinz Co* 246 F 3d 708, 715 (DC Cir 2001); Merger law rests upon the theory that, where rivals are few, firms will be able to coordinate their behaviour, either by overt collusion or implicit understanding in order to restrict output and achieve profits above competitive levels" (per Bork J).

Accordingly, the substantial lessening of competition test under s 47 involves an inquiry into comparative levels of market power along a continuum ranging from perfect competition to monopoly. A comparative assessment is required on this continuum between the merger proposal (the factual) and the counterfactual which is found to apply.

Predictions as to relevant counterfactuals are potentially troublesome. This difficulty is the subject of further principles in the second of the leading cases, namely the High Court's decision in *Woolworths v Commerce Commission*.[54]

The Court noted that, in many cases, there may be the likelihood of more than one counterfactual. It concluded this based on its acceptance that the test for likelihood required only that the counterfactual be "more than possible" and that "it need not be more probable than not".[55] This then led the Court to formulate the following principle in respect of counterfactual analysis:[56]

> We consider that the correct approach is that we must assess what are the possibilities. We are to discard those possibilities that have only remote prospects of occurring. We are to consider each of the possibilities that are real and substantial possibilities. Each of these real and substantial possibilities become counterfactuals against which the factual is to be assessed. If in the factual as compared with any of the relevant counterfactuals competition is substantially lessened then the acquisition has a 'likely' effect of substantially lessening competition in a market.

What is striking about the High Court's decision is how far it has departed from United States merger law which "begat" merger analysis. Not only did the High Court not use the status quo as the counterfactual, but it also introduced multiple counterfactuals. Also striking is that the High Court did not note how novel its concept of multiple counterfactuals was. No previous judicial authority had ever discussed multiple counterfactuals.

This multi-counterfactual approach is of particular relevance to failing and exiting firm circumstances. It means the failing or exiting firm scenario will be of less importance if there is a real possibility of a counterfactual other than failure or exit. If so, then an alternate counterfactual will be almost inevitably fatal to the merger application.

An obvious related question is whether probabilities should attach to multi-counterfactuals. For example, what happens where the Court takes the view that one of the counterfactuals is most likely to occur? The Court not surprisingly considered this matter. Its response was as follows:[57]

> We consider that where there is more than one real and substantial counterfactual it is not a case of choosing the one that we think has greater prospects of occurring. Such an approach may result in a higher threshold being applied to the 'likely' effect test than has been accepted as appropriate. That is because it may result in a clearance being granted to an acquisition in respect of which there is a real and substantial risk that competition may be lessened, because the prospect that it will not be lessened is higher.

54 *Woolworths Ltd v Commerce Commission* (2008) 8 NZBLC 102,128 (HC).
55 Ibid, at [112].
56 Ibid, at [122].
57 Ibid, at [118].

Accordingly, s 47 decision-making is now directed to identifying all likely counterfactuals, and making the competition assessment in respect of the least favourable counterfactual, even if it may not be the most likely counterfactual.

This framework is most unsatisfactory as it is deeply problematic. Indeed, such multiple counterfactual analysis is in a certain crisis for the following reasons:

First, predicting the future actual structure and likely conduct of markets is a risky occupation. Decision-makers placed in this situation face the strong prospect that their crystal ball gazing will turn out to be wrong.[58] The problem is that a test centred upon forward-looking likelihoods, in which the decision-maker will merely speculate upon the counterfactual the applicant predicted, is a very fluid test indeed. Such predictions are easy to make but hard to prove. As famed American baseball manager Yogi Berra put it: "It is always hard to make predictions, especially, about the future." *Woolworths* says nothing about when decision-making should assume a counterfactual other than the status quo – let alone multiple counterfactuals. The case provides no guidance to the circumstances when multiple counterfactuals are in play and what type of evidence supports either a counterfactual other than the status quo or multiple counterfactuals.

Second, there is also the risk that supporters and opponents of mergers may make erroneous predictions, or engage in gaming in the views that they express. The reliability of such evidence will often be a difficult matter for non-industry participants, such as the Commission or the courts, to assess. The decision of the Court of Appeal in *Woolworths* illustrated this point where the Court of Appeal expressed the view that the Court was "not prepared to second-guess the business judgment of senior management and directors of the Warehouse".[59] It appears that there was updating evidence in this case from the Chief Executive Officer of the Warehouse to the effect that the Warehouse's presence in the grocery market was likely to continue. The Court of Appeal relied on such evidence with the inevitable consequence that it allowed the appeal. But market developments, namely the Warehouse's decision to exit from groceries, occurred just two months after the Court delivered this decision.[60]

Third, multiple counterfactual tests have not been expressly formulated, and slavishly applied, in some other notable jurisdictions where the substantial lessening of competition test applies to mergers.[61] Indeed, New Zealand is unique in having multiple counterfactuals and so readily departing from using the status quo.

58 *Commerce Commission v NZ Bus Ltd* (2006) above n 52 at 691-695. Here the High Court held the counterfactual would be that another bus company would acquire the target. An investment company actually did, but subsequently sold on to another bus company.

59 Above n 45 at [142].

60 See below, sec 4A.

61 See, e.g., discussion of the application of the various substantial lessening of competition merger provisions applying in the United States (s 5 of the Clayton Act), Canada (s 92(1) of the Competition Act), and the UK (s 36 of the Enterprise Act) in Herbert Hovenkamp *Federal Antitrust Policy : The Law of Competition and its Practice* (3rd ed, West Group, St Paul, 2005), chapter 12, Trebilcock et al, above n 7 at chapter 4, Whish, above n 5 at, chapter 22.

Fourth, there are dangers in the application of a multiple counterfactual approach which makes no attempt to assess the probabilities of these counterfactuals.[62] There may be cases where an unfavourable counterfactual may be less likely to occur than other acceptable counterfactuals, and in such cases there will be false negatives.

Fifth, there may be the potential incentive for decision-makers who wish to block a merger to utilise and embellish upon the least favourable counterfactual.

And finally, the search for a counterfactual other than the status quo or multiple counterfactuals also has the risk of diverting attention away from whether the proposed acquisition substantially lessens competition to focus on what are the possible counterfactuals and whether there may be a preferable merger option.

Unless there is a large time period between first instance and appellate decisions, or the market in question is dynamic, it will be extremely difficult to establish that the first instance counterfactual was wrong. Unless intervening events occur, one cannot call speculation incorrect. Indeed ex ante the speculation may have been entirely justified.

B. The Effects of a Substantial Lessening of Competition

It is not only on counterfactual analysis that the courts have provided guidance, but also on what the effects of a substantial lessening of competition are. As mentioned earlier, the primary reason competition law regulates mergers is to prevent the exercise of market power, whether it be unilateral or co-ordinated. One of the effects of increased market power can be increased price to consumers. This is relevant in the failing firm context as if the target firm is in a perilous financial state, it is unlikely to be providing an effective competitive constraint to the existing firms over a relevant timeframe in competition law terms.

Recent High Court authority equates a substantial lessening of competition with an increase in price. The most extreme example is the High Court's penalty decision in *Commerce Commission v New Zealand Bus Limited.* [63] There the High Court held that New Zealand Bus Ltd's acquisition of 74 percent of Mana Coach Services Ltd was likely to have the effect of substantially lessening competition in the relevant market, contrary to s 47. At the penalty hearing one of the issues was what would have been the effect of the acquisition.

The Commission submitted that the Court's finding of a substantial lessening of competition meant that prices would have increased by 5-10 percent. The Court noted:[64]

62 This point is discussed in Michael Katz & Howard Shelanski, "Merger Analysis and the Treatment of Uncertainty: Should We Expect Better?", Working Paper, 20 September 2006.

63 HC Wellington 29 September 2006.

64 Ibid, at [48].

> [Counsel] reasoned that substantial lessening of competition was a likely result of the acquisition, and that under the SSNIP test used by the Commission to measure effects, substantial lessening ordinarily means an increase (or maintenance in this case), of at least 5-10% in price;, and that it is reasonable to suppose that half the Wellington market is susceptible to competition using Mana's existing operations as a base. (The SSNIP test inquires whether a supplier would be able to impose a Small yet Significant and Non-transitory Increase in Price, which the commission generally defines as a 5-10% increase that is sustained for a period of one year.)

Miller J held, in the circumstances, the SSNIP test supplied a reasonable first approximation of the gains an acquirer might make.[65] This reasoning is troubling, to the extent it may be considered to develop propositions beyond a level of broad approximation for a number of reasons.

The first problem is that the SSNIP test is a tool for the purpose of market definition. It is not a tool for measuring what a substantial lessening of competition constitutes. It is inappropriate to use the SSNIP to measure effects, or to state that a substantial lessening of competition ordinarily means an increase of at least 5-10%. On this point the Commission's Merger Guidelines provide: [66]

> This approach neither pre-supposes nor requires that such a SSNIP would result from the acquisition, rather, it allows the acquisition to be evaluated in terms of the relevant markets identified through the process.

The Commission's stance in not accepting the SSNIP as a guide to the meaning of a substantial lessening of competition is in line with international practice. The United States Horizontal Merger Guidelines states: [67]

> The 'small but significant and nontransitory' increase in price [i.e. a price increase of five to ten percent] is employed solely as a methodological tool for the analysis of mergers: it is not a tolerance level for price increases.

Furthermore, using the SSNIP test to measure the effect of a substantial lessening of competition would have deleterious effects. The market in which a decision-maker determines whether there has been a substantial lessening of competition is the one in which a hypothetical monopolist could profitably increase price by five to ten percent. If a substantial lessening of competition means such a price increase, then decision makers may say that only a merger which results in a monopoly breaches s 47. Under the SSNIP test only a monopolist can increase price by the requisite amount.

Fortunately, the High Court did not hold that a substantial lessening of competition equates to a five to ten percent increase in price. Although in the circumstances of the case, it was a reasonable first approximation. On the facts, this led to the finding that the effect would have likely been at least two million dollars. [68]

65 Ibid, at [51].
66 Above, n 49 at 14.
67 US Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines* (1992, section 1.0).
68 Above, n 63 at [51].

On appeal, the Court of Appeal did not directly discuss the meaning of a substantial lessening of competition in terms of a price increase. However, Wilson J observed: [69]

> On the present facts, only very minor lessening of competition would result and the consequent detriment would be modest. NZ Bus would therefore not face a difficult task in establishing sufficient public benefit to outweigh that detriment. Greater efficiencies of scale in all the services of Mana and NZ Bus could well in themselves be sufficient to do so, as could rationalization of their operations in the limited areas where they overlap.

It is difficult to reconcile two million dollars with a very minor lessening of competition. It is also hard to know how on the facts Wilson J could state that the public benefit in terms of efficiencies of scale and rationalisation would/could easily outweigh any detriment. This, perhaps, shows the dangers of courts speculating.

The High Court in *Woolworths* also accepted the idea of linking the SSNIP test and the effect of a substantial lessening of competition. However, there the Court used a four to five percent figure. The Court of Appeal did not endorse or even discuss this linking when overturning the High Court. [70]

C. Commission Guidelines

There has been further development of relevant principles through the Commission enunciating failing firm guidelines in both its Mergers and Acquisitions Guidelines (Guidelines) and recent clearance decisions.

The Guidelines recognise that failing firm circumstances fall for consideration under the assessment of the relevant counterfactual in question. The Guidelines provide that:[71]

> There are two scenarios where the Commission considers a failing firm counterfactual. The first is where, but for the anticompetitive acquisition, the business's assets would exit the market. The assets may become scrap or may be put to an alternative use. This option may involve only one potential purchaser.
>
> The second scenario is where there are a number of bidders for the failing firm, which must be sold. In this case, the Commission adopts a counterfactual that assumes an acquisition by a party that would not give rise to a substantial lessening of competition.[72]

The Commission has more recently expanded upon these points. In *Southern Cross/Aorangi Hospital* the Commission stated that it will, in the failing firm context, take into account:[73]

69 Above, n 52 at [272].
70 Above, n 54 at [138] and [145].
71 Guidelines, sec 4.2.
72 These two factors form an incomplete list of relevant considerations. Also, it assumes market circumstances which may not at times exist in a small economy. Where a firm is exiting the market, there may not always be multiple bidders, or bids which involve no substantial lessening of competition considerations.
73 *Southern Cross Health Trust/Aorangi Hospital*, Commerce Commission Decision 650, 4 September 2008, [149].

> … negative cash flows; the actual, imminent, or probable failure of one firm in the proposed merger; that there is no prospect of restructuring or refinancing the business; on closure, the assets will exit the market either becoming scrap or put to an alternative use; and there are no other purchasers for the business, despite reasonable attempts to find one.

The Commission has released supplementary guidelines on how it will treat merger applications involving the failing firm argument. These provide guidance on what evidence the Commission considers relevant in determining whether exit is likely. This impacts on whether exit is the relevant counterfactual.

These guidelines are based on other jurisdictions' merger guidelines. They state the Commission will take the following factors into account in assessing whether failure appears actual, imminent or probable. These include[74]:

Is the firm failing?:

- Is there a trend of negative cash flows over a sustained period of time? (In some situations the firm may already be in liquidation.)
- Is there any prospect of restructuring or refinancing the business?
- Have there been ongoing and serious, but unsuccessful attempts by the failing party to rescue the business?

Is there an alternative third party purchaser?

- Is there any prospect of a third party acquiring the business as a going concern?
- Have reasonable efforts been made by the failing firm to find a third party purchaser?
- On closure, will the firm's assets exit the market (either becoming scrap or put to an alternative use)? If not, is there any prospect of a third party acquiring the assets of the failing firm and using them to compete in the relevant markets?

The guidelines further note:[75]

> Sometimes a claim is made that a division of a firm is failing. Such cases require particular care because of the ability of the parent firm to allocate costs, revenues and intra-company transactions among itself, its subsidiaries and its divisions.
>
> An assertion that a firm is failing is easily made and hence each claim requires close examination. The Commission takes a rigorous approach to the types of evidence it expects to see in support of a failing firm argument. Situations where firm face declining sales or profits, or where the earnings rate is significantly below the shareholders' expectations, would, in isolation, be unlikely to satisfy the Commission that the firm is truly failing.

74 Guidelines, sec 3.03.
75 Ibid, at sec 3.04-3.05.

They also include a list of the types of supporting evidence the Commission considers useful.[76] The types of supporting evidence that may be usefully supplied to the Commission include:

- management accounts;
- budgets/forecasts for current year;
- analysis of margins and profitability;
- volume/demand data (trend analysis);
- board minutes and papers concerning viability;
- internal strategic plans;
- capital expenditure proposal documents;
- documents regarding initiatives or plans to restructure/improve business (or reduce costs);
- evidence of bona fide efforts to sell the business as a going concern or its assets on closure;
- any offers for the business;
- assets valuation reports;
- independent appraisal of the business;
- detailed costs of exit/closure;
- liquidation or the placement of the business into administration; and
- audited financial accounts if available.

Where claims of a failing division are submitted, the Commission would find additional information useful. The types of additional evidence may include details and analysis of:

- intra-corporate cost allocations, principles and figures;
- transfer pricing within the parent company;
- contribution of the failing division to the overhead costs of its parent company; and
- management fees charged by the parent company to the failing division.

76 Ibid, at sec 4.03 – 4.04.

D. Five Case Studies

Five recent cases provide useful insights into how the substantial lessening of competition test may apply to circumstances of financial failure or inevitable exit for reasons other than financial failure. These cases have involved the exit of both firms and divisions of firms. Such cases provide a template for how the Commission is likely to assess financial failure under the counterfactual test.

Regrettably, but understandably, the Commission has excised extensive (and perhaps the most important) extracts of these decisions in the public versions of these judgments, for reasons of confidentiality. This makes independent commentary more difficult and, at times, speculative. With this qualification in mind, the cases give rise to the following views.[77]

The case studies in question have concerned four different industries: namely, groceries, private hospitals, radiology practices and masonry products.

1. The Grocery Saga

This case concerned the market for the retailing of groceries in supermarkets, within geographic regions of five kilometres. Two major competitors, Foodstuffs and Woolworths, serviced this market. The companies have equivalent market shares.[78] There had been no new entry to this market for 20 years and, apart from the Warehouse, no other new entrant was thought likely.[79] The Warehouse, New Zealand's largest retailer of general merchandise, entered the retail groceries market in 2006 with its Sylvia Park Extra store in Auckland. Two other points of entry to this market were the Warehouse Extra stores in Whangarei and Te Rapa, where the Warehouse stores were opened in 2006 and 2007 respectively. The Warehouse then had plans to open 15 Warehouse Extra stores within five years. The primary business rationale for this venture was the "supercentre" concept, under which there would be increased sales of merchandise items as a result of the add-on of the retail grocery business.

Woolworths and Foodstuffs responded to this initiative by each acquiring a 10 percent toe-hold stake in the Warehouse, and then applying to the Commission for clearance to acquire up to 100 percent of the Warehouse's shares. In the course of the Commission's investigation of these clearance applications in 2007, it became apparent that the Warehouse's plans to open more than three grocery outlets were on hold.[80] By the time that the High Court heard updating evidence in October 2007, it appears that the Warehouse's assessment was that there were performance issues in its retail grocery sector which it needed to address, that it was too early to assess the

77 The Guidelines refer to two decisions not discussed here. However, they do not add anything to the analysis.

78 Foodstuffs and Woolworths had 56% and 44% shares respectively of national supermarket sales: see *Woolworths*, above n 54 at fn 2.

79 Ibid, at [1].

80 Ibid, at [71] – [80].

"supercentre" effect, and that the Board had not yet made decisions as to the future direction of the grocery strategy, except that there would be no expansion of such stores in 2008.[81]

The arguments advanced by Woolworths and Foodstuffs were to the effect that the retail grocery division of the Warehouse was not likely to remain in the market[82] and that, even if it did survive, it would have no substantial impact on the current state of competition. As an aside, if the Warehouse had no impact on competition, one wonders why the two incumbents were not only prepared to buy the Warehouse, but also engage in appellate merger litigation. These arguments caused the High Court to frame two counterfactuals to accommodate these alternative arguments. Under "counterfactual 1" the Court assumed that the three Warehouse Extra stores would continue for a limited time and then be reconfigured for purposes other than retail grocery sales. "Counterfactual 2" proceeded on the assumption that there would be further roll-out and continuation of the Warehouse Extra stores.

For present purposes, only counterfactual 1 is of particular relevance because this is the failing firm scenario. As it happens the Court thought this to be the most likely counterfactual,[83] although it did continue to assess counterfactual 2 for the sake of completeness.[84] On the assumption under counterfactual 1 that the Warehouse would abandon its three Extra stores after a further transitory period of operation, the Court held that it should permit the merger because there would be no competition concerns, assuming the exit of Warehouse Extra.[85] Duopoly competition would continue to reign, as it had in the past.

The Commission successfully appealed the High Court's decision in *Woolworths* on a number of grounds. However, the Court of Appeal's judgment does not further inform upon the subject at hand, because the Court rejected the prospect that "counterfactual 1" was likely to occur.[86]

81 Ibid, at [81] – [101].

82 In this context, the question of the financial viability of this Warehouse division was not in issue: ibid, at [218].

83 Ibid, at [225].

84 The High Court also concluded that even under counterfactual 2, the Warehouse Extra would not provide a material constraint on Woolworths and Foodstuffs; ibid, at[248] – [261]. Notwithstanding an apparent lack of reliable data, the Court felt competent to decide that the Warehouse Extra would on a forward looking basis be unable to cause pricing impacts of 2 percent or greater; ibid, at [256]. This was a bold prediction as to the future.

85 Ibid, at [211] and [234].

86 The Court of Appeal found that there was a real and substantial chance that the Warehouse Extra roll-out would continue, in light of the updating evidence from the Warehouse: above n 47 at [126] – [131] and [142]. Accordingly, it did not apply "counterfactual 1" analysis. The Court of Appeal also reversed the High Court's findings on "counterfactual 2" because it considered at this early stage it could not safely conclude that the Warehouse Extra would have no material impact on the markets at issue: ibid, at [189] – [207]. Regrettably, the Court of Appeal did not turn its mind to the multi-counterfactual point in its judgment.

2. The Private Hospital Mergers

There have been two recent private hospital merger clearance decisions which involved striking factual similarities, but resulted in different outcomes. Two private hospitals have serviced both Rotorua and Palmerston North. In both towns it was proposed that their two private hospitals be merged, via the formation of a joint venture vehicle. The Commission cleared the Rotorua proposal, but denied clearance to the Palmerston North proposal. The Palmerston North case is one of the two clearance decisions under review in this article that the Commission has determined since the enunciation of the multiple counterfactual approach by the High Court in *Woolworths*.

The first decision, *Southern Cross/QE Hospital*,[87] related to the provision of services in various private elective secondary surgery markets in the Rotorua region. The Commission considered the application of two counterfactuals in respect of this proposed reduction of two private hospitals to just one such hospital.

First, and relevant for present purposes, the applicants argued that exit of one of the hospitals was inevitable without the merger. Failing company (or failing division issues in the case of Southern Cross) were not, in fact, advanced. The evidence before the Commission was that, while QE Hospital was operating at close to full capacity, the Southern Cross Hospital was loss-making and under-utilised. Further, this hospital faced significant refurbishment and upgrading costs and the applicant also argued that the population base of Rotorua meant that there would only be demand for one private surgical facility in Rotorua in the medium-to-long term. Following its review of all the evidence the Commission accepted that exit of one of these hospitals was likely and, therefore, there would be little difference in the state of competition between the factual and this counterfactual.[88]

This alone would have been a basis for the Commission to clear the merger at the time of this decision. It was only "for completeness" that the Commission considered the additional counterfactual that both hospitals may remain over the short-to-medium term.[89] The Commission also granted clearance under this alternative counterfactual, essentially because different surgical specialties were performed at the two hospitals, and because the orthopaedic and urological surgeons based at QE Hospital said that they would not perform such procedures at Southern Cross.[90]

The second hospital merger case, *Southern Cross/Aorangi Hospital*,[91] provides an interesting contrast in terms of approach and outcome. The same private elective secondary surgery service markets were at issue here, but this time within the MidCentral DHB region.

87 *Southern Cross Health Trust/QE Hospital*, Commerce Commission Decision 620, 28 September 2007.

88 Ibid, at [83].

89 Ibid, at [84].

90 Ibid, at [85-93]. The Commission also accepted that there was some buyer constraint from ACC and private insurers: ibid, paras 106-09.

91 *Southern Cross Health Trust/Aorangi Hospital*, Commerce Commission Decision 650, 4 September 2008.

The failing firm (or failing division) argument was again not advanced in this case. Rather, the applicant argued that one of the hospitals, most likely Southern Cross, would close and exit the market because it could not continue to sustain its current levels of economic loss. Accordingly, while the applicant did not explicitly raise the failing firm doctrine in this case, it advanced parallel arguments.

The Commission, in line with *Woolworths*, reviewed all possible counterfactuals in order to determine which of these may be likely. First, the Commission accepted that one counterfactual was that Southern Cross would exit the market.[92] The Commission also reached the view that the evidence did not meet the international guidelines for failing firms, and that "the operating revenues at Southern Cross do not appear to be at a level that would indicate that its exit was inevitable".[93] Therefore, the Commission said that it was "unable to conclude, with any certainty" that the Southern Cross division in question was actually failing or that its closure was imminent.[94]

These various statements are somewhat opaque, because the Commission appears to both accept and reject that exit was likely. Perhaps the difference in view is explicable on the basis that the rejection of likely exit was made on the basis of the Commission not being "certain", which is not a relevant standard of proof under the Act.

The Commission then proceeded to consider the "less clear cut question" of whether there might be another counterfactual, namely that Southern Cross may remain in the market.[95] Significantly, the Commission reached the conclusion on the same facts that there was a real possibility that Southern Cross may also remain in the market, for reasons which the Commission summarised as follows:[96]

- The argument that Palmerston North was too small a catchment area to support two private hospitals was not persuasive or consistent with investment decisions made by the applicants;
- There was no evidence of Southern Cross planning for exit of the market;
- Southern Cross had recently upgraded its hospital, with no apparent analysis of closure and exit at that time;[97]
- Southern Cross had a variable history of profits and losses in Palmerston North, with losses being small in comparison with the organisation's overall profit;
- Closure of the hospital may have some impact on Southern Cross' medical insurance business;

92 Ibid, at [103 and 193].
93 Ibid, at [195-96].
94 Ibid, at [197].
95 Ibid, at [103].
96 Ibid, at [194].
97 The Commission did, however, accept that the costs in question were not sunk: ibid, at [114].

- Southern Cross had not increased prices to match Aorangi Hospital and so had not exhausted options to increase revenue; and
- There was no evidence that Southern Cross had fully investigated the sale of the Palmerston North hospital.

The Commission then proceeded on the basis that there was no need to analyse the first counterfactual, in which it (apparently) accepted that exit by Southern Cross was likely to occur. Rather, it simply analysed the proposal against the counterfactual which saw Southern Cross remaining in the market because the competition differences between the factual and this counterfactual would be greatest in this setting.[98] The competition assessment here differed to the *Southern Cross/QE Hospital* case, in that both Southern Cross Palmerston North and Aorangi Hospital performed a full range of elective surgical procedures, and Southern Cross had given evidence that it could not increase prices due to constraints provided by Aorangi Hospital.[99] It was this potential loss of competition which formed the basis for the Commission denying clearance. This conclusion is, nonetheless, somewhat problematic in the context of this case given that the Commission had in essence suggested to Southern Cross that it might increase its prices to match those of Aorangi Hospital in order to remain viable.[100]

3. The Radiology Merger

Briefly, the *Pacific Radiology/Wellington Radiology* decision[101] related to the proposed merger of the two providers of various private low and high tech radiology services in various parts of the Wellington region. The applicant argued that the counterfactual involved the inevitable exit of Wellington Radiology from this market because:

1. Wellington Radiology only had two radiologists, one of whom was about to retire. A search dating back to 1996 to secure a new partner had been unsuccessful; and
2. Wellington Radiology's equipment was in need of upgrade in order to meet the requirements of Bowen Hospital, being the primary location in which Wellington Radiology operated from leased premises. Without sufficient radiologists, Wellington Radiology was not prepared to commit to this capital investment.

The applicant and interested parties did not raise the issue of financial failure in submissions. It was also demonstrated that Wellington Radiology had made wide ranging attempts to find an alternative purchaser, but without success.

98 Ibid, at [200].
99 Ibid, at [217] and [221].
100 Ibid, at [194], bullet point 6.
101 *Pacific Radiology/Wellington Radiology*, Commerce Commission Decision 631, 20 December 2007.

Against this background the Commission found that under the counterfactual Wellington Radiology would be unlikely to continue in the market and granted clearance because there would be little difference between the factual and counterfactual.[102] In both cases, Pacific Radiology would become the sole private radiology service provider.

4. Masonry Merger

Fletcher Building applied for clearance to acquire the Whangarei and Auckland masonry business assets of the Stevenson Group (Stevenson).[103]

Stevenson (and Fletcher Building) claimed that it was experiencing sustained and substantial losses in its masonry business, despite having tried to turn the business around. Stevenson's Board had formally decided to exit on 23 September 2008 (either by sale or closure). Stevenson said in late 2008 that in its view no party other than Fletcher Building would ultimately present an offer that was more financially attractive to Stevenson than simply closing.[104]

This is a failing firm argument. It meant that the applicant and target argued that the counterfactual was the imminent closure of Stevenson's masonry business.

To assess this, the Commission investigated the financial performance of the Stevenson Group over the current and prior three financial years. It discussed Stevenson's attempts and strategies to turn things around. Stevenson had started the exit process, and had told customers of its decision to exit and potentially close the masonry business.[105] Stevenson provided evidence to the Commission of its closure value and the minimum sale price of the business as a going concern to avoid closure.[106] Stevenson had approached Fletcher Building about selling prior to its 23 September board meeting. It approached two other unnamed parties about six weeks later. Time was of the essence to Stevenson so it claimed it only approached other parties that it thought were real bidders.[107]

The Commission approached and discussed these and other possible alternative purchasers in the decision. It determined that any other purchaser would have to offer more than Stevenson's closure value, not more than Fletcher Building's offer.[108]

The Commission took all this into account in determining the counterfactual. It held that imminent closure of Stevenson's masonry business was likely and that there was no real and substantial prospect of a third party acquiring Stevenson's masonry business as a going concern or acquiring the assets and using them to compete in the relevant market. Any offer would be less than Stevenson's closure value. In assessing whether sale to a third party was likely, the Commission investigated whether any third party had taken

102 Ibid, at [97] and [101].
103 *Fletcher Building Ltd/Stevenson Group Ltd,* Commerce Commission Decision 663, 13 February 2009.
104 Ibid, at [17].
105 Ibid, at [18].
106 Ibid, at [19-20].
107 Ibid, at [22].
108 Ibid, at [84].

steps such as a form of due diligence, devising business plans, ascertaining what price they might offer or arranging finance. None of the unnamed third parties had taken sufficient of these or any other steps. There had simply been expressions of interest. Given the time constraints, the Commission was not satisfied that there was a real prospect of any alternative purchaser who would ensure that the business would remain and provide viable competition.[109] The Commission also took account of the downturn in the building industry and how the current recession exacerbated that downturn.[110] Accordingly, the Commission held that, absenting the acquisition, there was only one likely counterfactual, namely the imminent closure of Stevenson's masonry business. Given this, there would be no material difference between the factual and counterfactual. The Commission thus cleared the acquisition.

5. Public Benefit

The discussion of failing firm analysis all too often centres only upon the market power thresholds prevailing under s 47. This occurs perhaps because circumstances of financial stress require outcomes within the timeframe of clearance rather than authorisation applications. Nonetheless, as already mentioned above, authorisation of mergers which do not pass the s 47 market power threshold test may still be permitted where there are sufficient countervailing public benefits.[111] This test for public benefits takes into the kind of efficiency considerations raised earlier in section 2B pertaining to the rationale of the defence.

Commentators have previously asserted, under the old s 47 dominance threshold, that public benefits in the failing company context will be most readily established where it can be demonstrated that the output restriction will be smaller and the welfare loss correspondingly less if the failing firm's assets are acquired, than would be the case if those assets were scrapped or otherwise exited the industry.[112] This proposition applies equally to s 47 in its current form.

V. Conclusions

From the above discussion, one can advance the following conclusions and observations. The failing company defence has a troubled past. A proper economic rationale for the defence has been a matter of comparatively recent discovery. In practical terms, there is nothing particularly relevant under New Zealand law prior to the amendment of s 47 in 2001. The counterfactual test applying to the substantial lessening of competition threshold under s 47 means that, pragmatically, each of the following scenarios are open to parallel assessment:

109 Ibid, at [93-94].
110 Ibid, at [100].
111 See above text accompanying n 28-29.
112 See Berry, above n 4 at 61, 88.

a. Failing firms and failing divisions; and

b. In certain cases, firms (and divisions of firms) which will be likely inevitably to exit the market for reasons other than financial failure alone.

Applying the multiple counterfactual approach the High Court fashioned in *Woolworths*, means that clearance is only likely to be granted in failing or exiting company circumstances where there is no counterfactual other than failure or likely exit.

Guidance on the issues impacting upon the establishment of a failing company counterfactual is incomplete. The Commission's Guidelines are an appropriate start. The Commission's reference in its Guidelines for the need to assess the evidence against these guidelines presumably means these are matters to be taken into account in the round as a starting point; each of the guidelines' requirements will not, presumably, need to be met in each case. However, the Commission's decisions provide some further guidance.

Relevant considerations arising from the *Southern Cross/Aorangi Hospital* and *Fletcher Building* decisions are as follows:

a. First, it is convenient to cluster together the following factors which touch upon the probability of business failure and unlikely rehabilitation, namely "negative cash flows; the actual, imminent, or probable failure of one firm in the proposed merger; [and] that there is no prospect of restructuring or refinancing the business". Decision makers should take these factors into account as follows:

i. Where likely financial failure is the sole basis for the claimed counterfactual, a sufficiently strong showing of this likelihood will be required. There is the potential that this test may be applied strictly, in similar fashion to the United States jurisprudence on this subject.[113] As yet there is no New Zealand case law on how this financial analysis will be undertaken.[114] While *Fletcher Building* did undertake such an analysis, the material is confidential.

113 See part 2.

114 One possible point of guidance emerges in *Southern Cross/Aorangi Hospital* where the Commission appears to assess the losses in a division of a company against the profits in the company's overall accounts: above n 91 at [194]. It is not clear how this approach may have application. Such approach does not appear to accord with the views enunciated by Areeda & Hovenkamp, above n 11.

ii. Where financial failure is not the sole basis for the claimed counterfactual, the question of the target's financial state is a background consideration which may, or may not, be relevant to and determinative of the counterfactual. In many such cases, financial stress may be a relevant factor. For example, in *Southern Cross/QE Hospital* the Commission adopted an exit counterfactual in circumstances where claimed losses (with no assertion of financial failure) was but one of the relevant considerations.[115] But, in other cases, financial stress may not be relevant to, or the basis for, a counterfactual which is fashioned and applies in similar manner to the failing company defence under the substantial lessening of competition test. For example, financial failure was not in issue in *Pacific Radiology/Wellington Radiology*.

b. Second, reference is made to the prospect that "on closure, the assets will exit the market either becoming scrap or put to an alternative use". This inquiry was only made in *Fletcher Building*. This would be a difficult and speculative inquiry for the Commission or the courts to undertake, without some detailed factual background on matters relating to the potential productive uses of the assets in question. This issue is perhaps most likely to arise in the context of an authorisation application, where the applicant may assert that acquisition will result in less output restriction than would otherwise occur.

Finally, the *Southern Cross/Aorangi Hospital* checklist requires that "there are no other purchasers for the business, despite reasonable attempts to find one." The Commission undertook this inquiry in *Southern Cross/QE Hospital*, *Pacific Radiology/Wellington Radiology* and *Fletcher Building*.[116] This is a requirement that is likely to apply to all cases where it is asserted that there will be failure, or that exit of the target will be inevitable.

Finally, the economic rationale for the defence points to the potential for strong public benefits arguments in the context of authorisation applications, where an applicant can demonstrate that acquisition of the assets will result in less output restriction than would be the case should the assets be scrapped or put to an alternative use. Should the opportunity ever present itself for an authorisation inquiry to be held into a failing firm merger, this line of argument would go far to establishing countervailing public benefits in relation to the merger.

115 Where this is the primary basis for the claim of inevitable exit, then a close look may be taken at the financial circumstances of the target, in a manner similar to that which applies to the financial failure scenario discussed in [6(a)(i)] of the text above.

116 From *Fletcher Building* any offer must be greater than the closure value. See part 2 for an outline of principles.