

**THE STATE OF THE FAILING COMPANY**

**DEFENCE IN NEW ZEALAND**

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## I INTRODUCTION

At first glance, there is the temptation to make an artificial assessment of the competition issues which surround the acquisition of a failing company.<sup>1</sup> As the failing firm will no longer remain in the market, the view may be taken that its acquisition will not raise significant competition concerns. Indeed, the acquisition may be beneficial because the failing firm's productive capacity will be maintained. Furthermore, the rescue of the failing firm will be clearly to the advantage of shareholders and creditors, and may also be of benefit to employees of the failing firm and the community where its operations are based.

However, this analytical approach to the acquisition of failing companies is unduly simplistic because such acquisitions will frequently raise competition concerns, particularly if the acquirer already has significant power within the relevant market.<sup>2</sup> In a small economy such as New Zealand's, where monopoly and oligopoly circumstances are frequently under

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<sup>1</sup> This article will deal exclusively with horizontal mergers, which are mergers between competitors. The failing company defence also has the potential to apply equally to non-horizontal mergers. For a discussion of the similarity in application of the defence to vertical and conglomerate mergers, see P Areeda & D F Turner, *Antitrust Law: An Analysis of Antitrust Principles and their Application* (1980), vol 4, 288-96 and vol 5, 280-88. Consideration of arrangements between competitors in declining industries is also beyond the scope of this paper. For a case study of this issue see *Weddel Crown Corp & Ors* (1987) 1 NZBLC (Com) 99-514; *Weddel NZ Ltd & Ors*, unreported, Commerce Commission Decision 273 (2 February 1995) (application for authorisation of arrangements between competitors relating to certain closures of slaughtering facilities). For a commentary on these cases, see Waller, "A Comparative Look at Failing Firms and Failing Industries" (1996) 64 *Antitrust L J* 703.

<sup>2</sup> For a list of six possible anti-competitive effects, see Comment, "Federal Antitrust Law – Mergers – An Updating of the 'Failing Company' Doctrine in the Amended Section 7 Setting" (1963) 61 *Mich L Rev* 566, 577-78. For further discussion on possible anti-competitive effects, see Low, "The Failing Company Doctrine: An Illusive Economic Defense Under Section 7 of the Clayton Act" (1967) 35 *Fordham L Rev* 425, 428-29.

scrutiny, such competition concerns are all the more likely to arise.<sup>3</sup> Thus, there is the need to be vigilant in the analysis of failing company circumstances in New Zealand. In particular, there is the need to be wary of the acquirer with market power and the potential incentive to reduce productive capacity post-acquisition. Beyond this basic starting point, however, the matter becomes increasingly complex.

There are further potential competition issues. There may be a preferable alternative purchaser with no undue market power, although there is the prospect that the offer made by this purchaser will be substantially lower than that made by the already dominant firm. Another competitively preferable option may be to permit the failing firm to exit so that smaller firms will be provided with the opportunity to attract the failing firm's customers and resources. Alternatively, notwithstanding the presence and potential enhancement of market power, there may be countervailing efficiency gains attributable to the merger.

Private interests, unconnected to competition issues, will also be at stake. The interests of the failing firm's shareholders, and possibly also its creditors, will be prejudicially affected. These concerns will be of greatest magnitude where the merger is blocked because of competition concerns, with the result that the failing firm exits the market. Additionally, in this situation of exit by the failing firm, employees and the wider community may be adversely affected.

This brief outline identifies the various issues which confront the failing company defence. The defence potentially involves both competition concerns and private interests. The accommodation of public and private interests is no easy task as they will be frequently in

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<sup>3</sup> For a discussion of merger analysis in small economies, see R S Khemani, "Merger Policy in Small vs Large

conflict.<sup>4</sup> Indeed, the common tension between public and private interests in the merger setting is perhaps most acute in the case of the failing company defence. The public interest is arguably served by blocking any anti-competitive merger; the private interests associated with the rescue of a failing firm are served by permitting such a merger to proceed. Further, an internal conflict may even be possible in the case of private interests as the interests of shareholders and creditors may not, in many cases, be in harmony with the interests of the current employees and communities.<sup>5</sup> The conflicting and inconsistent nature of these various interests pose obvious difficulties in the development of an appropriate rule.

The failing company defence has its origins in United States antitrust case-law.<sup>6</sup> Initially, the defence was based on private noneconomic concerns.<sup>7</sup> The threat to competition was regarded as the “lesser of two evils”.<sup>8</sup> However, this non-economic approach has been questioned in the scholarship on the subject, and in recent times attempts have been made to justify the defence in terms of economic efficiency.<sup>9</sup> While Commonwealth jurisdictions such as Australia, New Zealand and Canada<sup>10</sup> have found the judicial formulation of the

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Economies” in R S Khemani & W T Stanbury (eds), *Canadian Competition Law and Policy at the Centenary* (1991) ch 9.

<sup>4</sup> For discussion on the contradictory nature of these interests, see Kauper, “The 1982 Horizontal Merger Guidelines: Of Collusion, Efficiency and Failure” (1983) 71 Cal L Rev 497, 526 (asserting that the defence is “a curious mix of competitive and noncompetitive concerns”); Baxter, “Remarks: The Failing Firm Doctrine” (1982) 50 Antitrust L J 247, 248 (asserting that the defence is “a mass of contradictions”).

<sup>5</sup> See infra Pt III.

<sup>6</sup> See infra Pt IV.

<sup>7</sup> For a discussion on noneconomic goals as background to the defence, see L Sullivan, *Handbook of the Law of Antitrust* (1977) 630.

<sup>8</sup> *United States v General Dynamics Corp* 415 US 486, 507 (1974).

<sup>9</sup> See infra Pt III.

<sup>10</sup> See infra Pts IV and V. A further jurisdiction of potential interest to New Zealand is the European Community, however, it will not be analysed because of significant legislative dissimilarities. The E C Merger Control Regulation (“MCR”) does not embody a failing firm defence. The relevant provision of the MCR under which failing circumstances may be analysed does not reflect efficiency considerations. Art 2(2) of the MCR provides: “A concentration which does not create or strengthen a dominant position as a result of which effective competition would be significantly impeded in the Common Market or in a substantial part of it shall be declared compatible with the Common Market.” The E C Commission has in one recent case considered the causation issues arising under art 2(2) in relation to failing company circumstances. The Commission developed a cumulative three step test to determine if the merger is the cause of the deterioration in competition. The merger will not be the cause if: (1) the acquired undertaking would in the near future be forced out of the market; (2) the acquiring undertaking would take over the market share of the acquired undertaking if it were

defence in the United States to be informative, the approaches taken to the defence in these jurisdictions differ to that of the United States essentially because of legislative guidance on efficiency considerations.

This article will:

- (1) briefly outline the competition laws which apply to mergers in New Zealand;
- (2) examine the theoretical basis for the defence, with particular reference to the New Zealand setting;
- (3) briefly review the North American approach to the failing company defence; and
- (4) critically review the response to the defence in New Zealand by both the judiciary and the enforcement agency, namely the Commerce Commission. The discussion of New Zealand developments will also trace the closely-related Australian response to the defence.

Two central arguments will be developed. First, failing company considerations are relevant to certain aspects of the competition assessment. More specifically, it will be argued that the failing company defence is of no particular relevance to the assessment of dominance.

However, the defence is potentially of real significance in providing an efficiencies justification for an otherwise unlawful merger.

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forced out of the market; and (3) there is no less anti-competitive alternative purchase. See *Kali and Salz/Mdk/Treuhand* [1994] O J L186/38, para 71. This three step test was affirmed by the European Court of Justice in Joint Cases C-68/94 & 30/95 *France v Commission* and *SCPA & EMC v Commission* [1998] 4 CMLR 829. For further discussion of European Community developments, see Monti & Rousseva, "Failing Firms in the Framework of the E C Merger Control Regulation" (1999) 24 E L Rev 38. For an outline of the approach taken in other jurisdictions to the failing company defence, see Hewitt, "The Failing Firm Defence" (1999) 1 OECD Journal of Competition Law and Policy 119.

The second central argument is that there is a conflict in the general principles enunciated in Australia and New Zealand. The Australian approach reflects the influence of international jurisprudence, while the New Zealand approach is to adopt a stricter, more literal approach, to the interpretation of the legislation. Notwithstanding such differences in approach, it will be argued that for the most part the analysis of failing company cases will be essentially the same in both jurisdictions. However, there is potentially one major exception to this should current judicial views prevail in New Zealand. Under the New Zealand approach the Commerce Commission and the courts have no mandate to shape what may be the most preferable outcome from a competition point of view. Rather, the inquiry is limited to the competition issues arising solely out of the proposal at hand. In contrast, there is the potential for greater enforcement discretion in Australia in the absence of any judicial limitations on the defence.

A concluding section will identify the issues which are of most immediate significance in further shaping the defence in New Zealand.

## II THE NEW ZEALAND SETTING

The central provision of the Commerce Act 1986 which governs business acquisitions is section 47.<sup>11</sup> Section 47(1) prohibits the acquisition of assets of a business or shares in two situations. First, no person may engage in merger activity if, as a result, they would or would be likely to acquire a dominant position in a market.<sup>12</sup> Second, if the acquirer is already dominant in a market, then such person may not acquire assets or shares if this position of dominance would or would be likely to be strengthened. The current test for dominance “requires a qualitative assessment of market power” and is established where there is “more than ‘high’ market power”.<sup>13</sup> The dominant position need not, however, be “so controlling that it is impenetrable”.<sup>14</sup> A more than de minimis approach applies to the test for the strengthening of dominance.<sup>15</sup> Various matters relating to the structure of the market and the extent of restraints imposed by competitors, both actual and potential, must be taken into account in assessing dominance. The courts have established that “the financial stability of the merged concern in relation to other operators in the market” is a structural factor to be

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<sup>11</sup> For an overview of the business acquisition provisions of Pt III of the Act, see M N Berry, “The Application of Competition Laws to Business Acquisitions in New Zealand” in J H Farrar (ed), *Takeovers, Institutional Investors, and the Modernization of Corporate Laws* (1993) ch 8. For coverage of updates since this chapter, see *Gault on Commercial Law* (1994), vol 1, 3-215 – 3-224.

<sup>12</sup> The Acting Minister of Commerce, Hon Trevor Mallard, has recently announced that the government proposes to amend the threshold contained in s 47. The current test of dominance will, under this proposal, be changed to a substantial lessening of competition threshold. See Media Statement, Acting Minister of Commerce, “Commerce Act Strengthened” (5 April 2000). The adoption of the substantial lessening of competition threshold may further impact upon the analysis of failing firm mergers. For example, it may be appropriate under the new threshold to take into account the enhanced potential for co-ordinated conduct between the remaining firms following the acquisition of the failing firm. For an outline of possible strategic motives which may arise in the context of this test, see Howe, “The Failing Firm and the Trade Practices Act” (1998) 14 ACCC Journal 1, 5-6.

<sup>13</sup> *Commerce Commission v Port Nelson Ltd* (1995) 6 TCLR 406, 441.

<sup>14</sup> *Port Nelson Ltd v Commerce Commission* (1996) 7 TCLR 217, 242. For further discussion on the evolution of general dominance principles in New Zealand see, Patterson, “The Rise and Fall of a Dominance Position in New Zealand Competition Law: From Economic Concept to Latin Derivation” (1993) 15 NZULR 265, 271-74; Berry, “The Impact of Economics on Competition Law in New Zealand: Some Reflections on the First Decade” (1996) 26 VUWLR 17, 26-29.

<sup>15</sup> *NZ Co-operative Dairy Co Ltd v Commerce Commission* [1992] 1 NZLR 601, 619-20.

taken into account in assessing dominance.<sup>16</sup> There is no elaboration in the case-law on how this factor is to impact on this exercise.

A voluntary premerger notification regime applies to business acquisitions in New Zealand.

Parties who propose to merge may seek prior clearance and/or authorisation from the

Commerce Commission. Clearance must be given to a proposal which involves no

acquisition or strengthening of dominance.<sup>17</sup> Authorisation must be granted if the proposal

has countervailing public benefits which outweigh the detriments arising from the dominance

concerns.<sup>18</sup>

Efficiency considerations are central to the concept of public benefit. Section 3A provides

that the Commission's analysis of public benefit must have regard to efficiencies,<sup>19</sup> a matter

which is reinforced in the leading judicial statement on the concept,<sup>20</sup> and in the Public

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<sup>16</sup> *Port Nelson*, supra n 13, 442. Further factors relevant to the identification of dominance are set out in the statutory definition of dominance, contained in s 3(9), and the expanded list of factors adopted by the High Court in *Port Nelson*, id, 442-43. These factors include market share, market concentration, the extent to which there is product differentiation, access to technical knowledge, materials and capital, the extent to which the market is competitive (imposing market constraints) and the height of barriers to entry. Further discussion of the dominance test is contained in the Commerce Commission's Business Acquisitions Guidelines (1996) ("Business Acquisitions Guidelines"), reprinted in *Gault on Commercial Law*, vol 1, supra n 11, App 6, 1 App 121-126.

<sup>17</sup> Commerce Act 1986, s 66(3).

<sup>18</sup> Commerce Act 1986, s 67(3) and *NZ Co-operative Dairy Co Ltd*, supra n 15, 630-36. Business acquisitions which receive prior clearance or authorisation are immune from challenge, by virtue of s 69, provided that they are implemented in accordance with the terms of the clearance or authorisation. Third parties have no right of appeal against any clearance or authorisation unless the Commerce Commission holds a public conference at which such third parties have participated: s 92(c)(iii). If a merger is implemented without prior clearance or authorisation it may be variously challenged by the Commerce Commission and third parties. The sole ground for any such challenge is the likelihood that the merger is in breach of the dominance test under s 47. Public benefit considerations are not relevant in this context, and may not be raised by way of defence. Remedies for a contravention of s 47 include penalties, injunctions, damages and orders for divestiture: ss 83-85.

<sup>19</sup> The relevance of efficiencies to the public benefit test had, in fact, already been recognised in the Commerce Commission cases decided prior to the introduction of s 3A on 1 July 1990. See *Gault on Commercial Law*, vol 1, supra n 11, 3-38(b).

<sup>20</sup> *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 and that, in assessing the magnitude of these benefits, the focus is on the durability of the efficiency gains rather than their immediate distribution).

Benefits and Detriments Guidelines issued by the Commerce Commission.<sup>21</sup> The concept of public benefit may, however, also extend beyond efficiency considerations to include “anything else coming within the widest possible conception of public benefit”.<sup>22</sup>

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<sup>21</sup> Guidelines to the Analysis of Public Benefits and Detriments in the Context of the Commerce Act (October 1994) (“Public Benefits and Detriments Guidelines”) reprinted in *Gault on Commercial Law*, vol 1, supra n 11, App 5, 1 App-81-84.

<sup>22</sup> *Telecom*, supra n 20, 530; Public Benefits and Detriments Guidelines, id, 1 App-84-85. Theoretically, social costs (such as those relating to regional development, employment effects and community harmony) may amount to public benefit considerations under this broad test. However, such social costs have been consistently given little or no weight as public benefits in the decisions to date. The distinction between economic and social effects has been regarded as artificial. For example, if a merged firm is able to produce the same output as its predecessor firms, but with fewer staff, this will be regarded unambiguously as a public benefit because of the productive efficiency gain. Further, problems in making value judgements about the weight to attach to social effects have been reflected in the decisions to date. Accordingly, the social costs associated with the acquisition of a failing firm will not be likely to feature in public benefit analysis. See Ministry of Commerce et al, *Review of the Commerce Act 1986* (1993) 13.

### III THEORETICAL BASIS FOR THE DEFENCE

The theoretical basis for the defence is uncertain. There are fluctuating views on whether the defence is based upon noneconomic values or whether it may be justified on grounds of economic efficiency. This conflict, in essence, mirrors the debate in the United States over the goals of antitrust law.<sup>23</sup>

Early on, and for some decades thereafter in the United States, it was assumed that the acquisition of a failing company would not raise competition concerns. Therefore, the justification for the defence centred upon the various private interests involved in the life of a failing firm. Thus, the defence was primarily concerned with protecting the interests of shareholders, creditors and employees of the failing firm, and potentially also the wider interests of the community within which the failing firm operated. Such largely non-economic concerns reflected a bias in favour of small business.<sup>24</sup>

A preoccupation with private interests as the basis for the defence is, however, problematic for three main reasons. First, populist goals in the United States, such as the protection of small business, have given way to economic goals. The continuing debate on the concept of consumer welfare in the United States focuses upon two economic goals. The so-called “Chicago School” views allocative efficiency as an absolute goal.<sup>25</sup> The rival view is that

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<sup>23</sup> For an overview of the various schools of thought on the goals of antitrust in the United States, see S F Ross, *Principles of Antitrust Law* (1993) ch 1.

<sup>24</sup> See Bok, “Section 7 of the Clayton Act and the Merging of Law and Economics” (1960) 74 Harv L Rev 226, 340.

<sup>25</sup> See eg R H Bork, *The Antitrust Paradox: A Policy at War With Itself* (1993 ed) 50-89; R A Posner, *Antitrust Law: An Economic Perspective* (1976) 8. More recently, it has been argued that innovative and productive efficiencies provide a more powerful contribution to social wealth. See Brodley, *The Economic Goals of Antitrust: Efficiency, Consumer Welfare, and Technological Progress* (1987) 62 NYU L Rev 1020, 1027.

antitrust laws should prevent the unfair acquisition of consumers' wealth by firms with market power.<sup>26</sup> The accommodation of noneconomic goals is even more problematic under New Zealand law as the Commerce Act has no populist underpinnings. Rather, the Act is concerned with economic goals. As the Court of Appeal noted in *Tru Tone Ltd v Festival Records Retail Marketing Ltd*:<sup>27</sup>

In terms of the long title the Commerce Act is an Act to promote competition in markets in New Zealand. It is based on the premise that society's resources are best allocated in a competitive market where rivalry between firms ensures maximum efficiency in the use of resources.

A second significant problem in basing the defence upon private interests is that various of these interests may diverge. Shareholders and creditors will most likely stand to gain under the defence. A greater value will presumably attach to the shares than would be the case should bankruptcy follow. Creditors will also benefit, even if only to save the costs associated with the enforcement of their security interests. But should antitrust laws be fashioned to protect such distributional interests? The reduction in shareholder wealth will often result from poor management<sup>28</sup> and creditors have the opportunity to protect their interests by taking appropriate security for their advances. It is inappropriate to develop competition laws with a view to protecting shareholders and creditors from normal commercial risks which are known and assumed to be taken.

The divergent private interests of employees and the wider community are even more problematic. Assume, for example, that a company fails and jobs are lost. If there are productive assets of the failed firm, these will not necessarily disappear, but will presumably

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<sup>26</sup> See Lande, "Wealth Transfers as the Original and Primary Concern of Antitrust: The Efficiency Interpretation Challenged" (1982) 34 Hastings L J 65.

<sup>27</sup> [1988] 2 NZLR 352, 358. For further discussion on the goals of the Act, see Berry, supra n 14, 19-20; Patterson, "How the Chicago School Hijacked New Zealand Competition Law and Policy" (1996) 17 NZULR 160.

<sup>28</sup> See Walthall, "The Failing Company Defense and Corporate Collapse: Probing for a Rational Approach to Business Failure" (1982) 5 GMU L Rev 51, 67.

be put to some other use which may continue to generate employment.<sup>29</sup> Assume, further, that it may be more efficient to relocate the failing firm's productive assets. Jobs and the related interests of suppliers and others which are lost in one community will be gained in another community. Again, it is inappropriate to shape competition laws around value choices involving various regional development options.

Finally, even if it is accepted that private interests should be taken into account, there are insurmountable problems in balancing and quantifying these interests. For example, assume the private interests of shareholders and creditors will be best served by moving operations elsewhere for efficiency reasons. Such private interests will be in conflict with those of the existing employees and community. There is no reason to require enforcement agencies and the courts to take into account these conflicting value choices. And, even if the inquiry was appropriate, it is improbable that any meaningful assessment could be made of the various private interests.<sup>30</sup>

Accordingly, the private interest explanation for the defence is unsustainable. It is, therefore, appropriate to consider the economic rationale for the defence, as this provides the modern-day basis for the rule. As alluded to above, there are two ways in which failing company circumstances may impact on the analysis of mergers in the New Zealand setting. The first is to take financial stability and failing firm circumstances into account when analysing the dominance threshold test. The second is to factor potential failure into the analysis of countervailing public benefits, should the dominance threshold come into play.

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<sup>29</sup> For further discussion of this possibility, see Baxter, *supra* n 4, 249.

<sup>30</sup> See Areeda & Turner, vol 4, *supra* n 1, 103-104; Walthall, *supra* n 28, 66.

Theoretically, financial stability and failing firm considerations are unlikely to be significant in determining questions of dominance. Judicial statements pointing to the relevance of the financial stability of the merged firm refer only to the potential strength of the merged firm relative to others in the market . Thus, in one sense, this consideration has no bearing on the defence at all. Rather, the issue is merely whether the merged firm will be likely to have such financial strength relative to others that it will raise dominance concerns.

The failing company doctrine has, in fact, been developed with limited reference to competition considerations. The preferred purchaser element of the defence is the only obvious element which has some competition foundation.<sup>31</sup> Under this approach the acquisition of a dominant position is permitted, but only in the absence of a competitively preferable purchaser.<sup>32</sup> However, the extent to which this approach properly accommodates competition concerns, rather than private interests, is questionable as a dominant position will still be the outcome. Competition will be harmed, but private interests will be protected. Further, the extent to which preferred outcomes may be the basis for decision-making is problematic in the New Zealand setting. In any given case the courts and the Commission must decide whether the merger proposal in question should be permitted. This task arguably only involves a consideration of the relevant competition threshold in relation to the proposal in question. The legislation provides no mandate to the courts or the Commission to explore preferred market outcomes.

The potential for failing circumstances to impact upon the analysis of dominance may be strongest when considering failure in circumstances where the assets of the failing firm

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<sup>31</sup> For discussion of the elements of the defence, see *infra* Pt IV.

<sup>32</sup> There are, nonetheless, competitive risks in the acquisition of under-performing companies which are not taken into account in this context. The acquiring firm may be burdened with excess capacity in need of

cannot be deployed. Theoretically, it may be preferable from a competition perspective for the failing firm to exit the industry in all cases where its acquisition raises dominance concerns, thus providing smaller firms with the opportunity to attract the former firm's customers and resources. But this may not follow. For example, the firm with existing unilateral power may successfully enter the contest for part of the failing firm's business utilising existing excess capacity, thus making their operations even more profitable. Nonetheless, there is at least the opportunity for smaller firms to compete for the business of the failing firm in this situation.

Thus, the failing company defence is, arguably, of no particular relevance in determining whether a particular competition threshold may be met. The defence is, however, potentially of real significance in explaining, in terms of economic efficiency, why an otherwise unlawful merger should be permitted to proceed on grounds of countervailing public benefits. While there is general agreement that the defence can be justified on efficiency grounds, there are divergent views on the appropriate analytical framework. Surprisingly, very little consideration has been given to the potential for the Williamson tradeoff model<sup>33</sup> to justify the acquisition of failing companies.<sup>34</sup> The Williamson model is silent on whether one or both of the merger parties must be healthy. In the case of the merger of two healthy companies, a competitive entity will leave the market only because of the acquisition. In the failing firm situation, exit of the weaker firm will occur in any event. This distinction does not appear to disentitle the application of the Williamson model because if there is a competition concern in either case, it is essentially the same. Will there be a post-merger

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rationalisation, and it may also be locked into long term contracts at established prices with existing customers. See McChesney, "Defending the Failing Firm Defense" (1986) 65 Neb L Rev 1, 17.

<sup>33</sup> Williamson, "Economies as an Antitrust Defense: The Welfare Tradeoffs" (1968) 58 Am Econ Rev 18 ("Economies/Welfare Tradeoffs"); Williamson, "Economies as an Antitrust Defence Revisited" (1997) 125 U Pa L Rev 699 ("Defense Revisited").

increase in market power with the result that the acquirer will be able to reduce output and increase price, thus resulting in deadweight loss? Williamsonian analysis asserts that if the merger achieves cost savings (calculated over the entire output of the firm post-merger) which outweigh the deadweight loss, then the merger will produce a net efficiency gain.<sup>35</sup> Under this model the distribution of profits between consumers and producers is treated as a matter of indifference. The Williamson model can, of course, be criticised in terms of its accuracy and workability.<sup>36</sup> But from a theoretical point of view it is the seminal work on the efficiencies defence.

Apart from Williamson's trade-off model, various attempts have been made specifically to justify the failing company defence on efficiency grounds. While early attempts to provide the justification were not compelling,<sup>37</sup> a significant body of economic literature has emerged since the mid-1980s which has the potential to provide a more satisfactory explanation.<sup>38</sup> Recall that, within the New Zealand context, the threshold for merger prohibition is dominance which under the *Port Nelson* test is established only where there is more than high market power. Thus, the scenario is one whereby the acquisition of the failing firm will lead

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<sup>34</sup> Only one of the recent commentaries on the subject expressly considers the possibility. See McChesney, supra n 32, 18-19.

<sup>35</sup> Williamson, "Economies/Welfare Tradeoffs", supra n 33, 22-23; Williamson, "Defense Revisited", supra n 33, 708-09.

<sup>36</sup> See Berry, "Efficiencies and Horizontal Mergers: In Search of a Defense" (1996) 33 San Diego L Rev 515, 536-38, 542-45.

<sup>37</sup> For a discussion of two such efficiency explanations, see Walthall, supra n 28, 63-65. The first is that the defence encourages market entry and risk-taking by minimising the investment losses associated with failure. The second is that the defence eases the transfer of assets into more productive hands and avoids the social costs of bankruptcy and reorganisation. There are significant questions relating to the weight to be given these considerations. For example, to what extent are prospective entrants likely to be influenced to enter the market because of the potential availability of the defence in the case of failure? And are the best savings to one firm, through the avoidance of bankruptcy proceedings, worth more than the costs to consumers of artificially higher prices over the long run?

<sup>38</sup> This literature focuses upon the efficiency considerations in the market where the failing firm's assets are engaged. It does not address the comparative efficiency implications of a failing firm's assets being deployed to another market. In practical terms it would be difficult to assess, in a meaningful way, the comparative efficiencies considerations should the assets be deployed. Should this happen, then presumably the remaining firm or firms in the original market, in which the assets were engaged, would attempt to engage in profit maximisation. The original market would be left with reduced productive capacity, subject to conditions of

to what may be viewed, for present purposes, to be a monopoly. This outcome, in its starkest form, has been most directly addressed by Shughart and Tollison.<sup>39</sup> The Shughart and Tollison model assumes that there is a two-firm competitive industry in which one of those firms is not viable in the long run. It also assumes that there is no alternative purchaser, that each firm has one production plant and that both firms are price-takers. One firm is more efficient than the other. 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 tradeoff 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 industry.

Shughart and Tollison argue that the welfare loss will be smaller in the case of acquisition by the surviving firm essentially for the following two reasons:

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expansion and new entry. On the other hand, the failing firm's assets will have potential efficiency implications in the new market in which they will be deployed.

<sup>39</sup> Shughart & 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* (2<sup>nd</sup> ed 1979), 186-89). For similar economic arguments, see Campbell, "The Efficiency of the Failing Company Defense" (1984) 63 *Tex L Rev* 251 (arguing that the defence is sometimes efficient); McChesney, *supra* n 32 (disputing Campbell's analysis and arguing that the defence is always efficient); Friedman, "Untangling the Failing Company Defense" (1986) 64 *Tex L Rev* 1375, 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).

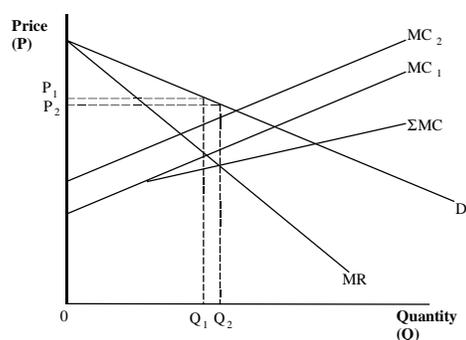
- (1) if failure occurs, the surviving firm will, in any event, choose the price-output combination which is consistent with profit maximisation;<sup>40</sup> and
- (2) the output of the merged firm will exceed the output of the surviving firm alone, resulting in a deadweight loss which will be less than would occur in the case of the failing firm's resources exiting the market.<sup>41</sup>

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<sup>40</sup> This price-output assessment would result in the normal deadweight loss associated with monopoly with a limit price dependent upon the transaction costs of reviving the failed firm or the shadow price of entry. See Shughart and Tollison, id, 360.

<sup>41</sup> Dr Michael Pickford provides a useful illustrative explanation of this proposition in a memorandum on file with the author dated 11 January 2000.

As with the Williamson tradeoff model, there are significant practical limitations which attach to the Shughart and Tollison approach. For example, the model assumes a two firm industry with no alternative purchaser. Further, in the premerger context there potentially will be significant measurement problems in demonstrating the merged firm's output because the demand and marginal cost curves will be potentially unknown over all possible relevant ranges of output.



In the two-firm industry where one firm is failing, the post-merger situation with and without the failing firm, in the “simple” model proposed by Shughart and Tollison, is shown in the figure above.  $MC_1$  is the marginal cost curve for the more efficient plant of the surviving firm. Given market demand curve  $D$ , the profit-maximising price and quantity will be  $P_1$  and  $Q_1$  respectively in the situation where the failing firm exits from the industry. In contrast, in the situation where the failing firm doctrine is applied, the surviving firm acquires the less efficient plant  $MC_2$ , thereby becoming a multi-plant monopolist. The two marginal cost curves are summed horizontally to give  $\Sigma MC$ . The surviving firm then maximises profit by producing at price  $P_2$  and quantity  $Q_2$ . Total cost is minimised by allocating output between the two plants so that the two marginal costs are equal to each other and to the common marginal revenue. As  $Q_2$  would normally be greater than  $Q_1$ , the deadweight loss from merger is less than that associated with the exit of the failing firm. Shughart and Tollison assume that the failure is triggered by a decline in market demand. While the model given above does not directly address that issue, it is broadly consistent with the inability of a high cost firm to survive in a situation where demand has fallen.

This explanation is based upon a number of assumptions. It is assumed that:

1. there is no other potential acquirer of the failing firm;
2. entry barriers prohibit new entry;
3. the possibility of a price cap on the surviving firm, imposed by any potential to revive the failing firm, is ignored;
4. the failing firm's plant is not so inefficient relative to the survivor's plant ( $MC_2$  is much higher than  $MC_1$ ), that the output of the survivor would be the same in either situation; and
5. the survivor will only acquire the failing firm if it is profitable to do so, i.e., the addition to its revenues exceeds the costs of acquisition (together with allowance being made for the impact on marginal costs).

For more detailed models on the subject, see Campbell, *supra* n 39 and McChesney, *supra* n 32.

One final point which warrants brief comment is the likelihood of excess capacity in the hands of a company which is permitted to acquire a failing firm. This possibility is not taken into account under the Williamson and Shughart and Tollison models which have just been described. It has been argued that in oligopolistic circumstances the leading firm or firms may maintain or increase excess capacity as a potential deterrent to new entry or as a potential weapon to discipline smaller rivals rather than to increase output and lower prices. However, considerable debate surrounds this deterrent explanation.<sup>42</sup> There is at least the potential that the acquisition of a failing firm may be motivated by strategic entry deterrence in the “merger to dominance” setting, and it is possible that excess capacity may deter or slow down entry. However, such a strategy potentially defies rational explanation. A strategic investment in excess capacity will compromise productive efficiency, particularly in the case of sunken investments.<sup>43</sup> Increasing total capacity beyond the competitive level will involve potential competitive risks and may provide an incentive as much as a deterrent to potential entrants, particularly in markets where there are no significant entry barriers.

Thus, notwithstanding the defence’s pragmatic appeal, its theoretical basis is problematic. Many of the original assumptions about the defence do not withstand close scrutiny. Theoretically, the strongest case for the application of the defence will be where 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. However, this efficiency explanation for the defence is still evolving, and there are potential concerns about its reliability in the adjudication process.

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<sup>42</sup> For coverage of the literature on the debate, see Kwoka & Warren-Boulton, “Efficiencies, Failing Firms, and Alternatives to Merger: A Policy Synthesis” (1986) 31 *Antitrust Bull* 431, 445-46; F M Scherer & D Ross, *Industrial Market Structure and Economic Performance* (3<sup>rd</sup> ed 1990) 392-93.

## IV THE NORTH AMERICAN EXPERIENCE

Before further reviewing the development of the failing company defence in New Zealand it is informative, by way of background, first to trace the emergence of the defence in the United States. By way of contrast, it is also informative to review the more recent Canadian response to the defence.

### A *United States*

The prevailing legislation which governs mergers in the United States is section 7 of the Clayton Act. This provision prohibits mergers where the result may be to lessen competition substantially or to tend to create a monopoly. The failing company defence was created by case-law against this background of no express statutory basis. The defence was first recognised by the Supreme Court as an alternative ground of decision in *International Shoe Co v Federal Trade Commission*.<sup>44</sup> In this case 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.<sup>45</sup> The most important passage of the judgment, which is regarded as the foundation for the defence, is as follows.<sup>46</sup>

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

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<sup>43</sup> See R Gilbert, "Mobility Barriers and the Value of Incumbency" in R Schmalensee & R Willig (eds), *Handbook of Industrial Organisation* (1989) vol 1, 476.

<sup>44</sup> (1930) 280 US 291. For an outline of earlier cases involving failing company defence considerations, see Wiley, "The Failing Company' : a Real Defense in Horizontal Merger Cases" (1961) 41 B U L Rev 495, 497-99.

<sup>45</sup> *Id.*, 299-300.

<sup>46</sup> *Id.*, 302-03. The Committee reports accompanying the Celler-Kefauver Act 1950 cited this passage with approval and confirmed the validity of the defence. See Areeda & Turner, vol 4, *supra* n 1, 100-01. The precise basis for this congressional acceptance is not clear, but appears to be based on private interest considerations. See Bok, *supra* n 24, 339-40. The Supreme Court reaffirmed the validity of the defence in *Brown Shoe Co v United States* 370 US 294, 319 (1962).

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.

This formulation of the defence has two key elements. First, the acquired company must face the grave probability of business failure with remote prospects of rehabilitation. Second, it must be shown that no other purchaser would keep the failing company in the market with a less significant reduction in competition. The establishment of these two elements will generally result in the courts applying an absolute defence.<sup>47</sup> Since *International Shoe*, there have been various judicial attempts to further define the elements of the defence as reflected in the following discussion.<sup>48</sup>

The first element, the failing condition requirement, imposes high standards of probable failure.<sup>49</sup> Regrettably, but perhaps inevitably, the cases provide imprecise standards for

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<sup>47</sup> See eg Campbell, supra n 39, 252. However, there has been some debate whether the defence is absolute or simply a factor to be taken into account in the overall assessment of the merger. For a variety of views, see eg, Walthall, supra n 28, 61 (arguing the defence is not absolute); Friedman, supra n 39, 1398-99 (arguing the defence is not absolute unless failure is certain or nearly so); Laurenza, "Section 7 of the Clayton Act and the Failing Company: an Updated Perspective" (1979) 65 Virginia L Rev 947, 965-70 (arguing for a flexible absolute defence requiring consideration of reasonable alternatives).

<sup>48</sup> The Department of Justice and Federal Trade Commission have also made the following policy statement: "A merger is not likely to create or enhance market power or facilitate its exercise if the following circumstances are met: 1) the allegedly failing firm would be unable to meet its financial obligations in the near future; 2) it would not be able to reorganise successfully under Chapter 11 of the Bankruptcy Act; 3) it has made unsuccessful good-faith efforts to elicit reasonable alternative offers of acquisitions of the assets of the failing firm that would both keep its tangible and intangible assets in the relevant market and pose a less severe danger to competition than does the proposed merger; and 4) absent the acquisition, the assets of the failing firm would exit the relevant market."

Department of Justice and Federal Trade Commission Horizontal Merger Guidelines (1992) ("US Guidelines") s 5.1 (footnotes omitted), reprinted in P E Areeda & H Hovenkamp, *Antitrust Law: An Analysis of Antitrust Principles and Their Application* (1998 Supp) App A. The US Guidelines, unlike the case-law, reflect an appreciation for the efficiency explanation for the defence, as discussed in Pt III above. The reference to the potential relevance of the exit of the assets from the relevant market in the US Guidelines was not, however, introduced until 1992. As the defence has only been accepted a few times by the courts in the United States (see H Hovenkamp, *Federal Antitrust Policy: The Law of Competition and its Practice* (1994) 496 n 9), the question of enforcement discretion by the antitrust agencies is significant. The defence is frequently raised before the agencies (see eg Kauper, supra n 4, 529) although there are no precise details on this. For further recent discussion on the enforcement discretion aspect of the defence, see eg Correia, "Merger Policy for Failing Firms and Distressed Industries" (1996) 19 World Competition L & Econ Rev 45.

<sup>49</sup> This article deals only with the failing company situation. It is also possible that the defence may apply to failing divisions or subsidiaries. The concept has been recognised by some courts and the administrative agencies, but has not yet been addressed by the Supreme Court. See eg *Federal Trade Commission v Great Lakes Chem Corp* 528 F Supp 84, 96 (ND Ill 1981); *United States v Reed Roller Bit Co* 274 F Supp 573, 584 n

determining failure. For example, the courts have variously required that the acquired company be “nearly worthless”,<sup>50</sup> “hopelessly insolvent”,<sup>51</sup> “deeply in debt”,<sup>52</sup> “in a failing or near bankrupt condition”,<sup>53</sup> and “irretrievably failing.”<sup>54</sup> In contrast, the defence has been held unavailable on the mere showing of declining sales and profits,<sup>55</sup> actual losses,<sup>56</sup> obsolete plants,<sup>57</sup> management difficulties<sup>58</sup> and “business reverses”.<sup>59</sup> Financial weakness has also been rejected as a basis for the defence.<sup>60</sup> At first glance these case-law tests may appear inadequate. However, it may not be possible to define more precisely whether insolvency or bankruptcy is imminent or highly probable.<sup>61</sup> So long as such high standards of probable failure are imposed, the absence of clearer criteria for failure may not be a matter of great concern as few cases will satisfy this test.<sup>62</sup>

The further inquiry into the acquired firm’s prospects of rehabilitation is more problematic and contentious. Clearly if a firm can reorganise and remain in the market as a competitive force, this will be a preferable outcome. However, the nature of the inquiry is highly speculative. The prospect of reorganisation has the potential significantly to limit the

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1 (WD Okla 1967); section 5.2 US Guidelines, *id.* For an outline of arguments for and against applying the defence to failing subsidiaries, see Areeda & Turner, vol 4, *supra* n 1, 112.

<sup>50</sup> *United States v United Steel Corporation* 251 US 417, 446 (1920).

<sup>51</sup> *United States v Diebold Inc* 197 F Supp 902, 906 (SD Ohio 1961), *rev’d on other grounds*, 369 US 654 (1962).

<sup>52</sup> *United States v Maryland & Virginia Milk Producers Association* 167 F Supp 799, 808 (DDC 1958), *aff’d*, 362 US 458 (1960).

<sup>53</sup> *Crown Zellerbach Corp v Federal Trade Commission* 296 F 2d 800, 831 (9<sup>th</sup> Cir 1961).

<sup>54</sup> *United States v MPM, Inc* 397 F Supp 78, 98 (D Col 1975).

<sup>55</sup> *United States v Pabst Brewing Co* 296 F Supp 994, 999-1000 (ED Wisc 1969).

<sup>56</sup> *United States v Blue Bell Inc* 395 F Supp 538, 550 (MD Tenn 1975).

<sup>57</sup> *United States v Greater Buffalo Press* 402 US 549, 555 (1971).

<sup>58</sup> *United States v Third National Bank in Nashville* 390 US 171, 188-89 (1968).

<sup>59</sup> *Dean Foods* 70 FTC 1146, 1268-87 (1966).

<sup>60</sup> See *Kaiser Aluminium & Chem Corp v Federal Trade Commission* 652 F 2d 1324, 1338-39 (7<sup>th</sup> Cir 1981).

<sup>61</sup> For discussion of the economic tests for failure, see Wiley, *supra* n 44, 502-12; Blum, “The Failing Company Doctrine” (1974) 16 B C Ind & Com L Rev 75, 106-12; Walthall, *supra* n 28, 72-99.

<sup>62</sup> See Areeda & Turner, vol 4, *supra* n 1, 108-09 (noting that the standard has been seldom satisfied).

application of the defence. However, the courts should exercise caution in reaching such findings because reorganisation is not often achieved.<sup>63</sup>

The requirement that the acquired firm's prospects of rehabilitation be remote was, as earlier set out, introduced in *International Shoe*. The Supreme Court affirmed this requirement in *Citizen Publishing Co v United States*<sup>64</sup> when it reiterated that, for the defence to apply, it must be proved that the acquired company could not continue to operate under receivership or reorganisation.<sup>65</sup> However, the extent to which courts will rigidly follow this requirement may depend on the facts of any given case.<sup>66</sup> In *Citizen Publishing* the Court noted that, at the time *International Shoe* was decided, companies often emerged from bankruptcy.<sup>67</sup> *Citizen Publishing* was a case involving the potential merger of the only two firms in the market. Given the severity of the likely anti-competitive effects it was not surprising that the issue of reorganisation was explored. The inquiries into the possibilities of reorganisation in these cases may, therefore, be limited to some extent to the facts of each case.

The second element to the defence is that there be "no other prospective purchaser".<sup>68</sup> This requirement was affirmed in *Citizen Publishing* on the basis that "if another person or group should be interested, a unit in the competitive system would be preserved and not lost to monopoly power".<sup>69</sup> Subsequent cases have considered the extent to which the merger parties must search for alternative offers. There is a need for reasonableness in this exercise, because widespread disclosure of the failing firm's difficulties may further reduce the value

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<sup>63</sup> Rasmussen, "The Efficiency of Chapter 11" (1991) 8 Bankruptcy Developments Journal 319, 322 (fewer than twenty per cent of firms filing for bankruptcy in the United States successfully reorganise).

<sup>64</sup> 394 US 131 (1969).

<sup>65</sup> *Id.*, 138 (the Court refusing to apply the defence in this case because of the possibility of reorganisation).

<sup>66</sup> See Areeda & Turner, vol 4, supra n 1, 107-12 (arguing that dim prospects for reorganisation should not be a universal prerequisite).

<sup>67</sup> Supra n 64, 138.

<sup>68</sup> *International Shoe*, supra n 44, 302.

<sup>69</sup> Supra n 64, 138.

of the failing firm.<sup>70</sup> To satisfy this search requirement a firm must make “a sufficiently clear showing” that it “undertook a well conceived and thorough canvas of the industry such as to ferret out viable alternative partners for a merger”.<sup>71</sup>

From this brief survey of the United States case-law, it is apparent that the judicial formulation of the defence has not advanced significantly since *International Shoe*. Thus the defence, arguably, continues to be based upon private interests and lacks an appropriate theoretical basis. There is no apparent room within which to manoeuvre efficiency arguments to the effect, for example, that the merged firm’s output will exceed the output of the surviving firm alone and that this will result in less deadweight loss than would occur should the failing firm’s assets exit the market.<sup>72</sup> It follows that judicial pronouncements on the defence in the United States deal with a narrower, and at times unrelated, range of considerations when compared with the factors relevant to the analysis of failing firms in New Zealand.

### *B Canada*

The approach taken in Canada to the acquisition of failing firms provides an interesting comparison. Absent the populist underpinnings found in United States law, the failing firm defence in Canada is based upon a more clearly economic range of considerations.<sup>73</sup> Unusually, failing firm circumstances are addressed in the legislation, namely the Competition Act 1986 (Canada). Section 93 (b) provides that, in determining whether a merger prevents or lessens, or is likely to prevent or lessen, competition substantially, a factor to be taken into account is whether the business or one of the merger parties “has failed or is

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<sup>70</sup> See Areeda & Turner, vol 4, supra n 1, 123-24.

<sup>71</sup> *Pabst Brewing*, supra n 55, 1002. In markets where there are few competitors it may be reasonable to expect that the failing firm will approach all of those competitors. See *Greater Buffalo Press*, supra n 57, 556.

<sup>72</sup> However, as mentioned above in n 48, the antitrust agencies have left open the possibility of taking such factors into account in the exercise of their discretion under the current US Guidelines.

<sup>73</sup> P S Crampton, *Mergers and the Competition Act* (1990) 411, 414.

likely to fail”.<sup>74</sup> A further provision of potential relevance to mergers which are likely to prevent or lessen competition substantially is section 96 which, in essence, provides an efficiencies defence. Orders will not be made against such mergers where they “bring about gains in efficiency that will be greater than, and will offset, the effects of any prevention or lessening of competition”.

There have been no significant case-law developments concerning failing companies in Canada. However, the Director of Investigation and Research issued Canada’s first Merger Enforcement Guidelines in 1991,<sup>75</sup> and these provide the current interpretative guidelines. The Merger Enforcement Guidelines address both the competitive significance of failure and the approach to be taken to the efficiencies defence in cases where a determination has been made that a merger is likely to prevent or lessen competition substantially.

The Merger Enforcement Guidelines place a gloss on the legislation. The first inquiry under section 93(b), whether failure is likely to impact substantially upon competition, is said to centre upon whether there are alternatives to the merger that would result in a materially higher level of competition. Section 4.4 of the Merger Enforcement Guidelines takes the approach that if there are no such alternatives, there can be no prevention of competition and any lessening that would occur cannot be attributed to the merger, because it would have happened in any event. The underlying rationale of section 4.4 is said to be equally applicable to all situations where a firm wishes to exit the market, whether or not it be a

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<sup>74</sup>Other factors under s 93 to be taken into account, in determining if the competition threshold of s 92 is contravened, are (a) the extent to which foreign products or foreign competitors will provide effective competition; (b) the availability of acceptable substitutes; (c) entry barriers; (d) the level of competition in the market; (e) the likelihood the merger would remove a vigorous competitor and (f) the nature and extent of change and innovation in the market.

<sup>75</sup> These guidelines are reprinted in G N Addy & W L Vanveen, *Competition Law Service* (1999) vol 2, B-57 (“Merger Enforcement Guidelines”).

failing firm.<sup>76</sup> The financial health of the failing firm may, nonetheless, be relevant to the competition assessment. For example, any prospective increase in the acquiring firm's market power will reduce as the financial health and relative market position of the failing firm deteriorates.<sup>77</sup>

The Canadian approach under section 93(b) is, therefore, essentially as follows. Is there a competitively preferable purchaser who is willing to pay a net price above liquidation value? If not, would the firm be able to remain in the market in some retrenched form with desirable competitive consequences? The final alternative is liquidation. If there is no preferred purchaser, and if retrenchment is not an option, then the competitive implications of liquidation must be assessed. Would liquidation and exit result in a materially higher level of competition than if the merger was allowed to proceed? In this context, the Merger Enforcement Guidelines indicate that an evaluation must be made as to whether liquidation would likely "facilitate entry into, or expansion in, a market by enabling actual or potential competitors to compete for the exiting firm's customers or assets to a greater degree than if the exiting firm merged with the proposed acquirer".<sup>78</sup>

If the analysis of these issues leads to the conclusion that the merger is substantially anti-competitive, and that exit is preferable, it is possible that the efficiencies exception contained in section 96 may come to the rescue of the merger.<sup>79</sup> In broad terms this exception requires an estimate of the likely increase in producers' surplus resulting from the anticipated efficiency gains. This must then be balanced against the estimated deadweight loss to the

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<sup>76</sup> The factors for assessing failure are set out in s 4.4.2 of the Merger Enforcement Guidelines.

<sup>77</sup> For discussion of further considerations relevant to the competition assessment, see Crampton, "Canada's New Merger Enforcement Guidelines: a 'Nuts and Bolts' Review" (1991) 36 Antitrust Bull 883, 935.

<sup>78</sup> Merger Enforcement Guidelines, s 4.4.5.

Canadian economy that is expected may result from a reduction in output and increase in price. This approach is consistent with the Williamson trade-off model. As yet, failing company circumstances have not been analysed under this efficiencies exception.<sup>80</sup>

The current Canadian approach, therefore, selectively adopts some elements of the United States judicial defence. Prospects of reorganisation and competitively preferable purchasers are relevant considerations. However, the Canadian approach also differs in a number of material respects from the United States judicial formulation of the defence. In Canada the defence is free of any private interest considerations. Further, if a proposed merger is substantially anti-competitive, there is the potential for the merger to be justified on efficiency grounds.

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<sup>79</sup> For discussion of the efficiencies exception, see Crampton, *supra* n 77, 955-70; Crampton & Corley, "Merger Review Under the Competition Act: Reflections on the First Decade" (1997) 65 *Antitrust L J* 535, 568-70; Sanderson, "Efficiency Analysis in Canadian Merger Cases" (1997) 65 *Antitrust L J* 623.

<sup>80</sup> Crampton, nonetheless, notes in this context the possibility that it may be more efficient for assets to remain in the industry, even in the hands of a dominant firm, than for them to exit. See Crampton, *supra* n 73, 419, 421.

## V THE AUSTRALASIAN APPROACH

As the Commerce Act is based upon the Trade Practices Act 1974 (Cth), it is not surprising that there are inter-related developments in Australia and New Zealand in the case of the failing company defence.<sup>81</sup> These Australasian developments can be conveniently traced in the following three parts:

- (1) the treatment of the defence prior to the enactment of the Commerce Act in 1986;
- (2) case-law developments since 1986; and
- (3) enforcement discretion.

### A Pre-1986

The failing company defence has not received legislative recognition in either Australia or New Zealand. The recommendation made by the Swanson Committee in its 1976 review of the Trade Practices Act, that there should be such a statutory defence,<sup>82</sup> was not adopted.

Nonetheless, failing company circumstances were taken into account, in various ways, in the early Australian cases under the Trade Practices Act. However, these decisions do not reflect any rigorous analytical framework. The Trade Practices Commission granted clearance,

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<sup>81</sup> The legislative regime in Australia is similar to that of New Zealand set out in Pt II of this article. There are some key differences. For example, a “substantial lessening of competition” threshold determines the legitimacy of mergers (under s 50), and the possibility for clearance of a merger on competition grounds is no longer available since the repeal of s 94 in 1977. For discussions of the Australian merger regime, see A I Tonking & R Baxt (eds), *CCH Australian Trade Practices Reporter*, vol 1, para 8-000, Mergers and Acquisitions tab; S G Corones, *Restrictive Trade Practices Law* (1994) ch 10.

<sup>82</sup> Trade Practices Act Review Committee, *Report to the Minister for Business and Consumer Affairs* (1976) 50-51. The Committee’s justification for the defence, and its outline of the possible content of the defence, was clearly influenced by the United States doctrine. The Committee concluded that there was little point in preventing the acquisition of a company which was clearly failing, and it also indicated that the defence would “minimise the general social cost of business failures and give reasonable consideration to the position of employees, creditors and others”. The suggested elements of the defence were that the company should be “imminently likely to go out of business” and that there should be “no alternative buyers on similar terms to those offered by the offeror”. The failing company defence was not considered in the subsequent reviews of the Trade Practices Act which addressed the merger provisions, namely House of Representatives Standing Committee on Legal and Constitutional Affairs, *Mergers, Takeovers and Monopolies: Profiting from Competition* (1989) (Griffiths Committee Report) and Report by the Standing Committee on Legal and

under repealed section 94, to a number of early merger cases involving failing company circumstances under the 1974 Act on the basis that those proposals did not involve any substantial lessening of competition.<sup>83</sup> However, these cases are of little significance in terms of developing the defence. They merely involved the acquisition of a failing company by a new entrant. Clearly, these cases did not contravene the competition threshold of section 50, and accordingly, no detailed consideration of the failing company defence is to be found in the Commission's decisions. The early Australian authorisation cases under section 90 also dealt with the defence in a cursory fashion, although some of the cases identified as "public benefits" matters which are recognised under the United States approach to the defence. For example, in various cases the absence of alternative purchasers<sup>84</sup> and the private interests of employees and communities<sup>85</sup> were taken into account in assessing whether public benefits would outweigh the detriments arising from the competition concerns. In another early case, the Commission authorised a rescue mission on the basis that the investment by the acquirer of funds, managerial skill and know-how would result in a significant improvement in the efficiency of resource utilisation.<sup>86</sup> The target company would not only remain viable, but would also be able to expand production to realise potential economies of scale.

Prior to 1986, different criteria applied to the determination of merger or takeover proposals in New Zealand. The central inquiry under the Commerce Act 1975 was whether any such

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Constitutional Affairs, *Mergers, Monopolies and Acquisitions: Adequacy of Existing Legislative Controls* (1991) (Cooney Committee Report).

<sup>83</sup> See eg *Interore Australia Pty Ltd*; *Melbourne Sports Depot Pty Ltd* (1975) 1 TPCD para 292; *Otis Elevator Co Pty Ltd*; *Arnold Engineering and Lifts Pty Ltd* (1974) 1 TPCD para 160; *Diverse Products Ltd*; *Coca-Cola Bottlers (Hobart) Pty Ltd and Te-Up Bottling Co Pty Ltd* (1975) 1 TPCD para 293; *Coca-Cola Operations Pty Ltd*; *Cohns Industries Pty Ltd* (1975) 1 TPCD para 137.

<sup>84</sup> See eg *PNQ Investments Pty Ltd and Rockhampton Newspaper Co Pty Ltd*; *Gladstone Observer Pty Ltd and Observer Printery Pty Ltd* (1975) 1 TPCD para 208, 277; *Monier Ltd* (1983) ATPR (Com) para 50-062, 55,279.

<sup>85</sup> See eg *PNQ*, id, 276-77; *Monier*, id, 55,290-91.

<sup>86</sup> *Farley & Lewers (Qld) Pty Ltd*; *Albert Readymixed Concrete Pty Ltd* (1976) 1 TPCD para 340, 580.

proposal would be, or likely be, contrary to the “public interest”.<sup>87</sup> The term “public interest” was exhaustively defined in section 80 and included consideration of a wide range of factors including the extent to which the proposal would assist or hinder the promotion of the interests of consumers, the efficient development of industry, the enhancement of employment opportunities, the reduction of production costs, the entry of new competitors, export trade and the interests of employees. Wide-ranging competition effects also entered the equation including, for example, the likelihood that prices and profits may increase and that competition may be prevented or restricted. This exhaustive attempt to define the public interest, which included both public and private interests, reflected “complete confusion and a lack of any clear statement of economic policy priorities.”<sup>88</sup>

The potential application of the failing company defence to the section 80 considerations was analysed in one decision of the Commerce Commission, namely *J Wattie Canneries Ltd.*<sup>89</sup> The target company was experiencing liquidity and profitability problems in this case which were found to be “almost chronic in character” and would be likely to cause the company to restructure.<sup>90</sup> Thus, it was not altogether clear that the company was, strictly speaking, failing.<sup>91</sup> The Commission approved the merger essentially on the grounds that there were close product substitutes, that entry barriers were not insurmountable and that competitive constraints were imposed by the import of product from Australia.<sup>92</sup> Continued employment undertakings were, not surprisingly in light of section 80, a further factor to justify approval

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<sup>87</sup> For an outline of the merger provisions under the Commerce Act 1975, see J G Collinge, *The Law Relating to Restrictive Trade Practices and Monopolies, Mergers and Takeovers in New Zealand* (2<sup>nd</sup> ed 1982) 347-545.

<sup>88</sup> Farmer, “The Harmonisation of Australian and New Zealand Trade Practices Law After CER” [1985] NZ Recent Law 214, 219.

<sup>89</sup> (1984) 4 NZAR 354.

<sup>90</sup> Id, 359.

<sup>91</sup> The Commission noted in the judgment that a company will not be failing where it “continues to provide significant competition, albeit on a less vigorous basis, by being able to reorganise its affairs by selling off unprofitable assets, obtaining extra equity capital, or otherwise restructuring.” Id, 360.

<sup>92</sup> Id, 358-59.

of the merger.<sup>93</sup> Thus, both public and private interests were addressed, as required by section 80.

The Commission also proceeded in *Wattie Canneries* to indicate that the defence may be justified on the basis that “if the target company were ‘failing’ to the extent that it was soon likely to cease business, then a takeover proposal relating to that company may be found not to significantly reduce competition.”<sup>94</sup> This passage appears to suggest that the acquisition of a failing firm which is about to cease business will not raise competition concerns. However, it is apparent from the judgment that little consideration was given to this point. Clearly this is a debatable proposition as is apparent from the earlier discussion.<sup>95</sup>

Thus, prior to the enactment of the Commerce Act in 1986, there was a general awareness of the failing company defence in both Australia and New Zealand. The Australian approach was clearly influenced by the United States formulation of the defence, while the New Zealand treatment of the subject coincided with this because of the wide ranging set of considerations contained in section 80 of the 1975 Act. However, this awareness of the defence had not, before the enactment of the Commerce Act in 1986, translated into any clearly recognisable formulation of the defence.

### *B Case-law Developments Since 1986*

The failing company defence has received its most detailed consideration in two cases decided in Australia and New Zealand in the early 1990s. Absent express legislative recognition of the defence, both cases have attempted to enunciate relevant principles.

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<sup>93</sup> *Id.*, 360.

However, the approaches taken in the two cases stand in marked contrast. The Australian approach reflects a preoccupation with the United States doctrine, and an attempt to develop a case-law rule based largely upon the United States model, while the New Zealand approach reflects a stricter and more literal approach to the interpretation of the Commerce Act.

The first decision is that of the Australian Trade Practices Commission in *West Australian Newspapers Ltd (No 2)* (“WAN”).<sup>96</sup> Briefly, the key facts were as follows. WAN published the *West Australian* newspaper and it also owned 49.9 per cent of the issued share capital of Community Newspapers (1985) Ltd (“CN”). A wholly-owned subsidiary of CN, Daily News Pty Ltd, was the publisher of the afternoon paper in Perth, namely the *Daily News*. The *Daily News* had been experiencing heavy losses, and the holder of the remaining 50.1 per cent of CN wished to dispose of all its shares. WAN was a willing purchaser. The Commission took the view that there was a separate market for newspapers, in terms of both advertising news and information, and that this market was distinct from other media. The conclusion was also reached that the newspaper markets were localised city-by-city and region-by-region.<sup>97</sup> It followed on this view of the market that the proposed acquisition of CN’s remaining shares would create a dominant firm and make competitive entry for a new metropolitan daily paper difficult.<sup>98</sup> Accordingly, the outcome in this case turned upon an application for authorisation under section 90. Such application involves a balancing exercise. Would the public benefits attributable to the proposal outweigh the competitive detriments?

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<sup>94</sup> Id, 359.

<sup>95</sup> See eg supra n 2.

<sup>96</sup> (1990) ATPR (Com) para 50-101.

<sup>97</sup> Id, 54,266. For critical comment on this aspect of the decision, see Shafron, “Failing Companies, Media Mergers and the Trade Practices Act: Application for Authorisation by West Australian Newspapers Ltd” (1992) 20 ABLR 91, 92.

<sup>98</sup> Id, 54,275. The Trade Practices Act, s 50(1), contained a dominance threshold at the time of this case.

The failing circumstances of the *Daily News* were central to the public benefit arguments.

The merger would, it was argued, result in the continued availability of the *Daily News*, the prevention of unemployment, the continued availability of an advertising source, and greater efficiency of operation.<sup>99</sup>

After noting the elements of the United States defence, the Commission then proceeded to set out the following expanded, but essentially parallel, list of considerations as being relevant to the Australian context under section 90:<sup>100</sup>

- Is the potentially failing firm going to fail irrespective of whether or not authorisation is granted?
- What are the real causes of the failure of the firm (rather than concentrating on the current financial status of the firm)?
- What alternative solutions to a merger are available, for example,
  - can the firm be successfully reorganised;
  - can new management be hired;that is, are there any less anti-competitive solutions internal to this firm?
- Is the proposed acquirer the only available purchaser?
- Have all good faith efforts been made to find other potential acquirers, which might pose a less severe danger to competition?
- Is the proposed acquirer the least anti-competitive acquirer available, in order to prevent assets leaving the industry?
- Will the apparent cause of the failure of the firm be addressed by the new acquirer?

Thus, under the guise of the non-specific public benefit test in section 90, the Commission developed a self-contained set of rules essentially covering preferred competitive outcomes.

Technically, this approach calls into question the potential boundaries of enforcement discretion. The public benefit test contained in section 90 requires a competitive assessment to be made in relation to the proposal in question. This does not necessarily provide a licence to the Commission to fashion preferred market outcomes. It is, nonetheless, noteworthy that the *West Australian Newspaper's* formulation of the defence contains no express reference to private interests, such as the retention of jobs. It also leaves open, at least indirectly, the potential to consider the efficiency implications of assets leaving the market.

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<sup>99</sup> Id, 54,261-63.

<sup>100</sup> Id, 54,266-67.

Surprisingly, the application of this framework to the facts resulted in a more restrictive application of the defence than may be expected in the United States. The approach taken by the Commission in deciding this case is also arguably at variance with its stated framework in several important respects. The Commission declined to authorise WAN's application for two main reasons. First, the facts were coloured to some extent by the presence of a potential alternative purchaser, namely Heytesbury Holdings Ltd. Heytesbury had in fact made an offer which had been rejected as unrealistic, and indicated that it proposed to proceed with a further bid. This had not eventuated by the date of decision. Not surprisingly, WAN argued that Heytesbury was not a serious bidder.<sup>101</sup> Nonetheless, the Commission emphasised that the question was whether Heytesbury's offer would be less anti-competitive and that it was not the Commission's function to determine whether a price was commercially realistic.<sup>102</sup> Further, the Commission emphasised that in many cases the owners of failing firms may have to accept offers falling far short of the price a dominant firm is prepared to pay.<sup>103</sup> Thus, on the basis of these facts and statements of principle, the proposition emerges that any alternative purchaser need not be bona fide and the alternative offer need not be reasonable. This position is extreme and potentially at variance with the United States model upon which it is based.<sup>104</sup>

A second theme, appearing in various parts of the decision, related to Heytesbury's signalled intention to enter the market should the *Daily News* be discontinued. The Commission stated that, from a competition point of view, the burden of new entry would be eased if it declined

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<sup>101</sup> Id, 54,265.

<sup>102</sup> Id.

<sup>103</sup> Id, 54,267.

<sup>104</sup> See supra Pt IVA.

the authorisation application.<sup>105</sup> This assumption then, apparently, provided a basis upon which to neutralise the social costs of job losses. Some 150 full time positions were at issue. However, the *Daily News* was not going to survive in its current form,<sup>106</sup> and the Commission accepted that should the paper survive, whether under the current structure with redundancies, or with a new entrant paper, approximately the same number of jobs would be retained.<sup>107</sup>

These various observations caused the Commission to conclude that it “had serious difficulty in balancing the social costs against the anti-competitive consequences” and that if the anti-competitive effects under the proposal were allowed this “would make competitive entry for a new metropolitan daily paper difficult by virtue of the barriers created.”<sup>108</sup>

The above reasoning is curious, particularly in light of the framework which the Commission itself developed in this case. It is far from clear that private interests, such as the social costs of job losses, can be reliably given much weight in the assessment of public benefits.

Further, given the Commission’s conclusion that approximately the same number of jobs would be retained in the case of new entry, it is in any event difficult to understand the significance of attempting to balance the social costs against the anti-competitive consequences. The more relevant inquiry, which was not directly explored in the reasoning, would have been to consider the consequences this decision would have in relation to the *Daily News* assets, should the company fail.<sup>109</sup>

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<sup>105</sup> Id, 54,269-70.

<sup>106</sup> Id, 54,267.

<sup>107</sup> Id, 54,272.

<sup>108</sup> Id, 54,272-73.

Turning to the New Zealand position, there has only been one reported case since 1986 which has directly considered the failing company defence. In *New Zealand Co-operative Dairy Co Ltd (NZCDC); Waikato Valley Co-operative Dairies Ltd (WVD)* the Commerce Commission expressly adopted the seven point test enunciated in *West Australian Newspapers*.<sup>110</sup>

However, on appeal,<sup>111</sup> the High Court expressed strong reservations about this approach.

This case involved the proposed merger of NZCDC and WVD. Both companies were co-operative dairy companies whose shareholders were the dairy farmer suppliers. The Court noted that the dairy industry accounted for over twenty per cent of New Zealand's export returns and that the monopsony buyer of produce, the New Zealand Dairy Board, exported approximately eighty per cent of NZCDC's and ninety-eight per cent of WVD's production.<sup>112</sup> WVD was in financial difficulty. At the time of the Commerce Commission consideration of the application for clearance or authorisation, the failing company argument was based on WVD's inability to match the payment to its dairy farmer suppliers which NZCDC was able to make. However, following the Commission's decision not to approve the merger, the cancellation of WVD's banking facility was only stayed on an interim basis pending the determination of the appeal. The Court accepted that, by the time of the appeal, WVD "will not survive as an independent dairy company and that its failure as such is imminent."<sup>113</sup>

Before turning to its findings on the facts the Court considered, in some detail, the appropriate approach to be taken in the case of failing company circumstances. The Court

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<sup>109</sup> In fact, the *Daily News* closed the day after the Commission's decision with the result that Perth no longer has an afternoon newspaper. For further criticism of this outcome, see Rose, "Failing Companies and the Revised Merger Guidelines" (1998) 6 CCLJ 1,4.

<sup>110</sup> (1991) 2 NZBLC (Com) para 99-530, 104,618-22.

<sup>111</sup> *New Zealand Co-operative Dairy Co Ltd v Commerce Commission*, supra n 15.

<sup>112</sup> *Id.*, 606-07.

emphasised that there is “neither the need nor the justification for the [failing company] doctrine” because a proper application of the Commerce Act is “perfectly capable of coping, in terms of competition law, with the consequences of the financial or other failure of a participant without the Commission or the Court endeavouring to engraft thereon some special doctrinal rules.”<sup>114</sup> The Court concluded: “Put simply, we think that the question of actual, imminent, or probable failure of a participant in a merger proposal is nothing more than a question of fact to be determined by the tribunal and taken into account in assessing questions of dominance and, if necessary, public benefit.”<sup>115</sup> In reaching this conclusion, the Court also emphasised that there were significant statutory differences between the Commerce Act and section 7 of the Clayton Act. Whereas section 7 imposed an absolute prohibition of mergers where the effect would be substantially to lessen competition or to tend to create a monopoly, there was a significant difference under the New Zealand regime whereby, under the authorisation process, public benefits could be weighed against competitive detriments.<sup>116</sup>

Finally, with reference to the Commission’s adoption of the seven factors from *West Australian Newspapers* as “an analytical framework to assess such claims”, the Court commented that it was a “mistake of principle” to treat these factors as tests to be applied in all circumstances.<sup>117</sup> The Court reiterated that:<sup>118</sup>

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

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<sup>113</sup> Id, 619.

<sup>114</sup> Id, 616.

<sup>115</sup> Id.

<sup>116</sup> Id.

<sup>117</sup> Id, 617.

<sup>118</sup> Id, 617-18.

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.

This approach was reflected in the Court's analysis of this case. As already mentioned, the Court found that WVD's demise was imminent, and so the task was to take this factor into account in the analysis of dominance and public benefit issues.

There were two markets in which there were dominance concerns. The first was the so-called town milk market, being the market for the processing and wholesale delivery of town milk in Auckland, Bay of Plenty, Waikato and other surrounding areas.<sup>119</sup> NZCDC conceded that it was already dominant in this market, and so the question was whether this position of dominance would be likely to be strengthened under the proposal. This matter was somewhat complicated by the state of regulatory flux facing the market, but one issue of competitive significance was the proposed arrangement whereby Woolworths intended to sell WVD's milk in its outlets.<sup>120</sup> An application had been lodged under the Milk Act 1988 for permission to conduct such sales in an area where there was a licensed processor other than WVD. The failing circumstances of WVD had a profound influence on the Court's assessment of this issue. The Court concluded that if WVD was not failing, then it would have upheld the Commission's finding that there was on these facts a more than de minimis strengthening of dominance.<sup>121</sup> The proposal would have removed the potential competitive influence of WVD in the town milk market in question. However, the Court concluded that WVD's imminent failure meant that it was no longer a real constraint. In reaching this conclusion the Court noted that "WVD in the hands of a receiver or liquidator does not seem to us to provide

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<sup>119</sup> Id, 607.

<sup>120</sup> Id, 622-23.

<sup>121</sup> Id, 627.

any realistic opportunity for a ‘Woolworths’ type scheme to be put into effect.”<sup>122</sup> Therefore, it was held that there was no strengthening of dominance in the town milk market. This analysis is potentially open to question. Given that the Court accepted that WVD’s two plants would remain in the market, any subsequent purchaser of them could, presumably, have attempted to enter into arrangements of the kind just described in relation to Woolworths.

A contrasting finding resulted in the case of the raw milk market, being the market for the supply and acquisition of unprocessed milk in the two overlapping milk catchment areas in which NZCDC and WVD took their milk from farmers.<sup>123</sup> NZCDC was not already dominant in this market. Notwithstanding that the Court accepted that the presence of alternative buyers and the co-operative structure of NZCDC may have imposed some constraint on the merged entity,<sup>124</sup> it was held that the merger would result in NZCDC becoming dominant. In reaching this conclusion the Court emphasised that WVD’s two large modern plants would remain as a constraint in themselves. The Court concluded that “those assets in the hands of a receiver, liquidator or one or more of the alternative suppliers presently add a real constraint on the activities of NZCDC.”<sup>125</sup>

However, the Court considered that these dominance concerns only gave rise to limited competitive detriments. Upstream the detriment was likely to be neutralised to a considerable extent by the co-operative structure of the company with the suppliers also being shareholders in the company. Downstream, the purchasers of the ultimate products were, at

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<sup>122</sup> Id.

<sup>123</sup> Id.

<sup>124</sup> Id, 628-30.

<sup>125</sup> Id, 629.

that time, subject to various regulatory provisions.<sup>126</sup> Thus, there needed to be only limited public benefits for this proposal to be authorised.

The Court's analysis of the public benefit claims did not make express reference to WVD's failing circumstances. The Court accepted that, should the merger proceed, WVD farmers would be likely to receive significant additional payouts. It was estimated that, over a period of five years, these payouts were likely to increase 32.5 per cent based on the average dairy farmer's gross income.<sup>127</sup> A related consideration was the suggestion that without the merger very few WVD farms would remain viable.<sup>128</sup> A final public benefit claim, to which some weight was attached, was the potential improvement of export performance following industry rationalisation. The Court concluded that increased payouts in the order of \$162 million over five years would lead to increased production by both the co-operatives and the dairy farmers. Various flow-on effects were seen as likely to result from this increased production. Farmers would be likely to invest in research and development with likely improvements in quality and quantity of product. Further, improved farm, factory and export efficiency was seen as likely to result in benefits which would flow through to rural communities and would ultimately benefit New Zealand consumers, albeit indirectly.<sup>129</sup>

Thus, potential production and innovation efficiencies heavily influenced the Court's finding that the merger should be authorised on public benefit grounds. However, there was no explicit discussion of efficiency considerations framed in terms of the failing company circumstances facing WVD. This was, perhaps, not surprising because WVD's key assets were not about to exit the market.

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<sup>126</sup> Id, 631.

<sup>127</sup> Id, 634.

<sup>128</sup> Id, 636.

<sup>129</sup> Id, 635-36.

*NZCDC; WVD* is an important decision for a number of reasons. It clearly rejects the need to develop specific doctrinal rules of the kind developed under the United States failing company defence. Rather, the High Court advocates a three step approach. First, is there failure, or is failure imminent? If so, then such circumstances are part of the overall assessment of dominance or the strengthening of dominance. Finally, assuming the dominance threshold is established, the failing circumstances of the firm to be acquired may be relevant to the overall assessment of public benefit flowing from the merger proposal.

These tests are framed in general terms, thus leaving considerable room for flexibility. Arguably, the tests are open-ended to the point of being of little, if any, assistance. The circumstances of this case are limited to its facts more than most, and a review of this case alone does not provide an adequate basis upon which to judge the workability, or otherwise, of the broad approach taken. There is, of course, the potential for more specific rules to emerge which are consistent with the general rule. Such developments are, it seems, most likely to occur in the analysis of public benefits where there is an efficiencies justification for the defence.

### *C Enforcement Guidelines*

The New Zealand picture would not be complete without brief reference to the role of enforcement discretion. Enforcement discretion has, in fact, been influential in permitting the merger of failing companies in circumstances where they would otherwise be prohibited on competition grounds. The approaches taken by the Commerce Commission to the reporting of its decisions, coupled with confidentiality considerations, make it difficult to assess the

extent of this influence with any accuracy.<sup>130</sup> Nonetheless, the failing circumstances of target companies have been and presumably will continue to be taken into account.<sup>131</sup> The Commission's most recent policy statements are contained in three sources, namely the Business Acquisitions Guidelines,<sup>132</sup> the Public Benefit and Detriments Guidelines<sup>133</sup> and the joint Australian Trade Practices Commission/New Zealand Commerce Commission paper on the failing company argument.<sup>134</sup>

The Commission sets out its basic policy on failing companies in paragraph 7.1 of the Business Acquisitions Guidelines as follows:

The Commission accepts that where a company is failing and that, as a result, it is likely that supply from that company will cease to come to market and the productive resources of the company will cease to be employed in that market, the acquisition of the failing company by another market participant will not create or strengthen a dominant position in that market, and therefore, a contravention of s 47 will not occur.

Taken in isolation, this proposition is contentious. However, paragraph 7.1 also advises that the Commission's approach to assessing this matter is further set out in the Joint Discussion Paper.<sup>135</sup> In some respects the Commission's adoption of the Joint Discussion Paper is

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<sup>130</sup> The practice of the Commerce Commission to issue reported decisions of all applications for clearance or authorisation of business acquisitions only commenced in January 1997. However, in a voluntary pre-merger notification regime even this information is potentially incomplete, because there may be non-notified proposals which may have been challenged but for failing company circumstances.

<sup>131</sup> In one early merger decision, the Commission noted that there was a general policy of approving mergers where rescue operations were involved. See *L D Nathan Co Ltd; McKenzies (NZ) Ltd* (1979) 2 NZAR 321, 375.

<sup>132</sup> *Supra* n 16.

<sup>133</sup> *Supra* n 21.

<sup>134</sup> Joint Australian Trade Practices Commission/New Zealand Commerce Commission Discussion Paper: Acquisition and the Failing Company Argument (October 1993) ("Joint Discussion Paper"), reprinted in *CCH Australian Trade Practices Reporter*, vol 1, *supra* n 81, para 8-452.

<sup>135</sup> At para 7 of the Joint Discussion Paper, there is a restatement of what is considered to be the failing company test:

"The relevant test is *not* whether the company is likely to fail. 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 are unlikely to have dominance or competition concerns under the Acts."

The factors to be considered in applying this test are set out in para 9. This begins by restating the list of considerations from *West Australian Newspapers*: see text *supra* accompanying n 100. This test is said to be non-exhaustive. Further factors are raised, some of which are said to be taken from the United States defence.

surprising given that it comes two years after the High Court's decision in *NZCDC;WVD*.

The paper sets out detailed criteria, including the seven factors from *West Australian Newspapers*. Such guidelines are clearly at variance with the general principles enunciated by the High Court in *NZCDC;WVD* and ignore the High Court's objections in that case to the approach taken in *West Australian Newspapers*. If there are dominance concerns, the Commission's guidelines leave open the possibility of authorisation. The Commission's Public Benefit and Detriments Guidelines state that: "Sometimes, however, associated with the failing company argument there may be related public benefits (eg greater utilisation of spare capacity, employment retention if unemployment would otherwise result, the reduction of social costs from reduced unemployment, the saving of relocation costs, etc)".<sup>136</sup> This statement is problematic to the extent that it suggests that significant weight may attach to private interests. However, the recognition that there may be greater utilisation of resources clearly addresses the potential efficiencies justification for the defence.

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These factors include inquiries into the target's insolvency, the unlikelihood that it will trade out of its difficulties and alternatives to outright sale.

<sup>136</sup> *Supra* n 16, 1 App-86. The equivalent Australian guidelines are set out in the Australian Competition & Consumer Commission, Merger Guidelines (July 1996), paras 5.134-36. For further analysis of the failing company sections of these guidelines, see Rose, *supra* n 109.

## VI CONCLUDING REMARKS

The failing company defence has grown out of the realisation that special considerations arise in the case of the acquisition of failing firms. The initial development of the defence in the United States was unsatisfactory, given its preoccupation with private non-economic interests. While it is now accepted that a more satisfactory economic explanation for the defence is required, the economic justification for the defence remains unsettled. The task is, admittedly, difficult as the defence involves a complex range of issues. Theoretically, however, the case for the defence is strongest where it can be demonstrated that the output of the merged firm will exceed that of the surviving firm alone, with the result that the deadweight loss will be less than if the failing firm's assets exit the market.

The defence has received a mixed reaction in New Zealand. Early on there was the questionable assumption that the defence would be available, so long as the target company was truly failing. There then followed the formulation of the defence in Australia, in *West Australian Newspapers*, in a manner largely consistent with the elements of the United States defence.

A prevailing theme of the *West Australian Newspaper's* decision was whether there was a preferable purchaser from a competition point of view. The most recent New Zealand judicial response has been to question the substance of this approach. But in so doing, the High Court in *NZCDC; WVD* has done no more than to outline in broad terms the essential inquiries under the Commerce Act. While there may be some justification in the Court's criticism of the approach taken in *West Australian Newspapers*, absent a legislative mandate

which permits consideration of preferred outcomes, the blandness of the principles enunciated in *NZCDC; WVD* is not particularly helpful. The resulting uncertainty is undesirable for a number of reasons. There are problems in predicting the likely outcome in any given case, and this may raise compliance costs. Further, more clearly defined principles may well be conducive to new entry. Potential new entrants may take some comfort from the possibility that their assets may be acquired by incumbent firms, should their attempts at new entry prove to be unsuccessful.

These concluding remarks therefore identify two key issues relating to the future development of the defence which are of most immediate significance in the New Zealand setting. The first relates to the preferred purchaser test. The enforcement agencies in Australia and Canada have arguably pushed legislative boundaries in giving expression to this test. In New Zealand, however, such freedom does not exist given the decision of the High Court in *NZCDC; WVD*. If the preferred purchaser test is seen to be appropriate in New Zealand, then it requires judicial redirection, or preferably, legislative clarification.

The second key issue relates to the development and application of efficiencies principles tailored to fit the failing company situation. The potential for such economic efficiencies principles to apply is clearly already open under the existing public benefit test.

Notwithstanding the evolving nature of the economics literature on the subject, public benefits under the authorisation test 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. The future recognition of such a framework will do much to place the defence in its proper context in New Zealand.

