

# MERGERS AND ACQUISITIONS: SUPPLEMENTARY GUIDELINES ON FAILING FIRMS

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## 1 INTRODUCTION

- 1.01 The Commerce Commission (Commission) sometimes receives applications for clearance that claim an otherwise anti-competitive merger or acquisition should be cleared by the Commission because one or more of the parties is failing, or has a failing division, and its assets will otherwise leave the market. This is commonly called the 'failing firm argument'. The Commission has found that the circumstances of claims that a firm is failing vary and so assesses each case on its facts.
- 1.02 If there is sufficient compelling evidence to support the failing firm argument, the Commission can grant clearance for the merger or acquisition to proceed. Claims of imminent failure will not be accepted at face value and without close scrutiny. It is also important that the parties provide the necessary information in a timely manner, to allow the Commission to investigate and reach a decision, particularly if an urgent decision is sought.
- 1.03 These guidelines outline:
- the types of information that should be included to assist the Commission to assess the merits of a claim that a firm will fail in the absence of the acquisition; and
  - the Commission's methodology for assessing such claims.
- The guidelines also set out the additional factors the Commission may consider when a claim is made that a division of a firm, rather than the firm itself, is failing.
- 1.04 The guidelines do not introduce any new principles or in any way alter the test that the Commission must apply when assessing whether or not a merger or acquisition will result in a substantial lessening of competition. The guidelines are not intended to be a binding statement on the process by which the Commission will reach a decision in any particular situation. They are also not a substitute for legal advice or a restatement or definitive interpretation of law.
- 1.05 These guidelines are supplementary to, and should be read in conjunction with, the Commission's Mergers and Acquisitions Guidelines.

## 2 MERGER AND ACQUISITION APPLICATIONS

- 2.01 Section 47 of the Commerce Act 1986 (the Act) prohibits the acquisition of a business or shares if it would, or would be likely to, substantially lessen competition. Section 66 of the Act allows the Commission to clear a business acquisition if the Commission is satisfied that the acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market. If the Commission cannot be so satisfied, it must decline the application.
- 2.02 In assessing whether an acquisition would give rise to a substantial lessening of competition, the Commission employs a hypothetical comparison of the future likely state of competition if the acquisition were to proceed (the factual), against the likely state of competition if it were not (the counterfactual). To do this, the Commission makes a comparison of the situations 'with or without' the merger, not 'before and after' it. The comparison reveals the extent to which competition may be lessened by the proposed acquisition.<sup>1</sup>

1. For further information on the broad analytical approach used by the Commerce Commission in applying the substantial lessening of competition test for mergers and acquisitions set out in section 47 of the Commerce Act 1986, see the Commission's *Mergers and Acquisitions Guidelines* of January 2004.

- 2.03 In a failing firm situation, the argument is that the factual and the counterfactual will be the same which means that there would be no substantial lessening of competition. However, there may be more than one counterfactual. Where there is more than one counterfactual, applicants need to be aware that it is not a case of choosing the counterfactual that the Commission considers to be the most likely.<sup>2</sup> Rather, all likely counterfactuals must be subject to a competition analysis to assess the ‘substantiality’ of any lessening of competition. Each real and substantial possibility becomes a counterfactual against which the factual is to be assessed.
- 2.04 If, in the factual, as compared with any of the relevant counterfactuals, the merger would be likely to result in a substantial lessening of competition, then the acquisition has a ‘likely’ effect of substantially lessening competition in a market. The Commission’s approach to the interpretation of ‘likely’ is detailed in the Mergers and Acquisitions Guidelines at paragraph 2.4.

### 3 THE COMMISSION’S APPROACH TO ASSESSING FAILING FIRM ARGUMENTS

- 3.01 There is no legal test for a ‘failing firm’ in New Zealand and the term is not used in the Act.
- 3.02 The Commission’s Mergers and Acquisitions Guidelines refer to two scenarios in which the Commission will assess a failing firm counterfactual:

“The first is where, but for the anticompetitive acquisition, the business’s assets would exit the market. The assets may become scrap or may be put to an alternative use. This option may involve only one potential purchaser.

The second scenario is where there are a number of bidders for the failing firm, which must be sold. In this case, the Commission adopts a counterfactual that assumes an acquisition by a party that would not give rise to a substantial lessening of competition.”<sup>3</sup>

- 3.03 When assessing failing firm submissions, the Commission may take into account a number of factors in assessing whether, on the evidence, failure appears to be actual, imminent, or probable.<sup>4</sup> These factors include the following:

#### **Is the firm failing?**

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

#### **Is there an alternative third party purchaser?**

- On closure, will the firm’s assets exit the market (either by becoming scrap or being put to an alternative use)?
- If not, is there any prospect of a third party acquiring the assets of the failing firm and using them to compete in the relevant markets, where this would not lead to a substantial lessening of competition?
- Have reasonable efforts been made by the failing firm to find a third party purchaser?
- Is there any prospect of a credible third party acquiring the target firm as a going concern, within the time period considered in the analysis, where this would not lead to a substantial lessening of competition? The Commission may choose to contact potential purchasers to assess the nature of their interest.

2. *Woolworths Limited & Ors v Commerce Commission* HC WN CIV 2007-485-1255 [29 November 2007], 118.

3. Commerce Commission *Mergers and Acquisitions Guidelines* January 2004, para. 4.2.

4. *New Zealand Co-operative Dairy Co Ltd* [1991] 4 TCLR 134.

- 3.04 Sometimes a claim is made that a division of a firm is failing. Such cases require particular care because of the ability of the parent firm to allocate some costs, revenues and intra-company transactions between its subsidiaries, branches and divisions.
- 3.05 Where it is asserted that a firm is failing the Commission will examine the claim closely. The Commission takes a rigorous approach to the types of evidence it expects to see in support of a failing firm argument. Situations where firms face declining sales or profits, or where the earnings rate is significantly below the shareholders' expectations, would, in isolation, be unlikely to satisfy the Commission that the firm is truly failing.
- 3.06 Ultimately, whether or not the Commission is satisfied that a party will exit the market under a failing firm analysis does not depend on any particular threshold or type of information. Rather, each case is assessed on the facts. In making its assessment the Commission will consider the likely counterfactual situations. In terms of section 66 of the Commerce Act, the Commission's concern is to establish whether it is satisfied that the proposed acquisition "will not have, or would not be likely to have, the effect of substantially lessening competition in a market".

## 4 SUPPORTING EVIDENCE

- 4.01 The Commission recognises that, if a firm is genuinely failing, the need for a decision on the clearance application may be urgent. As with all applications for clearance, the Commission will do all it can to make its decision in a timely manner. The time required is largely determined by the parties' ability and willingness to provide the necessary information on a timely basis.
- 4.02 The Commission cannot clear an application unless it is satisfied that the acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market. The Commission would be assisted in making this assessment quickly if relevant, complete and robust information is provided when a failing firm argument is made.
- 4.03 The types of supporting evidence that the Commission may find helpful include:
- management accounts;
  - budgets and forecasts for the current year and future years;
  - analysis of margins and profitability over a number of years;
  - volume/demand data (trend analysis);
  - board minutes and papers concerning viability;
  - internal strategic plans;
  - capital expenditure proposal documents;
  - documents regarding initiatives or plans to restructure or improve the business (or to reduce costs);
  - evidence of bona fide efforts to sell either the business as a going concern or its assets on closure;
  - any offers for the business;
  - asset valuation reports;
  - independent appraisals of the business;
  - detailed costs of exit or closure;
  - liquidation, or the placement of the business into administration; and
  - audited financial accounts, if available.

This is not an exhaustive list and not all of these categories will necessarily be applicable in every case. Some evidence may only be available from the target firm. The Commission recognises that in some cases events will have evolved rapidly and that the parties might not have had the opportunity to prepare particular documents. Nevertheless, the Commission will need to examine the factual situation. Where necessary information is not provided, the Commission may need longer for its analysis.

- 4.04 Where claims that a division is failing are submitted, the Commission would find additional information useful. The types of additional supporting evidence may include details and analysis of:
- intra-corporate cost allocations, transfer pricing within the group and details of the principles underlying the approaches used;
  - the contribution of the failing division to group overhead costs; and
  - management fees charged to the failing division.
- 4.05 When a clearance application that will include a failing firm claim is contemplated, the Commission encourages parties to contact it as soon as possible so that Commission staff can assist with identifying the types of evidence required. For further information on the clearance process, see the Commission's Mergers and Acquisitions Clearance Process Guidelines which are available on the Commission's website [www.comcom.govt.nz](http://www.comcom.govt.nz)

## 5 DECISION TIMELINES

- 5.01 As a general observation, when the Commission is requested to make an urgent decision on the grounds of imminent failure of a firm, it expects the appropriate parties to provide it with complete and convincing evidence and analysis to support the propositions that are being argued, and to do so in a timely manner. If all the relevant information is not provided in a timely manner, the time the Commission requires to investigate the application is likely to be extended.
- 5.02 For further information on the clearance process timeline, see the Commission's Mergers and Acquisitions Clearance Process Guidelines.

## 6 FURTHER READING

- 6.01 The Commission has made determinations on a number of clearance applications where elements of a failing firm argument were relevant. Those made in recent years include:
- Decision 638: *DFS Group Limited/The Nuance Group*
  - Decision 650: *Southern Cross Health Trust/Aorangi Hospital*
  - Decision 655: *Shell New Zealand Limited/Mobil Oil New Zealand Limited*
  - Decision 663: *Fletcher Building Limited/Stevenson Group Limited*

These decisions can be viewed on the Commission's website [www.comcom.govt.nz](http://www.comcom.govt.nz) under Public Registers.