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Merger control during the GFC, systemic risk issues and failing banks

While the global financial crisis has resulted in more compressed timetables for merger reviews in order to minimise financial systemic risk, regulators have been reluctant to accept failing firm arguments. And, now that the global maelstrom appears to be receding, competition regulators are again tightening their assessments.

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THE GLOBAL FINANCIAL CRISIS (GFC) has had a significant effect on markets across the world, leading to corporate failures and market consolidation. An emerging question is whether it is possible to obtain merger control clearance for transactions raising significant competition concerns on the basis that, absent the merger, the target would otherwise fail and exit the market, thereby leading to a diminution in competition.

Nevertheless, while 'failing firm' arguments have become more common, particularly in the financial sector, competition regulators have required that merger control processes must still be satisfied. Also, in most cases, regulators have tended to find that the target is 'flailing' rather than 'failing'.

This article examines the development and application of failing firm 'defences' in the context of the general media commentary that has occurred. It also compares the application of merger control rules to bank mergers involving failing firms in three leading jurisdictions.

The approach of the Australian Competition and Consumer Commission (ACCC) and other leading regulators to failing firm mergers has been to follow existing practice in the vast majority of cases. However, recent experience in relation to bank mergers indicates that while regulators have sought to administer merger control law in an objective and independent manner, in some jurisdictions there has also been a level of pragmatism required in the face of political and economic realities.

Merger control regimes

More jurisdictions have merger control regimes

The Organisation for Economic Co-operation (OECD) has noted that there are over 80 countries with some form of competition law in place, with those numbers growing rapidly.[2] Apart from established jurisdictions such as the United States, European Union, Japan and Canada, there are an increasing number of developing states with active merger control regimes. For example, a large majority of Latin American countries have mandatory pre-completion notification requirements (including smaller jurisdictions such as Nicaragua and El Salvador), as well as former Soviet or communist states, such as Ukraine and Serbia.

Most significantly, China introduced its Anti-Monopoly Law (AML) in August 2008. The AML is modelled on European Union law and requires that pre-completion merger approval is obtained when the parties meet certain turnover thresholds.[3]

India has a legislative and administrative framework in place and expects to introduce mandatory formal merger control rules during the course of 2010.

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The increase in global merger control regimes means that full analysis of all mergers is required to ensure compliance and to minimise the risk of corporations incurring financial penalties for breaching mandatory filing rules.[4]

Australia's merger control regime

Section 50 of the *Trade Practices Act 1974 (Cth)* (TPA) prohibits acquisitions of shares or assets that would have the effect, or be likely to have the effect, of substantially lessening competition in a market. Australia, however, does not have a mandatory pre-merger control regime, which means merging parties could complete deals either prior to, or without, notifying the ACCC, thereby accepting the regulatory risk should they choose to do so. Alternatively, parties may obtain pre-completion clearance.

When examining mergers under section 50 of the TPA, the ACCC will conduct an investigation in a manner consistent with its 2008 Merger Guidelines (Merger Guidelines)[5] and Merger Review Process Guidelines (Merger Process Guidelines).[6]

In relation to informal merger reviews,[7] the ACCC aims to conduct its analysis within six to eight weeks of notification, during which time third-party submissions and further information from the parties will be sought. The ACCC will examine the impact on competition of the merger by focusing on factors such as competitive constraints, barriers to entry, countervailing power and any vertical or coordinated effects.

Where a merger raises issues as to its compatibility with section 50 of the TPA, the parties may be able to offer undertakings to address the competition concern. If the ACCC considers that a transaction will substantially lessen competition, it may seek an injunction or court order to prevent the merger from completing or, in the case of a completed merger, to order divestiture of the acquired assets or entity. The ACCC merger review process is generally well understood by businesses and consistent with international best practice.

Although the GFC has created unprecedented regulatory challenges across the globe, mergers involving failing firms, including the rescue of financial institutions, will also be subject to a full merger review by the ACCC.

Development of the failing firm defence in the United States

The failing firm defence was first recognised by the United States Supreme Court in *International Shoe Co. v FTC*.[8] In that case, despite a significant competitive overlap resulting from the acquisition, the Supreme Court held that the target was facing 'financial ruin' and that, accordingly, the least anti-competitive result would be to allow the target to be acquired, rather than to exit the market altogether.

The failing firm defence has been refined in case law. Joint merger guidelines now require that, for an acquirer to establish a failing firm defence in the United States, it must demonstrate that:

- the allegedly failing firm would be unable to meet its financial obligations in the near future;
- it would not be able to reorganise successfully under the Bankruptcy Code;[9]
- it has made unsuccessful good-faith efforts to elicit reasonable alternative offers of acquisition 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
- absent the acquisition, the assets of the failing firm would exit the relevant market.[10]

Australian position on acquisitions involving failing firms

There is no failing firm *defence* in Australian law. Neither section 50 of the TPA, nor the ACCC's Merger Guidelines recognises a failing firm defence that might permit a merger that would otherwise result in a substantial lessening of competition. However, where a firm is failing (i.e. it is in imminent danger of failure, with the consequence that its assets would exit the market), the failing firm argument may be taken into account when conducting a merger review. In particular, it may form an essential element of the counterfactual analysis in which the ACCC determines the likely nature of competition in the market absent the merger.

Current failing firm guidance and recent decisions

The ACCC will consider a failing firm scenario where 'the state of competition prevailing at the time of a merger will overstate the future state of competition without the merger in situations where one of the merger parties is likely to exit the market in the foreseeable future'.[11]

The ACCC's position on failing firms has been most recently highlighted in relation to the proposed acquisition of Hans Continental Smallgoods Pty Limited (Hans) by P&M Quality Smallgoods Pty Limited (Primo).[12] Both Primo and Hans produce various luncheon meats and small goods, and the acquisition gave rise to substantial horizontal overlaps between the parties in the national market for small goods.

The ACCC examined the proposed acquisition in a manner consistent with section 50 of the TPA and its Merger Guidelines. Part of that process involved the ACCC considering the impact on competition in the relevant market both with and without the merger (i.e. the relevant counterfactual).

With regard to the counterfactual analysis, the ACCC considered whether:

- Hans was in imminent danger of failure and whether it could be restructured successfully absent the merger;
- the assets of Hans would be likely to exit the market absent the merger, thereby resulting in a diminution of competition; and
- the assets would be likely to be purchased by another competitor or independent purchaser.

The ACCC concluded (following extensive examination of the firm's finances) that Hans would fail and exit the market immediately absent the merger. With regard to alternative purchasers, the ACCC concluded that, though there was limited interest from other prospective bidders, it was likely that Hans would be broken up and its assets sold separately absent the merger.

In assessing the proposed acquisition, the ACCC identified significant competition concerns that would ordinarily be expected to result in a substantial lessening of competition by 'lessening … the competitive tension in the market and reduc[ing] the ability of customers to switch between suppliers'.[13]

Despite the significant anti-competitive effects identified, the ACCC concluded that, given the imminent failure and market exit of Hans and the absence of alternative purchasers, Primo's acquisition would not 'result in a substantially less anticompetitive outcome' than permitting Hans to fail (i.e. the relevant counterfactual).

The Primo case was the first for seven years in which the ACCC expressly accepted the failing firm argument. Accordingly, the circumstances in which a failing firm argument will drive the competition assessment of a merger are quite limited. In particular, the ACCC stated that it would assess any failing firm argument rigorously and 'require clear information to show both that the target is likely to fail without the acquisition, and that this is not a better outcome for competition than an acquisition by a competitor'.[14]

The approach adopted in Primo/Hans has been reiterated by the ACCC, with confirmation that failing firm arguments are not a separate defence, are assessed as part of the counterfactual, and that the Merger Guidelines requirements (as applied in Primo/Hans) will continue to apply, even in the current economic environment.[15] As such, speculation or evidence of a recent decline in profitability is insufficient to demonstrate failure. Detailed information on a firm's medium to long-term financial situation is required; there must be an imminent danger of failure, not simply a temporary failure of profitability or success.

Accordingly, firms that have healthy long-term prospects, but due to market or other circumstances have become less competitive, are likely to constitute 'flailing' rather than 'failing' firms and are therefore unlikely to benefit from the failing firm argument.

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In any event, the statutory test under section 50 of the TPA that the ACCC must apply is unaffected by the nature of the target and, in particular, whether it is 'failing' or 'flailing'. Consequently, the ACCC must assess under section 50 of the TPA whether the acquisition would, or would be likely to, result in a substantial lessening of competition in a market in Australia.

Application in recent bank acquisitions

The ACCC addressed the topic of 'failing' versus 'flailing' firms to a degree in its assessment of the acquisition of BankWest and St Andrew's Bank by Commonwealth Bank of Australia (CBA).[16] Prior to its acquisition, BankWest was a wholly owned subsidiary of HBOS plc (HBOS), a major United Kingdom bank. In assessing the proposed acquisition, the ACCC indicated that BankWest was unlikely to be a strong competitor absent the acquisition because of the impact of the GFC on HBOS.

In particular, the ACCC accepted that BankWest's historically aggressive price competition had been underpinned by cheap wholesale funds from global debt markets accessed through HBOS. As a result of the global economic crisis, the ACCC found that the financial condition of HBOS had deteriorated, such that, if the acquisition did not proceed, BankWest would not be supported in its continued growth, nor would its aggressive pricing strategies continue. The ACCC indicated, therefore, that, absent the merger, there was likely to have been a material change in BankWest's business model. There may also have been a risk that BankWest would have to scale back its operations, detrimentally impacting consumer choice.

Consequently, although the failing firm argument was not central to the CBA/BankWest merger, the ACCC assessed the future state of competition in the market absent the merger and found that BankWest would not be 'in a position to provide strong and sustainable competition going forward',[17] due to its parent's financial difficulties.

Comparison with international treatment of failing firms

United Kingdom

In light of the GFC, the United Kingdom Office of Fair Trading (OFT) has issued updated guidance for acquisitions of failing firms[18](OFT Guidelines).

The OFT Guidelines clarify ('restate') the position of both the OFT and Competition Commission (CC) as articulated in their existing merger guidelines. In particular, the OFT Guidelines make clear that, even in light of the changing economic and market conditions, the restatement does not constitute a departure from the OFT's basic approach. However, where relevant, 'meritorious failing firm cases should be allowed to proceed relatively swiftly through clearance by the OFT'.[19]

As in Australia, the OFT will assess failing firm arguments as part of the counterfactual analysis to determine, on the basis of 'compelling evidence', whether:

- the target will inevitably exit the market absent the merger; and
- there is no realistic and substantially less anti-competitive alternative, such as acquisition by an alternative purchaser, or simply permitting the target to fail.

Do banks count?

While the principles applicable to failing firm mergers in the United Kingdom are clear, their practical application in the banking sector has been unique, primarily because of systemic risks and the need for economic certainty.[20] Of particular relevance is the acquisition of HBOS by Lloyds TSB plc (Lloyds). HBOS faced imminent collapse in September 2008 as a result of its exposure to bad debts and inability to obtain short-term funding on the global markets. In order to preserve order in the United Kingdom banking sector, the Government facilitated the acquisition of HBOS by Lloyds, with the Crown acquiring an interest of approximately 40% in the merged entity.

Following the rapid deterioration of the financial sector, the United Kingdom Government legislated to enable the Secretary of State for Business to take the final decision on whether to clear the merger. Although the OFT reviewed the merger pursuant to the normal substantial lessening of competition test, and made recommendations to the Secretary of State, the competition authorities were not provided with the opportunity to apply the law and reach an independent decision pursuant to United Kingdom merger control rules.

The OFT concluded in its report to the Secretary of State that the acquisition may lead to a substantial lessening of competition. Ordinarily, therefore, the transaction would have been referred to the CC, where it would likely have been blocked or cleared subject to undertakings. However, despite the OFT's conclusion, the Secretary of State for Business cleared the transaction on the basis that 'on balance the public interest is best served by allowing this merger to proceed without a reference to the Competition Commission'.[21]

The extraordinary Government approach to the Lloyds/HBOS mergers has arguably set a precedent which may give rise to perceptions both of compromised independence on the part of the United Kingdom competition authorities, and the creation of a bespoke regulatory regime for bank mergers.[22]

United States

The United States allows both 'failing' firm and 'flailing' firm defences in appropriate circumstances. Though the United States position in relation to bank mergers has not been 'stress-tested' as with Lloyds/HBOS, the United States' treatment of bank mergers may also be different in practice to mergers involving failing firms in other sectors of the economy. In particular, the United States Treasury noted that bank mergers may be unlikely to be prohibited because 'when a failing bank is acquired by a healthy bank, the community of the failing bank is better off than if the bank had been allowed to fail'.[23]

Is Australia different?

The apparent inclination in the United Kingdom and United States to suspend or question the application of competition rules to bank mergers in the current economic climate is more overt given the structural financial services issues in those jurisdictions. By contrast, Australia's financial sector appears, to date, to be more robust, arguably limiting the likelihood of a similar approach in Australia.

ACCC Chairman Graeme Samuel has stated, however, that the ACCC 'would be looking at further mergers very, very closely … We would not accept at first or second blush the proposition that to not allow this merger would lead to instability in the market'.[24] In other words, in any failing firm context, one should expect a vigorous ACCC merger analysis and heavy reliance on the views of the Australian Prudential Regulation Authority and the Reserve Bank of Australia.

The ACCC's disinclination to clear bank mergers that may raise material competition issues, in order to underpin market instability, is likely to be supported in other jurisdictions, including the United Kingdom. However, given the global scale of the financial crisis and the example set in comparable jurisdictions, the question remains whether political realities would require further bank mergers to proceed irrespective of competition concerns, should Australia's situation worsen.

Moreover, new legislation applicable to certain disposals of distressed bank assets in Australia will apply in exceptional circumstances and will enable transactions to be cleared without requiring normal merger review.[25] However, the practical effect may be that the ACCC can continue to apply the objective competition test to all bank mergers that it reviews, without having to have such a degree of regard to external factors such as overall financial system stability.

Conclusion

The application of merger control across the world makes regulatory compliance essential. Given the current economic climate, there is greater potential for the failing firm argument to be invoked in the context of merger reviews.

The circumstances in which a merger takes place, however, will not affect the parties' obligation to obtain merger clearance. The evolution of the failing firm defence has been reductive, such that the circumstances in which a merger may be cleared on the basis of a failing firm argument are exceptional, irrespective of the sector affected.

In Australia, the ACCC will undertake a rigorous analysis of the evidence to determine whether the failing firm argument may be allowed. Consequently, merging parties will need to provide comprehensive evidence that the target will imminently exit the market, that no alternative purchaser (that would have led to a substantially less anti-competitive outcome) or successful restructuring would occur, and that permitting the acquisition would not be substantially less competitive than allowing the target to fail.

Notes

1 The views expressed in this paper are those of the authors and are not to be attributed to Mallesons Stephen Jaques or its clients.
2 Organisation for Economic Cooperation and Development 2005, *Merger control laws and procedures in Latin America and the Caribbean*, March, available online at: www.oecd.org/dataoecd/41/57/38835612.pdf.
3 The AML provides for mandatory pre-completion notification of mergers where (i) the combined worldwide turnover in the preceding fiscal year of all parties to the concentration exceeds RMB 10 billion, and each of at least two parties to the concentration has turnover in China exceeding RMB 400 million; or (ii) the combined turnover in China in the preceding fiscal year of all parties to the concentration exceeds RMB 2 billion, and each of at least two parties to the concentration has turnover in China exceeding RMB 400 million.
4 For example, if a qualifying merger is completed without notifying the authorities in the European Union, fines of up to 10% of the aggregate turnover of the merging parties may be imposed. Similarly, regulators in the United States, China and elsewhere around the world have power to fine parties for failing to comply with filing obligations in merger control laws.
5 *Merger Guidelines 2008*, 21 November, available online at: www.accc.gov.au/content/index.phtml/itemId/809866.
6 *Merger Review Process Guidelines 2006*, 1 July, available online at: www.accc.gov.au/content/index.phtml/itemId/740765.
7 Since January 2007, merging parties have had an option of making a formal merger notification to the ACCC prior to clearance. However, no formal notifications have been made to date, with informal notifications – which provide greater flexibility of timing and approach, and permit post-completion merger reviews to be undertaken – remaining the most popular route. A principal attraction of the informal process is the ability of parties to seek confidential clearance prior to the merger becoming public. While such a clearance will be subject to market inquiries once the deal is announced, confidential reviews permit the parties to engage with the ACCC early and identify the key competition issues raised by a merger.
8 280 U.S. 291, 302–02 (1930).
9 Title 11 of the United States Code.
10 Joint Federal Trade Commission and United States Department of Justice 1992, *Horizontal Merger Guidelines*, available online at: www.ftc.gov/bc/docs/horizmer.shtm. Recently issued joint horizontal merger guidelines maintain the approach by the United State Federal Trade Commission and Department of Justice to failing firm mergers (*Horizontal Merger Guidelines for Public Comment*, released on 20 April 2010).
11 *Merger Guidelines*, paragraph 3.22.
12 *Public Competition Assessment*, 13 March 2009, available online at: www.accc.gov.au/content/index.phtml/itemId/861342/fromItemId/751046.
13 *Public Competition Assessment*, paragraph 57.
14 ACCC media release: ACCC not to oppose proposed acquisition of Hans Continental Smallgoods by Primo, available online at: www.accc.gov.au/content/index.phtml/itemId/861349.
15 For example, paper delivered by Commissioner Sarah Court at the Inaugural Competition and Trade Practices Summit, Sydney, 11–13 March 2009.
16 Proposed acquisition of Bank of Western Australia Limited and St Andrew's Australia Pty Limited by Commonwealth Bank of Australia, *Public Competition Assessment*, 10 December 2008, available online at: www.accc.gov.au/content/index.phtml/itemId/852882/fromItemId/751043.
17 Proposed acquisition of Bank of Western Australia Limited and St Andrew's Australia Pty Limited by Commonwealth Bank of Australia, *Public Competition Assessment*, 10 December 2008, available online at: http://www.accc.gov.au/content/index.phtml/itemId/852882/fromItemId/751043, paragraph 60.
18 *OFT Guidelines 2008*, *Restatement of OFT's position regarding acquisitions of 'failing firms'*, December, available online at: www.oft.gov.uk/news/press/2008/146-08.
19 *OFT Guidelines*, paragraph 4.
20 The importance of a healthy financial sector as the foundation for more general economic recovery has been recognised by the International Monetary Fund through analysis of previous recessions and recoveries. It has concluded that 'coherent and comprehensive action to restore financial institutions' balance sheets, and to remove uncertainty about funding, is required before a recovery will be feasible'. International Monetary Fund World Economic and Financial Survey 2009, *World economic outlook, crisis and recovery*, April, available online at: www.imf.org/external/pubs/ft/weo/2009/01/index.htm.
21 Department of Business Enterprise and Regulatory Reform 2009, press release, 31 October: *'Peter Mandelson gives regulatory clearance to Lloyds TSB merger with HBOS'*, available online at: http://nds.coi.gov.uk/environment/fullDetail.asp?ReleaseID=382908&NewsAreaID=2&NavigatedFromDepartment=True.
22 The OFT in its *Financial services strategy consultation*, 7 April 2009, has indicated that 'in the short term … stabilisation of the financial system [has] to take priority'. However, the OFT acknowledges that 'the emerging market structures post crisis will need to be assessed to ensure they are pro-competitive and deliver the best outcomes for consumers'. Paper available online at: www.oft.gov.uk/news/press/2009/40-09.
23 Quoted in OECD 2009, *Competition policy, industrial policy and national champions*, publication DAF/COMP/GF/WD (2009)24, 12 February, available online at: www.oecd.org/dataoecd/6/42/42170012.pdf.
24 *The Australian Financial Review* 2009, 14 April.
25 *The Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act* 2008 (Cth).