DEALING WITH DYNAMIC COUNTERFACTUALS

Paul Anderson, Andre Frauenknecht and Fatima Fiandeiro[1]

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I. INTRODUCTION

The purpose of South African merger control is to prevent transactions that would significantly reduce competition. At its conceptual core, ascertaining the competitive effects of a merger requires a comparison of the state of competition with the merger, to that which would exist without the merger. Therefore, the merger counterfactual – that is the hypothetical future scenario in which the merger would not take place – is central to this enquiry.

Merger analysis, by its nature, is forward looking and its underlying analytical framework is characterised by a strong predictive element. It is obvious that identifying the state of competition post-merger is a predictive exercise. However, what may be less obvious is that identifying the state of competition in the counterfactual (which is used as the baseline for evaluating competition effects) can be an equally predictive exercise. Normally the counterfactual is taken as the status quo observed in the market, but in instances where the current market conditions are highly likely to change (regardless of the merger), then using the status quo becomes less appropriate and less relevant. The EU Merger Guidelines express this principle in the following terms:

> *"In assessing the competitive effects of a merger, the Commission compares the competitive conditions that would result from the notified merger with the conditions that would have prevailed without the merger. In most cases the competitive conditions existing at the time of the merger constitute the relevant comparison for evaluating the effects of a merger. However, in some circumstances, the Commission may take into account future changes to the market that can reasonably be predicted. It may, in particular, take account of the likely entry or exit of firms if the merger did not take place when considering what constitutes the relevant comparison."*[2] [3]

Therefore, in cases where there is strong evidence that the state of competition is very likely to change going forward it may be appropriate to consider a modified counterfactual against which the effect of the merger should be determined. However, in doing so, one should have sufficient and compelling evidence to indicate with a high degree of certainty what the likely counterfactual situation would be if the status quo is not applied.

Some of the common situations where a counterfactual different to the status quo is encountered are those of: a so-called failing firm; potential entry by either one of the merging parties or external players; and the possibility of alternative transactions. Where we have the possibility of a dynamic counterfactual

[1] *We thank Danita Da Costa for her research contributions. The authors of this paper are employees at Genesis Analytics. The views expressed in this paper are those of the authors and do not necessarily represent the views of Genesis Analytics*.

[2] Horizontal Merger Guidelines, para. 9.

[3] This view also echoed in the ICN Merger Guidelines which note that the counterfactual is typically taken to be the status quo. However, "likely and imminent changes in the nature of competition" should also be considered "in order to reflect, as accurately as possible, the nature of rivalry without the merger." See ICN merger guidelines workbook (2006), para 2.10.

which is different to status quo, the inclination is to formalise the approach to the situation and provide rules for guidance as to when that specific alternative counterfactual may be appropriate. We have seen these tests develop through case jurisprudence in relation to failing firms and potential entry.

In this paper we focus on the first of these dynamic counterfactual situations, namely the so-called failing firm defence, and examine the criteria in place for this alternative counterfactual to hold and the approach taken in South Africa to date. This paper argues that although clear sets of rules or guidelines are helpful in clarifying the situations as to when a failing firm defence might apply and the evidentiary requirements thereof, these should not be the sole focus and a goal in of themselves. In our view a degree of pragmatism and flexibility is required by authorities and practitioners when considering a failing firm counterfactual. Although the criteria of a failing firm test are helpful, an overly rigid application of this test could also miss the objective of identifying the true merger counterfactual. Whilst this paper primarily focuses on the dynamic counterfactual of a failing firm, the points apply more broadly to how we should conceptualise alternative merger counterfactuals in other settings such as potential entry or exit and even alternative mergers.

II. FAILING FIRM COUNTERFACTUAL AS APPLIED IN SOUTH AFRICAN JURISPRUDENCE

It is possible that a firm may be faced with the choice between exiting the market and the proposed merger. For example, the target firm may be experiencing serious financial problems which, absent the merger, will cause it to exit the market.[4] In this case, the relevant counterfactual may be a scenario whereby the target disappears from the relevant market for reasons unrelated to the merger. Competition authorities both locally and internationally typically refer to this scenario as the failing firm defence. In this case, because the firm is not a competitor in either the post-merger world or the status quo counterfactual, the merger may not necessarily remove an efficient competitor. Thus, when the failing firm consideration is applied, seemingly anticompetitive mergers may have relatively benign effects on competition. For this reason, if the failing firm defence is met in a merger case, authorities are likely to approve a merger which may have been ordinarily prohibited on account of competition concerns.

The failing firm test

The failing firm defence is provided for in the South African Competition Act under a list of factors to be considered in a merger assessment. Section 12A(2)(g) states that the Commission and Tribunal must take into account "*whether the business or part of the business of a party to the merger or proposed merger has failed or is likely to fail*."[5]

In *Iscor/Saldanha Steel* the Tribunal laid out the requirements for the failing firm defence in other competition law jurisdictions and under the South African Competition Act.[6] With reference to the position in the United States and European Union, the Tribunal identified the following requirements for successfully invoking the failing firm defence:

- In the US, the requirements are that "*1) the allegedly failing firm would be unable to meet its financial obligations in the near future; 2) it would not be able to reorganize successfully under Chapter II of the Bankruptcy Act; 3) 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*

[4] Geradin, D. (2011) The Counterfactual Method in EU Competition Law (slide deck), p. 8.
[5] The Competition Act, No 89 of 1998.
[6] Case 67LMDec01, par 77-110.

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".[7]

- In the EU, the requirements are more stringent in that the merging parties must demonstrate that "*a) the acquired firm would have withdrawn from the market if not taken over by the other firm; b) the acquirer would gain the market share of the acquired firm if the latter were to exit the market; and c) no alternatives were available that were less anticompetitive*".[8]

As the Tribunal has noted, the underlying rationale for accepting the failing firm defence under these conditions is that the state of competition should be no worse in circumstances where the merger takes place than if the target firm exited the market altogether. In this respect the EU test is more exacting as it evaluates the state of competition even in the event of failure (i.e. the distribution of market share amongst remaining competitors)[9] whereas the US test does not.

The Tribunal noted that the structure of the Competition Act places the 'failing firm defence' as a factor to consider in the process of determining whether a merger is likely to result in a substantial lessening of competition, rather than as a defence that is invoked only once a determination on the potential lessening of competition has been made (absent the failing firm consideration) as is the case in other jurisdictions.

> "*Our Act does not divide the inquiry into two discrete stages. The way section 12A(2) is drafted, the consideration of whether a merger is anti-competitive involves as part of that inquiry a consideration of a non-exhaustive list of factors, one of which is whether a party to the merger is a failing firm. In contrast to this, our 'efficiency defence' is a real defence to an anti-competitive merger and for this reason is located in a self-standing sub-paragraph of section 12A, as a reading of section 12A(1)(a)(i) makes clear. To invoke the efficiency defence one first has to conclude that the merger is anti-competitive.*"[10] (Footnotes omitted)

The Tribunal found this approach permits some flexibility in assessing the different aspects of the failing firm defence and summarised the application of the failing firm doctrine as follows:

1. *"A failing firm defence should not be invoked if it amounts in substance to another factor or defence which the Act already provides. In particular we draw attention to the efficiency defence and the public interest criteria.*

2. *The merger criteria for a failing firm set out in the tests of other jurisdictions will carry serious weight in our assessment. Organising ones evidence on the basis of these criteria would thus be useful and instructive to the Tribunal.*

3. *A merger would not be regarded as lessening competition if the conditions laid out in the more stringent EU test can be satisfied.*

4. *A party falling short of the "market share would have gone to us" requirement, but that could satisfy the other elements of the test or the standard in the US test, would have a reasonable possibility of success depending on the degree of the anti-competitive*

[7] *Ibid* par 80, cited from the 1997 US Horizontal Merger Guidelines. Subsequent to this ruling, the US Horizontal Merger Guidelines have been updated but the test for a failing firm remains the same (see 2010 US Horizontal Merger Guidelines section 10).
[8] Case 67LMDec01 par 82. Subsequent to this ruling, the EU has released horizontal merger guidelines that affirm this test (See Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings: 2004/C 31/03 pars. 89-91 incl. footnotes).
[9] A feature of the Australian test as well, ibid par. 89.
[10] *Iscor Limited/Saldanha Steel*, Case No: 67/LM/Dec01, para 103.

sting. Thus where the anti-competitive effects of the merger are otherwise slight, then the Tribunal might be less stringent in the application of some of the criteria. Here the party should have regard to evidence that establishes some rationale for the existence of the failing firm doctrine. We have referred to some of these in our discussion although we do not suggest that this is an exhaustive list.

5. *Evidence of the extent of failure or its imminence, would be weighed up against the evidence of the anti-competitive effect. The greater the anti-competitive threat the greater the showing that failure is imminent*

6. *No leniency would be afforded to the requirement that there be evidence that there is no less anti-competitive alternative.*

7. *The onus is on the merging firms to establish the evidence necessary to invoke the doctrine of the failing firm.*"[11]

In summary, whilst the Tribunal may be more flexible in applying the imminent failure aspect of the test where anti-competitive effects may be slight, it will not provide any such leniency where less anti-competitive alternatives exist. The latter would appear to include a comparison with the competitive outcome in the event of actual failure and the distribution of lost market share amongst the remaining competitors.

One question that seems to arise following the test laid out by the Tribunal is this: is it necessarily the case that meeting the stricter EU test guarantees there is no possibility of harmful competition effects and thus the approval of the merger is certain (that is, barring the consideration of non-competition issues such as public interest)? From the outset, it seems difficult to imagine how there could be substantial anti-competitive competition effects if the EU test was met. However, the Tribunal's approach to this seems somewhat ambiguous:

(i) On the one hand, the Tribunal has stated that *"a merger would not be regarded as lessening competition if the conditions laid out in the more stringent EU test can be satisfied"*. This suggests that when the failing firm defence strictly holds, it can be viewed as a silver bullet which secures an approval for an otherwise anti-competitive merger.

(ii) On the other hand, because the consideration of the failing firm defence occurs <u>prior</u> to the determination of whether the merger is anti-competitive, it is only one of many factors that should be considered.[12] Therefore, the weighing up of the relevant factors could lead to the finding that the merger is, on balance, anticompetitive. In this regard, the Tribunal noted the following in *Iscor Limited/Saldanha Steel*:

> *"[There is] an important contextual difference between the way we should apply the failing firm doctrine and the way it is applied in other jurisdictions." Specifically, "[i]n our Act, the failing firm doctrine is not used as a 'defence' to a merger that has been found on an initial market analysis to be anticompetitive. Rather it is recognised as one of a list of 'factors' that one takes into account before one can determine whether a merger is anti-competitive."*
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> "…<u>*even if it was established that the firm was failing, by say the application of the US or EU tests, one might nevertheless still find a merger to be anti-competitive*</u> *because of the way one balances this failing firm factor in relation to all the others. It is thus*

[11] *Iscor Limited/Saldanha Steel*, Case No: 67/LM/Dec01, para 110.
[12] *Ibid* para 100.

possible in terms of the Act that a credible failing firm theory may nevertheless not save a merger which raises serious competition concerns." (emphasis added)[13]

"*Conversely, where the competitive loss is low, then one may be less exacting in requiring a showing of all the elements of the traditional failing firm defence. If the failing firm concept was a defence, in the sense that the efficiency defence is, then this type of flexibility would be impermissible and one would have to satisfy all the elements of a test that the legislature had provided before it could be invoked*." [14]

Application in South African case law

Several mergers have been evaluated by the Tribunal and Competition Appeal Court ("CAC") where one of the merging parties was in financial decline and at least some elements of the failing firm defence featured and were material to the outcome of the case. These cases are summarised in the Appendix to this paper and are discussed in further detail below.

Schumann Sasol/ Price's Daelite (2001) was a vertical merger between a wax producer (Schumann Sasol) and a candle producer (PD).[15] The Tribunal found that following the merger, there would be a significant risk of vertical foreclosure in these markets.[16] The merging parties claimed that PD was a failing firm and the exit of its business (including its assets) would diminish competition in the downstream market for candles[17]. Based on this claim, the merging parties called for a lower anti-trust standard for the proposed transaction[18] To assess this claim, the Tribunal performed a relatively rigorous test to determine whether PD could indeed be classified as a failing firm and in so doing ameliorate the merger's competition concerns. Ultimately, the Tribunal rejected the failing firm defence and prohibited the merger. In arriving at its decision, it considered the following factors.

(i) The Tribunal placed most emphasis on what would happen to the market share of the failed firm (and the market in general). In this regard, an important factor was that the downstream candle market was characterised by excess capacity of up to 40% and low barriers to entry[19]. The Tribunal found it plausible that following PD's exit; the remaining competitors would expand and compete for PD's share of the market, whilst entry could take place as well[20]. The Tribunal concluded that competition may actually intensify if PD failed. The Tribunal also found at least some of PD's assets would likely be bought up by existing firms or new entrants.[21]

(ii) The Tribunal found that the possible restructuring of PD which the merging parties contemplated for restoring the firm to could take place without the merger.[22]

(iii) PD's financial performance was found to be dire, yet the Tribunal was not satisfied with the reasons for its potential insolvency or that its failure was imminent.[23]

In *Iscor Limited/ Saldanha Stee*l (2001**)** both firms were involved in the manufacture of steel products.[24] The Tribunal found that horizontal concerns arising from the merger were generally limited as Saldanha

[13] *Ibid*, para 104.
[14] *Ibid*, para 105.
[15] *Schumann Sasol (South Africa) (Pty) Ltd/Price's Daelite (Pty) Ltd*, Case No: 23/LM/May01.
[16] The Tribunal found there was high market concentration in the markets for the production of candle wax and the production of household candles.
[17] *Schumann Sasol (South Africa) (Pty) Ltd/Price's Daelite (Pty) Ltd*, Case No: 23/LM/May01, para 58
[18] *Ibid*, para 58.
[19] *Ibid*, para 59, 68.
[20] *Ibid*, para 67.
[21] *Ibid*, para 68.
[22] *Ibid*, para 66.
[23] *Ibid*, para 62-64.
[24] *Iscor Limited/Saldanha Steel*, Case No: 67/LM/Dec01

did not operate in the same market as Iscor.[25] However, the Tribunal found that Saldanha was at least a potential competitor of Iscor but, given its unfavourable geographic location, its potential to compete successfully with Iscor was remote.[26][27] It was also argued that Saldanha was a failing firm and the Tribunal concluded "*when we balance the loss of potential competition with the prospect of Saldanha failing we conclude the merger will not substantially lessen or prevent competition*."[28] The Tribunal considered the following factors with respect to the failing firm:

(i) As Iscor already owned 50% of Saldanha, the change in control arising from the merger was from joint to sole control.[29] In this regard, the Tribunal was of the view that Iscor was not trying to take advantage of a competitor's demise so that it may secure a monopoly (referred to as the standard problem presented by a failing firm).[30] Rather, the rationale of the transaction was deemed to be Iscor seeking to reduce its loss and protect its investment.[31] The Tribunal concluded: *"It would not serve the cause of competition policy, which seeks to encourage firms to invest in plant and innovation, to apply the failing firm doctrine so rigidly that we inhibit such schemes, otherwise firms may become afraid to risk their capital."* [32]

(ii) The Tribunal considered the long and difficult history of the plant (including delays in construction, underperforming production, plunging international steel prices, poor management and the like) in approving the merger.[33] This resulted in the difficult choice of whether to liquidate or mothball the plant.[34] Following advice not to liquidate and instead restructure its debt, the performance of Saldanha improved mostly on the back of a favourable exchange rate.[35] However, the Tribunal did not find that this recent improvement suggested Saldanha had turned a corner. The Tribunal concluded failure was still likely but not necessarily imminent and this is all it has to be shown in terms of the Act.[36]

(iii) The Tribunal further considered whether there was an alternative buyer and concluded there was none.[37]

(iv) The fact that the failure of Saldanha would result in devastating public interest effects was also taken into account.[38]

(v) The Tribunal also noted the transaction costs associated with Saldanha's exit or failure would be excessive, and these costs would affect the entire economy.[39]

In *JD Group/Profurn* (2002) both firms were active in the lower/middle furniture and appliances markets.[40] While there were indications that the merger may significantly increase market concentration, the Tribunal concluded: *"It is not necessary for us to definitively conclude whether this will result in a substantial lessening of competition because, as we explain below we have concluded that it is probable that this concentration would have occurred even absent the merger".*[41]In this regard, the merging parties raised a failing firm argument but the Tribunal did not find all the elements of the

[25] Saldanha mostly exported and the market was defined as national.
[26] Vertical issues were also raised regarding the security of supply for a local downstream firms but this concern was easily remedied with conditions.
[27] *Iscor Limited/Saldanha Steel*, para 66
[28] *Ibid*, para 156.
[29] *Ibid*, para 19.
[30] *Ibid*, para 140.
[31] *Ibid*, para 139.
[32] *Ibid*, para 140.
[33] *Ibid*, para 115.
[34] *Ibid*, para 118.
[35] *Ibid*, para 120.
[36] *Ibid*, para 132.
[37] *Ibid*, para 138.
[38] *Ibid*, para 144.
[39] *Ibid*, para 141.
[40] JD Group/Profurn, Case No: 60LMAug02.
[41] *Ibid*, para 101

failing firm defence to be present. This was mostly based on an unresolved dispute regarding the factual evidence on failure.[42] Nevertheless, the Tribunal still found that parts of Profurn's business were in a state of terminal decline[43] and would likely exit absent the merger.[44] This was mostly based on evidence of negative cash flows and general state of the market.[45] Ultimately, the key consideration was that in the event of Profurn's failure the distribution of its stores' market share between the remaining competitors presented a market concentration no better than that of the merger.[46] [47] It therefore seems in this case that the Tribunal was willing to accept the notion of failure outside of the realm of the strict failing firm test. It also appears that the market context played a role in the decision given the business climate in the furniture industry had become increasingly difficult. [48] The merger was ultimately approved with remedies that dealt with some vertical concerns

In *Ellerine Holdings/Relyant Retail* (2004), the Tribunal was presented with another horizontal furniture merger.[49] In this case the failing firm defence was <u>not</u> raised by the parties or the Commission. But the Tribunal focused on Section 12(2)(h) of the Act, which requires the examination of whether the merger removes an effective competitor.[50] The Tribunal concluded that while Relyant could not be considered a failing firm because of its sound financial footing, it was "*not a particularly effective competitor*".[51] This was based on Relyant's historical financial problems and the general adverse conditions of the furniture market.[52] A key piece of evidence was the chief executive officer's testimony on the bleak prospects for Relyant in the event of a further economic downturn.[53] An additional key piece of evidence was that the two businesses were differentiated from one another: Ellerines focused on the lower end of the market, while Relyant focused on a higher LSM band.[54] The Tribunal found that there was therefore a good fit between the two companies[55] and the merger would strengthen Ellerines' ability to compete in the upper end of the market (LSM 4-7). The merger was ultimately approved without conditions.

In *Phodiclinics (Pty) Ltd/ Protector Group Medical Services* (2005), the Tribunal found the parties met all aspects of the US test for a failing firm.[56] This conclusion arose from the following evidence: (i) New Protector had already been liquidated,[57] (ii) New Protector had made "good-faith efforts" in attempting to elicit alternative offers, but there were no other reasonable alternatives,[58] and (iii) it was highly likely that the firm would be broken up and disposed piecemeal if the merger had not passed i.e. its assets would exit the market.[59] Ultimately, the Tribunal concluded *that "the competition loss occasioned by this transaction will be low and is outweighed by the failing firm factor"*.[60] However, in this case the emphasis seemed to be more on the assessment of the actual competitive effects, and it seems that the merger may have still been approved irrespective of whether Protector was failing or not (though the Tribunal did not state as much).

[42] JD Group/Profurn, Case No: 60LMAug02, para 132
[43] *Ibid*, para 133
[44] *Ibid*, para 140
[45] *Ibid*, para 114
[46] *Ibid*, para 141
[47] If Profurn were allowed to fail market share would pass on to the other market participants, particularly Ellerines, which was better placed to capture this share. Ellerines had the second highest market share of 27.7% compared to JD Group's 8.5%.
[48] JD Group/Profurn, Case No: 60LMAug02, para 135-139
[49] *Ellerine Holdings Ltd/Relyant Retail Ltd*, Case No. 56/LM/Aug04
[50] *Ibid*, para 51
[51] *Ibid*, para 58
[52] *Ibid*, para 58
[53] *Ibid*, para 54
[54] *Ibid*, para 59
[55] *Ibid*, para 62
[56] Phodiclinics (Pty) Ltd/ Protector Group Medical Services, Case No. 122/LM/Dec05, para 66
[57] *Ibid*, para 66
[58] *Ibid*, para 89
[59] *Ibid*, para 90
[60] *Ibid*, para 181

In *Pannar Seed/Pioneer Hi-Bred International* (2011), a three-to-two merger in the maize seed industry[61], potential for competition concerns was significant given the market's existing concentration. At the time of the merger, Pannar - the target - did not meet any aspects or financial indicators of a failing firm.[62] Yet Pannar's market share had been in decline over the previous decade, as it struggled to keep up to date with technological advancements in the hybrid maize seed market.[63] The merging parties submitted that the relevant counterfactual was Pannar's continued decline and ultimate exit from the market.[64] The Tribunal rejected this argument and reverted back to a more rigid approach. The Tribunal found market exit could only be accepted as the counterfactual if the failing firm defence was met (which it found did not apply in this case).[65] In addition, the Tribunal found the time frame for Pannar's potential exit was too uncertain and that any counterfactual analysis beyond five years seemed highly speculative.[66] The Tribunal also found there were less anti-competitive alternative buyers.[67] Ultimately, the Tribunal adopted the status quo as the relevant counterfactual and the merger was prohibited.

In the merging parties' appeal of the decision, the CAC took a very different view to the Tribunal on the counterfactual. While the CAC agreed that Pannar was not a failing firm, it did not find that the relevant counterfactual was the status quo.[68] Rather the CAC found that Pannar was "*<u>in decline as a competitive force</u>*" as a result of "*a lack of adequate access, on competitive terms, to advanced breeding technologies, germplasm and genetically modified traits, which are vital to ensure that Pannar maintains its competitive position...*" (emphasis added)[69] Put differently, the CAC found Pannar was an "ailing firm", was and it was likely that it would no longer be a meaningful competitor in the future. In relation to the actual time frame of Pannar's anticipated exit, the CAC was more concerned about the likelihood of this occurring rather than when it would occur.[70] In this regard, the CAC stated, "*… the demise of one of the competitors is inevitable, albeit that the precise time when this will occur, is uncertain.*"[71] In addition, the context of this merger was that of an innovation market, which was found to be important consideration in Pannar's future as a meaningful competitor.[72] The CAC ultimately approved the merger with conditions and it seems that, in addition to the acceptance of dynamic efficiencies, consideration of the counterfactual was a key factor in the CAC's ruling.

Boxer Super Stores/Metcash Trading Africa (2012) related to a horizontal merger between parties active in the wholesaling and retailing of groceries and general merchandise in the towns in which they are located.[73] The Commission was initially concerned the transaction may remove a potential effective competitor (the wholesale store Cofimvaba Metro) in one of the localised markets. The concern being the removal of this competitor would raise the costs of retailers as they would have to travel to Queenstown to find alternative sources of supply.[74] In this regard, the Tribunal accepted the failing firm defence as a mitigating factor.[75] The Tribunal found that Cofimvaba Metro (i) was incurring losses, (ii) would close down and exit the market soon absent the merger, and (iii) had no alternative purchasers

[61] *Pannar Seed/Pioneer Hi-Bred International,* Case No: 81/AM/Dec10, para 53.
[62] *Ibid*, para 210.
[63] *Ibid*, para 201.
[64] *Ibid*, para 200.
[65] *Ibid*, para 210.
[66] *Ibid*, para 220.
[67] *Ibid*, para 262.
[68] *Pannar/Pioneer,* Case No: 113/CAC/Nov11, para 27.
[69] *Ibid*, para 2.
[70] *Ibid*, para 29.
[71] *Ibid*, para 29.
[72] *Ibid*, para 63.
[73] *Boxer Super Stores (Pty) Ltd/Metcash Trading Africa (Pty) Ltd,* Case No. 32/LM/MAR12.
[74] *Ibid*, para 12.
[75] *Ibid*, para 15.

for the store.[76] Ultimately, the Tribunal concluded the competition outcomes of the likely exit of this store and the proposed merger were very similar. The merger was approved unconditionally.[77]

In *Lewis/Ellerines Furnishers* (2014)**[78]**, the Tribunal considered a variety of possible geographic market definitions and found that if one adopted a narrow view of the market, the merger would result in horizontal overlaps in fifty out of sixty-three local markets and specifically a monopoly in four of these markets.[79] However, the Tribunal found that the outcome of the merger in these markets would be the same relative to the counterfactual, by invoking the failing firm defence.[80] Ellerines was in business rescue and thus there seemed to be little doubt regarding its future failure.[81] In addition, the Tribunal did not need to consider the question around the distribution of Ellerines' market share, given this was a merger to monopoly.[82] Furthermore, public interest played a role in the approval as there would have been significant employment losses in the event of the liquidation of these Ellerines stores.[83]

III. A PRAGMATIC APPROACH TO THE COUNTERFACTUAL IS REQUIRED

Section 12A(2) of the Competition Act requires that authorities take account of various factors in determining whether a merger will result in a substantial lessening of competition. One of these factors is

> "*whether the business or part of the business of a party to the merger or proposed merger has failed or is likely to fail…*;".[84]

In doing so it may be tempting to think of this as a type of "defence" to what might otherwise be found to be an anticompetitive merger (i.e. something akin to an efficiency defence or positive public interest considerations). However, given its location in the Act the Tribunal has recognised that this is not technically correct, and that rather this consideration forms a *"part of the competition assessment itself*."[85] From a purely analytical perspective this view of the Tribunal must be correct as the decline of one of the merging parties has a direct impact on the counterfactual against which the competition effects of the proposed merger need to be established.

There is great advantage in identifying specific criteria and evidentiary requirements to trigger the activation of the so-called failing firm defence (even though the word "defence" may be a misnomer). As a result, we have seen specifics of the failing firm test develop through case law in all the major anti-trust jurisdictions as well as South Africa, and also appear in the merger guidelines in both Europe and the US. The benefit and appeal of these "failing firm" criteria are clear: they assist in identifying situations where the firm is indeed expected to exit and where, as a result of this exit, the merger is unlikely to result in any harm to levels of competition. The criteria also have clear benefits in terms of providing clarity on the evidentiary standard required to accept this rather extreme counterfactual.

Notwithstanding the obvious benefits and importance of the "failing firm" criteria, it is our view that a high level of fluidity and pragmatism remains important when thinking about a failing firm scenario. Despite the fairly pragmatic track record of the Tribunal in dealing with the question of failing firms, this

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[76] *Ibid*, para 14.
[77] *Ibid*, para 1.
[78] *Lewis/Ellerine Furnishers*, Case No: 019893
[79] *Ibid*, para 17
[80] *Ibid*, para 17
[81] *Ibid*, para 8
[82] *Ibid*, para 17
[83] *Ibid*, para 18
[84] Section 12A(2)(g) of the Competition Act.
[85] See *Iscor Limited/Saldanha Steel*, Case No: 67/LM/Dec01, para 103

needs to be consistently applied going forward. Below we discuss some reasons as to why a high level of pragmatism and fluidity is critical when considering counterfactuals involving failing or declining firms.

A relevant counterfactual may still exist which is different from the status quo, but which falls short of the failing firm test

The great attraction of the criteria set out in the failing firm test is the clarity it gives in terms of which situations the decline of a firm might redeem an otherwise seemingly anticompetitive merger. But there are dangers in applying this test too rigidly and ignoring the broader role of the counterfactual in merger analysis. The specific criteria for the failing firm test are helpful for only for the extreme counterfactual scenario of a failing firm. They do not assist in providing guidance in terms of somewhat less extreme counterfactuals, for example where the requirements of the failing firm test are only partially fulfilled.

Case in point is where a firm is in decline but not yet on the brink of imminent exit (i.e. an "ailing" rather than "failing" firm). Here, the competitive constraint applied by the ailing firm in the true merger counterfactual will be less than indicated by a static analysis of the status quo. In this case a proper competitive analysis should compare the post-merger state of competition against the state of competition that would exist should the ailing firm continue in its weakened state.

The Tribunal would seem to be alive to the positioning of the failing firm test within broader counterfactual considerations for assessing mergers. This is reflected in the degree of flexibility and pragmatism which has been built into the South African approach to the failing firm defence (as described in earlier in this paper). The Tribunal has also stated that despite the necessity of assessing the failing firm defence, *"… in most anti-trust assessments, <u>the facts of the specific case will take precedence</u> over the application of a derived formula."* (emphasis added)[86] This pragmatic approach is evident in certain cases where there is recognition of a relevant counterfactual being different from the observed status quo due to the decline of a merging party – even though the firm did not meet the requirements of a failing firm.

- In *Profurn/JD Group*, Profurn was <u>not</u> accepted to be a failing firm, but the Tribunal nevertheless found that some of its businesses were in a state of "*terminal decline"*[87] and departure from the market was believed to be "*imminent*".[88] In *Ellerine Holdings/Relyant Retail,* the parties did not raise the failing firm defence and <u>neither</u> the target nor the acquiring firm was found to be failing. Yet the Tribunal recognised both had difficulties in certain areas which led to a rejection of the status quo as the relevant counterfactual. Here the Tribunal noted: "*While … Relyant is by no means a failing firm, we are not persuaded that it is in the short to medium term a particularly effective competitor. On the other hand, we are persuaded that the merger will strengthen Ellerines, which, though undoubtedly an effective competitor, appears to face significant obstacles in its attempts to establish a competitive position in the upper segment of our relevant market.*"[89]

However, this pragmatism has not consistently been applied. In *Pannar/Pioneer,* the Tribunal adopted a more rigid approach in its consideration of the failing firm counterfactual, which was overturned by the CAC.

- Pannar, the target, did not meet any of the financial indicators of a failing firm, although the merging parties argued that the relevant counterfactual was Pannar's continued decline and ultimate exit from the market. i.e. they presented an ailing firm type argument the likes of which

[86] *Schumann Sasol (South Africa) (Pty) Ltd/Price's Daelite (Pty) Ltd*, Case No: 23/LM/May01, para 60
[87] *JD Group/Profurn*, Case No: 60LMAug02, para 21
[88] *JD Group/Profurn,* Case No: 60LMAug02, para 140
[89] *Ellerine Holdings Ltd/Relyant Retail Ltd*, Case No. 56/LM/Aug04, para 58

> the Tribunal considered in *Profurn/JD Group*. The Tribunal rejected this argument for reasons already discussed and suggested the relevant counterfactual was the status-quo. The CAC took a very different view to the Tribunal on the counterfactual. While the CAC agreed that Pannar was not a failing firm, it did not agree that the relevant counterfactual was the status-quo and accordingly considered the decline of Pannar in its counterfactual analysis. The decision by the CAC suggests that even when competition concerns may be more significant, a pragmatic approach to the counterfactual should still be applied depending on the facts and context specific to the case at hand.

A key risk of applying the failing firm test rigidly without consideration for broader counterfactual concerns is that any alternative counterfactual to the status quo falling short of the "failing firm" test could be rejected out of hand - even though a counterfactual different to the status quo may indeed be strongly indicated by a factual and economic enquiry. Even in instances where not all of the boxes of the failing firm defence are ticked, the analysis should nevertheless take into consideration that the counterfactual to the merger may not be the status quo, but some variation of it. This approach allows for a fuller assessment of the facts of the case, without being myopically tied to the requirements of a failing firm defence. This is illustrated in the Pannar/Pioneer case – whilst a strict application of the test may indicate that Pannar was not a failing firm, to disregard the decline of Pannar as a competitive force from the analysis would constitute an incomplete assessment of the merger counterfactual. It bears emphasis that the failing firm scenario is but only the most extreme dynamic counterfactual associated with a declining firm. There seems little logic to dismiss somewhat less extreme alternatives just because they don't neatly fit into the "failing firm box" – even though these alternative counterfactuals may be demonstrated to be more likely to occur than the status quo. We should not lose sight of the guiding principle that applies to counterfactual analysis: *"the status quo should not be maintained as the counterfactual if it is not <u>likely</u> that it will continue.*"[90]

In the EU, *Olympic Air/Aegean Airlines* (2011, 2013) provides a further interesting example of where failure to adopt a more pragmatic approach may be costly. This merger was cleared on failing firm grounds following the prohibition of the same merger decided only two and a half years earlier. The criterion that the target would in the near future be forced out of the market because of financial difficulties or bankruptcy in the absence of any merger, was deeply investigated. In this case the adverse economic conditions in Greece, and the difficult financial situation of the parent company seemed to be present in both in 2011 and 2013, yet the Commission preferred a more rigid approach and only approved the merger once these difficulties become much more pronounced.[91]

Therefore, it is important that authorities and practitioners have a pragmatic and flexible conceptualisation of merger counterfactuals so that we can accommodate and evaluate potential counterfactual scenarios that fall short of a strict failing firm test, but nonetheless, may be just as relevant. This is not to say criteria for the failing firm test should be abandoned or ignored. To the contrary, this criteria is very helpful in identifying where the extreme counterfactual of complete exit is merited and where, as a result, competitive harm is unlikely. However, a more robust conceptualisation of merger counterfactuals will assist in appropriately accommodating, and correctly taking account, counterfactuals which diverge from the status quo but which are short of the failing form test. This call for adopting a pragmatic approach to the failing firm counterfactual would seem to be echoed by others commenting on the application of the failing firm defence in the EU:

> *"The approach required by the failing firm defense will not necessarily fit all these situations since there might be other counterfactual scenarios – requiring less strict conditions than the*

[90] Kemp, K.; Sutherland, P. (2014) Competition Law of South Africa, Durban, 10-3
[91] Pezzoli, A. (2014) Tomorrow is another day! Merger review and counterfactual analysis, p. 61.

failing firm defense – which still predict competitive conditions that are no worse than the post-merger scenario.

Considering more pragmatic alternatives might be useful if not necessary and the risks connected with "pragmatism" should not prevent case handlers from exploring solutions which are as rigorous as the failing firm defense requirements. In other words, I do not suggest the adoption of a more lenient policy but I will argue that competition authorities should consider the possibility of applying the general principles underlying the failing firm defense also in cases where the three criteria are not fully met."[92]

A more pragmatic and fluid understanding of the counterfactual will assist in situations beyond just a declining firm

In this paper we have focused on one of the most extreme alternative counterfactuals that could occur in a merger setting, namely that of a failing firm. However, a call for a more pragmatic and fluid approach to dealing with this counterfactual has more general benefit and application.

Firstly, a number of other fairly distinct scenarios exist where alternative counterfactuals to the status quo may arise. The most obvious of these are: (i) potential entry or expansion by a competitor to the merging parties, and (ii) potential entry or expansion by one of the merging parties. Both of these, like a failing firm scenario, have fairly established tests and sets of criteria to be met before these alternative counterfactuals can be applied. From the summary of these tests (shown in the table below) it is apparent that the criteria and evidentiary requirements differ between these two scenarios. However, both share a common objective which is to identify a situation where that alternative counterfactual would be considered relevant and likely). Therefore, it is important to have a clear underlying conceptualisation of dynamic counterfactuals[93] which is consistently applied across the failing firm test as well as these two scenarios.

Entry by an external competitor	Potential entry by one of merging parties
The key question here is whether future entry by a party external to the merger, is likely to provide a competitive constraint to the merging parties, and to what extent. Whether or not the prospects for entry are built into the merger assessment are based on three elements (i) Is it timely?: This is often taken to be within two to four years.[94] (ii) Is it likely?: This depends on whether it will be profitable taking account required assets, capabilities, capital and industry risks. Indications, plans and commitments by specific external players to enter the market indicate strongly that entry is likely. (iii) Is it sufficient? The new entrant should be able to replicate the scale and strength of one of the merging firms. It may be smaller if it is not at a significant competitive disadvantage.[95]	A merger between an actual and potential competitor can still lessen competition – as in the counterfactual the two firms could be competitors (if the entry did occur). The *threat* of entry could also constrain the behaviour of existing players in the market. The EC merger guidelines have two requirements to show that a merger with a potential entrant significantly impacts competition (i) The potential entrant exerts a significant constraining force, or be shown to have significant likelihood of growing into an effective competitive force. (ii) There is not a significant number of other potential competitors that could exert competitive pressure.

[92] Pezzoli, A. (2014) Tomorrow is another day! Merger review and counterfactual analysis, p. 60
[93] i.e. counterfactuals that differ from the status quo.
[94] For example in *Xstrata/Egalite/ICH* entry within 3 years was deemed sufficient; while in *Telkom/BCX* entry was found unlikely within 4 years.
[95] U.S. Horizontal Merger Guidelines (2010), p. 32

However, whilst it is helpful to have formulated tests under each type of scenario, this needs to be applied within a consistent framework for dealing with merger counterfactuals more generally. This is particularly important for both sets of entry scenarios, as in both cases the formulated tests are particularly focused on whether the potential entry will significantly change the counterfactual from the status quo. But unlike the failing firm test, neither of these criteria technically deals directly with the question of whether there will be substantial harm from the merger – this leg of the merger assessment would still need to be completed once the relevant counterfactual has been established. This is a key qualification as a temptation, and possible mistake, is to narrowly apply these alternative counterfactual tests without a full assessment of how the alternative counterfactual may impact the competition-effect of the merger.

(i) For example, consider a merger in a market with initially only 3 players, but where additional entry is found to be likely, timely and sufficient. There is a temptation to conclude that the merger could not easily harm competition as there are currently 3 players in the market and this will remain the case after the merger. Although with some intuitive appeal, this conclusion would however be analytically incorrect. In the true counterfactual to the merger there would be 4 players and this would reduce to 3 following the transaction. Although the new entry may lessen competition concerns, the merger may still be problematic given the high degree of concentration in the market.

(ii) With respect to a merger with a potential entrant, Geradin (2013) makes a similar observation. That is "*the Commission should systematically investigate the impact that the buyer's (or the target's) potential entry would have on the relevant market in the non-merger counterfactual. The simple fact that the buyer (or the seller) is a likely potential entrant in the relevant market should not suffice to oppose the transaction*."[96]

Second, for certain set counterfactual scenarios no clear set of criteria or rules exist as to when they should be considered as the relevant counterfactual. Case in point may be alternative mergers and certain types of public interest considerations. Therefore, it is important to develop a robust approach to the treatment of counterfactuals which is sufficiently pragmatic and flexible so as to be able to accommodate situations that fall outside of the standard "boxes" of failing firm and potential entry. We consider the examples of alternative mergers and public interest in more detail below.

(i) *Alternative mergers.* There is no set test for when an alternative merger should be used as the counterfactual to a merger. As a general rule, it would seem inappropriate to evaluate all other possible alternative mergers and weigh up their relative merits. The Competition Act requires an assessment of whether a given merger substantially lessens competition, not whether another merger might be better for competition. This seems to be the view of the Tribunal in *Mweb/Tiscali*.[97] However, an alternative merger may potentially be an appropriate counterfactual to consider in the following two circumstances. First, in the context of a failing firm defence as this requires the consideration of less competitive alternatives (discussed in detail earlier in this paper). Second, where there is a very high likelihood that an alternative merger will occur if it were not for the current transaction. It is also probable that a significant degree of clarity of the alternative merger would be required for it to be used as an appropriate counterfactual. For example, this may occur if competing bids are on the table and the target has indicated they will merge with one or the other of the parties. This is consistent with the

[96] Geradin, D. and Girgenson, I. (2013) "The Counterfactual Method in EU Competition Law", p. 15
[97] Competition Tribunal, case no. 72/LM/Sep04, par. 80; "*Although G-Soft, had it been successful as a purchaser, may have presaged a more competitive market than M-Web, this is not the test we have to apply. Our task is not to indicate which firm might be a preferred buyer, but only if the merger as proposed would be in violation of the Act. If the answer to the latter question is in the negative then the merger as proposed must be approved regardless of whether a better bride waits in the wings.*"

CAC's approach in *Pannar/Pioneer* where they considered the likelihood and feasibility of alternative mergers and found that none of these alternatives were likely to emerge.

(ii) *Public interest considerations.* It is plausible that applying different counterfactuals to that observed in the status quo may also be relevant for public interest considerations (and not only the competition assessment). For example in *Lewis/Ellerines*[98], public interest played a role in the approval as there would have been significant employment losses in the event of the liquidation of these Ellerines. Therefore, it is important to have a sufficiently pragmatic and fluid approach to counterfactuals so as to grapple with true public interest impacts of a merger under counterfactuals other than the status quo.

Third, we require the degree of pragmatism to deal with a combination of potential alternative counterfactuals that may present themselves in a given merger. For example, as occurred in *Pannar/Pioneer,* it may be that one of the merging parties is in decline <u>and</u> that alternative mergers are a possibility. Furthermore, when considering the potential entry of one of the merging parties it may also be necessary to simultaneously consider the extent to which existing players will be likely to expand or new players enter.

IV. CONCLUSION

This paper finds that defined sets of rules or guidelines are clearly helpful in clarifying the situations as to when dynamic counterfactuals might apply and to identify the evidentiary requirements thereof. However, it is our view that a degree of pragmatism and flexibility is required by authorities and practitioners when applying the tests that have been developed. Adopting a strict approach to the counterfactual may fail to address a variety of counterfactual scenarios, which despite not ticking all the right boxes, still clearly calls for a view of a counterfactual that is different to the status quo.

The "ailing firm" consideration is a case in point. In this scenario, a firm is in decline but not yet on the brink of imminent exit. While the firm may not meet the requirements of the failing firm test, it is nonetheless likely that the competitive constraint applied by the ailing firm in the true merger counterfactual will be less than indicated by a static analysis of the status quo. In this case, a proper competitive analysis should compare the post-merger state of competition against the state of competition that would exist should the ailing firm continue in its weakened state. To disregard the impact of an ailing firm because it does not meet the most extreme counterfactual of a failing firm would result in an incomplete assessment of the effects of the merger.

Similarly, merely ticking the boxes for the adoption of counterfactuals scenarios such as entry and exit without a broader conceptualisation of the role of the counterfactual would not seem to always provide a sufficient indication of the competition effect of the merger under investigation. For certain counterfactual scenarios, such as alternative mergers, no clear set of criteria or rules exist. It is therefore important to adopt a robust approach to the treatment of counterfactuals which is sufficiently flexible so as to be able to accommodate situations that fall outside of the standard "boxes" of failing firm and potential entry.

Finally, we note that despite calling for a more pragmatic view this does not amount to a more lenient approach to the determination of the counterfactual. Counterfactual scenarios other than the status-quo are predictive in nature and come with inherent uncertainty. Whatever the adopted counterfactual therefore may be, it remains necessary to demonstrate that there is sufficient factual evidence and analysis to substantiate a counterfactual scenario different from the status quo. .

[98] *Lewis/Ellerine Furnishers*, Case No: 019893

Appendix: Summary of case precedent

Overview of how the Tribunal and CAC's approach the failing firm in South African case law

Case	Key evidence considered for the failing firm defence	Other key factors	Competition concerns?	Role of failing firm
Schumann Sasol / Price's Daelite	• PD is shown to be insolvent but the Tribunal was not happy with why or whether its failure was imminent • Consideration of alternative buyers was irrelevant to the ultimate finding • Possible to improve the performance of PD by restructuring. This could be achieved without the merger • The most likely distribution of PDs market share post-failure is the existing players with spare capacity or a new entrant	• The extent of excess capacity • Barriers to entry are low and entry is easy • In the event of failure existing competitors (i) would expand because they have excess capacity or (ii) buy PD's assets, and (iii) entry may occur • Took a non-static approach – considered failure, expansion and entry at the same time	• Merger prohibited • The risk of vertical foreclosure was the main concern. • The CAC overturned this decision, but not on the basis of the failing firm defence	• Found the failing firm doctrine did not ameliorate the competition concerns • The key consideration - the competitive situation would not deteriorate as a result of the exit of PDs. This was a better outcome relative to the merger
Iscor Limited / Saldanha Steel	• Significant historical problems, large debt obligations, poor past performance, poor production and uncertain future of Saldanha • Evidence that Saldanha considered, mothballing, and liquidation • No alternative buyer • Saldanha performance improved just before the hearing but Tribunal found that it had not turned a corner • Failure was not imminent but found significant short-to-medium term risk of failure	• Iscor had a 50% share in Sadanha pre-merger so merger was joint to sole control • Tribunal worried about discouraging investment and innovation with a rigid application of the failing firm • Found Iscor to be protecting its investment • Public interest was important factor due to the dependency of the Saldanha community on the plant.	• Merger approved with conditions • Horizontal concerns were limited • Vertical issues regarding the security of supply for a local downstream firm. This was remedied with conditions.	• Accepted • The Tribunal stated the merger was approved following "*a balancing act between the competition concerns and failing firm concerns*" • Adopted a slightly more lenient approach to failing firm. • Other considerations such as protecting investment and employment were key factors

Case	Key evidence considered for the failing firm defence	Other key factors	Competition concerns?	Role of failing firm
Profurn /JD Group	• Not all elements of the failing firm defence present • But Tribunal found parts of Profurn business were in terminal decline given cash flow issues and would likely exit absent the merger • No other buyers • Key finding was the market concentration that would occur with and without the merger would be the same	• The parties alleged that Profurn relied on the failing firm defence to sanitise the merger • The difficult conditions in the furniture industry • Factual witnesses were unclear on whether Profurn was indeed a falling firm or not (there was a conflict of interest for some witnesses)	• Merger approved with conditions dealing with vertical concerns • No horizontal concerns • Some vertical concerns	• Tribunal rejected the failing firm in its pure form but seemed to accept an “ailing firm” argument • The most important factor being similar levels of consolidation were expected irrespective of the merger.
Ellerine / Relyant	• Relyant a failing firm, it was on financial footing • The Tribunal found it was not a *particularly effective competitor* • This was based on Relyant’s historical financial problems and the general adverse conditions of the furniture market • The testimony of Relyant’s CEO was also key in coming to this finding	• General adverse conditions of the furniture market • Merging parties had different business models and customer focus in terms of LSM • Synergies between the parties • Merger would strengthen Ellerines as a competitor in the upper end	• Merger approved • No significant competition concerns mostly because (i) the differentiated nature of these businesses and (ii) Relyant was not an effective competitor	• Tribunal did not accept apply traditional failing firm test (US or EU) • But seems Relyant was found to be “ailing” as it was not considered to be an effective competitor
Phodiclinic / Protector	• Protector met the US based test for a failing firm • Protector had already been liquidated • No other reasonable alternatives • Assets likely to exit the market	• The competition outcome would be the same if any of the other three competitors had acquired Protector	• Merger approved • Detailed competition assessment suggested competition loss would likely be low	• The failing firm was only one of the factors considered • What played a greater role in this case was a more in-depth competition analysis

Case	Key evidence considered for the failing firm defence	Other key factors	Competition concerns?	Role of failing firm
Pannar / Pioneer	• Three-to-two merger - merging parties claimed the target would exit the market absent the merger • Tribunal rejected Pannar's exit as no evidence to support the failing firm doctrine • CAC overturned this and found target firm was in terminal decline as a competitor and its ultimate exit was likely • This was based on its inability to keep up with the relevant technology in the market • Two companies were identified as less competitive alternatives but this - rejected by the CAC based on a lack of complementarity with the target	• This was found to be an innovation market • Competition concerns were potentially significant • Dynamic efficiency were raised	• Merger prohibited by the Tribunal based on significant horizontal concerns • Tribunal decision overturned by the CAC and merger approved with conditions	• Both Tribunal and CAC found the failing firm test did not apply • Tribunal suggested the status-quo was the counterfactual • But CAC found Pannar in terminal decline (ailing firm) and this was the counterfactual • The CAC focused more on the likelihood of exit versus when it would occur • The CAC also accepted dynamic efficiencies
Boxer / Metcash	• Tribunal accepted US test to show Metcash was a failing firm - found • Consecutive monthly losses incurred • No alternative buyer interested • Internal strategic indicated unsold stores would be closed; confirmed by oral testimony	• Allowing Metcash to fail would have adverse effects in terms of public interest	• Merger approved • Some competition concerns in one of the local wholesale markets	• The failing firm defence appears to have been a key argument in dealing with the competition concerns
Lewis / Ellerines	• Failing firm test met • Ellerines Furnishers was undergoing business rescue	• Public interest: liquidation of Beares would result in retrenchment of entire workforce	• Merger approved • Big horizontal overlap in four local markets	• The failing firm applied given with and without transaction Lewis would have a monopoly in the 4 local markets