FOREIGN AND INTERNATIONAL COMPETITION LAW DEVELOPMENTS

AUSTRALIAN NEWSLETTER

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Background

In this first Australian newsletter, it may be useful to make a few general observations about Australia and Australian competition law. Australia is very much like Canada in that there is a division of power between Commonwealth (federal) and state (provincial) governments. The federal government has always assumed responsibility for the development of Australian competition law but, as shall be pointed out below, state governments are now becoming interested in extending the Commonwealth law to the states.

Australian competition law has similarities to Canadian competition law in that it prohibits conduct such as price-fixing, other anti-competitive agreements between competitors, exclusive dealing, resale price maintenance and price discrimination. However, merger law is different, as mergers are prohibited if they lead to dominance or increased dominance, not substantial lessening of competition. In addition, there is provision to prohibit secondary boycotts by unions and other groups.

One major difference is that some of the prohibited conduct, including mergers, can be authorized by the anti-trust regulator, the Trade Practices Commission (TPC), if anti-competitive conduct is outweighed by public benefit. Furthermore, all offences are not criminal but civil, although subject to a pecuniary penalty.

Also, there is no requirement at the moment for the Trade Practices Commission to be notified of mergers, whether or not these mergers might breach the *Trade Practices Act*. This particular position may well change as a result of announcements recently made by the Attorney-General (see below).

Current Issues

Much is happening in competition law and policy in Australia, flowing both from the government's micro-economic agenda and associated deregulation and from the growing acceptance by both levels of government that competition law should be universal because of its major impact on the economic process. In fact, the Australian Prime Minister said on March 12, 1991:

> The *Trade Practices Act* is our principle legislative weapon to ensure consumers get the best deal from competition.
> But there are many areas of the Australian economy today that are immune from that *Act*: some Commonwealth enterprises, State public sector businesses, and significant areas of the private sector, including the professions.
> This patchwork coverage reflects historical and constitutional factors, not economic efficiencies; it is another important instance of the way we operate as six economies, rather than one.
> The benefits for the consumer of expanding the scope of the *Trade Practices Act* could be immense: potentially lower professional fees, cheaper road and rail fares, cheaper electricity.
> This has to be done—and I have initiated the process, by today writing to the Premiers urging a positive examination of all we can do, at the May Special Premiers' Conference, to widen the ambit of the *Trade Practices Act* to bring such excluded areas within the scope of a national framework of competition policy and law.

(For Canadians, these issues relate basically to the "regulated conduct" defence.)

This statement from the Prime Minister, when taken together with the proposed Senate (Australian upper house) inquiry into mergers and monopolies and some other areas of the law, and the amendments that are still to be enacted following the Griffiths Committee of Enquiry into trade practices law of 1989, means that the *Trade*

Practices Act is in a state of flux. In addition, the House of Representatives (the lower house) is about to launch an inquiry into media ownership. This inquiry will relate primarily to competition in the print media markets.

On August 2, 1991, the Attorney-General announced details of the government's submission to the Senate Committee. The government's proposals are:

- reintroduction of the private right to seek injunctive relief to restrain anti-competitive mergers;
- introduction of a prohibition on unconscionable conduct in commerce, designed to protect small business better;
- an administratively simple pre-merger notification scheme designed to give the TPC adequate opportunity to examine mergers before they take place, while at the same time ensuring that the *Trade Practices Act* places minimal impediments in the way of business (this scheme will allow mergers to proceed prior to the grant of authorization on the basis of enforceable undertakings given to the TPC as an alternative to requiring authorization prior to the merger);
- substantially increased maximum pecuniary penalties of $10 million for bodies corporate and $500,000 for individuals for breaches of sections 46 and 50 of the *Act*; and
- enhanced remedies for the Trade Practices Commission and private litigants.

Further, the recent enactment of the *Telecommunications Act* sets up a new deregulatory regime for telecommunications. In that context there is an industry-specific regulator (AUSTEL), but much of the economic regulation is to cease in 1997. Competition law, either through the *Trade Practices Act* or through specific regulation in the *Telecommunications Act*, is playing a vital part in this new telecommunications environment. There is to be an announcement very soon as to which of the consortia of overseas and Australian companies is likely to become the second carrier. The second carrier will obtain access to the network previously reserved to the statutory monopoly of Telecom, which itself will be merged with the Australian overseas telecommunications carrier OTC.

Other important issues emerging in current debate include the question of the deregulation of such areas as energy, rail and road transport. These areas are currently controlled by both federal and state laws. In addition, there is discussion of whether the professions, which currently are generally not covered by the *Trade Practices Act* should become subject to its operation. The Victorian Law Reform Commission has recently proposed that the *Trade Practices Act* be extended to cover activities in Victoria including those of the professions. Another major issue is whether there should be industry-specific regulators in the areas to be deregulated (as there has been in telecommunications), or whether the question of regulation should be left to the operation of the *Trade Practices Act* under the administration of the Trade Practices Commission. A threshold issue arising in relation to this matter is how the government should deal with "excessive pricing" by bodies that will be responsible for the distribution and maintenance of these sectors. Variations of the essential facilities doctrine also arise in regard to these developments.

Recent Major Decisions

- Professor Allan Fels, Chairman of the Prices Surveillance Authority, has been appointed to succeed Professor Baxt as Chairman of the Trade Practices Commission. Professor Fels will remain Chairman of both bodies for the time being.
- On June 24, 1991, the Trade Practices Commission gave its decision in a merger between the two Australian glass bottle manufacturers, AI and Smorgons (this is very similar to a recent Canadian case). The Commission granted authorization on the basis that public benefit outweighed any detriment flowing from the merger. The TPC built in conditions in relation to price and supply terms for some smaller customers of what would be a monopoly. This was a new development and an issue that will be faced by the Commission in other areas in the near future.
- The Federal Court of Australia recently handed down a judgment in *Eastern Express Pty*

Limited v. *General Newspapers P/L*, a case involving an allegation of predatory pricing against a regional newspaper *vis-à-vis* a new entrant. The case itself failed, but the judgment is interesting for the first detailed assessment by a court of the issue of predatory pricing and also for the market definition adopted by the court. The latter is quite narrow and relates to real estate advertising in a newspaper in a particular region of Sydney. This substantially expands the market threshold for abuse of market power cases. It is not known whether this matter will go to appeal.

On predatory pricing the Court said:

> Predatory pricing may be established in one of a number of ways: by express admission, by inference from facts other than the extent of the price cuts themselves, or by analysis of the effect of the price cuts, giving rise to an inference as to the purpose behind their adoption. Perhaps the special difficulty about a case of predatory pricing is that, although this practice is just as anti-competitive as exclusive dealing and tying arrangements, its existence may be more difficult to prove. Once the facts are uncovered, the true nature and purpose of an exclusive dealing or tying arrangement becomes readily apparent. But the outward manifestation of a decision to engage in predatory pricing is a lowering of prices, an action which, on its face, is pro-competitive. The factor which turns mere price cutting into predatory pricing is the purpose for which it is undertaken. That will often be difficult to prove. Traders rarely admit the existence of a proscribed purpose. In the absence of inference from other circumstances, the court will be faced with the question: what price cut effect is sufficient to warrant the inference that the cuts were undertaken for a proscribed purpose?

Other Current Issues

Petrol

There is ongoing concern about various matters in the petrol industry, in particular pricing at the retail level. A recent parliamentary enquiry is being analyzed by the government in conjunction with the Trade Practices Commission and the Prices Surveillance Authority. The latter two bodies are preparing a joint report for government.

Trade Practices Commission/Price Surveillance Authority

There is speculation that the Trade Practices Commission and the Prices Surveillance Authority will merge into one larger competition agency.

Unconscionable Conduct

The Trade Practices Commission has prepared a report to the government on the extension of unconscionability law to business transactions. This report, which will no doubt be submitted to the Senate Committee, could play an important part in the development of government policy in this area.

Intellectual Property

The Trade Practices Commission has issued a publication on competition law and intellectual property.

Consumer Credit Insurance

The Trade Practices Commission has just issued a report to the government on the consumer and competition complications of consumer credit insurance.

Australian/New Zealand Free Trade

There is increasingly close cooperation between Australia and New Zealand in a number of matters relating to competition law and practice. Previous arrangements with respect to trans-Tasman legislation dealing with the abuse of market power are currently being considered by governments on both sides of the Tasman to determine whether there should be further extension of the *Trade Practices Act* to deal with all of the competition provisions. In particular, both governments are exploring what institutional arrangements should be put in place to enable the Trade Practices Commission to cooperate and work more closely with the New Zealand Commerce Commission and vice versa.

Building Industry Bid-rigging

In the state of New South Wales a Royal Commission in the building industry is currently underway. In evidence given to the Commission, there are suggestions that building companies have engaged in collusive bidding. It has also been suggested that there has been collusive conduct between building suppliers. The Trade Practices Commission is currently examining the information being presented to the Royal Commission to determine whether legal proceedings should be brought in relation to the allegations.

The government has yet to decide whether any increase in penalties should apply to the provisions of the *Trade Practices Act* which prohibit secondary boycotts (sections 45D and 45E). It is also considering whether it would be more appropriate to have these or similar provisions included in separate legislation dealing with industrial relations matters. The official opposition does not support such a change, and this could create problems for the government in developing a strategy for dealing with this area.

FAILING COMPANIES, SHRINKING INDUSTRIES, AND STRANDED ASSETS—THE STRUGGLE FOR ORDER

By: Donald I. Baker, Sutherland, Asbill & Brennan, Washington,D.C.[1]

No area of U.S. antitrust practice is murkier than the so-called "failing company doctrine" and its various ideological cousins in the merger enforcement area. Decided cases are few in number and fairly inflexible in their terms, while enforcement practice is somewhat more pragmatic but tends to be non-public and camouflaged by a lot of dogmatic rhetoric. At a time of economic malaise and readjustment in the U.S. economy, the failing company doctrine is one of substantial practical importance—and recurring mystery.

The subject has taken on a special immediacy with several Federal Trade Commission (FTC) prosecutions in the past year or so, and a tough speech by the Director of the FTC's Bureau of Competition. These are, in fact, only the tip of the iceberg, because numerous mergers get dropped when the parties realize that, after full investigation, they cannot talk the FTC (or the like-minded Justice Department) out of suing. While the agencies do not deny the existence of such a defence, they thrust all the burdens of uncertainty on the merging parties and rarely find a set of facts which satisfy their "failing company" tastes.

The key practical problem with the failing company doctrine is that few truly failing companies can ride out the costs and delays of litigation. Moreover, the Federal Trade Commission (which has never allowed a failing company defence in a litigated case) can proceed with a post-closing administrative complaint even where it has lost a preliminary injunction in District Court—a process which makes the acquisition of the allegedly failing company less attractive to the acquirer. The net result is that most determinations of whether a company is "failing" are made in the course of negotiations between the merging parties and the government, which tend to occur at the pre-complaint stage.

The Failing Company Doctrine

Financial distress is a recurrent aspect of merger analysis in most industrial countries. However, in the United States it takes place in a highly structured form geared to litigation. First, government staff must establish that the proposed merger is anticompetitive and hence presumptively illegal under section 7 of the *Clayton Act*. Then the defendants must establish, as an affirmative defence, both that the acquired firm faces a serious threat of business failure, and that no less anticompetitive alternative is available to rescue it. This is not a balancing process: the defendants' burden of proof on "probable failure" or "less anticompetitive alternatives" does not become lighter because the market shares are

lower or the staff's affirmative case is otherwise close to the line.

The failing company doctrine owes its origin to *International Shoe Co.* vs. *FTC*, 280 U.S. 291 (1929), where the Supreme Court upheld an otherwise anticompetitive merger because the acquired firm's "resources [were] so depleted and the prospect of rehabilitation so remote that it faced the grave probability of a business failure with resulting loss to its stockholders and injury to the communities where the plants were operated." The Court seemed to rely on the assumption that the failing firm had been unable to find a less anticompetitive form of survival than sale to the industry leader.

The failing company doctrine now seems to rest on two distinctive policy themes. The first, "economic" theme seeks to insure that productive assets are retained in the market; and the second theme, which is older and might be labeled "social" or "populist", reflects concern about injurious effects flowing from business failures on workers, communities, lenders and even investors. During the Reagan and Bush administrations, the antitrust enforcers have tended to focus on the "economic" values while declaring the "social" ones irrelevant or simply ignoring them. Much to the surprise of many businesspeople, the doctrine has been applied since 1980 to block even very small mergers.

Government Gloss on the Doctrine

The Justice Department treated the failing company defence very briskly in three brief paragraphs in the 1984 Merger Guidelines. In the first, it described the defence as "long established, but ambiguous" and then warned that "because the defence can immunize significantly anticompetitive mergers, the Department will construe its elements strictly." It then went on to define these elements as follows.

> The Department is unlikely to challenge an anticompetitive merger in which one of the merging firms is allegedly failing when:
> (1) the allegedly failing firm probably would be unable to meet its financial obligations in the near future;
> (2) it probably would not be able to reorganize successfully under Chapter 11 of the *Bankruptcy Act*; and
> (3) it has made unsuccessful good faith efforts to elicit reasonable alternative offers of acquisition of the failing firm that would both keep it in the market and pose a less severe danger to competition than does the proposed merger.

In the third paragraph, the Department extended the defence to failing divisions, but further restricted its use by requiring that "the proponents of a merger involving a 'failing' division must establish, not based solely on management plans, which could be prepared simply for the purpose of creating evidence of intent, that the division would be liquidated in the near future if not sold." In addition, the "alternative purchaser" requirement would have to be met.

A recent speech on this subject by Kevin Arquit, Director of the FTC Bureau of Competition, is expansive rather than cryptic, comprising thirty double-spaced pages liberally spiced with footnotes. Arquit is particularly forceful and forthright on the "less anticompetitive alternative purchaser" aspect of the doctrine. He describes the defendant's burden of proof as "quite heavy, as it should be."[2] He notes that the Commission is "extremely skeptical of any [search] undertaken or initiated after an agreement [to merge] is signed."[3] Moreover, "it is not necessary that there is an alternative alternate purchaser prepared to purchase the failing company in its entirety. If a company were to be broken apart, several smaller companies might purchase and productively use the assets."[4]

Arquit focuses particularly on the issue of *price*: what does a prospective buyer have to be willing to offer to be considered a genuine "less anticompetitive alternative"? Not too much, according to Mr. Arquit, and certainly a lot less than the prospective merger partner. Having noted that a company with market power would be "willing to pay a premium for the ability to increase prices," Arquit starkly declares that the Commission would "suggest that the appropriate standard would be that a company is required to accept any offer above liquidation value, where the alternative is likely to be anticompetitive."[5] For him, "liquidation value is the value of the assets if used outside of the market in which they are being used. The key is that the offer be high enough to assure that assets will stay in the market."[6]

On the question of a "failing division", Arquit said that the issue was one of "prosecutorial discretion" for the Commission. He then repeated the formulation in the Justice Department Guidelines, emphasizing the need for "clear evidence that the division will be liquidated if the transaction is not completed."[7] He also rejected any broader "exiting assets" defence[8] because "the evidence rests entirely in the hands of the acquired company," and it would allow a company "to reap the benefits of an anticompetitive price simply by announcing that it is planning to exit the industry."

Recent FTC Cases

Tough talk from the FTC enforcement leadership has been backed up with tough action. Two examples are worthy of note.

In *Imo Industries Inc.*, the Commission had sought a preliminary injunction against Imo's US$69 million acquisition of a wholly owned U.S. subsidiary of a British company (Optic-Electronic Corp., (OEC). The November 1989 complaint alleged that this acquisition would substantially reduce competition in the production of a highly specialized defence industry product, *second generation* 25-millimeter image-intensifier night vision tubes. The U.S. District Court in Washington, D.C. granted a preliminary injunction over the defendant's assertion that OEC was a failing enterprise.[9] A year later (in November 1990) the Commission allowed the transaction to go forward, having found that OEC was "unlikely to be a significant supplier of Second Generation equipment" and that since OEC failed in the Defense Department's *third generation* procurement, it was "unlikely to gain the experience it needs to become an effective competitive force in Third Generation production."[10]

In *FTC* v. *Harbour Group Investments*,[11] the Commission again went to the U.S. District Court in Washington to block a "failing company" amalgamation. This was a manufacturing joint venture between two leading makers of telescopes used by amateur astronomers. The parties stipulated to the *prima facie* case, and therefore, the only issue was whether the defendants had established a failing company defence. The District Court noted that "the telescope industry has experienced an across-the-board decline in business ever since the public's interest in Halley's Comet faded in 1986," but it did not reach the "grave probability of business failure" prong of the test. Instead, the case was decided on the ground that the allegedly failing company had done an inadequate search for a less anticompetitive alternative. "Indeed, it appears that Harbour Group's efforts to find alternative purchasers were motivated by advice of legal counsel, after most of the deal [to establish the joint venture] had been completed." The Court added that "the efforts made by Merrill Lynch on behalf of Harbour Group did not comport with a normal Merrill Lynch exhaustive search." Finally, the Court noted that the acquiring partner's evidence suggested that part of its interest in Harbour Group was caused by "its concern that if it did not acquire [Harbour Group], another company might." This is truly inflammatory evidence in a failing company case!

Having handed the FTC a famous little victory, the District Court then queried:

> One can wonder why the FTC has chosen to sink such a substantial amount of its resources into blocking a merger of two small subsidiaries in an industry which makes telescopes for a minuscule part of the population. On the scale of consumer goods, it does not strike the Court as crying out for such substantial government attention.

The answer, of course, is that no merger case—let alone a failing company one—is too small for the FTC. If the parties' market shares are high and new entry seems unlikely (as is generally the case in a declining industry), then the Commission is fully prepared to sue.

In both *Imo* and *Harbour Group*, the Commission ultimately settled for a ten-year injunction against future acquisitions in the industry without the Commission's prior approval.

The General Problem of Excess Capacity

The strict approach to the failing company doctrine developed by the FTC (and generally supported by the Justice Department) does not work well in a situation of market decline. At the very least, it makes it difficult for a multi-product

company to dispose of a weak business in a declining industry. If, as is often the case, the only interested buyers are already in the business, then their market shares (or Herfindahl Index numbers) become prohibitively higher as the industry declines. Faced with a marginal or profitless business, management may decide that it is cheaper and less disruptive to shut the business down than to endure the prolonged uncertainty (and loss of good will) of a government antitrust investigation.

Yet the government has a good point made by Mr. Arquit: since the evidence related to future shutdown is largely in the hands of the merger proponents, it is not necessarily reliable. (The same point is also true, but perhaps to a lesser extent, with respect to the "imminent failure" and "alternative purchaser" prongs of the "failing company" defence.) Of course, that does not mean (as the enforcers sometimes wish) that the government should be allowed to decline to deal with the issue; it just goes to the weight of the evidence.

The difficulty of the "excess capacity" issue is well-illustrated by the commercial banking industry in the United States. For years banks were prevented by government regulation from competing on deposit rates and so they competed on service convenience—deploying endless numbers of branches around major metropolitan areas. Branch operations were simply factored into what bankers called "cost of funds". Now there are far too many branches for a price-competitive deposit world and, beyond that, some major banks are endangered by unwise lending operations. As a result, both healthy banks and the Federal Deposit Insurance Corporation (as the owner of distressed banks) are trying to streamline operations through mergers. These efforts are raising significant antitrust problems. Even though the failing company defence does not apply with full force to the banking industry, the more flexible "conveniences and needs" defence applied to bank acquisitions is subject to the same "less anticompetitive purchaser" requirement.

The Resulting Confusion

The failing company doctrine is not purely for domestic consumption. Where there is a North American market in some product and the allegedly failing enterprise is in Canada, the U.S. antitrust authorities will apply a strict failing company doctrine to any acquisition by a U.S. firm.

This is exactly what happened several years ago in a merger transaction in the agricultural tractor industry when Deere (of Illinois) sought to buy Versatile (of Manitoba). Versatile was failing, but the Justice Department did not think it had made an adequate search for an alternative purchaser and therefore refused to let the transaction go forward. Versatile folded and employees were terminated; months later the remainder of its business was acquired by Ford-New Holland, another major U.S. player.

The lesson for potential merging partners is to plan early and undertake a reasonable search for alternatives before presenting to the government an anticompetitive merger which can only be justified on failing company grounds.

The lesson for the antitrust enforcers is that they must look at a particular merger with a broader sense of market dynamics. There is a real trade-off to be made: if a merger keeps assets (or more efficient assets) in a business, then the industry is likely to be more competitive and flexible than if the business were allowed to exit through failure or just frustration. This is especially so where the "assets" are experienced workers who are scrapped along with the enterprise. In the context of a declining industry (such as second generation night vision tubes or amateur telescopes), enforcers ought to be looking at the situation less as *adversaries* and more as *regulators* seeking a "public interest" solution. Although antitrust enforcers hate being called "regulators", industrial decline will force them to face the "regulatory" reality that their decisions, based on often quite murky factual determinations, are likely to determine which enterprises and assets survive in a declining industry.

This regulatory reality is particularly notable in connection with the issue of the price an

"alternative purchaser" must pay to qualify. According to Mr. Arquit, it is the government's position that "a company is required to accept any [alternative] offer above liquidation value." Yet does this confiscatory approach make sense? Does it discourage a company from continuing to invest in a declining industry? It is one thing to say that a "failing" or "weak" seller should not be able to reap a "monopolistic windfall" by selling out to the IBM of its industry, but its only means of exit is to sell out to whomever puts up a "liquidation value" bid. This only adds economic injury to social injury. It also represents a *very static* approach to economic efficiency.

New merger guidelines are in the works in Washington, but one should not expect any loosening of the present failing company strictures. Indeed, the opposite may be true as the agencies seek to rearticulate this "long established, but ambiguous" doctrine. Mr. Arquit's message is consistent with Justice Department practice and is probably a good preface to the new guidelines.

Notes

1 ©Donald I. Baker, 1991.

2 Individual merger investigations are allocated between the two federal enforcement agencies by informal agreement based on various factors including staff availability, prior industry experience and intensity of interest. It is often very difficult to predict which agency will end up with a particular investigation.

3 Both aspects of the doctrine were re-emphasized in the Supreme Court's particularly draconian decision in *Citizen Publishing Co.* vs. *United States*, 394 U.S. 131 (1969). The Court seemed to go even further to suggest that the allegedly failing firm must also show that its prospects for surviving a reorganization in bankruptcy were dim or nonexistent.

4 "The Failing Firm Defense and Related Issues," remarks by Kevin J. Arquit before the American Bar Association, Antitrust Section, April 12, 1991.

5 *Ibid*, p. 13.

6 *Ibid*, p. 15.

7 *Ibid*, , p. 16.

8 *Ibid*, p. 18.

9 *Ibid*, pp. 18-19.

10 *Ibid*, p. 23.

11 This idea had been suggested by two leading antitrust economists. Kwoka & Warren-Boulton, "Efficiencies, Failing Firms and Alternatives to Merger: A Policy Synthesis" (1986), 31 *Antitrust Bulletin*, 431.

12 5 *Trade Reg. Rep.* (CCH) ¶22,768 (D.D.C. Nov. 22, 1989).

13 *FTC:Watch*, Nov. 19, 1990, pp. 4-5.

14 1990-2 *Trade Cas.* (CCH) ¶69,247 (D.D.C. 1990).

15 Even so, fragmentary evidence of pre-acquisition *intent* is not probative of the ultimate fact question of whether an "alternative purchaser" actually exists at the time of a later search.

16 *United States* vs. *Third National Bank in Nashville*, 390 U.S. 171 (1968).