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ROUNDTABLE ON FAILING FIRM DEFENCE

-- Note by Chile --

This note is submitted by the Delegation of Chile to the Competition Committee FOR DISCUSSION at its forthcoming meeting to be held on 21-22 October 2009.

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THE FAILING FIRM DEFENSE FOR THE ASSESSMENT OF MERGERS AND ACQUISITIONS

1. Introduction

1. Under economic recession, the failing firm defense becomes more relevant and pressuring on competition authorities, whose policies and decisions are compelled to consider changing market conditions and global consequences of a more uncertain economic environment.

2. From the competition authorities' view, merger analysis assesses the impact of a transaction, based upon a hypothetical comparison of the likely future state of competition on the affected relevant markets if the transaction goes on (i.e., the factual scenario) against the likely state of competition if it does not (i.e., the counterfactual scenario). In this assessment, the "failing firm defense" is sometimes used by merging parties to argue that the merger should be approved as the acquisition of a "failing firm" that otherwise would be forced to leave the market in the short term.

3. Under the failing firm defense criterion, a merger does not rise a substantial lessening of competition in cases in which the merged or acquired business will anyway exit the market. Hence, any substantial lessening of competition identified in the analysis of the operation is not directly attributable to the merger.

4. The Chilean experience on merger assessment is somehow determined by the fact that the Chilean Competition Act, enacted in 1973, does not consider mandatory notification provisions for mergers and acquisitions, in the sense that this restricts the number of cases that have been reviewed by the authorities. Perhaps for this reason, it is possible to find only one case law, in the early 80s –*Comercial Huechuraba Ltda.,* on the alcoholic beverage and beer's elaboration market– where the failing firm defense was argued by the involved parties and was fully considered by the Antitrust Commission to base on its final ruling.

2. Case law on failing firm defense in the breweries market

5. In January 1981, *Comercial Huechuraba Ltda*. acquired 95% of the equities of *Cervecera del Pacífico S.A*. As stated in the case, the acquirer was owned by the controllers of *Cervecerías Unidas S.A.* (CCU), the leading domestic beer company, a clear dominant player in the market.

6. Once the *Comisión Preventiva Central* (CPC[1]) reviewed the facts, they determined that the transaction should have previously been consulted, since this company could have represented a competitive alternative for CCU in the alcoholic beverage and the beer market.[2] Accordingly, the CPC's

[1] Administrative body in charge of the issuance of preventive injunctions and recommendations on competition matters. They existed until the 2004 amendments to the DL 211

[2] Decision No 275 / 1981, May.

instructed the *Fiscalía Nacional Económica*[3] to investigate the case, and to pursue a fine for the companies since they did not consult the operation.

7. The acquirer challenged this decision by submitting an appeal to the *Comisión Resolutiva*[4] (Antitrust Commission), based on the argument that the Competition Act had no provision on mandatory consultation for any conduct.

8. The Antitrust Commission decided[5] to accept the claim grounded on the fact that there was no provision requiring consultation to buy shares of an insolvent company by a competitor since, under such conditions, it does not mean eliminating an effective or a potential competitor. In addition, its ruling also established that the **disappearance of a competitor in bankruptcy or insolvency, whose market share has been very weak, does not seriously affect competition in the affected market**.

9. Among the information available to the Antitrust Commission was the fact that:

- **Market share**: *Cervecera del Pacífico* reached a monthly share of 7,500 hectoliters (just 5% of the whole domestic market) and an installed capacity of 30 thousand hectoliters per month (i.e., 20% of the domestic beer market);
- **Financial reports:** Towards the end of 1980, according to their financial statements (audited by an external firm), *Cervercera del Pacífico* had lost over 70% of its capital and reserves, results that were confirmed by a second audited statement in June 1981;
- **Liquidity:** when the firm decided to sell, it required US$ 8 million to avoid bankruptcy, an amount it could neither reach with its owners nor rise from financial markets;
- **Alternatives**: Due to the bad image of the firm, which eroded even the brand value, there were no alternative buyers.

10. Thus, although the ruling did not explicitly mention the failing firm defense criterion, the Antitrust Commission took into consideration that (1) it was foreseeable that *Cervecera del Pacífico* would have exited the market had not the operation gone ahead; and (2) there was no realistic less anti-competitive alternative to the acquisition; concluding that any consequent loss of competition was, therefore, attributable to the predictable failure rather than to the acquisition itself.

3. Competition Authority's horizontal guidelines

11. Historically, since the first Competition Act was enacted in 1973,[6] Chile has no mandatory notification provision for merger and acquisitions (M&A), but a voluntary consultation system. Since the 2004's amendments to the Competition Act,[7] M&A may be reviewed by the Competition Tribunal

3 The Competition Agency which is responsible for investigating competition cases.

4 A quasi-judicial body that decided on antitrust matters with adjudicative powers, until the 2004 amendments to the DL 211 by which the TDLC was created

5 Ruling No 125/1982, November.

6 Decree Law No. 211, 1973.

7 The amendments to the Competition Act enacted in Law No. 19911 / 2004 introduced structural changes for the Competition System, mainly the creation of a Competition Tribunal. Recently, the last amendments enacted by Law No. 20361/2009, increases FNE□s powers to deal with cartels and collusive agreements.

(*Tribunal de Defensa de la Libre Competencia,* TDLC[8]) if, according to an interested party or to the FNE, such merger may prevent, restrain or obstruct free competition as established under the Competition Act, article 3. In accordance with Competition Act, although mergers are not *per se* reproachable, they are susceptible to be blocked or conditioned following competition criteria. Nevertheless, the Competition Act does not contain specific rules on merger assessment.

12. On October 2006, the FNE issued a guideline for the assessment of horizontal mergers (the *"Guía interna para el análisis de operaciones de concentración horizontal"*,[9] hereinafter, 'the Guide'). This Guide is an internal working tool providing useful information and orientation for firms and interested parties, concerning the main aspects, procedures and methodology employed by the FNE when analyzing a horizontal merger, though its content is not mandatory for the TDLC or private parties. The Guide reflects the FNE's understanding that the assessment of M&A is aimed at weighing up the risks of carrying out anticompetitive conducts by the resulting merger entity due to the increased concentration in the relevant market, *vis-à-vis* the resulting efficiency improvements.

13. The Guide focuses on relevant market definition, concentration levels, entrance conditions, risks resulting from the M&A and the expected efficiencies involved in the operation. In the Guide, the failing firm defense criterion is explicit. Thus, while assessing any M&A operation leading to horizontal concentration, the FNE considers whether the conditions to the failing firm defense are met.

14. Notwithstanding, since the issuance of the Guide there has been no consultation on M&A fencing the criterion of the failing firm. Moreover, of the 30 decisions -in non adversarial cases- rendered by the TDLC since its creation in 2004, only 5 have been related to M&A,[10] none of which has been related to failing firms.

4. Conclusions

15. To prevent the pressures on competition authorities in times of economic slowdown, in order to provide excessive consideration to failing firm arguments, it is advisable that authorities commit *ex ante* to the criteria they shall take into consideration when analyzing M&A. Guidelines seem to be powerful and useful tools in this sense.

16. Parties invoking the failing firm defense have to prove that the deterioration in the market competitive structure, following an M&A operation, is not caused by the operation itself. Defining clearly what constitutes adequate evidence that a firm is actually failing, and avoiding policy changes in regard to economic cycle seem to be key requirements for a consistent analysis and decisions by competition authorities.

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8 The Competition Tribunal, which decides on antitrust matters with adjudicative powers. It is integrated by five judges -three lawyers and two economists.

9 The Guide was issued in May 2006 when the FNE uploaded a first draft of the document on its Website, in order to receive comments. Three months later the FNE released the final version of the Guide, which tenets have been followed by the FNE in concentration analysis ever since. A Spanish version of the Guide is publicly available at its Website, or linking http://www.fne.cl/?content=guia_concentracion.

10 These operations were: Resolution No 1/2004; about the merger between the two main Chilean cable television operators (*VTR-Metropolis*); Resolution No 2/2005; about the takeover of *BellSouth* by *Telefonica Movil*, in the mobile phone industry; Resolution No 20/2007, about the acquisition of a series of radio broadcast licenses by the subsidiary of an important radio conglomerate (*Prisa*); Resolution No 23/2008, about the merger between two pension and retirement plan administrators (*ING AFP Santa Maria* and *AFP Bansander)*; and Resolution No 24/2008, rejecting the proposed merger between one of the main Chilean retail companies, Falabella, and the most important supermarket chain, D&S.

17. In addition to adequate evidence on failure, before issuing their decision competition authorities should thoroughly examine two key aspects of the case. First, whether the failing firm can be acquired by an alternative buyer in such a way that market competition is not lessened (it is often the case that it can actually be enhanced), and finally examine whether the failure of the firm is not the result of anticompetitive conduct, which clearly rise a series of practical matters.

18. The FNE is currently assessing its respective Guide to reflect recent experiences in its application, changes in the legal framework and new procedural regulations issued by the TDLC.