COVID-19: PRESSURE POINTS: A CONSIDERATION OF FACTORS THAT MAY INFLUENCE MERGER CONTROL INVOLVING DISTRESSED FIRMS FOLLOWING THE COVID-19 PANDEMIC (SOUTH AFRICA)

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Legal Briefings – By **Nick Altini, Leana Engelbrecht, Sandhya Foster (with research assistance from Lauren Paxton)**

It is clear that the COVID-19 pandemic is already having a far-reaching impact on local, regional and global economies, with many firms facing severe financial constraints due to the limitations and government interventions introduced to tackle the global pandemic.

As humanitarian efforts are, generally, being placed ahead of commercial economic interests some firms are severely impacted by the economic slowdown and it is likely that the financial and economic impact of these interventions will have a long-lasting impact on businesses.

In the wake of this, it is probable that many firms will be placed in a distressed position and will explore merger opportunities as a means of avoiding business rescue, or even liquidation. Similarly, firms with more robust balance sheets will doubtless seek acquisition targets in friendly or hostile takeovers. Consolidation in many sectors is inevitable and will take place through a blend of attrition as a result of the lockdown and mergers where either or both firms seek to merge in order to survive in a far more Spartan market than that which existed before.

The question that then arises is how mergers involving one or more distressed firms will be dealt with by the South African competition regulators. During the nationwide lockdown, the focus of competition regulators has not been on regulating merger activity (although this duty was by no means abandoned by the regulators), but rather competition concerns that are arising from the pandemic (such as addressing unwarranted price increases and unfair practices in respect of essential goods).

It is beyond dispute that any post-lockdown mergers will have to be assessed by the competition authorities through the lens of the economic apocalypse that is already taking hold in many sectors and will inevitably spread. Merger assessment will not be "business as usual" when it comes to assessing both the competition and public interest effects of mergers involving distressed firms and where at least a substantial part of the merger rationale is corporate survival following the pandemic. That said, the existing legislated framework for merger assessment will remain in place and will be the starting point. The Competition Act already makes provision for merger assessment where the target of a merger transaction is a so-called *failing firm*.

The competition authorities have on several occasions considered the failing firm doctrine or "defence". The Competition Tribunal has held that the failing firm doctrine is not used as a "defence" to a merger that has been found, on an initial market analysis, to be likely to yield anti-competitive outcomes but is rather recognised as one of the list of "factors" that is taken into account to determine whether a merger is anti-competitive. Nonetheless, a successful reliance on the failing firm doctrine may result in the approval of a merger that might otherwise be prohibited as anti-competitive because the exit of the firm from the market would leave the market with less productive capacity, and thus more inefficient, while the supply-demand balance shifts which may place upward pressure on prices. The Tribunal has noted that the underlying rationale for the approach adopted in assessing mergers involving failing firms lies in the fact that the post-merger state of the market should not be less competitive because the acquiring firm would gain a greater market share on acquisition of the failing firm than it would have if the latter exited (see *Iscor Limited and Saldanha Steel Proprietary Limited, CT Case No: 67/LM/DEC01*).

The Tribunal developed a flexible approach to assessing the failing firm doctrine under South African competition law, which can be summarised as follows:

1. The merging parties should not invoke the failing firm doctrine if it amounts in substance to another factor which the Competition Act already provides. In particular, it should not amount to an efficiency justification or a public interest argument;

2. The Tribunal confirmed that a merger involving a failing firm would not be regarded as one likely to lessen competition if (i) absent the acquisition the target firm would have exited the relevant market; (ii) if the target firm were to exit the market, the acquiring firm would gain the former's market share; and (iii) no less anticompetitive alternatives are available for the target (which means that it is necessary for the merging parties to

show that there are no other viable purchasers of, or merger partners for, the target);

3. Where a party falls short of these requirements, the failing firm doctrine may still succeed if the merging parties are able to show that (i) the target firm is unable to meet its financial obligations in the near future; (ii) the failing firm would be unable to successfully reorganise its affairs through business rescue (or similar) processes; (iii) the failing firm has unsuccessfully made efforts to obtain reasonable alternative offers for the acquisition of its assets which would keep the assets in the market and present a less severe danger to competition than the proposed merger; and (iii) absent the acquisition, the assets of the failing firm would exit the relevant market. Whether these factors would be sufficient to uphold the failing firm doctrine will be dependent on the degree of the anti-competitive effect. Where the anti-competitive effects of the merger are insignificant, then the Tribunal might be less stringent in the application of some of the criteria. In respect of this, evidence that demonstrates the rationale for the application of the doctrine must be provided.

4. The Tribunal will weigh up evidence of the extent of failure or its imminence against the anti-competitive effect. The Tribunal has found that "*the greater the anti-competitive threat, the greater the showing that failure is imminent.*"

5. *The Tribunal further held that no leniency would be afforded to the requirement that there be evidence that there is no less anti-competitive alternative; and*

6. *The onus is on the merging firms to establish the evidence necessary to invoke the doctrine of the failing firm.*

It is clear from the above that merging parties will have to be in a position to show an actual imminent probability of the failing firm leaving the market and leaving the competitive dynamics of the market in a worse off position than if the ostensibly anti-competitive merger were to be consummated. This doctrine is, accordingly, not one that can be relied upon in all circumstances where distressed firms are being acquired and the Tribunal has made it clear that it will apply the strict tests to apply this doctrine in line with its own and international jurisprudence. In this respect the Tribunal has noted that "*[w]e must stress that in the case of an anticompetitive merger the private interests of firms cannot ever trump the broader public interest consideration of a substantial lessening or prevention of competition, with concomitant negative effects on consumers.*" (see *Pioneer Hi-Bred International Inc & Others v The Competition Commission, CT Case No: 81/AM/DEC10* at para 229 and *CAC Case No: 113/CAC/NOV11* at para 22).

But these words may have a somewhat different application in the pale light of the economic dawn that will follow in the immediate aftermath of the pandemic. The Commission and Tribunal will both have to forecast the effects of mergers on competition in markets making assumptions about the levels of competition in markets that will have indelibly changed in a very short period of time. Pre-lockdown competitive dynamics may be of very little relevance in predicting how a merger will impact competition post-lockdown, simply because competition in that market will not be the same as before. But in the case of horizontal mergers, mere concentration should not be a basis for prohibition without a forward looking prediction (as far forward as possible) as to the likely longevity of either firm absent the merger. This is not necessarily the exercise mandated by the Tribunal in respect of the failing firm doctrine. Rather, this would entail taking into account the need to ensure that in the future healthy industry participates will emerge to play an ongoing role in, and make a contribution to, an economy in a state not seen before. This will require both deftness of action and a willingness to accept that any dogmatic orthodoxies of the past are simply not appropriate and may be even destructive. It goes without saying however, that the baby cannot be thrown out with the bathwater. Transactions involving distressed firms must still be subject to pragmatic scrutiny to ensure that the claims of distress are not opportunistic shams to achieve clearance for mergers that should not be permitted in any circumstances.

Effects of mergers on the public interest will likely ascend to become the more prominent feature of assessment (relative to competition effects) when regulators consider transactions involving financially unhealthy firms short on other options. It is often a misconception that the failing firm doctrine can be relied upon in instances where, absent the proposed merger, the target firm may have to rationalise its business and retrench employees. Naturally public interest considerations, especially whether a transaction would result in job losses, are incredibly important in merger assessment in South Africa, but this factor cannot be relied upon in support of a failing firm doctrine to allow an otherwise anti-competitive merger. This does not mean however that public interest considerations could not otherwise be highly persuasive factors – since recent amendments to the Competition Act our competition authorities are obliged to accord equal weight to competitive effects and public interest considerations in merger assessment. A merger that presents a likelihood of chilling competition may nevertheless be approved (with appropriate conditions) if it is also likely to guarantee or enhance employment levels.

Public interest factors have been relied upon to ensure the expedited approval of merger transactions. For instance, a merger involving a company that was placed in provisional liquidation with resultant imminent job losses was assessed by the Commission in 4 business days and heard by the Tribunal on the same day that the Commission's recommendation was submitted to it, resulting in more than 600 jobs being saved (see *Stefanutti Stocks (Pty) Ltd and Energotec (a division of First Strut) (Pty) Ltd (017590)*). Another merger was assessed by the Commission and heard by the Tribunal on an urgent basis and concluded in 12 business days in order to prevent a target firm from going into provisional liquidation which would have resulted in approximately 4,200 job losses (see *Pamodzi Gold Ltd / President Steyn Gold Mines (Free State) (Pty) Ltd [2007] 2 CPLR 417 (CT)*).

Even prior to the COVID pandemic, the competition authorities emphasised the importance of saving jobs, particularly in our socio-economic circumstances. For instance, in 2018, the Tribunal noted that "*South Africa is currently experiencing low economic growth and high levels of unemployment. Where possible, jobs must be saved, particularly in areas where poverty is rife*" (see *K2014202010 (Pty) Ltd / Noordfeld (Pty) Ltd; AM Alberts (Pty) Ltd (in business rescue) t/a Progress Milling [2018] 1 CPLR 260 (CT)).* This is even more imperative in current circumstances and the competition authorities are likely to look to protect jobs even more so than they have previously done.

Where a merger involving a distressed firm may result in jobs being saved, the merging parties should be able to rely on this public interest benefit to obtain approval of the merger. That being said, other public interest factors, such as ensuring the promotion of economic participation by previously disadvantaged persons will also be assessed and if the merger results in further concentration in the market that could be viewed as detrimental to transformation objectives, these factors may be relied upon to argue that the merger should not be approved. In our view, however, the promotion of employment and protection of jobs would likely carry more weight in assessing a merger involving a distressed firm as the public interest benefits in approving such a merger are clear and have an immediate impact.

One of the amendments to the Competition Act that is not yet in effect is the provision that requires approval for foreign investments where issues of national security are concerned by a special committee established by the President. This provision, once in force, can conceivably be used as a tool to prevent investments by foreign companies where those transactions could be viewed as a run on the South African economy in light of the aftermath of the pandemic. It seems improbable now however that any foreign direct investment would be turned down in the foreseeable future and once this provision comes into effect (if indeed it does), unless there was a very clear and present danger to national security.

Although time will tell how the South African competition authorities deal with this inevitable result of the pandemic, it is interesting to note that other competition regulators have already had to deal with cases of this nature. The UK Competition and Markets Authority (**CMA**) has already provisionally approved the acquisition by Amazon of Deliveroo (an online food delivery service) relying on the failing firm doctrine. The CMA's press release states that the CMA has been "*considering this new evidence as a matter of urgency"*, in light of the *"wholly unprecedented circumstances*" resulting from the current crisis. It has provisionally concluded that the transaction will not be expected to result in a substantial lessening of competition, on the basis of the so-called "failing firm" defence: Deliveroo is likely to exit the market unless it receives the additional funding available through the transaction, and the loss of Deliveroo as a competitor would be more detrimental to competition and to consumers than permitting the Amazon investment to proceed. Further information on the CMA provisional clearance can be obtained here.

It should be hoped that our authorities will similarly be willing to redefine the parameters of the failing firm doctrine or, absent that, be willing to readily accept that there must be a "new normal" for merger assessment, before COVID-19 notches up a higher corporate mortality count than can be prevented through a revised perspective.

More on COVID-19

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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