

## Commerce Act - Failing firms in the context of COVID-19

**The COVID-19 pandemic is having a significant impact on New Zealand businesses. Many are facing restructurings, asset sales and sadly some permanent closures. The flip-side is that businesses in a strong financial position may have the opportunity to acquire failing businesses or their assets – opportunities not available in other stages of the economic cycle.**

This article considers the Commerce Commission's approach to "failing firm" arguments that are raised by applicants seeking Commerce Act clearance in the context of the economic fallout from COVID-19.

The New Zealand Commerce Commission's (NZCC) role in promoting competition for the benefit of consumers by enforcing the Commerce Act 1986 (Act) is as relevant as ever. Yet unusual times can call for unusual measures. In May 2020 the NZCC issued guidance regarding business collaboration during COVID-19. The thrust of the guidance was that the exceptional circumstances created by COVID-19 may require competing businesses to collaborate in ways that would ordinarily breach the Act to ensure security of supply of essential goods and services.

So – will the NZCC take a similar approach to clearing mergers and acquisitions in the context of COVID-19?

Under sections 47 and 66 of the Act, a business can apply to the NZCC for clearance of a proposed merger or acquisition. Clearance will be granted if the NZCC is satisfied that the merger or acquisition is not likely to substantially lessen competition in a market. Acquiring

some or all of a competing business, generally reduces competition. If the lessening is considered substantial, clearance will not be granted.

In seeking a clearance, businesses sometimes argue that a transaction should be cleared because the business to be acquired is a failing firm. The failing firm argument is essentially that the target business is in terminal decline and its assets will leave the market unless the acquisition goes ahead.

### The failing firm argument – the NZCC's approach

In New Zealand there is no legal test for determining if a business is a "failing firm" and the term is not used in the Act. In all cases, when presented with an application for clearance the NZCC compares the future likely state of competition if the acquisition were to proceed (the factual), against the likely state of competition if it were not (the counterfactual). In a failing firm situation, the argument is that the factual and the counterfactual will be the same because of the loss of competition from the failing business.

The High Court has made it clear that the failing firm argument is just one potential counterfactual that should be assessed by the NZCC as a matter of fact.

"Put simply, we think that the question of actual, imminent, or probable failure of a participant in a merger proposal is nothing more than a question of fact to be determined by the tribunal and taken into account..."<sup>1</sup>

### How does the NZCC determine a business is failing?

The Commission's Mergers and Acquisitions Guidelines identify two scenarios in which the Commission will assess a failing firm counterfactual:

- the assets would become scrap or be put to

<sup>1</sup>New Zealand Co-operative Dairy Co Ltd v Commerce Commission - [1992] 1 NZLR 601, (1991) 3 NZBLC 102,059, [1991] NZAR 433 at 28-29, 32.

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alternative use; and

- there are a number of bidders and the firm must be sold. In this case, the NZCC assumes an acquisition by a party that would not substantially lessen competition.

During the GFC the NZCC issued Failing Firms Guidelines explaining how it assesses a failing firm claim.<sup>2</sup> Each claim will be assessed on its facts and the NZCC expects to see considerable, robust evidence before it can conclude a firm is truly failing e.g.:

- budgets and forecasts for the current year and future years;
- an analysis of margins and profitability over a number of years; and
- board minutes and papers concerning viability.

Evidence of declining sales or profits alone is unlikely to be sufficient.

The Commission will then carry out a rigorous assessment, asking questions such as:

- Is there a trend of negative cash flows over a sustained period of time?
- Is there any prospect of restructuring or refinancing the business?
- Have there been ongoing and serious, but unsuccessful, attempts by the owner to rescue the business?

### The impact of COVID-19?

To date the NZCC's case register for merger clearances has not shown an uptick in clearance applications that make failing firm arguments. However the NZCC is anticipating an increase. In its response to the Minister of Commerce and Consumer Affairs' annual Letter of Expectations for 2020/21 the NZCC stated that, in light

<sup>2</sup>[https://comcom.govt.nz/\\_data/assets/pdf\\_file/0018/65142/comcom-mergersandacquisitionssupplementaryguidelinesonfailingfirms.pdf](https://comcom.govt.nz/_data/assets/pdf_file/0018/65142/comcom-mergersandacquisitionssupplementaryguidelinesonfailingfirms.pdf)

of COVID-19, one of its immediate areas of focus is making timely decisions on mergers involving failing firms:

"...we will seek to prioritise any requests for merger approvals where the financial viability of a firm is in jeopardy because of the current economic circumstances. We will continue to assess each application on a case-by-case basis, taking into account the current environment, and the longer-term impact on competition from any change in the structure of markets".

However New Zealand businesses should not read this recognition of the need for expediency as an indicator that the NZCC will relax how it assesses failing firm arguments. The NZCC's peer agencies in the USA and the United Kingdom have addressed this explicitly. The USA Federal Trade Commission's (FTC) Bureau of Competition stated in May 2020 that it "will not relax the stringent conditions that define a genuinely failing firm"<sup>3</sup> and the United Kingdom's Competition and Markets Authority has stated that it "remains critical to preserve competition in markets through rigorous merger investigations".<sup>4</sup>

The FTC cautioned argument to:

"think twice before making apocalyptic predictions of imminent failure during a merger investigation".

The FTC apparently has no shortage of examples of firms that have experienced "miraculous recoveries" after the abandonment of proposed mergers that were not granted clearance.

All indications are that the NZCC, like its international peers, will continue to expect substantial evidence about the future viability of a so called "failing firm". COVID-19 has been recognised as a relevant aspect of

<sup>3</sup><https://www.ftc.gov/news-events/blogs/competition-matters/archive/202005>

<sup>4</sup><https://www.gov.uk/government/publications/merger-assessments-during-the-coronavirus-covid-19-pandemic/annex-a-summary-of-cmas-position-on-mergers-involving-failing-firms>

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the landscape in which the firm is operating, but this does not suggest that a more lenient approach will be adopted to assessing failing firm arguments.

**Want to know more?**

If you have any questions about the NZCC's approach to failing firm arguments, or about the merger clearance process generally, please contact Sarah Simmers, our [Competition](#) specialist.