THE FAILING FIRM DOCTRINE DURING COVID-19: A PERSPECTIVE FROM SOUTH AFRICA

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I. INTRODUCTION

The COVID-19 pandemic is likely to result in a large number of firms facing financial distress. This will likely lead to increased merger notifications appealing to the failing firm doctrine ("FFD"). The Commission will be faced with the difficult task of balancing future weakened competition in an already highly concentrated economy with possible firm exit in a country with an already high unemployment rate of 30.1 percent. This challenge will be heightened by requests for expeditious assessment of numerous mergers simultaneously.

In the four months to July 2020, the Competition Commission of South Africa ("CCSA") had already received two filings formally appealing to the failing firm doctrine and a further four filings in which firms claimed to be under severe financial pressure and facing imminent exit as a result of the economic effects of the COVID-19 pandemic. In comparison, the Commission evaluated three cases under the formal FFD in the previous financial year.

This article sets out some preliminary thoughts on the application of the failing firm doctrine in the context of the COVID-19 pandemic in South Africa. It starts with a brief review of the FFD in South African competition law, followed by considerations on the application of the FFD in the current circumstances.

II. FFD IN SOUTH AFRICA

The South African Competition Act explicitly recognizes the FFD as one of the factors that must be assessed to determine whether a merger will substantially prevent or lessen competition. The failing firm doctrine is therefore not a defense against an anticompetitive merger in South Africa; instead, the Commission is required to assess whether the business or part of the business of a party to the merger has failed or is likely to fail, as part of the merger review process.

The test in South Africa, which was primarily set out in the 2002 *Iscor/Saldahna Steel* merger decision broadly involves assessing whether the following conditions have been met:[2]

1. Whether the target firm has failed or is it likely to fail.

2. Whether there is a more competitive alternative purchaser of the target.

3. Absent the acquisition, whether the assets of the failing firm would exit the relevant market.

2 Competition Tribunal, *Iscor/Saldanha*, Case No. LM047Dec01, February 21, 2002.

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Even if the assets were to exit absent the merger, the assessment would still determine whether that outcome is a more competitive alternative to the merger. This would be the case if the market share of the failing firm were to be distributed more evenly among the remaining competitors than is the case with the merger.

If merging parties, who bear the burden of proof, argue the FFD, the Commission is required to weigh up evidence on the extent of failure or its imminence against the anti-competitive effect. The "*greater the anti-competitive threat, the greater the showing that failure is imminent.*" [3] At this stage of the assessment, the Commission does not evaluate the potential positive effects of allowing a potentially anticompetitive merger involving a failing firm on factors such as employment, for example. That assessment is done separately as the South African regime requires a distinct assessment of the public interest effects of the merger which includes an explicit assessment of the employment effects, among several other public interest grounds.

III. WHAT DOES COVID-19 MEAN FOR FFD ASSESSMENTS?

In response to the COVID-19 pandemic, the South African government implemented a hard lockdown with severe restrictions on economic activity from March 26, 2020 to April 30, 2020. From May 1, 2020, the government implemented a risk-adjusted strategy which saw the easing of lockdown restrictions and gradual opening up of the economy under less restrictive lockdown levels, though with continued restrictions in sectors such as hospitality and tourism where the risk of transmission was considered to be higher.

We have identified three broad ways in which the COVID-19 pandemic and associated constraints on economic activity may impact the assessment of the FFD.

Firstly, in the context of the risk adjusted response, the economic lockdown will have a differential impact on various sectors of the economy. Some sectors will not be impacted significantly and may even see increased demand as a result of the crisis (e.g. mobile operators, e-commerce, courier delivery, grocery retail, and pharmacies). Many other sectors will be impacted in the short-term due to closures but should be able to resume operating under less restrictive lockdown levels (e.g. clothing and other retail). There may also be a lingering impact from reduced demand as the country moves into a recession. Finally, there are sectors that will be impacted for a longer period due to extended closures and customers trying to limit their exposure to one another even after lockdown restrictions are lifted (e.g. air transport, tourism, personal services, live entertainment events and any other goods or services where consumption is social in nature). Therefore, a blanket approach to all firms appealing to the FFD due to the COVID-19 pandemic is not appropriate.

Secondly, government and development finance agencies have introduced measures to relieve distressed companies during this period such as grants, loans or assistance with payroll. Some of these are especially geared towards helping micro, small and medium-sized enterprises. Relatedly, the CCSA granted block exemptions to financial institutions which enables them to offer debt relief to distressed firms.[4] A block exemption was also granted to retail property landlords which enables them to provide payment holidays and/or rental discounts to tenants as well as suspend or adjust lease agreement clauses that make it difficult for retailers to ensure their viability during the crisis.[5] These measures provide an enhanced basis for salvaging businesses from failure rather than distressed mergers and consideration thereof would need to form part of the assessment of likelihood of exit under the FFD.

Thirdly, the widespread financial distress that the pandemic has precipitated means that markets may look very different to how they have looked in the past, in particular those markets that are likely to be subject to long-term effects. Therefore, backward looking assessments of competition may no longer be as informative about future competitive dynamics.

3 Competition Tribunal, *Iscore/Saldanha*, Case No. LM047Dec01, February 21, 2002, para.110.

4 DTI, March 23, 2020, Covid-19 Block Exemption for the Banking Sector, available at https://www.gov.za/sites/default/files/gcis_document/202003/43127rg11058gon355.pdf [27 May 2020].

5 DTI, March 24, 2020, Covid-19 Block Exemption for the Retail Property Sector, available at https://www.gov.za/sites/default/files/gcis_document/202003/43134rg11059gon358.pdf [27 May 2020].

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IV. IMPACT OF COVID-19 IN DIFFERENT INDUSTRIES

The Table below presents a non-exhaustive list of industries that are likely to (A) have been largely unaffected by COVID-19; (B) to be impacted in the short-term primarily; or (C) experience a longer lasting impact.

Table 1: Categorization of industries based on likely impact of COVID-19

Category A – no or positive impact	Category B – short-term impact	Category C – long-lasting impact
Grocery wholesale & retail	All other retailers	Airlines
Healthcare	Tobacco producers	Restaurants and bars
e-Commerce	Alcohol producers	Hospitality
Pharmacies	Mining	Cinemas
Food value chain	Construction	Personal fitness
Mobile operators	Real estate	Tourism
Essential hygiene / medical product manufacturers & distributors	Manufacturing industries	Personal care
		Online Travel

For firms in Category A, there is less likelihood of distressed mergers, and any potential failure is unlikely to be solely related to the COVID-19 crisis. There is therefore little reason to apply the FFD any differently to the ordinary case.

Category B contains industries whose operations were temporarily suspended or severely curtailed during the lockdown but may resume operations under less stringent lockdown levels. In some industries listed in Category B, such as mining and construction, it is possible that the general and sustained depression in demand will cause longer-term damage to their businesses. For example, press reports indicate that some mining and manufacturing companies are not operating at full capacity until there is enough demand in the market even though they were already permitted to resume operations under eased lockdown levels.[6] Others, such as glass manufacturers, are keeping their operations running due to the high costs of shutting down and re-starting their furnaces despite the fact that they generate no sales at the current lockdown levels.[7] Temporary debt relief and payment holidays for rent are likely to offset some of the harm experienced by firms in these industries, reducing the potential for failure and the imperative to resolve such failure through mergers with rivals. If the business is fundamentally sound, finding alternative ways to salvage the business should be a viable alternative. This assessment will obviously change, the longer restrictions remain in place.

The greatest likelihood of distressed mergers with limited alternatives are firms falling into industries that are likely to experience a long-term impact of COVID-19 (i.e. those listed under Column C). These are industries that are likely to continue to be affected – either because they are not permitted to operate under most lockdown levels or because customers will avoid them to limit their exposure to COVID-19. However, even among the industries in Category C, some sectors are more concentrated than others and more concentrated sectors would warrant closer scrutiny.

6 For example, Arcelor Mittal will keep one of its two blast furnaces offline until steel demand recovers. See https://carletonvilleherald.com/32406/level-3-arcelormittal-will-be-able-to-operate-with-100-of-its-workforce-but/.

7 https://www.dailymaverick.co.za/article/2020-05-17-alcohol-bans-catastrophic-consequences-for-the-glass-industry/#gsc.tab=0.

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V. ASSESSING COMPETITION IMPACT IN THE CONTEXT OF THE COVID-19 PANDEMIC

The relevance of the FFD primarily arises in the context where there is a likely substantial prevention or lessening of competition ("SLC") arising from the merger. Absent such an SLC, there would be little reason to engage in the FFD analysis as a failure to do so would still not prevent the approval of a merger.

The competition assessment has to be forward-looking and focus on the entire sector to determine which firms are likely to survive and what concentration levels in the sector will look like post-COVID-19. This may be relatively straightforward for industries that continue to operate under lockdown restrictions or face relatively short-term impact, as historic shares may be reflective of likely future shares. For firms that are severely impacted by the economic restrictions, historic information on market shares and concentration levels may not be informative of competition levels in the future. For example, in the airline sector, many airlines have announced they will not operate under eased lockdown levels and the phasing in of airports will limit others to operating on certain routes. Therefore, pre-crisis market share information will not be informative of market shares and dynamics in air travel going forward, both in general and on specific routes. The relative strength of competitors prior to COVID-19 is unlikely to be a good indication of their current financial position and ability to resume operations.

It is therefore important to consider the likelihood of further failure in the sector, the current plans for the resumption of operations by competitors and the timing of the restart of operations. This analysis, as well as the classification of the economic impact alluded to above, will likely change the longer the economic lockdown lasts.

Due to the current climate, entry and/or expansion of firms may also be limited for some time and therefore potential competition needs to be treated with some caution. A firm's plans to enter or expand in a particular market prior to the pandemic should not be taken as given in the competition assessment as these plans will have to be verified as to whether they will still proceed.

In the next section, we look at factors that are material to the elements of the FFD set out above.

VI. ELEMENT 1: IS THE DISTRESSED FIRM FAILING OR LIKELY TO FAIL?

In assessing this element, we should have regard to the liquidity of a firm and its ability to continue trading. A relevant counterfactual in this respect is whether the firm would be able to survive if it were placed under business rescue and receive a reprieve from short term debts. A critical consideration will be whether the firm will be able to obtain access to post-commencement funding to continue to operate under business rescue.

Where business rescue has been initiated, the liquidity of the firm and its ability to continue trading while its debts are renegotiated is specifically considered by the business rescue practitioner. If business rescue has not been initiated, it is thus important to consider similar factors to determine the likelihood of exit. In particular, this includes assessing whether (a) the firm has a fundamentally sound business; (b) whether the financial distress is only likely to be short-term rather than long-term; and (c) what alternatives have been explored to alleviate the firm's liquidity problems.

This analysis could also extend to evaluating whether the firm has attempted to renegotiate debt repayments, whether it has considered reorienting its business or cutting costs to offset its losses, and whether the firm has attempted to access alternative sources of funding such as government grants and loans, and loans from other lenders.[8] The reasons for not taking up alternative forms of funding should be probed as reasons such as non-preferred interest rates, for example, are not necessarily an acceptable reason for rejecting a loan offer. If a distressed firm were offered funding but declined to take up the funding, it may be relevant to consider whether the funding was sufficient to alleviate the distressed firm's financial troubles and whether it could become available timeously.[9]

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8 In the recent merger between Amazon and Deliveroo in the UK, Deliveroo started delivering grocery items in addition to takeout. However, the CMA found that these efforts could not offset the business' losses in any significant way. Source: CMA, April 16, 2020, Anticipated acquisition by Amazon of a minority shareholding and certain rights in Deliveroo: Provisional Findings Report, available at https://assets.publishing.service.gov.uk/media/5ea6e697e90e0704930d8a97/PFs_Report_.pdf [May 18, 2020].

9 Deliveroo was not eligible for any such financial support in the UK at the time of the provisional findings since it was too large to qualify as an SME and was not 'investment grade' prior to the crisis. Source: *Ibid.*

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Finally, it is also relevant to determine whether distressed industries could avoid widespread individual firm failure by way of a temporary competition exemption that is used to manage capacity and financial health through the crisis.

For mergers in which the target firm has already started a business rescue process, many of the above analysis would have already been undertaken by the business rescue practitioner. Nonetheless, that process should still be subject to an interrogation of the findings on the salvageability of the distressed firm in the absence of the merger.

VII. ELEMENT 2: IS THERE A LESS ANTI-COMPETITIVE ALTERNATIVE PURCHASER?

The FFD still requires a consideration of less anti-competitive alternatives and there is no reason to relax this requirement, lest there be opportunistic mergers pleading application of the FFD. This is of particular significance where the merger is likely to result in a significant lessening of competition. A failure to engage in a process of finding alternatives to an anti-competitive merger means that the firm will not be able to confirm that no such alternatives exist, exposing it to a negative finding in this regard.

As is ordinarily the case, it is important to consider all alternative purchasers that offered a price at or above the liquidation value rather than a test of whose offer was the more lucrative, as that is likely to be the one with the largest anti-competitive effects. It is also important to verify this information with business rescue practitioners and alternative purchasers.

VIII. ELEMENT 3: WILL THE ASSETS OF THE FAILING FIRM EXIT THE MARKET?

The FFD requires that the merging parties show that if the firm were to fail, its assets would exit the market rather than being acquired and put to productive use by other firms. The pandemic should not remove this onus. It is possible that under pandemic conditions, there may be fewer potential purchasers of the failing firm's assets than there would have been pre-crisis. Furthermore, the assets may be less valuable than they would otherwise have been pre-COVID-19, especially for industries that are likely to be affected long-term. Nonetheless, remaining firms may still wish to acquire productive capacity for the future at cut-rate prices and therefore it is still important to verify whether there would be interest in the failing firm's assets from its competitors. As is ordinarily the case in an FFD assessment, the distribution of market share in the event of failure should be considered, and whether that distribution is less anti-competitive than the merger scenario.

IX. PUBLIC INTEREST CONSIDERATIONS

Merging parties are likely to argue that the public interest of job retention outweighs any anti-competitive effects of mergers during this pandemic. However, these need to be carefully considered and balanced against the long-term anti-competitive effects and structural changes to the economy which may be hard to reverse in future.

This is particularly the case where the merger may not necessarily save jobs and there could still be non-merger specific job losses, for example due to a decrease in demand in the short or medium term. In other instances, job losses may be short term and the sector is likely to re-employ people once business resumes, regardless of whether the merger takes place or not. Finally, if the saved jobs are indispensable to the operation of the distressed firm's assets or meeting pre-existing customer demand, then it is possible that there is no difference between employment under the merger and under the counterfactual over the medium-to-long-term. The difference may merely be the location of the employment, i.e. in the merged entity or in other entities. It is therefore important to get a proper perspective on employment effects in order to balance public interest considerations against the long-term competition effects of mergers.

Public interest also extends to the impact of a merger on a region or sector of the economy. In the case of manufacturing capacity, the public interest concerns the retention of productive capacity and associated skills in the economy. Therefore, it is important to understand if a potential failure will remove productive capacity from the economy altogether or if the assets will be acquired or replaced by other firms in the sector.

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X. CONCLUSION

There will be increased pressure on competition authorities to approve mergers quickly in the next few months. Nonetheless, it is vital that the evidentiary burden on the merging parties to prove they are faced with a failing firm is not relaxed during the COVID-19 pandemic particularly where these mergers may have long-term structural effects.[10]

Due to the analytical challenges discussed above, the assessment of mergers under the FFD will require, in addition to all the normal elements of the FFD, several other considerations. These include:

1. A forward-looking assessment of competition in the relevant markets taking into account any likely exit or business reorganization of significant competitors due to COVID-19;

2. Adjustments to the business plan, tapping into financial relief measures, and negotiation with creditors, as well as the reasons why such measures may have failed or were not pursued;

3. The likely length of the impact of COVID-19 on the distressed firm's business, the number of employees that would be able to retain their jobs under the merger and how this would compare with the counterfactual for both the short-term and the medium-term once the economy reopens and demand recovers;

4. Whether the merger will save manufacturing capacity that would otherwise be lost permanently, and whether alternative strategies including temporary reorganization were considered.

10 This is in line with the approach taken by other jurisdictions including the CMA, EC, and FTC.

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