

STRATEGIC ALLIANCES AND THE COMPETITION ACT: THE DIRECTOR'S ENFORCEMENT APPROACH

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Strategic alliances are a vital part of many firms' business strategies in the 1990s. Recognizing this, and out of concern that uncertainty could chill beneficial transactions, the Director of Investigation and Research under the *Competition Act* (the "Director") has released an Information Bulletin providing guidance on the application of the *Competition Act* to strategic alliances.^{1/}

The Director makes clear in the Information Bulletin that few strategic alliances raise issues under the *Competition Act*.^{2/} Strategic alliances are more likely to lead to positive innovation and efficiency gains without accompanying negative effects on competition. But behavior which is potentially injurious to competition becomes more likely the greater the market power collectively held by the parties to an alliance. This increases the risk of an inquiry under the *Competition Act*.

In the Director's experience, horizontal arrangements more often raise competition-related issues than vertical or conglomerate alliances, which only rarely are found to maintain, create or enhance market power. As a result, the Information Bulletin focuses on the provisions of the *Competition Act* relevant to horizontal alliances.

The Director's Approach

A strategic alliance may come to the Director's attention through media reports, research, a complaint (e.g., from a customer or competitor) or by the parties to the alliance. In any case, staff in the Bureau of Competition Policy will conduct a preliminary examination to determine whether the alliance raises issues under the *Competition Act*, and whether further action is warranted.

Strategic alliances are not defined in the *Competition Act*, and the Director does not define or attempt to limit the concept of "strategic alliance" in the Information Bulletin. A single strategic alliance can raise issues under several sections of the *Competition Act*, and the Director is obliged to commence an inquiry under the *Competition Act* if he has reasonable grounds to believe that a criminal offence has been committed or that grounds exist for the Competition Tribunal to make an order with respect to a reviewable practice (e.g., merger, abuse of dominant position).^{3/}

The Director's focus is on the competitive effects of a strategic alliance -- i.e., will there be a substantial or undue lessening or

prevention of competition? The Information Bulletin suggests that agreements between competitors which are clearly aimed at increasing prices, reducing output or constraining non-price competition are likely to be tested against the criminal conspiracy provision. Alliances having less of a competitive effect typically are reviewed under the non-criminal provisions of the *Competition Act*, which allow for efficiency justifications to be considered. While the Director may launch an inquiry under more than one provision of the *Competition Act*, he cannot take enforcement action under more than one of the conspiracy, merger or abuse of dominant position provisions on the basis of the same or substantially same set of facts -- he must choose the most relevant provision under which to proceed. Of particular importance are the conspiracy, merger and abuse of dominance provisions.

Conspiracies

Strategic alliances most often raise issues under the criminal conspiracy provision of the *Competition Act*. Unlike in the United States, Canada's conspiracy offense is not *per se*.

A criminal offense is committed under the *Competition Act* by parties who, among other things, enter into an agreement that prevents or lessens competition unduly in a market, or that is likely to do so. On conviction, parties to an unlawful conspiracy can be subject to fines of up to CDN\$10 million, imprisonment for terms up to five years, or both.⁴¹ Action against conspiracies is an enforcement priority of the Director, who would like to see increased deterrence through greater fines and prosecutions against individuals.⁵¹

To determine whether a strategic alliance is an unlawful conspiracy, the Director will consider the following: (i) have the parties to the alliance entered into an "agreement"; (ii) does the alliance, or is it likely to, lessen competition unduly; and (iii) do the parties have the requisite "guilty mind" -- *i.e.*, did the parties enter into the agreement, fully aware of its terms with the intention to carry it out. In this connection, it is necessary that the parties intended to lessen competition "unduly," which is established when a reasonable business person, who can be presumed to be familiar with the business in which he or she engages, would or should have known that the likely effect of the agreement would be to prevent or lessen competition unduly.

Whether an agreement will have "undue" (*i.e.*, serious or significant) effect can only be determined following analysis of properly defined product and geographic markets and consideration of the market power of the parties in those markets. If the strategic alliance results in a combination of market power and behavior injurious to competition which is serious or significant, it will be unlawful, and subject to criminal enforcement action. The Supreme Court of Canada has determined that "a particularly injurious behavior may . . . trigger liability even if market power is not so considerable."⁶¹ The Director takes the position that the converse is also true -- that with a considerable amount of market power, a less injurious behavior may trigger initiation of an inquiry under the *Competition Act*.⁷¹

If the Director determines that a strategic alliance does result in some serious or significant effect, he will target for full remedial action only those elements of the alliance that have that effect. The beneficial aspects of an alliance may go unchallenged, to the extent they can be separated from the greater whole.

DEFENSES AND EXCEPTIONS TO THE CONSPIRACY PROHIBITION

The *Competition Act* contains twelve specific defenses to a conspiracy prosecution. Efficiency gains is not a defense under the Canadian law. However, agreements regarding the exchange of statistics, the definition of product standards, the size and shape of product packaging, cooperation in research and development, restrictions on advertising and promotion, or measures to protect the environment are exempt unless they result in an undue lessening of competition with respect of:

- quantity or quality of production,
- markets or customers, or
- channels or methods of distribution,

or if the agreement is likely to restrict any person from entering into or expanding a business.⁸² The defense will be lost if an alliance has effect on one or more of these areas, even though the agreement may not be directed explicitly at any of the fields.

A defense is also provided if an otherwise unlawful conspiracy relates only to the export of products from Canada. But this defense is not absolute, and should be relied upon with caution. For example, the defense will be lost if the export alliance has any negative effect on Canadian markets, such that it cannot be said to relate solely to exports or if it restricts other firms from entering into or expanding the business of exporting products from Canada. (Of course, the defense provides protection under Canadian law only, and parties to export alliances should consider other relevant laws, including the laws of the country of import.)

INFORMATION SHARING

As a general rule, information exchanges will be benign in the absence of market power or if the information exchanged relates to matters that lack competitive significance. The greater the market power and more sensitive the information, the more likely it is that the Director will commence an inquiry under the conspiracy laws on the basis that the exchange of information might reduce uncertainty about rivals' competitive responses. Exchanging information with respect to current or future pricing, costs, trading terms or marketing strategy is particularly dangerous, and the competition-related concerns will be enhanced if the products involved are relatively homogeneous or if the firms compete on a limited number of competitive variables.

Risk of an inquiry by the Director into information exchanges will be reduced if mechanisms are established to exchange the information in a manner which preserves the ability of individual parties to determine "independently" what strategy, outside of the alliance, they will follow in the market -- e.g., if the information is exchanged through third parties. In any event, however, evidence of anti-competitive intent will increase significantly the likelihood that an inquiry will be initiated.

Specialization Agreements

The conspiracy provision does not apply to so-called "specialization agreements" that are registered with the Competition Tribunal. Section 85 of the *Competition Act* defines a "specialization agreement" to be:

an agreement under which each party thereto agrees to discontinue producing

an article or service that he is engaged in producing at the time the agreement is entered into on the condition that each other party to the agreement agrees to discontinue producing an article or service that he is engaged in producing at the time the agreement is entered into, and includes any such agreement under which the parties also agree to buy exclusively from each other the articles or services that are the subject of the agreement.

The specialization agreement provision is meant to encourage and protect firms that can benefit from efficiencies not available except through cooperation which might otherwise have an adverse effect on competition. The definition of a specialization agreement is quite narrow, however, and applies only to production in existence at the time the agreement is entered into. Most often, strategic alliances deal with current and future products and processes.

If an application is made to register a specialization agreement with the Competition Tribunal, the Tribunal must consider whether the arrangement is likely to bring about gains in efficiency that will be greater than, and will offset, the effects of any prevention or lessening of competition that is likely to result. The Competition Tribunal must also be satisfied that the efficiency gains would not be realized in the absence of a specialization agreement. If these thresholds are met, the agreement will be registered. The Competition Tribunal has yet to consider registration of a specialization agreement.

Merger

Strategic alliances that involve an equity or other investment by one party in another

could be reviewed under the merger provisions of the *Competition Act*. Section 91 of the *Competition Act* broadly defines "merger" to mean:

the acquisition or establishment, direct or indirect, by one or more persons, whether by purchase or lease of shares or assets, by amalgamation or by combination or otherwise, of control over or significant interest in the whole or part of a business of a competitor, supplier, customer or other person.

"Control" means *de jure* control -- a direct or indirect holding of more than fifty percent of the voting rights of the target corporation is required. The Director takes the position that a "significant interest" arises when one or more persons directly or indirectly acquire or establish the ability to materially influence the economic behavior of all or part of another business.⁹² Thus, if an alliance gives a firm the ability to influence materially another firm's decisions with respect to pricing, purchasing, distribution, marketing or investment, a significant interest might be acquired.

The framework set out in the Director's *Merger Enforcement Guidelines* will be used to assess the competitive effects of a strategic alliance that is a merger. These alliances will be tested against a standard of substantial prevention or lessening of competition. Much like the analytical framework adopted by U.S. antitrust enforcement authorities, markets are defined on an economic basis, and a judgment is made about supply and demand responses that will result from the merger. In his *Merger Enforcement Guidelines*, the Director adopts a market power test to measure the likelihood of a substantial lessening of competition which will be presumed to exist if a merger enables a material price increase to be imposed for two years. Although concentration data remains a key consideration in any analysis, the

Competition Tribunal may not find against a merger solely on the basis of market share. A number of other factors set out in the *Competition Act* must also be considered.¹⁰ Ease of entry into the market, effectiveness of remaining competition and the likelihood of business failure have to date proven to be most important.

Even if a merger might result in a substantial lessening of competition, the Competition Tribunal may not interfere with it if there are likely to be gains in efficiency that will outweigh the anticipated negative effects of the merger and if the gains were unlikely to be obtained otherwise. The Competition Tribunal has yet to provide any definitive interpretation of the statutory efficiency defense, and the Director has indicated that he will not permit any anti-competitive merger to proceed on the basis of gains in efficiency in the absence of an order from the Tribunal that the gains outweigh the negative effects.

Joint Ventures

There is a narrow exemption from the merger provisions for strategic alliances that are joint ventures under Section 95 of the *Competition Act*. Under that section, no order may be made to enjoin a joint venture if:

- the joint venture is formed to undertake a specific project or a program of research and development;
- the project or program would not reasonably have taken place in the absence of the joint venture;
- no change in control over any party to the combination results from the joint venture;

- the joint venture is created by written agreement which requires that one or more of the parties contribute assets, and provides for termination on completion of the project or program; and
- the venture does not prevent or lessen, or is not likely to prevent or lessen, competition except to the extent reasonably required to undertake and complete the project or program.

Because the joint venture provision applies only to an agreement related to a specific project, its application to strategic alliances, which often involve a broader collaboration, is somewhat limited.

Abuse of Dominance

Finally, the abuse of dominance provision might provide a relevant analytical framework to consider the effects of a strategic alliance. Anti-competitive conduct by firms occupying a dominant marketplace position is subject to non-criminal review and corrective action by the Competition Tribunal. However, size alone is not grounds for complaint. Remedies are available only where a dominant firm -- or a group of firms -- substantially control a market and are engaged in anti-competitive behavior that has, or is likely to have, the effect of preventing or lessening competition substantially in that market.

The *Competition Act* provides a non-exhaustive list of anti-competitive acts (e.g., preemption of scarce facilities or resources, adoption of product specifications that are incompatible with products produced

by any other person), and the Competition Tribunal has shown a willingness to expand the list to include essentially any conduct that has an intended effect which is predatory, exclusionary or disciplinary.¹⁴ Upon a finding of abuse that has had or is likely to lead to a substantial lessening or prevention of competition, the Competition Tribunal may make an order prohibiting the dominant firm from engaging in further anti-competitive acts.

Conclusions

As Canadian businesses seek to increase their competitiveness in global markets and North American markets in particular, strategic alliances will continue to be key. Although the Information Bulletin is somewhat disappointing in its depth of analysis, it likely will reduce the uncertainty associated with alliances between competitors and enhance the likelihood that alliances that are beneficial to the Canadian economy will be pursued. The lack of analytical depth in the Information Bulletin is offset somewhat by the useful examples appended to the Bulletin to illustrate the analytical approach the Director might take in evaluating strategic alliances including conspiracy, information sharing, cooperative measures to meet environmental regulations, export consortia, specialization agreements, mergers, international alliances, abuse of dominance, and industry wide alliances. The Information Bulletin should be consulted by the parties to any strategic alliance involving Canadian businesses.

NOTES

^{1/} Ottawa, Director of Investigation and Research, Information Bulletin: "Strategic Alliances Under the *Competition Act*" (December, 1995). A draft of the Information Bulletin first appeared for public comment in August 1994 (hereinafter "Information Bulletin").

^{2/} *Competition Act*, R.S.C. 1985, c. C-34 (hereinafter "*Competition Act*").

^{3/} *Competition Act*, ss. 10(1).

^{4/} *Competition Act*, ss. 45(1).

^{5/} To date, few individuals have been prosecuted for conspiracy, and no individual has been imprisoned. The Director has expressed a desire to reverse this trend. See H. Chandler, *Getting Down to Business: The Strategic Direction of Criminal Competition Law Enforcement in Canada* (Insight Conference, March 10, 1994).

^{6/} *R. v. Nova Scotia Pharmaceutical Society et al.*, [1992] 2 S.C.R. 606 at 657. This decision, and Canadian conspiracy laws generally, are discussed in detail in J. Clifford, *Did You Intend to Lessen Competition Unduly? A Commentary on Canada's Conspiracy Law*, 21 A.B.A. SEC. PUB. CAN. L. NEWSL. 19 (Spring 1994).

^{7/} Information Bulletin, at 7.

^{8/} *Competition Act*, ss. 45(3) and 45(4).

^{9/} See Ottawa, Director of Investigation and Research, Information Bulletin: "Merger Enforcement Guidelines" (April, 1991).

^{10/} See *Competition Act*, s. 93.

^{11/} See *Canada (Director of Investigation and Research) v. The NutraSweet Company* (1990), 32 C.P.R. (3d) 1, and *Canada (Director of Investigation and Research) v. Laidlaw Waste Systems Ltd.* (1992), 40 C.P.R. (3d) 289.