PANDEMIC, ECONOMIC CRISIS, AND THE FAILING FIRM DEFENSE

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I. INTRODUCTION

The profound economic shock caused by the COVID-19 pandemic is likely to cause the failure of a number of firms and possible consolidation in some sectors of the economy. Firms whose business model was faltering pre-crisis will not survive and this may generate M&A activity in relation to distressed assets. This poses a dilemma for competition authorities. On the one hand, they will need to remain vigilant and be concerned by the medium to long-term effects of possible consolidation. On the other hand, some have argued, competition policy should not get in the way of the exit of "*zombie firms that trap industries into low productivity cycle, limited technology diffusion and weak economic dynamism*"[2] and the COVID-19 crisis provides an opportunity to abandon its focus on rivalry. It is possible that in cases of acquisition of distressed assets competition authorities will come under political pressure if the parties argue persuasively that the acquisition will preserve, at least in the short term, some employment opportunities.

These authors do not believe that this area of merger control policy requires a radical rethinking and, on the contrary, competition authorities need to remain alert to the effects of consolidation that may be caused or accelerated by the crisis. The decisional practice developed at EU level (and in the UK) in relation to failing and flailing firms described in this article provides sufficient flexibility. However, the articulation of a correct counterfactual against a background of profound changes that will affect a number of sectors will require that competition authorities calibrate correctly their assessment of the competitive strength of each of the parties and the overall degree of competition.

II. THE EU FAILING FIRM DEFENSE

Under EU law the failing firm defense is firmly anchored on the notion of lack of causality. The parties need to show that the deterioration of the competitive structure that follows the merger cannot be said to be caused by the merger itself.[3] The consequence of succeeding with a failing firm defense is that no regulatory intervention in the merger is justified either through prohibition or through remedies. Therefore, the European Commission's ("EC") Horizontal Merger Guidelines set a high bar for the parties to show that the competitive structure of the market would deteriorate to at least the same extent in the absence of the merger. The following three criteria are "*especially relevant*" to the analysis:

2 Jorge Padilla, Nicolas Petit, Competition policy and the Covid-19 opportunity, May 2020, Concurrences N° 2-2020, Art. N° 94317, pp. 2-6.

3 Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings Official Journal C 031 , 05/02/2004, p.5-18 (Horizontal Merger Guidelines, available here), paragraph 89.

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1. The firm would, in the near future, be forced out of the market because of financial difficulties if not taken over by another undertaking.

2. There is no less anticompetitive alternative purchase than the notified merger.

3. In the absence of a merger, the assets of the failing firm would inevitably exit the market. This is relevant as it may support a finding that the market share of the firm would in any event accrue to the other merging party, particularly if the transaction is a merger to monopoly.[4]

The burden is on the notifying parties to provide sufficient evidence in good time for the failing firm defense to be established.[5] Although the EC's guidelines refer to a failing "firm," the defense has been successfully raised in respect of a division of an undertaking being sold off, including in the *Olympic/Aegean Airlines* and *Shell/Nynas* cases.

The evidential burden is understandably high and this is perhaps best illustrated in the two *Olympic/Aegean* cases. In 2011, the EC prohibited a transaction that would have brought Olympic Air and Aegean Airlines under common joint control,[6] concluding that none of the three failing firm criteria applied to Olympic. Then, in 2013, the EC unconditionally cleared Aegean's acquisition of sole control over Olympic on the basis that the criteria were met.[7]

Taking each of the criteria in turn:

(i) In relation to the prospect of exit, in 2011 the EC had looked at the financials of Olympic and its parent and concluded that in the absence of the transaction Olympic Air would most likely continue domestic operations and retrench from international operations rather than exit entirely.[8] In 2013, two years further into the Greek economic crisis, the EC examined the seller and target financials and internal documents as they then were. Based on the evidence, absent the transaction Olympic's parent was likely to be unable to continue to support Olympic[9] and in any case had no strategic or financial incentive to keep funding Olympic any further.[10]

(ii) As to potential less anticompetitive purchases, in 2011 the parties had been unable to provide evidence that another potential buyer had been sought or that there was no realistic prospect of a less anticompetitive purchaser.[11] In 2013, the EC reviewed extensively the seller's emails to verify that no other purchasers had been interested. A credible alternative purchaser was unlikely to emerge in the immediate future in any event, since: (i) the Greek state had previously tried to sell Olympic four times and the only interested parties had been the seller of Olympic in this case and Aegean; (ii) the seller had had an incentive to find an alternative purchaser after the previous prohibition of the transaction; and (iii) the EC's market investigation also did not reveal any credible alternative purchaser.[12]

(iii) Olympic's main assets were its brand, air traffic rights and aircraft. In 2011, the EC was not satisfied that these would exit the market absent the transaction. The Olympic brand was attractive and likely to find a potential alternative buyer,[13] Olympic's air traffic rights would have reverted back to the Greek state and been allocated to other airlines and Olympic's aircraft would likely have been leased by other Greek airlines.[14] In 2013, the EC tested again what was likely to happen to these assets absent the transaction. 19 out of 20 market inves-

4 *Ibid*. paragraph 90 and footnote 111.

5 *Ibid*. paragraph 91.

6 EC decision in Case No COMP/M.5830 of January 26, 2011 (*Olympic/Aegean I*) (available here).

7 EC decision in Case No COMP./M.6796 of October 9, 2013 (*Olympic/Aegean II*) (available here).

8 *Olympic/Aegean I* paragraph 2068.

9 *Olympic/Aegean II*, paragraph 751.

10 *Olympic/Aegean II*, paragraphs 764 and 805.

11 *Olympic/Aegean I*, paragraphs 2078-2089.

12 *Olympic/Aegean II*, paragraph 816.

13 *Olympic/Aegean I*, paragraph 2106.

14 *Olympic/Aegean I*, paragraph 2117.

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tigation respondents confirmed that they would not have been interested in acquiring the Olympic brand and its aircraft. The respondent that had expressed an interest raised considerable doubts as to its seriousness and credibility.[15] As to Olympic's traffic rights, Aegean was the most likely candidate to acquire these on the routes that would otherwise have raised competition concerns.[16] So, the EC was satisfied that, absent the transaction, the assets would have exited the market or been acquired by the acquirer in any event.

In clearing *Olympic/Aegean II* in 2013, the EC was keen to emphasize that the defense had only succeeded "*under the particular and exceptional circumstances of the present case, which is characterised by the protracted adverse economic conditions in Greece, significant decline in passenger numbers on Greek domestic routes, historic unprofitability of Olympic without conceivable prospects for reversal in the near future, difficult finances of the parent company and its limited ability and incentive to further financially support Olympic*…"[17]

The "*especially relevant*" criteria for the defense are not always applied precisely as they are expressed in the EC's Horizontal Merger Guidelines if it is clear that the more fundamental requirement that the merger itself does not cause competitive deterioration is met. *Shell/Nynas*, for example, did not involve a "failing" division strictly meeting the first of the criteria listed above, but rather a refinery that the seller had decided to close because of a combination of poor financial performance and strategic focus on other activities.[18] Shell had a clear intention to close the refinery, substantiated by public and internal documents and consistent with what would be economically rational and was likely to shut the refinery unless it could sell it.[19] Following an extensive review of internal correspondence as well as correspondence with a third party that had previously bid for the refinery, the EC concluded that the other criteria of the failing firm defense had been met. The exit of the assets in the counterfactual would have led to a reduction of EU production capacity and a likely increase in EU prices.[20] The transaction was likely to lead to a capacity increase at the relevant refinery (based on detailed plans from Nynas), more competitive pressure and lower prices than in the counterfactual,[21] which was therefore "*much worse for the competitive structure of the relevant markets than the reasonably foreseeable effects of the concentration*."[22] The EC cleared the transaction unconditionally.

Although the failing firm defense succeeded twice in 2013 (in *Shell/Nynas* and *Olympic/Aegean II*) we are not aware of the defense being raised successfully since and are only aware of one subsequent decision in which the EC even considered (and rejected) the defense. In 2018, the EC dismissed the parties' failing firm arguments in *Arcelormittal/Ilva* because it was at least the case that the second and third criteria in the EC's Horizontal Merger Guidelines had not been met. The seller had received an alternative binding offer from a less anticompetitive purchaser. The assets would also not have exited the market given their value; the notifying party had not in any case provided evidence that the market share of the failing firm would accrue to the other merging party.[23]

15 *Olympic/Aegean II*, paragraphs 823 and 829.

16 *Olympic/Aegean II*, paragraphs 824 and 925.

17 *Olympic/Aegean II*, paragraph 833.

18 EC decision in Case No. COMP M.6360, of September 2, 2013, paragraph 327 (available here).

19 *Ibid.* paragraph 327.

20 *Ibid.* paragraphs 422 and 505.

21 *Ibid.* paragraphs 475 and 505.

22 *Ibid.* paragraph 526.

23 EC decision in Case No COMP/M.8444 of May 7, 2018, paragraphs 404 to 433 (available here).

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III. "FLAILING" FIRMS/DIVISIONS IN EU MERGER CONTROL

Where a merging party is struggling but not failing or exiting, the EC may still adjust its counterfactual and/or competitive assessment to reflect the deteriorating competitive strength of the business. As with the failing firm defense, the EC makes adjustments on this basis only where there is clear evidence from the parties and market participants and sufficient certainty that the deterioration is not temporary.

In *KLM/Martinair*, for example, the EC concluded that the competitive constraint posed by Martinair would be eroded in the foreseeable future and the merger-specific effects of the transaction were therefore likely to be limited.[24] Martinair had been loss-making and the market investigation had indicated that its long-haul passenger operations were unsustainable. It appeared unlikely that Martinair's shareholders (KLM and Maersk) would, absent the transaction, invest to the extent necessary to restore its competitive strength.[25]

More recently, in *T-Mobile NL/Tele 2*, the EC considered evidence in relation to anticipated challenges facing the target, including the target's internal plans should the merger not materialize and concluded that in the absence of the transaction, the target's competitive strength would likely deteriorate. This in turn informed the EC's assessment of the target as not an important competitive force.[26]

We can expect to see more of these cases in the wake of COVID-19, and a prospective assessment of the long-term effects of the pandemic on some sectors is likely to be a challenge for competition authorities in a merger control context. The recent example of *Amazon/Deliveroo* in the UK provides a good illustration.

IV. THE UK EXITING/FAILING FIRM DEFENSE

The UK Competition and Markets Authority ("CMA") applies broadly similar criteria to the EC in relation to exiting/failing firms and the authority has already been tested as to its application post COVID-19. As a result, the CMA recently restated the criteria for the defense to apply in its guidance on the assessment of UK mergers during COVID-19. These are:

(i) Whether the firm would have exited (through failure or otherwise) absent the transaction.

(ii) Whether there would have been an alternative purchaser for the firm or its assets. Any possible offer above the liquidation value of the assets will be regarded as a possible alternative offer for these purposes.

(iii) What the impact of exit would be on competition compared to the competitive outcome that would arise from the acquisition.[27]

The third consideration had previously been phrased in the 2010 UK merger assessment guidelines as "*what would have happened to the sales of the firm in the event of its exit.*"[28] However, the CMA's more recent guidance clarifies that in practice it considers the broader impact of the firm's exit when making a comparison with the potential anticompetitive impact of a transaction.

In recent years, the exiting/failing firm defense has been considered more often in CMA decisions than EC decisions. Since January 2017, 13 final CMA decisions mention arguments that the target or part of the target would have exited the market absent the merger.[29] This could

24 EC decision in Case No COMP/M.5141, decision of December 17, 2008, paragraph 175 (available here).

25 *Ibid*. paragraphs 163 to 175.

26 EC decision in Case No COMP/M.8792, decision of November 27, 2018, paragraph 443 (available here).

27 Summary of the CMA's position on mergers involving failing firms ("2020 Failing Firm Guidance") (available here).

28 Merger Assessment Guidelines, paragraph 4.3.10 (available here).

29 *VTech/Leapfrog, Boparan/Bernard Matthews, East Coast Buses/East coast operations of First Scotland East, Steven Eagell/Toyota dealerships, Euro Car Parts/Andrew Page, Just Eat/Hungryhouse, Mole Valley/Countrywide Farmers, Medtronics/Animas, Aer Lingus/Cityjet, Danspin/Lawton Yarns, Bauer Media Group A*cquisitions.

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reflect a number of factors including the more volatile rise in corporate insolvencies in the UK compared to the rest of Europe in recent years[30] and/or difficulties that bigger players whose transactions may trigger EUMR thresholds may face in seeking to establish that they or one of their divisions are "failing." However, the merging parties have only been successful in establishing an "exiting firm" defense in two of those recent UK cases.[31]

These two cases (*Cityjet/Aer Lingus* and *East Coast Buses/East Coast operations of First Scotland East*) were cleared unconditionally at Phase I on the basis of straightforward evidence that met the CMA's criteria. Crucially, both cases were "exiting" rather than failing firm cases and the CMA was able to satisfy itself based on the evidence in both instances that the seller had taken the decision to exit the market without needing to assess the more complicated factual question of whether they were "failing." In *Cityjet/Aer Lingus*, the CMA did not mention in its decision the evidence the CMA had reviewed on the certainty of exit, but in *East Coast Buses*, the CMA confirmed it had reviewed internal documents that showed that as part of a wider restructuring, the seller had taken decisive action to cease the target's operations. In both cases the market investigation and available evidence showed no credible alternative purchaser was likely to exist (*East Coast Buses* had received a bid below liquidation value, but this was not credible). In both cases, the sales of the target were likely to accrue to the acquirer in the event of exit; *Cityjet/Aer Lingus* was a merger to monopoly in which Cityjet would otherwise redeploy its assets elsewhere, reducing capacity on the relevant market and in *East Coast Buses*, the acquirer was the only competitor likely to be able to move into the target's routes.[32]

The cases in which the defense has failed to get over the line show that the CMA carefully examines claims that there is no realistic less anticompetitive purchaser. In *Danspin/Lawton Yarns,* the CMA denied the exiting firm defense where substantially less anticompetitive purchasers had made offers for the target at prices better than liquidation value.[33] In *Medtronic/Animas*, the exiting firm defense was not available because the seller had not approached alternative purchasers and the CMA market investigation identified other willing buyers.[34]

For pipeline and future deals, the CMA has been keen to emphasize that the COVID-19 pandemic "*has not brought about any relaxation of the standards by which mergers are assessed or the CMA's investigational standards.*"[35] Failing or exiting firm claims by parties are "*only likely to be accepted…. where supported by a material body of probative evidence, which the merging parties can expect the CMA to test thoroughly with both the merging parties and their advisers, as well as third parties.*"[36]

It is clear that the hurdle is set high. Indeed, the CMA's provisional and final decisions in *Amazon/Deliveroo* show the breadth and depth of evidence required to establish a firm as "failing" and the challenges that may also be faced by other authorities. The CMA reviewed extensive internal documents and third-party advice to provisionally conclude in April 2020 (during the initial phase of UK lockdown) that without a very quick injection of additional funds, Deliveroo's directors would soon be obliged to declare it insolvent and that none of the alternative sources of funding available at the time of the transaction would have allowed it to survive. These provisional conclusions reflected a detailed assessment of the particular business model and funding requirements of Deliveroo as well as the stage that it was at in its funding cycle at the time of the transaction.[37] The assessment included consideration of whether UK Government COVID-19 initiatives could have helped Deliveroo not to fail, applying similar logic to the Office of Fair Trading ("OFT") in *Lloyds/HBOS*, where the OFT found that the failing firm defense could not apply if the Government would not realistically have allowed a firm to fail.[38] By way of contrast, the parties in *Just Eat/Hungryhouse* were not able to establish the failing firm defense because even though the target business was consistently loss-making, there was insufficient evidence that this would

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30 Global Insolvency Outlook 2020 by Allianz and Euler Hermes Economic Research, Statistical Appendix, Table 2, "Business insolvencies growth" https://www.eulerhermes.com/content/dam/onemarketing/ehndbx/eulerhermes_com/en_gl/erd/insightsimport/pdf/insolvency-report-jan20-compressed.pdf.

31 In addition, in *Euro Car Parts/Andrew Page*, the CMA concluded that an "exiting" counterfactual applied to some, but not all, of the target assets.

32 Case ME/6782/18, decision of December 21, 2018 paragraphs 56-75 (available here) and Case ME/6642-26, decision of January 23, 2017, paragraphs 22 – 74. (available here).

33 Case ME/6870/19, SLC decision of November 5, 2019, paragraph 61 (available here).

34 *Medtronic/Animas* decision of May 20, 2018, paragraph 75 (available here).

35 2020 Failing Firm Guidance.

36 *Ibid.*

37 Provisional Findings Report in Amazon/Deliveroo of April 16, 2020, paragraph 4.80 ("*Amazon/Deliveroo PFs*") (available here).

38 OFT Report to Secretary of State in Lloyds/HBOS of October 24, 2008, paragraph 58 (available here).

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lead to closure of the target and the seller had already made plans for the year ahead that assumed the target would remain in business.[39]

The *Amazon/Deliveroo* provisional decision also provides a helpful case study for the assessment the CMA will make to compare the counterfactual with the impact of a transaction. The potential anticompetitive effects that the CMA had identified were the possible disincentivizing of Amazon to re-enter – and compete aggressively in – the provision of online restaurant platforms in UK and/or that both parties could be disincentivized to grow and improve their businesses in the nascent online convenience groceries market. In its April provisional findings, the CMA found that in the online food platforms market, exit by Deliveroo would result in significantly weaker competition over an extended period of time even if Amazon re-entered successfully, than if the transaction were to proceed.[40]

However, by the time the CMA delivered its final *Amazon/Deliveroo* report in August 2020 it concluded that the failing firm defense did not apply, although it still cleared the transaction, having reached a more positive conclusion on the effects of the transaction than it had expected in April. Fatally for the failing firm defense, in the intervening months between the CMA's provisional findings and its final report, Deliveroo performed significantly better than it had forecast. Demand for the services of Deliveroo and its competitors had improved, UK lockdown measures had eased, and funding markets had started to recover. Deliveroo's cashflow had moved from negative to positive and afforded it more time to seek additional funding and rationalize its operations. In the absence of sufficient evidence to the contrary, the CMA concluded that the most likely counterfactual in the absence of the transaction was that Deliveroo would continue to compete and to be able to raise funds to do so.[41]

V. "FLAILING" FIRMS/DIVISIONS IN UK MERGER CONTROL

The CMA has signaled willingness to adopt a dynamic approach to the counterfactual and competitive assessment of a merger, including to adjust for a party becoming a weakened competitor during, or in the foreseeable future after, the CMA's review. It has said that this could include the impact of COVID-19 on a firm.[42]

Merging parties have nonetheless only succeeded rarely in making "flailing firm" arguments in the UK. When they have succeeded this has only been achieved with significant supporting evidence. In *Muller/Dairy Crest*, for example, the CMA concluded the relevant counterfactual was a downsized target firm based on a thorough examination of the target's financials and internal documents as well as the parties' valuation of the business and views from market analysts.[43]

"Flailing firm" arguments most often fail for lack of sufficient certainty that the relevant party will be really be a weakened competitor in the foreseeable future. In *JD Sports/Footasylum*, the CMA rejected arguments that the impact of COVID-19 on Footasylum's ability to compete should be reflected in the counterfactual because it was uncertain that the effects described by the parties would endure.[44] The CMA also rejected arguments from the parties that its competitive assessment should reflect Footasylum becoming a weaker competitor as a result of COVID-19. It was not clear that the impact of COVID-19 would reduce materially the extent to which the parties were close competitors or increase materially the aggregate constraints posed by other retailers on the parties, at the time of the decision or in the foreseeable future.[45]

39 Final report in *Just Eat/Hungry House* of November 16, 2017, paragraph 5.33 (available here).

40 *Amazon/Deliveroo* PFs, paragraph 4.80.

41 Final report in *Amazon/Deliveroo* of August 4, 2020, paragraphs to 6.41 to 6.74 (available here).

42 "…*[e]vents…during the CMA's review of a transaction (such as the business impact of Coronavirus (COVID-19), but which are not a result of the merger, can be incorporated into the counterfactual. Where future events or circumstances are not certain or foreseeable enough to include in the counterfactual, the analysis of such events can take place in the assessment of competitive effects*", 2020 Failing Firm Guidance.

43 Case ME/6524/15, decision of June 12, 2015, paragraph 91 (available here).

44 Final Report in *JD Sports/Footasylum* of May 6, 2020 paragraphs 5.77 to 5.87 (available here).

45 *Ibid*, paragraph 9.306. This is consistent with previous UK merger control decisional practice, including *Kerry Foods/Headland Foods*, where the OFT rejected both failing and flailing firm arguments (Case ME/4893/11, decision of July 12, 2011, paragraphs 41 and 42 (available here)).

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VI. CONCLUSION

As the pandemic continues to play out, we will no doubt see more failing and flailing firm arguments put forward in merger control reviews. The EU and UK regimes have demonstrated a degree of flexibility to accommodate dynamic counterfactuals and competitive assessments and regulators may come under political pressure to exercise that flexibility. Moreover, at EU level the EC will be mindful of the General Court's recent *H3G UK/Three UK* judgment on the robust evidence required to demonstrate an "important competitive force."[46] However, the uncertainty that this pandemic brings may present significant difficulties for those in some sectors who want to reflect its effects in a well-evidenced counterfactual. The *Amazon/Deliveroo* case is a cautionary tale about the risk of seeking to rely on failing firm arguments based on short-term considerations notwithstanding its happy ending for the parties.

46 Case T-399/16, Judgment of May 28, 2020, paragraphs 434 to 455.

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