The Failing Firm Defence – Some Further Thoughts Post Nynas/Shell and Aegean/Olympic II Introduction

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In late 2013, the Commission adopted in quick succession two decisions which applied the so-called failing firm defence ("**FFD**") to clear unconditionally transactions which would lead to monopoly or near-monopoly in the relevant markets. In the first, in September 2013, the Commission cleared the proposed acquisition by Nynas of certain refinery assets of Shell Deutschland GmbH,[1] leaving the acquirer as the only EEA-based producer of the relevant products. And in the second, in October 2013, the Commission applied the FFD to clear the acquisition by Aegean of Olympic Airlines,[2] despite the resultant monopoly on a number of Greek domestic airline routes. Both represented instances where the Commission concluded that the FFD test was met by a division, rather than the firm as a whole.

Historically, the Commission had applied the FFD in very limited circumstances and had never found the test to be met in respect of a failing division. Therefore, in an article[3] published shortly afterwards (based on information publicly available at the time) we asked whether these two decisions might indicate a move by the Commission away from the previous strict approach to the FFD and towards a broader counterfactual analysis.

The publication of the Commission's decisions in both cases provides a welcome opportunity to revisit that question with the benefit of having now reviewed the Commission's detailed analysis.

In short, we believe that the Commission indeed appears to have updated – through greater flexibility – its views on the FFD, where a division, rather than a whole firm, is allegedly failing. It appears that it is now possible for notifying parties to benefit from the FFD without needing to demonstrate that the viability of the whole group is endangered by the allegedly failing division. Rather, it will suffice that the parties can demonstrate – on the basis of detailed and objective evidence – that the parent genuinely no longer has the ability or incentive to support the failing division, provided that certain other safeguards are observed. This is used as a counterfactual which enables the Commission to conclude that the merger is not the cause of the deterioration of competition which would take place anyway even absent the merger following a prohibition decision.This was the explicitly stated approach of the Commission in *Aegean/Olympic II* and appears to have been adopted implicitly by the Commission in *Nynas/Shell/Harburg Refinery*.

Both decisions continued, however, to demand a very high evidentiary standard. Both decisions involved clear instances where the division was in obvious financial difficulty, and where, absent the merger, the assets would have inevitably exited the market and no alternative buyer was available.

Based on the evidence of these decisions, parties continue to face a significant burden when attempting to invoke the FFD and these decisions should not be seen as a general softening of the Commission attitude towards the FFD.

Summary of the FFD

The Commission considers that "*an otherwise problematic merger is nevertheless compatible with the common market if one of the merging parties is a failing firm. The basic requirement is that the deterioration of the competitive structure that follows the merger cannot be said to be caused by the merger.*"[4] (Emphasis added).

Three cumulative criteria are "*especially relevant*"[5] for a FFD to be accepted, namely: (i) the allegedly failing firm would in the near future be forced out of the market because of financial difficulties if not taken over by another undertaking; (ii) there is no less anti-competitive alternative purchaser than the notified concentration; and (iii) in the absence of the merger, the assets of the failing firm would inevitably exit the market.

The Commission has applied these criteria strictly in its previous practice and has historically been particularly suspicious of 'failing division' cases where the parent company remains in a healthy financial state. The Commission has previously noted the need to assess whether the claimed imminent closure of a division has arisen due to a management decision to withdraw from the market (and to design the balance sheet of the division to fit the criteria), or due to a real economic failure.[6] Prior to *Nynas/Shell* and *Aegean/Olympic II*, no parties had successfully established the existence of a 'failing division.'

Conversely, there have been a few instances where the Commission departed from its strict analysis by clearing transactions where the strict FFD test was not met but where, on a broader counterfactual analysis, the merger scenario resulted in less harm to competition than other alternative scenarios.[7]

Nynas/Shell/Harburg Refinery

Nynas/Shell/Harburg Refinery represented a rare occasion where the Commission found that the FFD criteria were met. Not only that, it was the first occasion where the Commission concluded that the FFD criteria were met in respect of a division, rather than a firm as a whole. As noted above, the Commission had previously expressed extreme skepticism about the prospects of demonstrating the existence of a 'failing division,' noting that "*the burden of proving that the defence of lack of causality is valid must be especially heavy in such circumstances.*"

It is somewhat surprising that as the first ever successful invocation of a 'failing division' argument the decision does not mention explicitly the terms 'failing firm' or 'failing division,' albeit it refers to the Horizontal Merger Guidelines. However, it is clear from the text of the decision that this was the test applied by the Commission. Furthermore, Commissioner Almunia confirmed in the press conference accompanying the *Aegean/OIympic II* decision that the FFD had been applied in *Nynas/Shell/Harburg Refinery.*[8]

The Commission concluded that no competition concerns arose in circumstances where Nynas would remain the only producer of napthenic base and process oils in the EEA and the largest producer of transformer oil, facing substantial competition only from a US-based importer. The Commission found that, absent the transaction, the Harburg plant would simply have been closed and the assets would have exited the market. Furthermore, this would have resulted in significant capacity shortages on the European market and higher prices for European customers. Conversely, the acquisition by Nynas would result in a reduction of variable costs, with the prospect of some savings being passed on to consumers. Each of the three FFD criteria is assessed in turn below.

(i) Allegedly failing firm/division would be forced out of the market in the near future

The economic evidence submitted by Shell in conjunction with its internal documents convinced the Commission that, absent the transaction, the rational decision was to close the Harburg site. The Commission noted that the refinery site had been loss-making for a period of five to ten years.[9] Furthermore, an exit would be in line with Shell's business strategy due to a focus on larger scale facilities. This conclusion was bolstered by internal Shell documents[10] and Annual Reports pre-dating the notification to the Commission, together with practical steps that Shell had already taken to convert other parts of the refinery (which did not form part of the transaction).

The Commission therefore concluded that, absent the transaction, the refinery assets would be closed and would be forced out of the market if not taken over by another undertaking, due to their poor financial performance and Shell's strategic focus on other activities.[11]

Here, unlike in *Aegean/Olympic II* (discussed below), the Commission made no reference to the historically stricter test to establish the existence of a failing division. The Commission merely concluded that the first limb of the FFD was met, based on a combination of the financial situation of the refinery assets and the internal documents of Shell.

(ii) No less anti-competitive alternative purchaser

The Commission reached the conclusion that no less anti-competitive alternative purchaser existed for the assets relatively quickly but on the basis of a detailed review of the facts. The only credible alternative purchaser (Ergon, the remaining competitor on the EEA market for napthenic base oils and transformer oils) had already mounted one abortive attempt to acquire the assets in 2011 but had failed to make a credible binding offer due to the level of return on offer.

Following the issuance of the SO, Shell invited Ergon to confirm its interest in acquiring the assets on the 2011 terms but no deal was made. Interestingly and applying a full counterfactual analysis, the Commission also noted that the incentives Ergon had in 2011 to acquire the assets i.e. to reduce the capacity available to its main competitor in the EEA market, would disappear in the event of a Commission prohibition decision.[12] Ergon's existing spare capacity, together with an absence of internal documents evidencing a continued strategic interest in acquiring the Harburg refinery assets enabled the Commission to conclude that no less anti-competitive alternative purchaser existed.

(iii) Inevitable exit of assets

The Commission therefore concluded that, in light of the above factors, and the prohibitive cost of relocating the assets elsewhere, the most likely outcome that could reasonably be predicted was that the assets would exit the market.[13]

Counterfactual analysis

Applying a counterfactual analysis, the Commission then proceeded to assess the effects on competition of the transaction, compared to the effects on competition of a closure of the assets.

The Commission concluded that, absent the transaction, Nynas would need to rely on expensive imports or forego non-EEA sales in order to meet expected EEA demand. Both would reduce Nynas' incentives to compete aggressively in the EEA. While closure of the assets would result in a higher market share for Ergon, which had spare production capacity in the US, this would likely also result in higher prices for customers. Nynas could not verify that the notified transaction would result in a lower variable cost of production, but the Commission acknowledged that Nynas' external purchases could be substituted with cheaper EEA production due to the transaction.

As regards consumer benefit, the Commission concluded that the transaction appeared to result in additional supply by Nynas on the EEA market and that Nynas would "*have the ability and most likely the incentive to partly pass on the cost savings to consumers.*"[14] While these conclusions were far from categorical, the Commission ultimately found that the notified transaction would have a positive effect on EEA prices compared to a counterfactual absent the notified transaction.

Some thoughts on Nynas/Shell/Harburg Refinery

As noted above, the absence of any explicit reference to either a 'failing firm' or 'failing division' in the Commission's decision is interesting, particularly as the decision is the first instance of the FFD being made out for a failing division.

The Commission has adopted a more flexible approach compared to its past strict approach, which required that the parties demonstrate that the whole group's financial position would be endangered. The Commission did not comment specifically on the fact that the continued operation of the refinery assets would not imperil the financial position of Shell as a whole. Rather, the Commission concluded that the FFD was made out based on the financial position of the assets, the strategic plans of Shell as a parent company and the non-existence of a credible alternative purchaser, i.e. on the basis of a counterfactual analysis without undue reliance on specific (dogmatic) criteria.

This more flexible approach does not, however, mean that the Commission has relaxed the evidentiary standard that needs to be met. This decision makes clear that detailed evidence is required. In particular the internal documents of a company (and indeed any potential rival purchasers) will be key to the Commission's decision. This is consistent with recent changes by the Commission to the long-form and short-form merger notification forms, requiring parties to provide significant internal documentation relating to the transaction.[15] Here, Shell could point to documentary evidence of a broad strategy to focus on key assets, consistent with its proposed exit of the Harburg assets. Conversely, Ergon was not able to demonstrate any evidence supporting a continued strategic interest in acquiring the assets.

That said, the Commission's decision does appear to have been based on certain assumptions and expectations, again on the basis of a counterfactual analysis. The Commission assumed that, once acquired, Nynas would keep the assets in operation to fulfill additional EEA capacity requirements. It also assumed that Nynas would have an incentive to "partly" pass on cost-reductions to customers. Further details of Nynas' incentives to pass these cost reductions to customers may have been beneficial, in light

of the Commission's conclusion that the cost base of Ergon would remain unchanged in the event of the transaction.[16]

Overall, this case should not be seen as a relaxation of the FFD criteria themselves but rather an application of those criteria in a more flexible manner, which focuses on the evidence and the counterfactual. It was clear that, absent the transaction, the assets would be removed from the market in the near future. The evidence also did not demonstrate the existence of a credible alternative purchaser, meaning that the third criterion – inevitable exit of the assets – was satisfied. As such, the decision can be seen as an implicit moderation of the strict requirement that a failing division must jeopardise the financial survival of its parent company in order for the FFD test to be satisfied. This point was addressed more explicitly by the Commission in its decision in *Aegean/Olympic II*.

Aegean/Olympic II

The Commission's decision in *Aegean/Olympic II* (just a month after *Nynas/Shell/Harburg Refinery*) represented its second assessment of the proposed combination of the firms. The first, in 2011,[17] had resulted in the adoption by the Commission of a prohibition decision (after an in-depth investigation) and a categorical rejection of the FFD on the basis that none of the three necessary conditions were satisfied. However, by 2013, the financial situation of Olympic Air (as a division) and that of its parent company Marfin had altered sufficiently to enable the Commission to conclude that, with or without the merger, Olympic Air would be forced to exit the market in the near future and the FFD had been made out in respect of Olympic Air.

The Commission's clearance decision was attributable solely to its FFD analysis.[18] The Commission's competitive assessment had concluded that the transaction would lead to a merger to monopoly on five routes and would eliminate the most likely potential competitor on six additional routes. However, the Commission also observed that, absent the transaction, the same deterioration of competition would be observed. Therefore, no significant impediment to competition arose as a result of the transaction. So what happened in the intervening period to permit the Commission to conclude that the FFD was made out in 2013 but not in 2011?

(i) Allegedly failing firm/division would be forced out of the market in the near future

2011 Decision:

In 2011, the Commission gave significant weight to the substantial financial strength of Olympic's sole shareholder, Marfin. The Commission noted Marfin's "*significant cash reserve*"[19] and its ability to support its subsidiary. The Commission also pointed to the fact that Marfin's investment strategy often involved acquiring financially distressed companies with a long-term view to turning them around for resale[20] and that its acquisition of Olympic was consistent with this strategy. Further, Marfin had significant financial incentives to avoid a bankruptcy of Olympic[21] with the financial losses experienced by Olympic attributed by the Commission to start-up rather than structural problems.[22]

Moreover, as a case involving an alleged failing division rather than a failing firm, the losses incurred by Olympic were not of a magnitude that would endanger the whole Marfin group.[23]

2013 Decision:

By 2013, Olympic had repositioned itself as a regional carrier. However, it continued to incur significant losses to the point that the Commission concluded its survival was attributable only to the numerous cash injections it had received from Marfin.[24] Furthermore, by 2013, the financial position of Marfin had (in line with the macroeconomic situation in Greece) altered considerably. Marfin was suffering substantial financial losses due to write-offs of investments in Greek assets and its annual accounts indicated uncertainty regarding its ability to continue as a group.[25] A bond issue had also failed to raise significant capital, despite extensions of the deadline for subscription.

Relaxation of the test for an alleged failing division

In a departure from its 2011 decision (and previous practice), the Commission stated that it was not necessary to demonstrate that, as a failing division, Olympic would endanger the viability of the Marfin group. Rather, it would be sufficient to establish that Marfin would no longer be able to support Olympic and that therefore Olympic would fail. The Commission pointed out that this approach corresponded more closely to the rationale underlying the failing firm analysis, "*namely that because of the failure of the acquired company (and not necessarily of its parent) the competitive situation post-merger would not be worse than absent the merger.*"[26] This is in essence just a counterfactual analysis.

The Commission noted that Marfin's financial situation was not irrelevant as it conditioned Marfin's ability and incentive to support Olympic. Further, as part of a group, it was necessary to assess Olympic's financial results in a way which reflected its true economic costs (rather than any intra-group arrangements that would present Olympic as more loss-making than it would be as an independent company). Finally, any decision by Marfin to let Olympic fail would need to make sense for the group as a whole.

Applying these criteria, the Commission concluded that Marfin's difficult financial position left it "*most likely not able to continue financing Olympic.*" Furthermore, and in contrast to the 2011 decision, Marfin had no incentive to keep funding Olympic because any investment would be unreasonable from a business perspective. Indeed, Marfin's other subsidiaries also had funding requirements but appeared to offer much better investment opportunities.[27] Finally, the Commission concluded that it would be less costly for Marfin to shut Olympic down rather than to keep operating it. Therefore, it was reasonable to assume that an investor such as Marfin, acting reasonably, would cease supporting Olympic and would shut it down completely.

(ii) No less anti-competitive alternative purchaser

2011 Decision:

In its previous decisional practice, the Commission has required parties to provide evidence of significant efforts to allow alternative purchasers to enter into negotiations

to acquire the allegedly failing firm.[28] This enabled the Commission to conduct a counterfactual assessment of what the market would look like in the case of alternative acquirers.[29]

In 2011, the parties did not provide any evidence to the Commission that Marfin had looked for another potential buyer for Olympic, nor any reasons why negotiations with potential buyers would have been unsuccessful.[30] Therefore this criterion was not met.

2013 Decision:

Interestingly, the 2013 decision does not present evidence that Marfin actively sought alternative purchasers for Olympic. However Marfin stated that it was not aware of any alternative purchaser and the Commission confirmed the veracity of this statement by examining Marfin's internal documents. Further, the Commission issued questionnaires to 24 European airlines to assess whether they had any interest in acquiring Olympic, receiving a negative response and it considered but discounted the credibility of an alternative purchaser which emerged during the investigation. The Commission also took into account the historical unsuccessful attempts by the Greek State to sell Olympic, the unhelpful market conditions and the fact that Marfin would have had an incentive to find an alternative buyer, if one existed, due to the Commission's prohibition of the first Olympic/Aegean attempted merger.[31]

(iii) Inevitable exit of assets

2011 Decision:

In 2011, it was not clear to the Commission that the assets of Olympic would inevitable exit the market, absent the transaction. First, the brand name of Olympic, licensed from the Greek government was considered a significant asset in the air transport market in Greece, with a high degree of brand recognition and appeal, particularly for Greek travellers.[32] Even in the event of the bankruptcy of Olympic, the Commission concluded that the brand would be returned to the Greek State, and licensed to another existing Greek airline or new entrant. Further, Olympic's bilateral rights to operate flights to certain countries would also revert to the State and would be distributed to different market participants.[33] Finally, the Commission concluded that certain Olympic aircraft would be leased by other market participants.[34] Therefore, the Commission concluded that, absent the transaction, the assets of Olympic Air would not have inevitably exited the market.[35]

2013 Decision:

The Commission disposed of this criterion quite swiftly in the 2013 decision. As in the 2011 decision, the Commission found that the Olympic brand name would revert to the Greek State if Olympic exited from the market. However, the Commission's market investigation revealed no interest in its acquisition by any credible market entrant. Olympic's bilateral traffic rights and certain turboprop aircraft were irrelevant to the routes with which the Commission was concerned (internal Greek routes) and the Commission's market investigation had revealed no credible interest in the acquisition of Olympic's remaining aircraft. Thus, the Commission found that the assets would inevitably exit the market.

Overall Commission Conclusion

The Commission therefore concluded that "*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, the Commission concludes that Olympic meets the requirements of the failing firm within the meaning of the Horizontal Merger Guidelines.*"[36]

Some thoughts on Aegean/Olympic II

The *Aegean/Olympic II* transaction was set against the backdrop of increasingly adverse economic conditions in Greece, together with low demand in the airline sector. These factors played a key role in the Commission's decision to conclude that the FFD was met in 2013. Further, at the time of the adoption of the 2011 decision, Olympic had only been commercially active for less than a year, since its acquisition by Marfin.[37] As such, the Commission had attributed Olympic's losses to start-up rather than structural issues. However, by the time of the 2013 decision, the Commission was in a position to note, on the basis of several years of financial data, that Olympic had never been profitable since its acquisition and was surviving only due to the continuous funding received from its parent.

These factors, together with the significant decline in the fortunes of Marfin resulted in a clear conclusion that the three FFD criteria were made out.

Nevertheless, the Commission's relaxation of the traditional criteria where an alleged failing division rather than failing firm is at issue - also evident implicitly in *Nynas/Shell* - is to be welcomed. As the Commission noted, the previous requirement for the division to undermine the viability of the group as a whole was inconsistent with the rationale of the FFD, i.e. to assess whether the competitive situation post-merger would not be worse than absent the merger. As such, this is an explicit acknowledgement from the Commission that, while the three conditions for the FFD remain strict, the FFD is a specific example of the counterfactual analysis. It is also sensible that the Commission applied some safeguards, to avoid the prospect that parent companies could tailor the balance sheet to fit the revised criteria.

As with *Nynas/Shell*, the decision is a further example of the Commission's renewed focus on internal documents in the merger control process. It draws heavily on various Olympic and Marfin internal emails to bolster its conclusions regarding the financial position of both companies.[38] In contrast to the 2011 decision (where such information was redacted) the public version of the 2013 decision refers explicitly to the authors and recipients of such emails, which provides greater transparency to interested third parties.

It is also notable that in the 2013 decision Aegean as notifying party made an express submission to the Commission in favour of the FFD whereas in the 2011 decision, the parties had not explicitly argued the FFD but had "*put forward arguments analyzing the defence criteria.*"[39] Marfin also in 2013 provided written confirmation to the Commission that it was unable and unwilling to support Olympic.[40]

Conclusion

To return to the question posed in our previous article: has the Commission gone soft, and is it time to bid farewell to the failing firm defence in favour of a broader counterfactual analysis?

On the evidence of these two decisions, the Commission still applies the test strictly, does not appear to be departing from the three substantive criteria and requires detailed evidence. However, its analysis of situations of failing divisions shows some flexibility and openness by relaxing the requirement that the whole group's financial position is imperiled and instead focusing on an objective counterfactual analysis with regard to the division in question. The question is whether, on the basis of evidence, the group will have the ability and incentive to continue supporting the failing division or whether it will let the division fail. The explicit recognition in *Aegean/Olympic II* that this analysis forms part of the counterfactual analysis, rather than a separate consideration, is to be welcomed. The safeguards outlined by the Commission in that case to discourage the engineering of accounts by parent companies in order to invoke the FFD are also sensible.

Will we see more cases invoking the FFD? This remains to be seen. A claim that a division, or a firm is "failing" is naturally a matter of great sensitivity for companies. Therefore, notifying parties will justifiably be reluctant to make the claim unless it is clear that other avenues have been exhausted. In addition, the analysis is demanding and rigorous and requires significant and detailed evidence based on internal documents and other sources to prove that the counterfactual is indeed that of a failing firm/division such that a conclusion can be reached that the merger is not the cause of any deterioration in competition compared to the counterfactual. Companies wishing to invoke an FFD will therefore still need to back it up with very detailed evidence. As is evident in these cases, a FFD requires a thorough examination by the Commission before it can be accepted, meaning that a Phase II investigation and a Statement of Objections is almost inevitable.

In our view the FFD will continue to be invoked rarely and succeed only in clear-cut situations where the Commission can be clearly convinced of the counterfactual analysis.

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[1] Case No M.6360 *Nynas/Shell/Harburg Refinery*, Decision of 02 September 2013.
[2] Case No M.6796 *Aegean/Olympic II,* Decision of 09 October 2013.
[3] "*Time to Bid Farewell to the Failing Firm Defence? Some Thoughts in the Wake of Nynas/Shell and Olympic/Aegean*", Competition Policy International, Europe Column, December 2013.
[4] Guidelines on the assessment of Horizontal Mergers, para. 89.
[5] Guidelines on the assessment of Horizontal Mergers, para. 90.
[6] OECD Competition Committee, Meeting of 21 October 2009, Roundtable on Failing Firm Defence, Note by the services of the European Commission, paras. 13-14.
[7] See, for example, Case No COMP/M.2810 *Deloitte & Touche/Andersen (UK)*, Decision of 01 July 2002.
[8] Press conference, 9 October 2013.
[9] Para. 316.
[10] Para. 319.
[11] Para. 327.
[12] Para. 346.
[13] Para. 361.
[14] Para. 470.
[15] Commission Regulation (EC) No 802/2004 of 21 April 2004 implementing Council Regulation (EC) No 139/2004 on the control of concentrations between undertakings, as amended by

Commission Regulation (EC) No 1033/2008 and by Commission Regulation (EU) No 1269/2013.

[16] Para. 469.

[17] Case No M.5830 *Olympic/Aegean Airlines*, Decision of 26 January 2011.

[18] At the press conference announcing the decision, (then) Commissioner Almunia noted that "*had Olympic been able to continue operations outside of the Aegean Group, the decision would have been a prohibition*".

[19] Para. 1966.

[20] Paras. 1972, 1974.

[21] As a result of considerable exit costs and the likely negative effect on Marfin's credit ratings and ability to raise funds in the equity markets. See paras. 2030-2039.

[22] Para.1950.

[23] Para.1986.

[24] Para. 669.

[25] Para. 674.

[26] Para. 688.

[27] Para. 752.

[28] See, for example, Case No *COMP/M.4381 - JCI/FIAMM*, Decision of 10 May 2007, para. 734.

[29] OECD Competition Committee, Meeting of 21 October 2009, Roundtable on Failing Firm Defence, Note by the services of the European Commission, para. 5.

[30] Para. 2086.

[31] Para. 816.

[32] Paras. 2100-2102.

[33] Para. 2110.

[34] Para. 2117.

[35] Para. 2119.

[36] Para. 833.

[37] Para.1950.

[38] See, for example, references to internal communications involving *inter alia* the Financial Planning and Control Director of Olympic and the Chief Financial Officer of Marfin.

[39] Para. 1988.

[40] The timing of these submissions is interesting as they came almost 2 months after the adoption by the Commission of its SO which had reached the preliminary conclusion that Marfin had the financial means to continue to support Olympic. The last of these submissions was made approximately one month before the Commission's adoption of its decision clearing the transaction. (see paras.737-739).