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Failing Firm Defense

CPI COMPETITION POLICY INTERNATIONAL

TABLE OF CONTENTS

03 **Letter from the Editor**

04 **Summaries**

06 **What's Next?**
Announcements

07 **Epic Fail: Why It Is Better to Focus on a Competitive Effects Analysis Than the Failing Firm Defense**
By James A. Fishkin, Brian Rafkin & Blair W. Kuykendall

14 **Failing Firm Analysis and the Current Economic Downturn**
By Ken Heyer

20 **Pandemic, Economic Crisis, and the Failing Firm Defense**
By Antonio Bavasso & Jessica Bowring

27 **The Failing Firm Defense in Times of (the COVID-19) Crisis: Is It Worth Revisiting?**
By Kyriakos Fountoukakos, Clémence Barraud & Daniel Barrio

36 **Canadian Merger Review: Assessing Failing Firm Claims in Market Conditions Disrupted by COVID-19**
By Jeanne Pratt & Darya Shevchenko

44 **The Failing Firm Doctrine During COVID-19: A Perspective from South Africa**
By Raksha Darji, Rahma Leuner & Tamara Paremoer

LETTER FROM THE EDITOR

Dear Readers,

This Chronicle addresses the failing firm defense in merger control. The failing firm defense is frequently invoked, but is seldom successful.

In theory, at least, the defense has a certain intuitive appeal. By definition, for a merger to be illegal, its implementation must substantially lessen (or "significantly impede") competition. If, in the counterfactual, the acquired firm would simply go out of business, there can be no lessening of competition. But, in reality, acquirers of viable firms have an incentive to exaggerate the woes of the target to receive approval.

As such, enforcers and courts worldwide set a high bar for a failing firm defense to be accepted. Yet this does not mean that the defense is a dead letter. In certain (rare) circumstances, the defense has been successful. In the wake of the COVID-19 pandemic, the specter of mass bankruptcies (and, hence, the failing firm defense) is raising its head once more.

The articles in this Chronicle critically assess the failing firm defense in its various incarnations around the globe. The perspectives offered by the authors will be invaluable to the evaluation of the future of the failing firm defense as it is inevitably raised with greater frequency in the current economic context.

Lastly, please take the opportunity to visit the CPI website and listen to our selection of Chronicle articles in audio form from such esteemed authors as Maureen Ohlhausen, Herbert Hovenkamp, Richard Gilbert, Nicholas Banasevic, Randal Picker, Giorgio Monti, Alison Jones, and William Kovacic among others. This is a convenient way for our readers to keep up with our recent and past articles on the go, in the gym, or at the beach.

As always, thank you to our great panel of authors.

Sincerely,

CPI Team

SUMMARIES

07

Epic Fail: Why It Is Better to Focus on a Competitive Effects Analysis Than the Failing Firm Defense

By James A. Fishkin, Brian Rafkin & Blair W. Kuykendall

The failing firm defense is the fortune cookie of merger analysis: prevalent in merging parties' advocacy, tantalizingly full of potential, but in the end, stale and unsatisfying. However, the failing firm defense is not the only way for merging parties to explain the context of their transaction to the Antitrust Division of the Department of Justice and the Federal Trade Commission (the "agencies") or to courts. Merging parties typically can achieve more favorable outcomes by presenting facts about firms' relative competitiveness and the competitive conditions facing the industry in the context of a competitive effects analysis rather than within the tight strictures of the failing firm defense. These compelling arguments are especially important as the failing firm defense has become top-of-mind as businesses grapple with the impact of COVID-19.

14

Failing Firm Analysis and the Current Economic Downturn

By Ken Heyer

This is not the first time, even in recent memory, that large numbers of firms in our economy were suffering from a severe economic downturn. During the Great Recession that began in 2008 a similar situation arose. At that time, many observers were calling for more lenient treatment of mergers proposed by firms in economic distress. Today, some in Congress are arguing for the exact opposite. In this brief note I revisit some of the issues raised by the failing — and flailing — firm defenses in times of severe economic distress, discuss certain nuances that may be specific to our current circumstances, and briefly sketch an approach that may be useful in helping competition agencies navigate these timely issues in circumstances where theory may be sound and generally agreed upon, but where information and evidence are subject to significant uncertainty.

20

Pandemic, Economic Crisis, and the Failing Firm Defense

By Antonio Bavasso & Jessica Bowring

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. 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 which 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 the 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.

27

The Failing Firm Defense in Times of (the COVID-19) Crisis: Is It Worth Revisiting?

By Kyriakos Fountoukakos, Clémence Barraud & Daniel Barrio

The recent COVID-19 pandemic has affected all areas of economic activity and competition law was not spared. Regulators around the world had to deal with the situation of the crisis from administrative-type issues (teleworking including for hearings, submissions etc.) to how to apply substantive competition law in times of crisis. In this article we revisit the FFD in light of the COVID-19 crisis. We focus on the analysis undertaken by the UK Competition and Markets Authority in a string of recent cases (including Amazon/Deliveroo). We conclude – once more – that, while regulators will be receptive to FFD arguments, they are unlikely to relax their rules. Evidence will remain key. However, we also argue that regulators including the Commission could make greater use of a wider counterfactual scenario (beyond FFD) and look at changes that are likely to take place in the market conditions in the medium and longer term due to COVID-19.

SUMMARIES

36

Canadian Merger Review: Assessing Failing Firm Claims in Market Conditions Disrupted by COVID-19

By Jeanne Pratt & Darya Shevchenko

The disruption of the economy due to COVID-19 is leading some companies to experience financial difficulties and struggle for survival. It is not unlikely that competition authorities will face an increased number of "failing firm claims" in the context of acquisitions involving distressed targets. This article outlines the Canadian Competition Bureau's merger framework, its approach to assessing failing firm claims in times of global crisis and to what degree its approach appears consistent with some other jurisdictions. The work of competition authorities, while important in any economic environment, is even more crucial in times of economic crisis to support short and long-term recovery efforts. Conscious of the challenges that businesses are facing, firms raising failing firm arguments may expect that the Canadian Competition Bureau will try to work as quickly as possible to evaluate the evidence, but this will not imply any relaxation of the standards by which mergers are assessed.

44

The Failing Firm Doctrine During COVID-19: A Perspective from South Africa

By Raksha Darji, Rahma Leuner & Tamara Paremoer

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 Competition Commission of South Africa 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. 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.

WHAT'S NEXT?

For October 2020, we will feature Chronicles focused on issues related to (1) **CRESSE Insights**; and (2) **Capitol Hill Policy Roundtables**.

ANNOUNCEMENTS

CPI wants to hear from our subscribers. In 2020, we will be reaching out to members of our community for your feedback and ideas. Let us know what you want (or don't want) to see, at: antitrustchronicle@competitionpolicyinternational.com.

CPI ANTITRUST CHRONICLES NOVEMBER 2020

For November 2020, we will feature Chronicles focused on issues related to (1) **Data Portability**; and (2) **Collaboration Agreements**.

Contributions to the Antitrust Chronicle are about 2,500 – 4,000 words long. They should be lightly cited and not be written as long law-review articles with many in-depth footnotes. As with all CPI publications, articles for the CPI Antitrust Chronicle should be written clearly and with the reader always in mind.

Interested authors should send their contributions to Sam Sadden (ssadden@competitionpolicyinternational.com) with the subject line "Antitrust Chronicle," a short bio and picture(s) of the author(s).

The CPI Editorial Team will evaluate all submissions and will publish the best papers. Authors can submit papers on any topic related to competition and regulation, however, priority will be given to articles addressing the abovementioned topics. Co-authors are always welcome.

EPIC FAIL: WHY IT IS BETTER TO FOCUS ON A COMPETITIVE EFFECTS ANALYSIS THAN THE FAILING FIRM DEFENSE

BY JAMES A. FISHKIN, BRIAN RAFKIN & BLAIR W. KUYKENDALL[1]

  

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The failing firm defense is the fortune cookie of merger analysis: prevalent in merging parties' advocacy, tantalizingly full of potential, but in the end, stale and unsatisfying. However, the failing firm defense is not the only way for merging parties to explain the context of their transaction to the Antitrust Division of the Department of Justice and the Federal Trade Commission (the "agencies") or to courts. Merging parties typically can achieve more favorable outcomes by presenting facts about firms' relative competitiveness and the competitive conditions facing the industry in the context of a competitive effects analysis rather than within the tight strictures of the failing firm defense. These compelling arguments are especially important as the failing firm defense has become top-of-mind as businesses grapple with the impact of COVID-19.[2]

I. THE FAILING FIRM DEFENSE HAS PROVED TO BE A HIGH HURDLE

A. The Failing Firm Defense Has Stringent Requirements

The Horizontal Merger Guidelines and case law both endorse a failing firm defense.[3] The defense is designed as a mechanism to preserve failing assets that otherwise would exit from a market. The prototypical example is a strong hospital acquiring a failing hospital, allowing both hospitals to keep operating and serving patients. The rationale for allowing the failing firm defense is that customers "are not worse off after the merger" than they would be but-for the merger.[4]

In practice, however, the defense "rarely succeeds."[5] The agencies also will not lower the requirements for a failing firm defense during economic downturns, including the current COVID-19 induced recession.[6] This position is consistent with past practice, most recently in the Great Recession. There, the agencies warned that they would not relax the way they applied the failing firm defense to account for poor economic conditions.[7] The agencies have been similarly resolute during the pandemic, explaining that it is no excuse for dampening enforcement.[8] The agencies' concern is easy to grasp: they fear that changing their enforcement standards to account for temporary (even if large) economic shocks will cause long-term harm when the shock subsides.

Under the 2010 Horizontal Merger Guidelines, to offer a successful failing firm defense, a company must meet three criteria. The company must demonstrate (i) that it is in imminent danger of financial failure, in other words that it cannot meet its financial obligations in the near future, (ii) that it could not successfully reorganize under Chapter 11 of the bankruptcy code, and (iii) that it has no reasonable alternative acquisition offer, despite good faith efforts, that would allow it to maintain its assets and would pose a less severe danger to competition than the proposed merger.[9] The Horizontal Merger Guidelines framework largely mirrors the failing firm criteria first enumerated in *Citizen Publishing Co. v. United States*.[10] Lower courts have followed similar criteria to the Horizontal Merger Guidelines.[11]

To meet the first prong, a firm must establish that there is "imminent danger" of financial failure, i.e. it will not meet its financial obligations in the near future. Whether a firm can meet its financial obligations in the near future is judged on a case-by-case basis, with the agencies

2 Ian Conner, On "Failing" Firms — and Miraculous Recoveries, FTC Blog (May 27, 2020), https://www.ftc.gov/news-events/blogs/competition-matters/2020/05/failing-firms-miraculous-recoveries.

3 See Horizontal Merger Guidelines, Department of Justice and Federal Trade Commission (2010), § 11 ("Horizontal Merger Guidelines"); see also *Citizen Publ'g Co. v. United States*, 394 U.S. 131 (1969).

4 Horizontal Merger Guidelines § 11.

5 4A Phillip E. Areeda & Herbert Hovenkamp, Antitrust Law ¶ 953 (4th ed. 2016) ("Antitrust Law").

6 See Ian Conner, On "Failing" Firms — and Miraculous Recoveries, FTC Blog (May 27, 2020), https://www.ftc.gov/news-events/blogs/competition-matters/2020/05/failing-firms-miraculous-recoveries.

7 See Carl Shapiro, Competition Policy in Distressed Industries (May 13, 2009), https://www.justice.gov/atr/speech/competition-policy-distressed-industries; J. Thomas Rosch, Implications of the Financial Meltdown for the FTC (Jan. 29, 2009), at 10, https://www.ftc.gov/sites/default/files/documents/public_statements/implications-financial-meltdown-ftc/090129financialcrisisnybarspeech.pdf.

8 Joint Antitrust Statement Regarding COVID-19, DOJ (Mar. 2020), https://www.justice.gov/atr/joint-antitrust-statement-regarding-covid-19 ("Joint Antitrust Statement Regarding COVID-19").

9 Horizontal Merger Guidelines § 11.

10 394 U.S. 131 (1969).

11 See *United States v. Energy Sols., Inc.*, 265 F. Supp. 3d 415, 445 (D. Del. 2017) (applying a two-part test: "To successfully assert the defense, defendants have the burden of showing (1) that the resources of [the seller] were so depleted and the prospect of rehabilitation so remote that it faced the grave probability of a business failure, and (2) that there was no other prospective purchaser for it.") (internal citations omitted).

considering factors including: sufficient cash flow,[12] whether total liabilities exceed total assets over time,[13] and whether a company's costs are greater than its revenues.[14] The agencies also consider the ability of a firm to obtain new revenues or new customers, whether its productivity is declining, whether its supply of key inputs is being exhausted, and whether it is simply being poorly run by current management.[15] Declining sales or negative current profits are not sufficient to show a firm will be unable to meet its future financial obligations.[16] This prong can create a self-fulfilling prophesy in the case of unconsummated mergers. The very fact that the merging parties are able to submit themselves to a lengthy antitrust investigation and (potentially) litigation may suggest in and of itself that the seller is not in imminent danger of financial failure.

The second prong requires that a firm be unable to reorganize under Chapter 11 of the bankruptcy code. The prospects of reorganization must be "dim" or "nonexistent."[17] The agencies will look at whether a company's financial situation can be resolved if its debt is eliminated in a bankruptcy proceeding. Reorganization is not possible if a company cannot meet its current and future operating expenses from expected revenues and has no more capital.[18] The agencies may go so far as to speak with a company's creditors to determine how willing they are to restructure the company's debts.[19]

Meeting the third prong — that there is no reasonable alternative acquisition offer — is difficult. The issue turns on the good faith effort of the seller to elicit a competing offer. For example, in *United States* v. *Energy Solutions*, two low-level radioactive waste disposal companies failed to show that the buyer was the "only available purchaser" of the purportedly failing seller.[20] The court explained that the merging parties must demonstrate that the seller made "good faith efforts to elicit reasonable alternative offers…that would both keep it in the market and pose a less severe danger to competition."[21] The court found that the seller did not make good faith efforts to elicit reasonable alternative offers because it entered into "no-talk" and "no-shop" agreements with the buyer that hamstrung the seller's ability to solicit alternative buyers.[22] The agencies also have stated that sellers soliciting alternative offers must avoid discouraging any offer above liquidation value, meaning that they must not suggest that bids below a certain level will not be entertained.[23] This provision can be difficult to meet because it requires a firm that is in dire financial straits to undertake a time-consuming and costly wide-ranging search for buyers.

As the three-pronged test suggests, the agencies typically will not fast-track potentially anticompetitive mergers beyond the expedited timing requirements for bankruptcy mergers under the HSR Act even if a firm faces imminent liquidation.[24] For example, Dean Foods filed bankruptcy in November of 2019, and Dairy Farmers of America ("DFA"), a national cooperative, successfully bid to purchase most of Dean Foods' milk processing plants.[25] Following a five-month investigation, the Department of Justice ("DOJ") filed a consent decree that required DFA to

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12 US Contribution to the Roundtable on Failing Firm Defence, Directorate for Financial and Enterprise Affairs Competition Committee (Oct. 6, 2009), at 4, https://www.ftc.gov/sites/default/files/attachments/us-submissions-oecd-and-other-international-competition-fora/failingfirm.pdf ("US Contribution to the Roundtable on Failing Firm Defence").

13 See *California v. Sutter Health Sys.*, 130 F. Supp. 2d 1109, 1134-35 (N.D. Cal. 2001).

14 US Contribution to the Roundtable on Failing Firm Defence, at 4.

15 *Id.*

16 *Id.*

17 *California v. Sutter Health Sys.*, 130 F. Supp. 2d at 1135.

18 US Contribution to the Roundtable on Failing Firm Defence, at 5.

19 *Id.*

20 *United States v. Energy Sols.*, 265 F. Supp. 3d at 445.

21 *Id.* (citing *Dr. Pepper/Seven–Up Co.* v. FTC, 991 F.2d 859, 865 (D.C. Cir. 1993)).

22 *Id.*

23 US Contribution to the Roundtable on Failing Firm Defence, at 6.

24 One exception is the 2010 *Tops Market/Penn Traffic* supermarket merger enforcement action. In this matter, where Penn Traffic had filed for Chapter 11 bankruptcy, the FTC stated: "Because a full FTC investigation before the deal was completed could have led the bankruptcy court to liquidate the Penn Traffic supermarket assets, the FTC staff reached an agreement with Tops that allowed the transaction to close immediately, while allowing staff to complete its review after the deal was completed. At the same time, Tops agreed to keep all the newly acquired Penn Traffic stores open and subsequently to sell any stores that posed competitive concerns for the FTC." Press Release, U.S. Federal Trade Commission, FTC Order Requires Tops Market to Sell Severn Penn Traffic Supermarkets," (Aug. 4, 2010), https://www.ftc.gov/news-events/press-releases/2010/08/ftc-order-requires-tops-markets-sell-seven-penn-traffic.

25 DOJ proposes DFA sell additional Dean Foods Assets, Food Business News (May 4, 2020), https://www.foodbusinessnews.net/articles/15962-doj-proposes-dfa-sell-additional-dean-foods-assets.

divest three of Dean Foods' milk processing plants in the Midwest and New England.[26] In addition, DFA abandoned plans to acquire additional plants in the Upper Midwest in response to DOJ concerns.[27] DOJ permitted rival dairy Prairie Farms to acquire Dean Foods' plants in the South and Midwest after DOJ concluded that there were no alternative bidders and the plants would otherwise be shut down.[28] The Prairie Farms acquisitions appear to have surmounted the failing firm hurdle.

B. Merging Parties Claiming the Failing Firm Defense Often Fail

Because the failing firm defense functions as a shield from agency enforcement, it stands to reason that the requirements for success are lofty. There are few known examples of the agencies accepting a failing firm defense, though some non-public matters likely have been closed based on this basis.[29] In one of the few publicly-available examples, the FTC closed an investigation into Scott & White Healthcare's 2009 consummated acquisition of rival King's Daughters Hospital in Bell County, Texas. The FTC explained that it was not seeking to unwind the deal because the only alternative buyer declined to acquire the King's Daughters Hospital due to its poor financial condition.[30] Another example is a 2016 FTC matter clearing the merger of the two largest providers of certain types of physician services in St. Cloud, Minnesota after the buyer agreed to eliminate non-compete agreements and provide incentives for physicians to leave for other practice groups or to establish a new group.[31] The FTC recognized a failing firm defense when it stated that the seller was "a financially failing physician practice group that has been unable to find an alternative purchaser for the entire practice," even though another physician group agreed to acquire a subset of the practice group.[32] In a concurring statement, Commissioner Ohlhausen argued that the seller did not meet the "stringent failing firm criteria set forth in the Horizontal Merger Guidelines and case law."[33] Nevertheless, she accepted the consent agreement because of the seller's unique financial circumstances and certain physicians' plans to leave that would "diminish the competitive significance" of the combined entity.[34]

Courts similarly have been skeptical of failing firm arguments.[35] There are few examples of merging parties prevailing on this issue.[36] Most recently, in *United States v. Energy Solutions*, the Department of Justice challenged a proposed merger between two providers of low-level radioactive waste disposal services.[37] While the court recognized that some evidence supported a conclusion that the seller was at imminent risk of failing (the first and second prongs of the analysis[38]), the court found that the merging parties failed to show that Energy Solutions was the only available purchaser (the third prong).[39] The court explained that the seller did not make a good faith effort to identify other purchasers and that it

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26 Press Release, Justice Department Requires Divestitures as Dean Foods Sells Fluid Milk Processing Plants to DFA out of Bankruptcy; Department Also Closes Investigation into Acquisition of Other Dean Plants by Prairie Farms (May 1, 2020), https://www.justice.gov/opa/pr/justice-department-requires-divestitures-dean-foods-sells-fluid-milk-processing-plants-dfa.

27 *Id*.

28 *Id*.

29 The FTC and DOJ typically do not disclose the rationale for why they closed an investigation.

30 See Statement of Bureau of Competition Director Richard Feinstein on the FTC's Closure of Its Investigation of Consummated Hospital Merger in Temple, Texas (Dec. 23, 2009), https://www.ftc.gov/sites/default/files/documents/closing_letters/scott-white-healthcare/kings-daughters-hospital/091223scottwhitestmt.pdf.

31 See Press Release, U.S. Federal Trade Commission, Healthcare Provider in St. Cloud, MN Settles FTC Charges That Its Acquisition of Rival Provider Would Likely Lessen Competition for Certain Physician Services (Oct. 6, 2016), https://www.ftc.gov/news-events/press-releases/2016/10/healthcare-provider-st-cloud-mn-settles-ftc-charges-its (explaining that St. Cloud Medical Group "is failing financially, has lost its sole remaining line of credit, and appears unlikely to improve its financial condition. Also, a number of physicians have already left the practice and others are likely to depart – and may leave the St. Cloud area altogether – if the merger does not close.").

32 Analysis of Agreement Containing Consent Orders to Aid Public Comment, *In the Matter of CentraCare HealthSystem* (Oct. 6, 2016), https://www.ftc.gov/enforcement/cases-proceedings/161-0096/centracare-health-system.

33 Concurring Statement of Maureen K. Ohlhauasen, *In the Matter of CentraCare Health System* (Oct. 6, 2016) (footnote omitted), https://www.ftc.gov/public-statements/2016/10/concurring-statement-maureen-k-ohlhausen-matter-centracare-health-system.

34 *Id*.

35 Antitrust Law ¶ 953; see *United States v. Energy Sols.*, 265 F. Supp. 3d at 445.

36 See *California v. Sutter Health Sys.*, 130 F. Supp. 2d 1109; *Reilly v. Hearst Corp.*, 107 F. Supp. 2d 1192 (N.D. Cal. 2000); see also *United States v. Energy Sols.*, 265 F. Supp. 3d at 444 (agreeing that the defense "rarely succeeds").

37 *United States v. Energy Sols*, 265 F. Supp. 3d at 420.

38 The court set out a two-part test, in which the first prong appears to encompass both the first and second prongs of the Horizontal Merger Guidelines' three-part test. See *id.* at 444 ("To successfully assert the defense, defendants have the burden of showing (1) that the resources of [the seller] were so depleted and the prospect of rehabilitation so remote that it faced the grave probability of a business failure, and (2) that there was no other prospective purchaser for it.") (internal citations omitted).

39 *Id*. at 444-45.

sought "fair value" for the company as opposed to any offer above liquidation value.[40]

As one can see from its three elements, the failing firm defense focuses entirely on a company's financial viability, *not* its competitive viability. In other words, the failing firm defense does not address the underlying question of whether the merger likely will substantially lessen competition. Rather than jumping straight to a failing firm argument, merging parties can achieve a favorable outcome to their merger investigation or litigation by approaching this issue from the perspective of a competitive effects analysis. This allows merging parties to present facts and arguments about their relative competitiveness and industry conditions without confining them to the elements of a failing firm defense.

II. A FIRM'S COMPETITIVENESS (OR LACK THEREOF) IS BETTER EVALUATED THROUGH A COMPETITIVE EFFECTS LENS, NOT FAILING FIRM

Competitive effects analysis avoids the all-or-nothing framework of the failing firm defense and shifts the focus to where it ought to be – the merging parties' competitive positioning, the competitive conditions in the industry, and what those facts say about the likely competitive effects of the proposed merger.

In the seminal *United States v. General Dynamics* case, the Supreme Court established that Clayton Act Section 7 analysis is forward-looking, and requires that courts consider evidence of the merging parties' ability to compete in the future.[41] In this merger between competing coal producers, the defense demonstrated that although the seller was highly profitable and not at risk of failing, it lacked uncommitted coal resources which limited its future ability to compete.[42] In permitting the merger, the Court explained that "[e]vidence of past production does not, as a matter of logic, necessarily give a proper picture of a company's future ability to compete."[43] Later decisions reaffirmed the dynamic merger analysis established in *General Dynamics*.[44]

Logically, then, if merging parties can demonstrate that one party will be weak going forward, anticompetitive effects are unlikely to result from the merger.[45] While courts rely on market shares and concentration statistics as a proxy for post-merger market power, they also must consider whether it is appropriate to extrapolate those market shares and concentrations into the future: "[E]ven accepting the [market share] statistics as the primary index of market power, 'only a further examination of the particular market — its structure, history and probable future — can provide the appropriate setting for judging the probable anticompetitive effect of the merger.'"[46] In *FTC v. Arch Coal/Triton*, for example, the court declined to enjoin a merger between two competing coal suppliers in part because the seller was a "relatively weak competitor" with "no convincing prospects for improvement."[47] The court found that although the failing firm defense did not apply, the seller's high-cost position, low coal reserves, uncertain future competitive prospects, weak financial position, and no realistic prospects for alternative buyers remained "relevant to an examination of whether substantial anticompetitive effects are likely from the transaction."[48] This approach is consistent with the Horizontal Merger Guidelines, which explain that "recent or ongoing changes in market conditions may indicate that the current market share of a particular firm either understates or overstates the firm's future competitive significance."[49]

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40 *Id.*

41 *United States v. General Dynamics Corp.*, 415 U.S. 486 (1974).

42 *Id.* at 503.

43 *Id.* at 501.

44 See, e.g. *FTC v. Nat'l Tea Co.*, 603 F.2d 694, 700 (8th Cir. 1979); *United States v. Citizens & Southern National Bank*, 422 U.S. 86, 121 (1975).

45 *US v. Int'l Harvester Co.*, 564 F.2d 769, 773 (7th Cir. 1977) (relying on the "very precarious" financial situation of a seller to affirm a district court judgement that a merger was not anticompetitive).

46 *Id.* at 774 (quoting *Brown Shoe Co. v. United States*, 370 U.S. 294, 322 n. 38 (1962)).

47 *FTC v. Arch Coal, Inc.*, 329 F. Supp. 2d 109, 157 (D.D.C. 2004).

48 *Id.*

49 Horizontal Merger Guidelines § 5.2.

Some courts have skeptically addressed this analysis as a "flailing firm" or "weakened competitor" argument.[50] One court called it the "Hail-Mary pass of presumptively doomed mergers."[51] These cases generally focus on the weak company's financial position. For example, in *Kaiser Aluminum & Chemical v. FTC*, the Seventh Circuit wrote that "[f]inancial weakness, while perhaps relevant in some cases, is probably the weakest ground of all for justifying a merger."[52] Other courts have blocked mergers on similar grounds.[53] While these courts were right to demand evidence that a purportedly weak competitor actually was weak, they inadvertently fell into the trap of focusing on the companies' financial condition while overlooking dynamic company- and industry-level factors that bear on the question of what the world will look like but-for the transaction.

Indeed, delving into the "why" behind a company's poor performance informs proper merger analysis because it places the emphasis on competitive effects. Companies may decline for any number of reasons other than financial reasons, such as: aggressive competition; oversupply or excess capacity in the market; declining or changing customer demand; failed business strategy; failure to keep pace with competing firms; product quality or brand issues; leadership problems; criminal or civil litigation; or any number of other reasons. These problems have different solutions and companies can recover from some more easily than others. Assessing the "why" behind a fledgling company allows the fact finder to determine the likelihood that those issues will change in the future, and consequently, what effect a merger actually will have on competition. This is not a defense for or justification of an otherwise anticompetitive merger,[54] but rather evidence establishing why a merger is not anticompetitive in the first place.

The merging parties deployed this argument in *T-Mobile/Sprint*, persuading the court that Sprint was a weak competitor that likely would decline further going forward. In 2019, a group of states led by New York challenged the proposed merger between wireless telecommunications providers T-Mobile and Sprint.[55] The defense argued that Sprint was declining in competitive significance, and would weaken further in the future.[56] The court agreed that "a variety of conditions … may render statistical market share evidence misleading, including a firm's lack of resources required to compete long-term, financial difficulties that constrain the firm from improving its competitive position, and poor brand image and sales performance."[57] The court then analyzed Sprint's competitive position in the market and found that it was in the midst of a downward spiral. Sprint made some strategic missteps in the past and consequently was falling farther and farther behind its rivals. As the court explained, "Sprint's network and product offerings have been distinguished for years for poor operational quality and negative customer perception … Sprint's financial difficulties hamper its ability to invest in its network, which in turn prolongs its poor network quality and hurts its ability to generate the revenues necessary to improve its financial condition."[58] Sprint did not qualify as a failing firm – indeed, the defense did not even argue the point – but its decline was a key factor in convincing the court that the merger would not lead to anticompetitive effects after the parties' consent agreement with the Department of Justice.

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50 See, e.g. *FTC v. Univ. Health, Inc.*, 938 F.2d 1206, 1221 (11th Cir. 1991) (explaining that the court will credit the "weak competitor" defense "only in rare cases, when the defendant makes a substantial showing that the acquired firm's weakness, which cannot be resolved by any competitive means, would cause that firm's market share to reduce to a level that would undermine the government's prima facie case"); *ProMedica Health Sys., Inc. v. FTC*, 749 F.3d 559, 572 (6th Cir. 2014) (calling the "weakened competitor" argument "probably the weakest ground of all for justifying a merger"). We do not like these monikers because ultimately the argument is about competitive effects, not meeting specific elements of a defense.

51 *ProMedica Health Sys., Inc. v. FTC*, 749 F.3d at 572.

52 *Kaiser Aluminum & Chemical v. FTC*, 652 F.2d 1324, 1339 (7th Cir. 1981).

53 See *FTC v. Warner Commc'ns, Inc.*, 742 F.2d 1156, 1164-65 (9th Cir. 1984) (finding that "a company's stated intention to leave the market or its financial weakness does not in itself justify a merger"); *ProMedica Health Sys., Inc. v. FTC*, 749 F.3d at 572 (finding that the seller was not in "such dire straits before the merger that it 'was not a meaningful competitive constraint'").

54 See *FTC v. Univ. Health*, 938 F.2d at 1221 (explaining that an acquired firm's weakness is one of many factors that a defendant can introduce to rebut the government's prima facie case, but is not a defense).

55 *New York v. Deutsche Telekom AG*, No. 1:19-cv-05434, Opinion and Order (S.D.N.Y. Feb. 11, 2020).

56 *Id.* at 84.

57 *Id.*

58 *Id.* at 86.

Another example is Boeing's proposed acquisition of McDonnell Douglas, a 3-to-2 merger with entry barriers that the FTC unconditionally cleared in 1997, despite the fact that Boeing's market share for large commercial aircraft was approximately 60%.[59] The Commission majority's closing statement issued after an "extensive and detailed investigation" states that "Our decision not to challenge the proposed merger does not reflect a conclusion that McDonnell Douglas is a failing company or that Douglas Aircraft is a failing division."[60] Instead, the majority found that "(1) McDonnell Douglas, looking to the future, no longer constitutes a competitive force in the commercial aircraft market and (2) there is no economically plausible strategy that McDonnell Douglas could follow, either as a stand-alone concern or as part of another concern, that would change that grim prospect."[61] This closing statement also states that "the failing company defense comes into play only where the Commission first finds that the transaction is likely to be anticompetitive" but in this matter, "the absence of any prospect of significant commercial sales, combined with a dismal financial forecast, indicate that Douglas Aircraft is no longer an effective competitor, and there is no prospect that position could be reversed."[62]

The merging parties in the recent *FTC v. Peabody/Arch Coal* merger litigation also rely on this argument, explaining that a "dynamic and forward-looking assessment" of the merging companies' competitive and financial position is critical to an "overall assessment of the transaction's likely competitive effects."[63] The case is pending a decision in the Eastern District of Missouri.

The particular facts and circumstances of a transaction dictate whether merging parties can credibly make this competitive effects argument. The common theme among cases where the merging parties won antitrust approval, such as *T-Mobile/Sprint, Boeing/McDonnell Douglas*, and *Arch Coal/Triton*, is that the sellers were weak both in terms of their competitive position and their financial position. For example, Sprint and McDonnell Douglas had long histories of strategic missteps that caused them to lag farther and farther behind of their rivals. By comparison, arguments that focus on the seller's financial position alone have tended to fail. For example, in *ProMedica Health System v. FTC*, the Sixth Circuit was not persuaded that the acquired hospital's precarious financial situation inhibited its ability to compete effectively going forward.[64] The merging parties did not identify any qualitative reason why the merger would not harm competition (such as a structural decline in demand or persistent quality issues) and some of the merging parties' own documents contradicted their arguments.[65]

III. CONCLUSION

Merging parties may be more likely to prevail in front of the agencies and in court when they frame facts about a firm's weakness as a competitive effects inquiry rather than as a failing firm defense. Merging parties should craft a narrative grounded in the documents, testimony, and data that describes why one (or both) of the merging parties is declining, and what the effects will be going forward. Then, the merging parties can offer a convincing explanation as to why their merger is good for consumers.

59 See Press Release, U.S. Federal Trade Commission, FTC Allows Merger of Boeing Company and McConnell Douglas Corporation (Jul. 1, 1997), https://www.ftc.gov/news-events/press-releases/1997/07/ftc-allows-merger-boeing-company-and-mcdonnell-douglas; see also Commentary on the Horizontal Merger Guidelines, Federal Trade Commission and Department of Justice, at 16 (2006) ("Although McDonnell Douglas was not a failing firm, staff determined that McDonnell Douglas' significance as an independent supplier of commercial aircraft had deteriorated to the point that it was no longer a competitive constraint on the pricing of Boeing and Airbus for large commercial aircraft").

60 Statement of Chairman Robert Pitofsky and Commissioners Janet D. Steiger, Roscoe B. Starek III and Christine A. Varney in the Matter of The Boeing Company/McDonnell Douglas Corporation (Jul. 1, 1997), https://www.ftc.gov/public-statements/1997/07/statement-chairman-robert-pitofsky-commissioners-janet-d-steiger-roscoe-b.

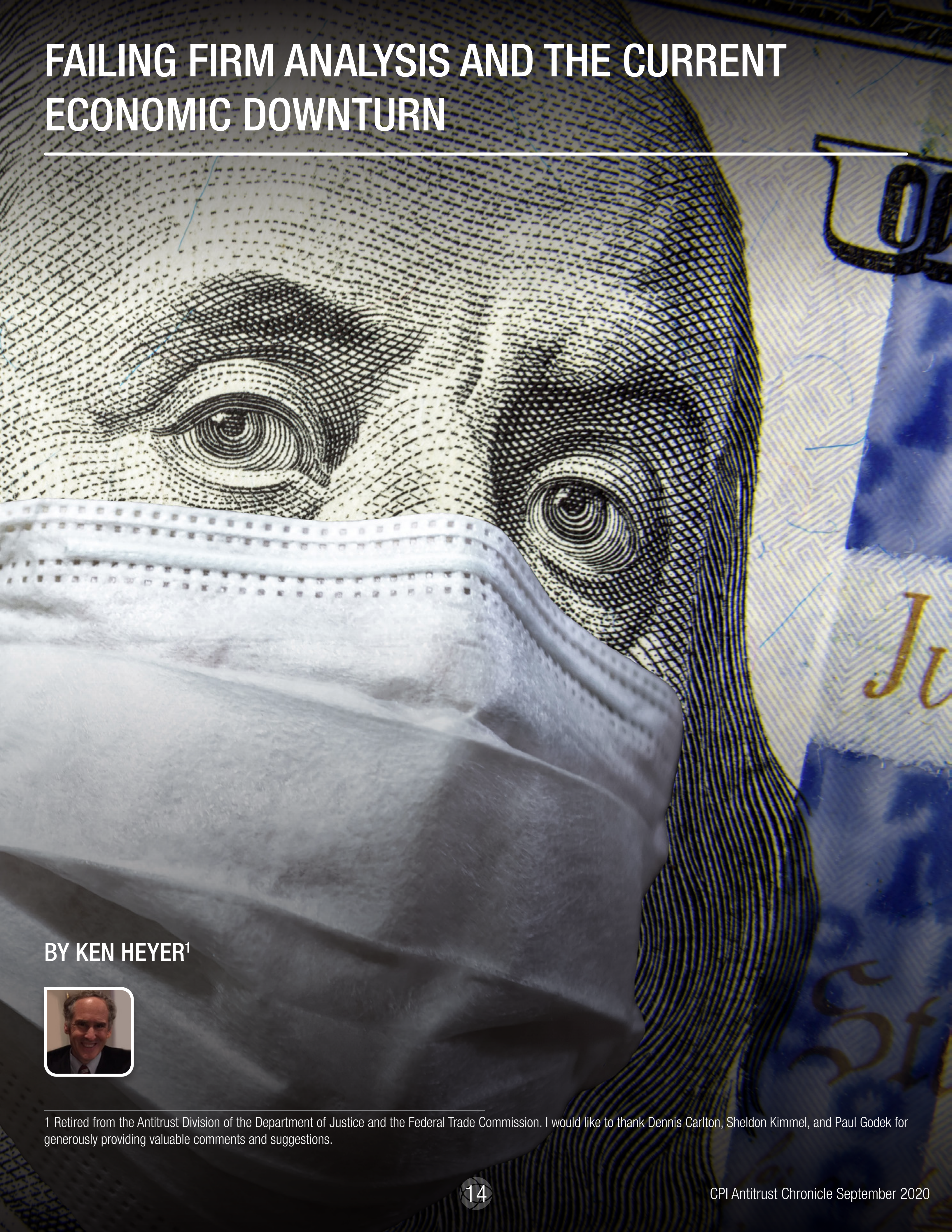
61 *Id.*

62 *Id.* Commissioner Mary L. Azcuenaga, in a separate statement, observed that "One problem with accepting a 'flailing firm' or 'exiting assets' claim is that it creates an incentive for strategic action to avoid competitive overlaps and government challenge under Section 7 of the Clayton Act. This is a dangerous precedent when we move from the realm of finite reserves of natural resources [in General Dynamics] to the more indeterminate realm of managerial discretion, because of the susceptibility of the defense to self-serving statements, manipulation and strategic behavior." Statement of Commissioner Mary L. Azcuenaga in The Boeing Company (Jul. 1, 1997) (footnotes omitted), https://www.ftc.gov/public-statements/1997/07/statement-commissioner-mary-l-azcuenaga-boeing-company. We view this as an academic concern. It is unlikely that an executive who has significant financial incentive to turn the company around would instead choose to run it into the ground for the speculative and uncertain prospect of obtaining antitrust approval.

63 *FTC v. Peabody Energy Corp.*, No. 4:20-cv-00317, Defendants' Response to Plaintiff's Memorandum of Law Addressing Failing and Weakened Firm Arguments, at 1, 3 (Aug. 5, 2020).

64 *ProMedica Health Sys., Inc. v. FTC*, 749 F.3d at 572.

65 *Id.*



FAILING FIRM ANALYSIS AND THE CURRENT ECONOMIC DOWNTURN

BY KEN HEYER[1]

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I. INTRODUCTION

This is not the first time, even in recent memory, that large numbers of firms in our economy suffer from a severe economic downturn. During the Great Recession that began in 2008 a similar situation arose. At that time, many observers were calling for more lenient treatment of mergers proposed by firms in economic distress. Today, some in Congress are arguing for the exact opposite.

In a paper published in November 2009 by Competition Policy International, Sheldon Kimmel and I addressed the issue and concluded as follows:

> In recessions, we expect to see an increase in both the number and share of mergers where at least one of the parties is having difficulty independently staying afloat. This raises the importance of adopting a sound framework for analyzing merging firms in some form of financial distress. This paper concludes that, while it can be hard to evaluate a failing firm defense under the Merger Guidelines, the principles underlying the test are generally sound, even when the overall economy is going through very difficult times. The recent severe downturn may lead to more proposed mergers between financially distressed firms, but it does not imply that looser standards ought to be applied when evaluating them.[2]

That conclusion remains economically sound. The logic underlying it, and the logic's application today, are worth revisiting. In this brief note I revisit some of the issues raised by the failing — and flailing — firm defenses in times of severe economic distress, discuss certain nuances that may be specific to our current circumstances, and briefly sketch an approach that may be useful in helping competition agencies navigate these timely issues in circumstances where theory may be sound and generally agreed upon, but where information and evidence are subject to significant uncertainty.

Firms seeking to persuade competition agencies that proposed mergers should not be challenged have available to them an assortment of possible defenses, the logic and validity of which are as applicable today as they have been during more robust economic times. These include arguments that entry would be timely, likely, and sufficient; that large cognizable efficiencies would result from the merger; and that the parties are not especially close competitors. These defenses are described and discussed at some length in the Horizontal Merger Guidelines ("HMG"), and some or all of them are commonly invoked during a merger review.

The HMG include also a discussion of one additional defense, something that has come to be known as the "failing firm defense." It states that "a merger is not likely to enhance market power if imminent failure…of one of the merging firms would cause the assets of that firm to exit the relevant market." Demonstrating imminent failure requires the parties to prove that: (1) the allegedly failing firm would be unable to meet its financial obligations in the near future; (2) it would not be able to reorganize successfully under Chapter 11 of the Bankruptcy Act; and (3) it has made unsuccessful good-faith efforts to elicit reasonable alternative offers that would keep its tangible and intangible assets in the relevant market and pose a less severe danger to competition than does the proposed merger.

Given the current economic downturn, the failing firm defense seems likely to play an increasing role in antitrust merger reviews. Faced with rapidly declining demand for their goods and services, a large number of firms, many of whom had been highly successful, are suddenly struggling to survive. Some of these firms, perhaps as a last resort, can be expected to seek a lifeline from more solvent enterprises willing and able to acquire them. Further, it seems likely that in many cases the would-be acquirers will be firms in the same industry.

While such mergers may well generate cognizable efficiencies of one type or another, they may also be a means of obtaining market power and harming consumers. When faced with horizontal mergers in concentrated markets, the competition agencies, together with lawyers and economists working for the merging parties, customarily devote considerable time and resources to analyzing the likely net effect of these two forces. To the extent that a merger satisfies the failing firm defense, however, a rigorous analysis of likely efficiencies or increased market power, much less a careful balancing of the two, becomes unnecessary. For this reason, the failing firm defense provides a potentially quite powerful "get out of jail free" card for struggling firms and their would-be acquirers.

The failing firm defense has a compelling logic to it. Merger policy, properly applied, is forward looking. If one of the merging parties (and its assets) are not going to remain in the market in the future, why should approval of a merger be held hostage to the fact that the two firms may previously have been significant competitive constraints on one another? A merger cannot be anticompetitive if there would be no future

2 Heyer, Ken & Kimmel, Sheldon, "Merger Review of Firms in Financial Distress," Competition Policy International, November 1, 2009.

competition to preserve. Further, there may be some benefits to permitting the owners of firms that are otherwise going out of business to earn, through merger rather than liquidation, a somewhat greater return on their initial investments.

In applying the failing firm defense to proposed mergers in our current environment, I consider below three issues. One is whether the requirements of the failing firm defense are too strict. In determining whether to clear mergers involving firms that are struggling greatly, the competition agencies should not, it is argued, ignore the fact that the struggling firm is "flailing," even if not literally failing under the demanding requirements of the defense. We consider circumstances under which a "flailing but not quite failing" firm defense should be permitted.

A second issue relates to whether the failing firm defense may be too lenient. In particular, is it robust enough to account properly for all of the relevant "but for" scenarios that might, in our current environment, disqualify a firm from successfully claiming failing status?

Third, I examine briefly the call from some in Congress that there be a complete moratorium on certain mergers. Fearing the prospect of large companies using the current crisis as an opportunity to scoop up struggling firms, one proposed piece of legislation would prohibit companies with more than $100 million in revenue, financial institutions, and most private equity partners and hedge funds, from acquiring or merging until the U.S. economy is no longer under financial stress. Is there a legitimate justification for such a moratorium, a closure of the market for corporate control; or is traditional antitrust analysis of mergers, including the failing firm defense, adequate to the task?

I conclude with a general suggestion for analyzing mergers, including those in which the failing firm defense is raised, in those many circumstances where outcomes are uncertain and the optimal decision may not be at all obvious.

II. IS THE FAILING FIRM DEFENSE TOO STRICT?

It is well recognized that simply because a firm may be struggling financially, this alone ought not justify permitting an otherwise anticompetitive merger to take place. The "flailing" firm — a struggling firm that is not exiting the market and thus does not satisfy the demanding conditions of the failing firm defense — can often be expected to continue as an important competitive constraint on its rivals. Indeed, it may even compete for business *more* aggressively, and more effectively, than it had been doing when its very survival was not at stake. Requiring that such a firm remain independent, or otherwise sell itself to a third party whose incentives will be strong to continue competing, seems generally to be the better course unless some combination of the usual merger defenses suggest otherwise. The struggling firm's stockholders may suffer, but consumers will benefit, and it is the welfare of the latter that antitrust is properly concerned with.

That said, mergers involving firms that are "flailing but not failing" should, in certain circumstances, be afforded more relaxed antitrust treatment than were they not flailing. In particular, where the firm's financial distress can be expected to leave it significantly less competitive in the future than it had been in the past, a more lenient posture towards the merger is simply a proper application of the principle that antitrust is forward looking, not some sort of static analysis held hostage to a very different history.[3] This observation is neither new (the Supreme Court recognized it in its *General Dynamics* decision, and a District Court accepted it recently when ruling to permit T-Mobile's acquisition of Sprint), nor inconsistent with the competition agencies' appropriate focus on the "but for" world.

During a severe and prolonged economic downturn, many successful firms are facing difficult choices, and it cannot simply be assumed that as long as they manage to survive, they will come out of the crisis as anything like what they had once been. Firms in severe financial distress may present a weaker competitive force going forward for any number of reasons. Perhaps important investments will be deferred by the firm, if not abandoned permanently. Needed capital may be impossible to raise — particularly if markets "freeze up," making it virtually impossible for flailing firms to obtain funding. Costly competitive initiatives may be abandoned. Perhaps scarce and valuable employees will leave in order to take more remunerative or more secure positions elsewhere. Perhaps the firm's suppliers will lose confidence that they will be paid in a timely fashion and will be more reluctant to continue investing in a relationship with the firm. For any number of reasons, that is, it could be the case — particularly during economic crises such as the one we are currently experiencing — that the relatively low bar of "continued existence in the marketplace" is no guarantee that the distressed firm will in fact remain an effective competitive constraint going forward.[4]

3 The converse is true as well. The competition agencies are certainly on firm ground in viewing with great skepticism claims that nascent competitors who have yet to turn a profit and may not yet be a strong competitive force in the marketplace are not worth preserving as independent entities. Whether or not such firms have yet recorded profits seems less relevant than whether, for example, these firm have been able to continue raising necessary capital in the marketplace. If they have been able to – and many "unprofitable" startups do seem to have very high stock market valuations – investors apparently view the firm's future prospects to be promising.

4 That having been said, to the extent that assets departing from the flailing firm would flow to the more successful rival even absent a full merger, one would want to consider whether a merger that keeps the entire bundle of assets of the flailing firm together (under the control of the acquiring entity) is more efficient than piecemeal dismemberment. If not, then the merger presents fewer, perhaps no, cognizable efficiencies and eliminating the diminished, but not exiting, rival is more likely to be of competitive concern.

Where the struggling firm will provide in the future a less significant competitive constraint in the market, the competition agency's analysis should treat it as such, and should adopt a commensurately more lenient policy towards the merger — weighing any cognizable efficiencies against the remaining risk that eliminating even a diminished competitive force could prove harmful to consumers. Of course, the flailing firm's weakened competitive position may be only short-lived, or it may not impact very materially the firm's ability to compete even in the short term, or the claim may not be supported by evidence. Nevertheless, it cannot simply be assumed that a flailing-but-not-failing firm will be as competitive going forward as it may have been in the past. That is hardly a certainty, and plausible evidence to the contrary should be examined and treated as seriously as the agencies treat other issues relevant to their overall analysis. This seems all the more important during serious economic downturns, when such outcomes may well be more plausible, and more widespread, than usual.

III. THE FAILING FIRM DEFENSE AND THE RELEVANT "BUT FOR" SCENARIO

In asking what would happen if a proposed merger involving a potentially failing firm is not permitted, the HMG properly asks about the likely "but for" scenario. It looks to the ability of the firm to reorganize itself under the bankruptcy laws while still remaining in business, and looks also at its ability to sell off relevant assets to a buyer likely to replace its competitive role in the market. Understandably, given the somewhat unprecedented times we find ourselves in, the HMG does not refer explicitly to the ability of an otherwise failing firm to stay afloat through other means — specifically, through loans or grants from the government. The extraordinary and virtually unprecedented role being played by the Federal Reserve and the federal government today arguably provides this additional lifeline to otherwise struggling firms, supplementing the role of ordinary capital markets in helping maintain in the market a firm that would otherwise be forced to exit.

Though fully consistent with the spirit of the HMG's failing firm requirements, this potential avenue through which otherwise failing firms might be able to survive ought to be a factor in the competition agency's assessment of its failing firm claims. Reliably predicting how successful government efforts to keep particular firms alive through the crisis is, however, no easy task. The process is difficult and uncertain, and there may be significant fixed costs of working with a government bureaucracy that, particularly for smaller firms, may not be worth incurring.

On the other hand, a struggling firm may well prefer to be bought out by a competitor (at an attractive price) than go through the process of securing support from the government. A firm may even refuse to apply for an ostensibly available government loan, or it may express to antitrust officials strong skepticism that such support will be forthcoming quickly enough, and on terms that it can live with.[5] Nevertheless, where evidence plausibly demonstrates that this lifeline would indeed maintain the firm as an independent player in the market, the competition agencies should be more reluctant to accept the failing firm defense.

IV. THE FAILING FIRM DEFENSE AND CALLS FOR A MERGER MORATORIUM

Finally, there is the question of when or whether antitrust enforcers should ever object to mergers involving bona fide failing firms — i.e. firms whose assets would literally exit the market in the absence of the proposed acquisition. Why, in particular, should a merger moratorium be employed during times of severe economic distress? A handful of reasons might be suggested, though none appear particularly compelling. One is a fear that the big and successful will, through acquisition of a failing adversary, become even bigger and more successful. This argument either ignores the fact that acquiring a failing firm does not eliminate a future competitor (which, as discussed above, is reason enough for permitting the acquisition), or treats the most likely explanation for such a merger — efficiencies — as a reason for condemning the merger rather than approving of it.

Antitrust enforcement generally assumes that there can be no anticompetitive effect when one firm wants to acquire the assets of an otherwise exiting rival. The logic of that position has prevailed over the past half century; there is no reason to abandon it now. To the extent there is a fear that firms made larger and more efficient through merger could more readily engage in anticompetitive or exclusionary practices going forward, a more reasonable response would seem to be to address those practices through antitrust interdiction when — and if — they take place, rather than adopt a blanket policy against becoming large and efficient at all.

Another possible explanation for demanding a merger moratorium might be a concern that the competition agencies cannot be expected to evaluate the failing firm defense correctly. Perhaps the agencies might inadvertently approve anticompetitive mergers on the mistaken view that the struggling to-be-acquired firm would be exiting when in fact it would not. Or perhaps the competition agencies in the current adminis-

5 Also of potential concern is the risk — perhaps modest, though certainly non-zero — that a flailing firm defense might incentivize firms to become flailing in order to strengthen their chances of receiving merger clearance from the government.

tration are not — in the view of a moratorium's supporters — sufficiently aggressive when it comes to enforcing the antitrust laws and would use the current economic environment as a pretext for being far too lenient. A moratorium would, it could be argued, hold things in place until a new, perhaps more interventionist, administration came to office.

These are, of course, possibilities. Decision makers at the competition agencies are human and — like courts and even legislators — do make mistakes from time to time. The fact that mistakes can be made, however, hardly seems a reason for abandoning analysis altogether and, in this case, simply prohibiting mergers entirely. The vast majority of mergers cannot seriously be expected to prove harmful, and a concern for occasionally getting things wrong (or for being perhaps a bit more lenient under a Republican Administration than under a Democrat one) [6] would surely be outweighed by the benefits of permitting the marketplace — where traditional competitive concerns do not clearly arise — to reallocate assets during economically distressed times through mergers and acquisitions.[7]

V. ANTITRUST ENFORCEMENT GIVEN THAT OUTCOMES ARE UNCERTAIN

Failing and flailing firm claims, as with other defenses put forward by merging parties, clearly involve difficult questions for the competition agencies to navigate successfully. No matter how talented, dedicated, and hard working their staffs (and I can personally attest from decades of experience working in government that their staffs tend to be all of those things), one never knows with certainty whether a merger defense should be accepted or rejected, and whether a potentially anticompetitive merger truly is anticompetitive, or whether it is benign. "Predicting is hard" Yogi Berra once said, "especially about the future."

Still, predicting the future is a good part of what antitrust analysis is all about, and difficult issues relating to would-be-failing-firms are ones that cannot be ignored. One possible approach to dealing with the high degree of uncertainty involved in trying to determine whether a merger involving a distressed firm should be cleared (indeed, a method that a number of writers have suggested be used by the agencies more generally),[8] would be to adopt more formally a decision-theoretic approach to analyzing the costs and benefits of allowing the merger, recognizing explicitly that the decision maker can never be one hundred percent certain that it is making the correct decision.

As a step in furtherance of this approach, and to give a brief flavor of how such a process might be employed, consider the agency proceeding somewhat along the following lines.

First, to get at the expected costs of mistakenly approving the merger when, in fact the firm was likely to be a significant competitive constraint going forward, the agency could ask itself:

- a1) How much harm to consumers do we think will occur if the merger is indeed anticompetitive and we incorrectly permit it by accepting the failing (or flailing) firm defense?
- a2) What is the probability that permitting the merger on failing (or flailing) firm grounds will, in fact, be a mistake?

To get at the expected costs of mistakenly blocking the merger — i.e. not crediting the failing (or flailing) firm defense when it should have been credited — the agency could ask itself:

- b1) How large are the benefits of permitting a benign merger that properly qualifies for this defense?
- b2) What do we think is the probability that the firm truly does qualify for the defense?

6 As an aside, based on my experiences working as an economist for more than three decades at the two federal competition agencies, I believe that the differences in merger enforcement across Republican and Democrat Administrations have been, while not zero, somewhat exaggerated. Further, I have seen virtually no difference across Administrations in how strictly or how leniently the failing firm defense has been applied in those cases where it has been asserted, and am not aware of any significant evidence suggesting otherwise.

7 Nor is it clear that the Supreme Court would tolerate the "taking without compensation" of property implied by a blanket prohibition on the buying and selling of assets.

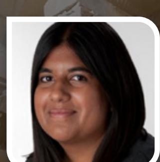
8 See for example: Ken Heyer, A World of Uncertainty: Economics and the Globalization of Antitrust 72 Antitrust Law Journal 375 (2005) and Katz, Michael L. & Howard A. Shelanski. "MERGER ANALYSIS AND THE TREATMENT OF UNCERTAINTY: SHOULD WE EXPECT BETTER?" *Antitrust Law Journal*, vol. 74, no. 3, 2007, pp. 537–574.

If the expected costs (a1 x a2) are greater than the expected benefits (b1 x b2), then blocking the merger is expected to prove beneficial. Conversely, if the expected costs are less than the expected benefits, the merger should be permitted.

Determining these costs, benefits and probabilities with a high degree of accuracy is, of course, difficult and one should not ignore or minimize the challenges involved. Nevertheless, in the course of investigating whether or not to challenge a merger, the agencies frequently and appropriately, though rarely publicly and explicitly, ask themselves these types of questions all the time. Since outcomes are typically uncertain, the agencies may benefit from more explicitly employing a range of reasonable estimates, examining the sensitivity of the outcome to these alternative assumptions, and through this process better understanding the sets of circumstances under which the failing (or flailing) firm defense ought to be accepted or rejected.

PANDEMIC, ECONOMIC CRISIS, AND THE FAILING FIRM DEFENSE

BY ANTONIO BAVASSO & JESSICA BOWRING[1]



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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:

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]

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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.

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).

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 investigation 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

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.

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.

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]

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.

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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).

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).

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 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]

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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.

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).

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 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]

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).

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).

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]

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.

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)).

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

THE FAILING FIRM DEFENSE IN TIMES OF (THE COVID-19) CRISIS: IS IT WORTH REVISITING?

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I. INTRODUCTION

The recent COVID-19 pandemic has affected all areas of economic activity and competition law was not spared. Regulators around the world had to deal with this crisis from administrative-type issues (teleworking including for hearings, submissions, etc.) to how to apply substantive competition law in times of crisis. In Europe, the European Commission ("Commission") reacted very swiftly and made use of all the legal instruments in its armory to ensure its procedures and analysis remained fit for purpose during the crisis.

In the area of State aid, the Commission issued a Temporary Framework for State aid on March 19, 2020, aimed at supporting the Member States' efforts to inject much needed capital into businesses under financial stress.[2] Similarly, in the field of antitrust, the Commission issued on April 8, 2020 a Temporary Framework with guidance for cooperation projects between competitors aimed at addressing a shortage of supply of essential products and services due to the coronavirus outbreak.[3]

In the area of merger control (which is the focus of the present article), the Commission also put in place some measures[4] to ensure business continuity and the adequate implementation of the EU Merger Regulation ("EUMR").[5] At the same time, the Commission acknowledged that its procedures and analysis under the EUMR would inevitably be affected. For example, from a procedural perspective, it became evident that, in some cases, the Commission would face difficulties in gathering information from the notifying parties and third parties such as customers, competitors and suppliers due to the disruption caused by the lockdowns. Notifying parties were therefore encouraged to discuss the timing (and indeed, to the extent possible, delay) of their merger notifications with the relevant case teams and to use electronic means to file transactions.[6]

In substantive terms, this crisis led to many businesses facing financial problems and thus becoming potential targets, sometimes by way of rescue acquisitions. These acquisitions may have positive effects as they avoid the target going under with the beneficial side effect of avoiding potential losses in assets, supply and employment. In such a scenario one may wonder: what is the role of merger control and competition policy in general? Should the rules change in times of crisis by acknowledging the greater financial distress of such companies to allow their takeover even where this would otherwise lead to a loss of competition?

The merger control regime in the EU has long offered a possible solution to this situation with the concept of the failing firm defense ("FFD"). By applying the FFD to an otherwise problematic merger, the Commission has a solid basis to authorize an acquisition and avoid that a failing firm disappears from the market with the subsequent loss in consumer welfare. However, the FFD has very rarely been applied in the EU and the number of successful cases can be counted with one hand. This is probably not only because the number of cases that raise FFD issues in the first place may be limited in practice, but also due to the very high evidential burden that the notifying parties must meet to be able to rely on the FFD.

A previous article by one of the co-authors in the same publication back in 2015[7] reviewed the Commission's practice at that time and considered whether the Commission had relaxed its rules in the wake of two cases where the FFD was successfully applied: *Nynas/Shell* and *Aegan/Olympic II*. In this article we revisit the FFD in light of the COVID-19 crisis. Given the absence of cases raising clear FFD issues at EU level we focus on the analysis undertaken by the UK Competition and Markets Authority ("CMA") in a string of recent cases (including *Amazon/Deliveroo*). We conclude – once more – that, while regulators will be receptive to FFD arguments, they are unlikely to relax their rules. Evidence will remain key. However, we also argue that regulators including the Commission could make greater use of a wider counterfactual scenario (beyond FFD) and look at changes that are likely to take place in the market conditions in the medium and longer term due to COVID-19 overall.

2 Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak, March, 20, 2020. Available here https://ec.europa.eu/competition/state_aid/what_is_new/sa_covid19_temporary-framework.pdf.

3 Temporary Framework for assessing antitrust issues related to business cooperation in response to situations of urgency stemming from the current COVID-19 outbreak, April 8, 2020. Available here https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52020XC0408(04)&from=en.

4 See Commission's website https://ec.europa.eu/competition/mergers/covid_19.html.

5 Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings.

6 See Commission's website https://ec.europa.eu/competition/mergers/information_en.html.

7 K. Fountoukakos & L. Geary, The Failing Firm Defence – Some Further Thoughts Post Nynas/Shell and Aegean/Olympic II Introduction, *Competition Policy International*, May 2015.

II. THE FAILING FIRM DEFENSE IN THE EU: A RECAP

A. Introduction

Before exploring in more detail the role of the FFD in times of COVID-19, it may be worth revisiting the foundations of the FFD in the EU. Article 2(3) of the EUMR prohibits concentrations "*which would significantly impede effective competition* [SIEC]*, in the common market or in a substantial part of it, in particular as a result of the creation or strengthening of a dominant position.*" This provision establishes a principle of causality according to which concentrations that are the cause of an SIEC should be prohibited, however, concentrations that do not result in an SIEC should, in principle, be allowed.[8]

In performing its review, the Commission uses a counterfactual analysis by comparing the situation without the merger and the situation with the merger. As set out in the Horizontal Merger Guidelines:[9]

> *"In assessing the competitive effects of a merger, the Commission compares the competitive conditions that would result from the notified merger with the conditions that would have prevailed without the merger. In most cases the competitive conditions existing at the time of the merger constitute the relevant comparison for evaluating the effects of a merger. However, in some circumstances, the Commission may take into account future changes to the market that can reasonably be predicted. It may, in particular, take account of the likely entry or exit of firms if the merger did not take place when considering what constitutes the relevant comparison."*

This comparison and the causal link required between the concentration and an SIEC is precisely where the FFD makes sense. In the case of a failing firm, the SIEC is not caused by the concentration itself but instead by the likely exit of the failing firm from the market absent the merger. This reasoning is set out in paragraph 89 of the Horizontal Merger Guidelines according to which "[*t*]*he Commission may decide 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. This will arise where the competitive structure of the market would deteriorate to at least the same extent in the absence of the merger*."

The key factor is therefore whether in a counterfactual scenario – i.e. in the absence of the merger – the competitive conditions on the market would be worse or equally bad than if the failing firm is rescued. In such a comparison, the merger is not the cause of the SIEC and in addition – beyond the strict legal test in the EUMR – the merger may be preferable from a wider perspective by rescuing the target and avoiding a bankruptcy.

In order for an FFD to be accepted, the parties to a concentration must satisfy three cumulative criteria that are set out in the Horizontal Merger Guidelines and which are based on the case law of the Court of Justice of the EU ("CJEU" or "Court"). These criteria are strict and are there to ensure that the merger is really not the cause of a possible SIEC: (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 purchase than the notified merger; and (iii) in the absence of the merger, the assets of the failing firm would inevitably exit the market.[10] The burden of proof that these cumulative criteria are satisfied falls on the notifying parties.[11]

8 Joined Cases C-68/94 and C-30/95, *Kali+Salz*, para. 110.

9 Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings, OJ C 31, 5.2.2004, p. 5–18 ("Horizontal Merger Guidelines") para. 9.

10 Horizontal Merger Guidelines, para. 90.

11 Horizontal Merger Guidelines, para. 91.

i. The failing firm may be forced out of the market due to financial difficulties

According to the first criterion, the notifying parties must demonstrate that 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. It is not required that bankruptcy proceedings or similar restructuring are already ongoing but rather that it is likely that the failing firm would have to exit the market absent the merger. Financial difficulties may exist for example when no shareholder or financial investor would be willing to provide the necessary capital for the business to continue.[12]

The evidence that a firm is under financial stress is normally measured by reference to the company's balance sheet in terms of profitability, liquidity, and solvency. However, the assessment of these parameters must be done on a case-by-case basis and subject to the characteristics of each industry.[13] In the current post-COVID-19 economic environment, it may be increasingly easier for firms to demonstrate that they are under financial difficulties and that market exit is a likely scenario in the near future.

ii. There is no less anticompetitive alternative

The second criterion of the FFD requires that there should be no less anti-competitive alternative purchase than the notified merger. The obvious difficultly with this second limb of the FFD lies in that the parties must be able to demonstrate a negative: i.e. the parties must be able to prove that they have made all efforts to find an alternative purchaser but were unable to do so. Timing is also important. In normal circumstances, a business may be able to reasonably predict whether it needs to be rescued by an investor. However, in times of economic turmoil there may be little time left to find possible investors until the business is forced to exit the market.

iii. The assets would inevitably exit the market

The third and last criterion deals with the question of whether the assets of the failing firm would inevitably exit the market, absent the merger. In essence, the third limb of the FFD test tries to determine whether the assets of the failing firm would completely exit the market or whether any third parties may be willing to purchase those assets and keep them in the market. If the assets of the failing firm are likely to remain in the market, the disruption to competition may be less or even more beneficial than the acquisition of the entire business. In practice, this part of the test has been applied rather strictly and is generally very difficult to satisfy.[14]

III. THE VERY STRICT APPLICATION OF THE FAILING FIRM DEFENSE

A. Overview

The FFD can be a key, central argument to save an otherwise problematic merger. However, the FFD has been rarely successful. This is largely due to the high evidential burden placed on the parties. The Horizontal Merger Guidelines clarify at paragraph 91 that "*it is for the notifying parties to provide in due time all the relevant information necessary to demonstrate that the deterioration of the competitive structure that follows the merger is not caused by the merger.*"

This high evidential burden means that the parties should be able to provide sufficient supportive evidence to convince the Commission that all three criteria of the FFD test are satisfied: a very difficult standard to meet in practice. The timing of providing the relevant evidence is also important: if the parties invoke the FFD too late in the proceedings (e.g. by not referring to it in the Form CO) their claims are likely to have less weight as they may seem to be improvised out of a sense of imminent prohibition of the proposed merger.[15]

12 OECD, *Failing Firm Defence* (2009), page 183, available at https://www.oecd.org/competition/mergers/45810821.pdf.

13 *Ibid*. page 184.

14 *Ibid*.

15 See, e.g. M.2876, *Newscorp/Telepiù*, April 2, 2003, para. 215.

In the EU, the first time the FFD was accepted (following an earlier rejection in *Aerospatiale-Alenia/De Havilland* in 1991[16]) was in 1993 in the *Kali+Salz/MdK/Treuhand* case which raised the question of whether an undertaking with large market shares (Kali+Salz) could acquire its main failing competitor (MdK).[17] In this case, the Commission found that there was no strict causal link between the proposed merger and the deterioration of the competitive structure in the German market because even if the merger were prohibited, Kali+Salz would inevitably reinforce its position of dominance given it was the only relevant player in the market.[18] Therefore, on balance, it would be better if the failing competitor were to remain in the market. The Commission concluded that (i) the failing firm would in the near future be forced to exit the market absent the merger; (ii) the acquirer would in any case absorb the market share of the failing firm if it were to exit the market; and (iii) there was no less anti-competitive alternative purchaser.[19]

The Commission applied the *Kali+Salz* criteria in a restrictive manner for a long time. It was not until 2001 that the Commission accepted another FFD in *BASF/Eurodiol/Pantochim*.[20] This case was a significant departure from the *Kali+Salz* criteria, especially on the absorption of the market share criterion. In *BASF/Eurodiol/Pantochim*, the Commission considered that the absorption of the market share criterion was too restrictive and that for a FDD to be successful, it would be sufficient to show that the assets of the failing firm would inevitably exit the market absent the merger, and that there was no less anti-competitive alternative purchase.[21] This broader interpretation of the FFD was in line with the Court's *Kali+Salz* judgment[22] and was later enshrined in the 2004 Horizontal Merger Guidelines.

It took twelve years until the FFD was applied again successfully. In 2013, the Commission adopted the *Nynas/Shell*[23] and *Aegean/Olympic II*[24] decisions in which the Commission recognized for the first time the concept of a "failing division defense." We analyzed these decisions in detail in a previous article dated May 2015.[25]

B. Nynas/Shell and Aegean/Olympic II

In *Nynas/Shell*, the Commission approved Nynas' acquisition of Shell's Harburg refinery assets after considering that absent the merger, the refinery was very likely to be closed. Shell was not a failing firm but a refinery (i.e. the "division") which had been unprofitable for years. There was therefore a very real risk that the refinery would have to exit the market in the absence of the merger with the subsequent reduction in production capacity and increase in prices.

The economic evidence submitted by Shell in conjunction with its internal documents convinced the Commission that, absent the merger, the rational decision would be to close the refinery because it had been loss making for five to ten years.[26] Further, an exit would be in line with Shell's business strategy that focused on larger scale facilities. This conclusion was bolstered by Shell's internal documents and annual reports pre-dating the notification to the Commission.[27] The Commission therefore concluded that "*it is very likely that the Harburg refinery will be closed and that the assets will in the near future be forced out of the market if not taken over by another undertaking, because of their poor financial performance and because of Shell's strategic focus on other activities*."[28]

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16 IV/M.053, *Aerospatiale-Alenia/de Havilland*, October 2, 1991.

17 M.308, *Kali+Salz/MdK/Treuhand*, December 14, 1993. For e.g. in cases relating to the aviation sector, the Commission has considered that slots at congested airports would be allocated to other airlines and therefore that the criterion about exit of assets would not be fulfilled. See for example, M.6447, *IAG/bmi*, March 30, 2012 para. 621.

18 *Ibid*. para. 72.

19 *Ibid*. para. 71.

20 M.2314, BASF/Eurodiol/Pantochim, July 11, 2001.

21 *Ibid*. para. 142.

22 Joined Cases C-68/94 and C-30/95, *France et al v. Commission (Kali+Salz)* [1998] ECR I-1375.

23 M.6360, *Nynas/Shell/Harburg Refinery*, September 2, 2013.

24 M.6796, *Aegean/Olympic II*, October 9, 2013.

25 K. Fountoukakos & L. Geary, The Failing Firm Defence – Some Further Thoughts Post Nynas/Shell and Aegean/Olympic II Introduction, *Competition Policy International*, May 2015.

26 M.6360, *Nynas/Shell/Harburg Refinery*, September 2, 2013, para. 316.

27 *Ibid*. para. 319.

28 *Ibid*. para. 327.

In October 2013, just one month after *Nynas/Shell*, the Commission unconditionally approved the *Aegean/Olympic II* merger after concluding that Olympic was failing and would be forced to exit the market absent the merger. The Commission approved this transaction despite having prohibited the same merger in 2011, because at that time, it would have led to the acquisition of Aegan's closest competitor and a monopoly in several routes.[29]

In 2013, Olympic Air's financial situation (as a division) and that of its parent company Marfin had deteriorated to such an extent – in part due to the significant drop in demand for domestic air travel due to the financial crisis in Greece – that the Commission was convinced that absent the merger, Olympic Air would be forced to exit the market in the near future. In the clearance decision, the Commission solely relied on the FFD to conclude that even if the transaction would lead to a merger to monopoly in five routes and would eliminate the most likely competitor for six additional routes, there was no causal link between the transaction and the deterioration of the competitive conditions and that absent the merger, the competitive conditions would deteriorate at least to the same extent.[30]

While these cases seemed to suggest that the Commission had adopted a more flexible approach towards the FFD, the truth is that the criteria and strict application in terms of evidentiary standard remained intact. A slight relaxation was that in failing division situations, the Commission seemed to accept that notifying parties were no longer required to prove that the viability of the whole group is endangered.

IV. RECENT DEVELOPMENTS IN LIGHT OF COVID-19[31]

A. The CMA Merger Guidance on COVID-19 and the Amazon/Deliveroo Case

There has not (yet) been an EUMR case which has assessed the FFD in the context of the COVID-19 pandemic. It is therefore helpful to consider recent national developments, in particular in the UK, where some interesting recent cases included an FFD analysis.

In the UK, the test is broadly similar to the one applied by the Commission:[32] the CMA considers (i) whether the firm would have exited (through failure or otherwise) absent the transaction;[33] (ii) whether there would have been an alternative purchaser for the firm or its assets; and (iii) what the impact of exit would be, and how this would compare to the impact of the transaction.

The CMA (and its predecessors) has accepted the FFD more often than the Commission and its approach seems slightly more flexible grounding the analysis in an overall counterfactual assessment rather than focusing more mechanistically on the three FFD criteria. The most recent example is *Aer Lingus/CityJet* which cleared at Phase 1 a long-term wetlease arrangement and landing slots transfer between Aer Lingus and CityJet relating to air transportation services between London City airport and Dublin.[34] The CMA found that the FFD applied since CityJet had taken the decision to stop providing services on this route prior to the agreement and the CMA's detailed investigation showed that no other airline would have been interested in taking over the business.

In April 2020, the CMA issued guidance on merger assessments during the COVID-19 pandemic,[35] including a separate summary of its position on how the CMA will assess "failing firm" arguments in a merger review context. The CMA emphasized that its overall approach to assessing whether a merger gives rise to competition concerns remained unchanged and expressly stated that COVID-19 "*[had] not brought about any relaxation of the standards by which mergers are assessed or the CMA's investigational standards*."[36] The CMA noted that the impact

29 M.5830, *Olympic/Aegan Airlines*, January 26, 2011.

30 See for a more detailed analysis of this decision, K. Fountoukakos & L. Geary, The Failing Firm Defence – Some Further Thoughts Post Nynas/Shell and Aegean/Olympic II Introduction, *Competition Policy International*, May 2015.

31 This section includes developments up to July 27, 2020.

32 CC2, CMA Merger Assessment Guidelines, September 2010, paras 4.3.8 to 4.3.18. While the CMA Guidelines and decisions usually refer to the "exiting firm scenario," we have used the "FFD" terminology in this article for ease of reference.

33 While the Horizontal Merger Guidelines expressly refer to an exit of the market because of financial difficulties, the CMA Merger Assessment Guidelines note that "[t]*he exiting firm scenario is most commonly considered when one of the firms is said to be failing financially. However, exit may also be for other reasons, for example because the selling firm's corporate strategy has changed*," para. 4.3.9.

34 Completed agreement between Aer Lingus Limited and CityJet designated Activity Company, CMA decision of December 21, 2018.

35 CMA Guidance, Merger assessments during the Coronavirus (COVID-19) pandemic, April 22, 2020.

36 CMA Guidance, Annex A: Summary of CMA's position on mergers involving 'failing firms,' April 22, 2020, para. 26.

of COVID-19 will be factored into the substantive assessment of a merger "*where appropriate*" but "*even significant short-term industry-wide economic shocks may not be sufficient, in themselves, to override competition concerns that a permanent structural change in the market brought about by a merger could raise*."[37]

However, a few days before issuing this guidance, the CMA provisionally cleared Amazon's investment in Deliveroo on the basis of failing firm arguments.[38] The CMA noted in particular the "*wholly unprecedented circumstances*" and the "*stark outcome*" for food delivery options that would result if Deliveroo exited the market.[39]

As for the first condition (market exit), the CMA found that Deliveroo had provided evidence that, without the Amazon investment, it would fail financially and be forced to exit the market. Based on financial data from early-April 2020, the CMA reached such conclusion against the backdrop of restaurant closures, consumer fears over contamination and a significant reduction of available couriers, and considered that Deliveroo could not have re-structured its operations to avoid a market exit.[40] The CMA also noted that Deliveroo's current financial constraints could not be attributed to its decision to accept investment from Amazon: any alternative investment available at the time would not have put Deliveroo in a viable position to survive the COVID-19 disruption.[41]

In respect of the second condition (no less competitive alternative purchaser), the CMA found that Deliveroo's current shareholders were not a source of viable alternatives and that, given COVID-19, alternative funding was very unlikely and would not have been provided in the timing required.[42] As for the third condition (impact of exit), the CMA found that Deliveroo's exit would result in significantly weaker competition over an extended period of time, and this would be the case even if Amazon ultimately re-entered the market successfully.[43] Therefore the CMA provisionally concluded that Deliveroo exiting the market would have had a greater negative effect on competition and consumers than any effect from allowing the transaction to proceed.

This decision has been heavily criticized by third parties. In particular, third party submissions raised the temporary nature of the adverse impact of the COVID-19 on Deliveroo's business so that the CMA failed to take into account the likely increase in order volumes and revenues which took place a few weeks after COVID-19's outbreak.[44] For example, Deliveroo's competitor Just Eat noted that the negative COVID-19 impact on its business was only for about 1-2 weeks followed by a quick and strong recovery even to a level above the original benchmark both in the UK and in other markets.[45] In light of these developments, the CMA's Final Report's deadline was extended by eight weeks to allow the CMA to reflect the impact of COVID-19 in the CMA's assessment.[46]

On June 22, 2020, the CMA issued revised Provisional Findings which changed the grounds for provisional clearance. The CMA acknowledged that its previous decision was issued in the urgency of the situation but that market conditions and Deliveroo's financial situation had materially changed since that decision.[47] First, the CMA found that COVID-19 had had a more limited impact than expected on Deliveroo's business, and notwithstanding the company's ongoing reliance on external funding, the most likely counterfactual was that Deliveroo's exit was not inevitable.[48] Second, the CMA found that Deliveroo was no longer facing a financial "cliff-edge" and that the urgent funding need due to COVID-19 envisaged in the April Provisional Findings no longer appeared to have arisen. The CMA therefore provisionally concluded that the

37 CMA Guidance, Merger assessments during the Coronavirus (COVID-19) pandemic, April 22, 2020.

38 Anticipated acquisition by Amazon of a minority shareholding and certain rights in Deliveroo, notified on April 16, 2020 ("*Amazon/Deliveroo*").

39 Press Release, CMA provisionally clears Amazon's investment in Deliveroo, April 17, 2020.

40 *Amazon/Deliveroo*, Provisional Findings report, April 16, 2020, paras 4.24-4.49.

41 *Ibid*. paras 4.45-4.49.

42 *Ibid*. paras 4.50-4.65.

43 *Ibid*. paras 4.66-4.89.

44 See for example Company D's response to the CMA's Provisional Findings in *Amazon/Deliveroo*, May 13, 2020, section B.

45 Just Eat Takeaway.Com, Submission to the CMA in response to its request for views on its Provisional Findings in relation to the *Amazon/Deliveroo* merger inquiry, para. 21.

46 Reference relating to the Anticipated Acquisition by Amazon of a minority shareholding and certain rights in Deliveroo, CMA Notice of extension of inquiry period under section 39(3) of the Enterprise Act 2002, 10 June 2020, para. 4.

47 *Amazon/Deliveroo*, CMA Summary of revised provisional findings, April 22, 2020, paras 2-3.

48 *Amazon/Deliveroo*, CMA Revised Provisional Findings, June 22, 2020, paras 19-22.

most likely counterfactual was that Deliveroo would have continued to compete in the market, and to raise funds to do so, in the same way as it anticipated prior to the crisis.[49]

This "U-turn" in the CMA's provisional conclusions confirms that the FFD cannot be used to address short-term financial difficulties; rather it is the long-term impact of the crisis on the target that prevails. It also confirms that, as provided in its guidance, the CMA is not willing to flex the test as a result of COVID-19.

B. Other Recent COVID-19 Related Developments in the UK

To date, the CMA has not accepted arguments relating to the adverse impact of the COVID-19 pandemic in its competitive assessment.

In *Sabre/Farelogix*, which was blocked on April 9, 2020, the CMA indicated that the significant disruption that COVID-19 is expected to create to the travel industry did not change its assessment of the consequences of the merger on competition.[50]

In *JD Sports Fashion/Footasylum*, which was blocked by the CMA on May 6, 2020, the CMA noted that, while COVID-19 is significantly affecting the sector, it had not found evidence that this would remove its competition concerns. In particular, the CMA found that, while there remained considerable uncertainty around the extent and the duration of COVID-19's impact,[51] the parties were not hit harder relative to other retailers, such that either party would be in a much weaker competitive position in comparison to each other and other retailers, or that other competitors would become significantly stronger.[52] The parties also confirmed to the CMA that none of them would go out of business. However, the CMA took the uncertainties of the current situation into account in the time given to JD Sports to sell Footasylum.[53] JD Sports Fashion plc has appealed the CMA's decision before the Competition Appeal Tribunal (the "CAT"). One ground for the appeal argues that the CMA erred in law and/or acted irrationally by excluding the effect of COVID-19 on Footasylum when considering the relevant counterfactual. JD Sports further alleges that the CMA was also mistaken in finding that COVID-19 would not materially affect Footasylum's competitive constraint.[54] Beyond the strict conditions of the FFD, JD Sports' appeal raises the question of considering the impact of COVID-19 more broadly in the competitive assessment, namely in the changes to the structure of competition and consumer behavior. It will therefore be interesting to see the CAT's response to JD Sports' allegations.

In *Circle Health Holdings Limited/BMI Healthcare Limited*, which was conditionally cleared on June 23, 2020, the CMA took into account the contemporaneous arrangement between the parties and the NHS for temporary capacity allocation. The CMA however considered that this arrangement was unlikely to impact the long-term competitive dynamics of the private healthcare industry.[55]

In *Viagogo/StubHub*, which was referred to Phase II on June 25, 2020, the CMA noted that the COVID-19 outbreak had had, at least in the short-term, a substantial impact on the live events and ticketing industries.[56] However, the CMA considered that there remained considerable uncertainty about the duration and long-term effects of this impact while a "*merger investigation typically (…) considers what lasting structural impacts a merger might have on the relevant market.*"[57] The CMA found no evidence indicating that the COVID-19 outbreak would have a disproportionate impact on the parties relative to other providers. It therefore considered pre-merger conditions of competition to be an appropriate proxy for assessing the lasting structural impact of the merger.[58]

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49 *Ibid*. paras 23-25.

50 Anticipated acquisition by Sabre Corporation of Farelogix Inc., CMA Final Report, April 9, 2020, para. 55. Sabre Corporation has appealed the CMA's decision.

51 Completed merger on the acquisition of Footasylum by JD Sports Fashion plc, CMA Final report, May 6, 2020, paras 8.305, 9.223, 13-152, 13-153.

52 *Ibid*. para. 4.

53 *Ibid*. para. 5.

54 Case No. 1354/4/12/20, *JD Sports Fashion plc v. Competition and Markets Authority*, CMA Summary of application under section 120 of the enterprise act 2002, para. 2.

55 Completed acquisition by Circle Health Holdings Limited of GHG Healthcare Holdings Limited, a parent of BMI Healthcare Limited, CMA decision on relevant merger situation and substantial lessening of competition, April 8, 2020, paras 56-57.

56 Completed acquisition by PUG LLC Of StubHub, Inc., StubHub (UK) Limited, StubHub Europe S.à.r.l., StubHub India Private Limited, StubHub International Limited, StubHub Taiwan Co., Ltd., StubHub GmbH, and Todoentradas, S.L., Summary of the CMA's decision on relevant merger situation and substantial lessening of competition, June 11, 2020, para. 5.

57 *Ibid*. para. 5.

58 *Ibid*. para. 5.

One specific difficulty for the parties to convince the CMA to take into account the impact of COVID-19 in the counterfactual - that comes out of the recent cases - is to demonstrate that the pandemic had a disproportionate impact on the parties relative to its competitors. This puts a very high burden of proof on the parties, especially as market data is not necessarily available to them in these uncertain times and while the commercial pressure to complete quickly (or remove a hold separate order) is high.

These decisions show that the CMA will be vigilant and will not easily accept FFD arguments especially when these are based on a short-term impact assessment. Given the uncertainty surrounding any impact of COVID-19 (and with many jurisdictions moving back to reopening their economies), it seems unlikely that the FFD will be accepted more easily purely on COVID-19 related grounds. This highlights the importance of a case-by-case assessment which takes into account the commercial dynamics and the evidence available to the parties in given circumstances. The defense may therefore continue to apply as before, i.e. only where it can clearly be demonstrated that the target will inevitably exit the market imminently or in the short term and the remaining criteria are satisfied.

V. CONCLUSION – A STRICT APPLICATION OF THE FFD IS LIKELY TO CONTINUE DESPITE THE COVID-19 CRISIS?

The recent cases in the UK as well as the precedents at EU level show that the requirements of the FFD remain very demanding, even in times of a global pandemic. Whether the FFD should be made more lenient or not seems to be a debate that keeps creeping back in times of economic turmoil. Already in 2009, the Commission and other OECD Member countries rejected this idea in the midst of one of the worst financial crises since the Great Depression of 1929.[59]

Back then, a number of competition authorities recognized that the low number of mergers in which parties claimed the FFD was probably due to the perception that the FFD criteria are too strict. However, the consensus was that those criteria should not be loosened, even in light of a global economic crisis, mainly because there are other policy instruments (e.g. State aid or bankruptcy law) better suited to help failing firms in times of crisis.[60]

Nonetheless, the reason FFD arguments always resurface in times of crisis is a simple one. A crisis does create a sense of urgency and the deteriorating economic environment does indeed make it more likely that some firms will fail. In such situations, a merger with a financially stronger competitor may be the only option left for a firm to ensure its viable continuation and avoid having to exit the market.

In addition, with crises that may have a longer-term impact (and it remains to be seen what the impact of COVID-19 will be on various sectors of the economy), a proper counterfactual analysis (beyond the strict parameters of FFD) is necessary. Regulators need to assess whether the new economic situation in the medium and longer term will result in permanent changes to the market that need to be taken into account when analyzing the merger. Such a wider counterfactual analysis could include elements of FFD without fixating on the strict criteria of FFD in a mechanistic manner. In the recent CMA cases such a counterfactual analysis was undertaken but ultimately the CMA was not convinced that this should result in it departing from using the pre-merger level of competitive interaction as the relevant counterfactual. As the longer-term impact of COVID-19 may become clearer and the economy moves (to use a cliché) to a "new normal," it remains to be seen whether firms will raise FFD and wider counterfactual arguments and how receptive regulators and in particular the Commission will be.

59 OECD, Failing Firm Defence (2009), page 12-13: available at https://www.oecd.org/competition/mergers/45810821.pdf.

60 *Ibid*. page 13.

CANADIAN MERGER REVIEW: ASSESSING FAILING FIRM CLAIMS IN MARKET CONDITIONS DISRUPTED BY COVID-19

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I. INTRODUCTION

The coronavirus pandemic has disrupted the global economy, transformed supply chains, and shocked daily lives across the world. This is a crisis – a challenging moment in time, and the work of competition authorities, while important in any economic environment, is even more crucial in times of economic crisis to support short- and long-term recovery efforts.

A wave of proposed transactions involving distressed companies is anticipated by some as a result of the COVID-19 pandemic crisis. If such a wave materializes, these proposed transactions may require swift review by competition authorities, especially in jurisdictions like Canada with *ex ante* regimes. There are calls from the business community in Canada and elsewhere for competition authorities to relax their standards for review in a failing firm context due to the exigent circumstances presented by the crisis. Relaxing standards in a crisis period may have long-term implications in key sectors of the economy where the irreversible and immediate enhancement of market power through strategic acquisition could lead to deeper and longer-term implications for the economy and its recovery.

Experience in evaluating failing firm claims in a recent case in Canada indicates that rigor and speed need not always be at odds. Where the parties to the proposed transaction come in early and provide the evidence, data and information required in order for the reviewing authority to do its work quickly, parties may get the certainty they need within ambitious timelines that recognize the urgency of companies in true financial distress without compromising the public interest in competition that is vital to support short- and long-term economic recovery efforts.

II. IMPORTANT LESSONS FROM PAST CRISES

The advice of antitrust enforcers and lessons learned from prior crises is one of the only guides we have to navigate the current crisis. This advice tells us that the need for antitrust law to foster competitive markets is especially pronounced in times of economic crisis.[2] The words of our former Commissioner during the 2009 Global Financial Crisis ring true today:

For companies and consumers, timely, transparent and predictable application of the law is arguably more important than ever. Staying true to competition principles is not a luxury, to pursue only when there is a perception we can afford it; quite the contrary. In tough times, we need to be vigilant to ensure that lasting harm to competition does not result from unscrupulous exploitation of vulnerable consumers and business, or even a well-meaning but misguided relaxation of standards. [..] [J]ust as the *Competition Act* applies during times of prosperity to prevent conduct that deprives markets of the innovation, efficiency and productivity that would otherwise be fostered, it is of equal, or greater, importance during times of economic hardship.[3]

The lessons of the Great Depression may also be prescient during this period. Academic study points to the loosening of the application of competition laws and policies in the late 1920s and early 1930s as a factor that may have contributed to wage and price fixing and a deepening and prolongation of the Great Depression.[4] During this period, the welfare of firms took priority over the welfare of consumers. Consequences included restricted output, higher prices and reduced consumer purchasing power.[5]

Based upon experience in past crises, not many proposed transactions involving distressed firms raise competition issues. A very small proportion of cases involve both substantive competition issues and failing firm claims. Where there is little prospect of a substantial prevention or lessening of competition, proposed transactions in Canada generally receive the necessary guidance to proceed to complete the transaction within fourteen days. This has continued to be the case so far during the COVID-19 crisis in Canada. For the very small minority of proposed transactions that may raise competition concerns worthy of investigation that also involve failing firm claims, it remains a priority to maintain the rigor of an evidence-based review.

Now is not the time to relax our standards, including for proposed transactions that present substantive competition issues in a failing firm context. Permitting strategic acquisitions that may harm competition over the short and long term to proceed will hamper recovery efforts.

2 Christine A. Varney, Assistant Attorney General, Antitrust Division., U.S. Department of Justice, *Vigorous Antitrust enforcement in this Challenging Era*, May 12, 2009, available at https://www.justice.gov/atr/speech/vigorous-antitrust-enforcement-challenging-era.

3 Speech made by Melanie L. Aitken, Interim Commissioner of Competition, February 12, 2009, Northwinds Professional Institute, 2009 Competition law and policy forum, Cambridge, Ontario, available at https://web.archive.org/web/20150219152934/http:/www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/02994.html.

4 Alan J. Meese, Ball professor of Law, William & Mary Law school, article "*Competition Policy and the Great Depression: lessons learned and a new way forward*," Cornell Journal of Law and Public Policy, Vol. 23, No. 2, 2013, page 256 and page 335 available at https://www.lawschool.cornell.edu/research/JLPP/upload/Meese-final.pdf.

5 Christine A. Varney, *supra* note 2.

Parties to such proposed transactions subject to review in Canada can expect that the Canadian Competition Bureau ("CCB") will try to work as quickly as possible to evaluate the evidence based upon the criteria set out in our merger enforcement guidelines with respect to failing firms. Parties can also expect that where we see competition concerns and a lack of evidence to support the failing firm factor, the CCB will continue to vigorously enforce the merger provisions of the Canadian *Competition Act* (the "Act").

The remainder of this article examines Canada's merger control framework and summarizes the CCB's approach to acquisitions of failing firms and how it compares to the approach of other agencies internationally.

III. CANADA'S APPROACH TO THE FAILING FIRM FACTOR

A. Canada's Merger Regime

Canada has a prosecutorial model for mergers that is similar in many respects to the United States. There is an *ex ante* merger regime for proposed transactions that meet certain thresholds which provides that parties are required to notify the Commissioner of Competition (the "Commissioner") and provide certain prescribed information. Absent positive clearance from the Commissioner, parties may not take steps to complete a proposed transaction that is subject to notification for a period of thirty days. For more complex proposed transactions that require further information to be examined, the Commissioner may issue a supplementary information request. The issuance of such a request triggers a second statutory waiting period that prohibits parties from taking steps toward closing a proposed transaction until thirty days after the parties have provided all of the information requested.

Where the Commissioner has concerns that a proposed transaction may substantially prevent or lessen competition, he may apply to the Competition Tribunal, comprised of Federal Court of Canada judges and lay members who generally have expertise in competition law or economics, for an order to remedy the likely substantial prevention or lessening of competition. The Act provides a one-year period following completion of any transaction (regardless of whether subject to the *ex ante* regime or not) for the Commissioner to file an application to challenge. The Commissioner has the burden to prove, on a balance of probabilities, that the merger is likely to substantially prevent or lessen competition.

Section 93 of the Act sets out a non-exhaustive list of factors that the Competition Tribunal may consider in determining whether a transaction is likely to substantially prevent or lessen competition. These factors also guide the CCB in its review of proposed transactions. The "failing firm factor" is one of the factors enumerated in section 93 of the Act. Subsection 93(*b*) states:

> *In determining, for the purposes of section 92, whether or not a merger or proposed merger prevents or lessens, or is likely to prevent or lessen, competition substantially, the Tribunal may have regard to the following factors:*
> *(…)*
> *(b) whether the business, or a part of the business, of a party to the merger or proposed merger has failed or is likely to fail.*

B. CCB's Approach to Evaluating the Failing Firm Factor

Failing firm claims are not treated as a defense to an otherwise anti-competitive merger under the Act. These claims are assessed as part of the competitive effects analysis of a proposed transaction. For the vast majority of proposed transactions that are unlikely to lead to a substantial prevention or lessening of competition based upon minimal overlap between the parties or the evaluation of other factors such as barriers to entry and effective remaining competition, failing firm is not a factor that is operative in the review. It is only in a very small minority of transactions where there is a likely competition issue that the CCB is likely to take an in-depth review of the available evidence supporting the failing firm factor.

The CCB's analytical approach to the assessment of claims made pursuant to subsection 93(*b*) is outlined in its Merger Enforcement Guidelines ("MEGs").[6] Part 13 of the MEGs provides that the CCB considers a firm to be failing if: (i) it is insolvent or is likely to become insolvent; (ii) it has initiated or is likely to initiate voluntary bankruptcy proceedings; or (iii) it has been, or is likely to be, petitioned into bankruptcy or receivership. The MEGs contemplate that, if the imminent failure of a firm and the exit of assets from the market are likely, the loss of the actual or future competitive influence of the failing firm is not attributable to the merger. Based upon personal experience, parties to proposed transactions may initially argue that the failing firm factor applies due to general claims of financial difficulty but it is fairly rare for the financial position of the firm to meet the requirements of these three circumstances.

6 Available at https://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/03420.html.

The insolvency or likely insolvency must relate to the business where competition concerns arise. If the portion of a company's business that is responsible for the relevant market in which competition concerns arise is not failing and is an identifiable part of the business such as a division or subsidiary, it is less likely that the CCB will consider the failing firm factor to apply since exit of assets from the relevant market may not be viewed as likely. On the other hand, the CCB may examine the factor carefully where the larger enterprise may not be failing but the operating division or subsidiary that is relevant to the competition concerns otherwise meet the failing firm criteria.

When the CCB concludes that a firm is likely to meet the requirement of imminent failure and likely exit, it examines the likelihood of various counterfactual scenarios and the expected levels of competition in the market under such scenarios prior to concluding that a merger involving a failing firm is not likely to result in a substantial lessening or prevention of competition. These counterfactual scenarios include: the restructuring or retrenchment of the failing firm; the liquidation of the failing firm's assets; or, the sale of the firm's assets to a competitively preferable purchaser.

It is the examination of the third counterfactual that some in the legal and business community in Canada argue should be relaxed in a crisis environment on the basis that failing firms may not have the time and liquidity to permit a full shop of the assets relevant to the competition analysis in order to demonstrate an evidentiary foundation for the assessment that a competitively preferable purchaser does not exist. As indicated in the MEGs, when no such shop has been conducted, the CCB may request that an independent third party be engaged to carry out a search for alternative buyers before the failing firm rationale is accepted. When parties claim that a thorough search for alternate buyers has been conducted, the CCB will require documents and information showing such *bona fide* attempts have taken place.

Recent experience in examining the failing firm factor in the context of a distressed business demonstrates that where the CCB is provided with the information it needs to evaluate the failing firm factor, it can complete its review quickly so that the rigor necessary to protect competition and the pragmatic urgency presented by a situation involving a truly financially distressed business need not be at odds.

C. Recent CCB Experience Evaluating the Failing Firm Factor

American Iron & Total Metal Recovery[7]

The CCB evaluated the failing firm factor in its investigation related to the acquisition of Total Metal Recovery ("TMR") by American Iron & Metal Company Inc. ("AIM"), the two largest scrap metal processors in the Canadian province of Quebec. The merging parties initially submitted pre-merger notification filings in early November 2019. The filings were subsequently withdrawn after the parties determined that the proposed transaction did not trigger the thresholds for notification under the Act. The CCB initiated a formal inquiry into the transaction on December 5, 2019. On December 17, 2019, AIM entered into a court enforceable Consent Preservation Agreement with the Commissioner to preserve and maintain the assets of TMR for a period of 60 days following the closing of the transaction. The transaction closed on December 20, 2019.

In January 2020, the CCB sought and obtained orders to compel information from the merged parties as well as from a third party who had expressed interest in purchasing TMR. The recipients of the orders were required to produce information to the CCB under tight timeframes prior to expiry of the court enforceable preservation agreement.

The CCB examined the likelihood of three counterfactual scenarios: the restructuring or retrenchment of the failing firm, the sale of the firm to a competitively preferable purchaser, and liquidation of the failing firm's assets.

With respect to the first counterfactual, the CCB determined based upon review of the available evidence that further attempts at the retrenchment or restructuring of TMR would not have prevented its failure nor enabled it to survive as a meaningful competitor.

With respect to the second counterfactual, the CCB examined:

- the extent that one or more alternative buyers expressed interest in buying the failing firm;
- evidence demonstrating the steps taken by the failing firm and the interested buyer in relation to negotiations and attempts to finalize a deal;
- evidence from an interested purchaser to assess how effective or competitive that interested party would be if they were successful in purchasing the failing firm; and

7 CCB's April 29, 2020 statement is available at https://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/04528.html.

- evidence pertinent to the ability of an alternative buyer to finalize a transaction in a timely way in order to assess its viability as an alternative to the potentially anti-competitive merger under review.

The CCB determined that a thorough search for potential alternative purchasers of TMR had been conducted, but that no competitively preferable purchaser to AIM existed.

With respect to the third counterfactual, the CCB considered whether liquidation of the failing firm's assets would nonetheless be a materially better competitive alternative to a merger that may raise competition issues. Because liquidation is disruptive to all parties involved and may not result in an efficient allocation of resources, there are very limited circumstances under which the CCB may determine that liquidation is the preferable outcome. In this case, the CCB determined that liquidation of TMR's individual assets would not have been a determining factor in facilitating entry of a competing shredder operation within the Quebec marketplace and was not likely to result in a materially higher level of competition than if the merger did not proceed.

The CCB ultimately concluded that the failing firm factor was met and the transaction proceeded without challenge.

This case example demonstrates that the CCB can work quickly within the exigencies presented in a true failing firm context without relaxing its standards. The CCB reviewed the parties' and third parties' internal documents, expert financial analysis and conducted in person interviews with dozens of stakeholders across the province of Quebec. The CCB completed its entire investigation in two months including a holiday period when it is often more challenging to gather evidence from key market participants.

Transcontinental Inc. & Quebecor Media Inc.[8]

Transcontinental Inc. ("Transcontinental") and Quebecor Media Inc.'s ("QMI") merger is another acquisition where the CCB faced claims about the financial health and viability of the firms and conducted its analysis within a short period of time. On January 13, 2014 the CCB was notified about the acquisition of all of the Quebecor Media's 74 community newspapers in Quebec, including web, mobile and printed formats, as well as some regional offices and pre-press by Transcontinental Inc. On December 9, 2013, QMI also announced that it was ceasing door-to-door distribution of community newspapers and flyers in Quebec.

The parties argued that many of the newspapers being purchased through the transaction were experiencing serious financial difficultly and, as a result, should not be considered vigorous or effective competitors.

After an extensive review of QMI's internal documents and consultation with its financial expert, the CCB concluded that QMI's distribution network was in a state of financial distress, despite past strategic changes aimed at getting the business to break-even. The evidence also indicated that there was no likely buyer for the distribution network (alone or in concert with the sale of certain newspapers) due to the network's current financial state, high fixed costs, and the need for a strong reputation. The CCB found that liquidation was unlikely to spur or facilitate entry due to the limited assets available for sale. Ultimately, the CCB concluded that QMI's exit from distribution was unlikely to result in a substantial lessening or prevention of competition as a result of the proposed transaction.

With respect to the newspaper business, the CCB carefully reviewed the parties' financial statements, and retained the expertise of an accounting firm and determined that at least one of the parties' newspapers was in financial distress in the vast majority of markets where the parties competed.

On May 28, 2014, the CCB reached a consent agreement with Transcontinental which tested the parties' arguments regarding the financial distress of many of the newspapers. The aim of the consent agreement was to preserve competition in the sale of advertising in community newspapers in several areas in the province of Quebec by requiring that 34[9] community newspapers be put up for sale. Out of the newspapers put up for sale, 14 subsequently found buyers,[10] and 19 were discontinued by Transcontinental.[11]

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8 CCB's May 28, 2014 statement is available at https://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/03740.html.

9 Following July 24, 2014 Competition Tribunal Order allowing an application to vary a consent agreement, 33 newspapers were required to be divested. The Order is available at https://decisions.ct-tc.gc.ca/ct-tc/cdo/en/463166/1/document.do.

10 CCB's September 3, 2014 statement is available at https://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/03807.html.

11 Transcontinental's announcement of the results of the divestiture process is available at https://tctranscontinental.com/company-overview/news-room/press-releases/transcontinental-inc-announces-results-sale-process.

IV. INTERNATIONAL CONTEXT

The CCB's approach to failing firm claims anticipated in the context of the COVID-19 does not appear to be remarkably different to its key international merger enforcement partners. As recently stated by the Organisation for Economic Co-operation and Development ("OECD"), the overall approach to merger assessments remains unchanged and the approach to failing firm defense appears similar across jurisdictions.[12]

A. United States

Since a 1930 U.S. Supreme Court decision,[13] failing firm is treated at law as a defense in the U.S. The parties to a merger therefore have the burden to prove it. Despite the legal distinction between a factor in Canada and a defense in the U.S., the approach to the analysis of a failing firm claim is similar. In the U.S. Horizontal Merger Guidelines ("Merger Guidelines")[14] published jointly by the U.S. Department of Justice ("DOJ") and Federal Trade Commission ("FTC"), merging companies invoking the failing firm defense are guided to provide evidence to establish all of the following three elements: (1) the allegedly failing firm would be unable to meet its financial obligations in the near future; (2) it would not be able to reorganize successfully under Chapter 11 of the Bankruptcy Act; and (3) it has made unsuccessful good-faith efforts to elicit reasonable alternative offers that would keep its tangible and intangible assets in the relevant market and pose a less severe danger to competition than does the proposed merger. The DOJ and FTC do not normally credit claims that the assets of the failing firm would exit the relevant market unless all of the three circumstances are met. [15]

Similarly, the need for continued rigor during the COVID-19 crisis period has been emphasized by enforcement officials, including the head of the FTC's Bureau of Competition, Ian Conner, who has indicated that the FTC will continue to closely scrutinize failing firm claims by merging parties:

> [. . .] [P]arties contemplating such an argument should understand that the Bureau will not relax the stringent conditions that define a genuinely "failing" firm. We will continue to apply the test set out in the Guidelines and reflected in our long-standing practice, and in doing so we will require the same level of substantiation as we required before the COVID pandemic. As I noted previously, we have not relaxed, and will not relax, the intensity of our scrutiny or the vigor of our enforcement efforts. Consumers deserve the protection of the antitrust laws now as much as ever.[16]

Recently, parties were claiming the failing firm defense in Dairy Farmers of America, Inc. ("DFA") and Prairie Farms Dairy Inc. ("Prairie Farms") acquisition of Dean Foods Company ("Dean"),[17] which resulted in a divestiture of certain assets in May 2020. The case involved the acquisition by DFA, the largest cooperative of dairy farmers in the United States, and by Prairie Farms, of Dean, the largest milk processor in the country. In a nutshell, Dean filed for bankruptcy on November 12, 2019 and the United States Bankruptcy Court for the Southern District of Texas ordered an accelerated auction process because of Dean's liquidity condition, which continued to worsen and was exacerbated by shrinking demand for milk caused by the pandemic. Dean informed the bankruptcy court of its worsening financial condition and that it would not be able to pay farmers for raw milk or be certain that it could continue to process fluid milk beyond May 2020. After a short bidding process, DFA was selected as the winning bidder and agreed to purchase 44 of Dean's 57 fluid milk processing plants and other related assets for $433 million. Additionally, Prairie Farms won 8 Dean's fluid milk processing plants and related assets, in the South and Midwest for $75 million.

The DOJ approved the Prairie Farms' acquisition of fluid milk processing plants from Dean in the South and Midwest after concluding that the plants at issue likely would be shut down if not purchased by Prairie Farms because of Dean's distressed financial condition and the lack of alternate operators who could timely buy the plants. In this scenario, the lack of alternative buyers indicated that while applying a failing firm analysis to what otherwise might have been an anticompetitive acquisition, the DOJ undertook the additional analysis as to whether other buyers with fewer anticompetitive implications were viable.

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12 OECD Webinar on Merger Control in Times of Crisis, May 26, 2020. Some materials are available at http://www.oecd.org/daf/competition/competition-policy-responses-to-covid-19.htm.

13 See *International Shoe v. FTC*, 280 U.S. 291 (1930).

14 Available at https://www.ftc.gov/sites/default/files/attachments/merger-review/100819hmg.pdf.

15 *Id*. Section 11. Failure and Exiting Assets, page 32.

16 Ian Conner, On "Failing" Firms – and Miraculous Recoveries, Federal Trade Commission: Competition Matters Blog (May 27, 2020, 10:13 AM), available at https://www.ftc.gov/news-events/blogs/competition-matters/2020/05/failing-firms-miraculous-recoveries.

17 The Department of Justice May 1, 2020 announcement is available at https://www.justice.gov/opa/pr/justice-department-requires-divestitures-dean-foods-sells-fluid-milk-processing-plants-dfa, and the Proposed final Judgment is available at https://www.justice.gov/opa/press-release/file/1273021/download.

On the other hand, the DOJ filed a civil antitrust lawsuit to block the DFA's acquisition of 3 fluid milk plants from Dean and requested a divestiture of these plants and associated assets. Regarding the proposed settlement with DFA, Assistant Attorney General Makan Delrahim stated:

> This is a tumultuous time for the dairy industry, with the two largest fluid milk processors, Dean and Borden Dairy Company, in bankruptcy, and a pandemic causing demand for milk by schools and restaurants to collapse. In the face of these challenges and Dean's worsening financial condition, the department conducted a fast but comprehensive investigation, and our actions today preserve competition for fluid milk processing in northeastern Illinois, Wisconsin, and in New England.[18]

This milk processing case illustrates that, similar to CCB, rigor and speed are possible, even in an industry experiencing challenges during the COVID-19 pandemic.

B. United Kingdom

Another example of the recent analysis of the failing firm claim is the Amazon and Deliveroo case in the United Kingdom.[19] In April 2020, the Competition and Markets Authority ("CMA") provisionally approved the proposed acquisition by Amazon, which operates across a large number of sectors, including delivery and logistics network, of certain rights and a minority shareholding in Deliveroo, a London based online food delivery company. The CMA's investigation related to, *inter alia*, the assessment of whether Amazon's $575 million investment in Deliveroo might reduce competition in the food delivery sector, in particular by discouraging Amazon from re-entering the online restaurant food market and further developing its presence within the online convenience grocery delivery market in the UK. Parties argued that the impact of the pandemic would make Deliveroo's business fail and it would exit the market without Amazon's investment. In its provisional findings, the CMA concluded that (i) Deliveroo, which has experienced a significant decline in revenue as a result of the COVID-19 crisis, was likely to exit the market unless it received the additional funding available through the transaction in question; (ii) no less anti-competitive investor was available; and (iii) the loss of Deliveroo as a competitor would have been more detrimental to competition and to consumers than approving the transaction. However, in June 2020, after reviewing additional evidence, the CMA published revised provisional findings.[20] In the light of additional evidence, including large volumes of internal documents from the parties, a survey of over 3,000 consumers, and extensive submissions from interested third parties, the CMA concluded that Deliveroo was not a failing firm. The provisional conclusion remains that the acquisition should be cleared, but this decision is based specifically on the impact of the transaction on competition between the two businesses and not the failing firm claims of Deliveroo.

This case illustrates that despite the need for an urgent decision in the coronavirus outbreak, a thorough analysis of the available evidence may be conducted by antitrust authorities.[21]

C. Directorate General for Competition of the European Commission

With respect to the Directorate General for Competition of the European Commission ("DG Comp"), it examines similar factors to the CCB and the U.S. antitrust enforcement agencies. The DG Comp's horizontal merger guidelines note that the following three cumulative criteria are especially relevant: (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 purchase than the notified merger; and (iii) in the absence of a merger, the assets of the failing firm would inevitably exit the market.[22] These conditions have been applied by DG Comp, for instance, in the Aegean/Olympic merger in 2013,[23] which took place in the wake of a global financial distress. The European Commission has explicitly recognized the seriousness of the current global situation[24] and the DG Comp has not indicated any relaxation of its standards during the current crisis.

18 The Department of Justice May 1, 2020 announcement, *supra* note 17.

19 CMA's April 17, 2020 statement is available at https://www.gov.uk/government/news/cma-provisionally-clears-amazon-s-investment-in-deliveroo. The CMA asked for public comments on its provisional approval and will make a final decision shortly.

20 CMA's June 24, 2020 statement is available at https://www.gov.uk/government/news/cma-revises-provisional-findings-in-amazon-deliveroo-case.

21 For additional guidance on merger assessments during the COVID-19 pandemic by CMA, see https://www.gov.uk/government/publications/merger-assessments-during-the-coronavirus-covid-19-pandemic/merger-assessments-during-the-coronavirus-covid-19-pandemic.

22 European Commission, 2004, Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings (2004/C 31/03), par. 89-91, available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52004XC0205(02)&from=EN

23 COMP/M. 6796-Aegean/Olympic II, No 139/2004 available at https://ec.europa.eu/competition/mergers/cases/decisions/m6796_20131009_20682_4044023_EN.pdf.

24 European Commission, Coordinated economic response to the COVID-10 Outbreak, 3 March 2020, available at https://ec.europa.eu/info/sites/info/files/communication-coordinated-economic-response-covid19-march-2020_en.pdf.

D. Australian Competition and Consumer Commission

Lastly, the Australian Competition and Consumer Commission ("ACCC") is no different. ACCC provided some guidance on its approach to merger reviews in the context of COVID-19 by advising that "[it] will take into account not only the present situation but also the longer-term impact on competition of any change in the structure of markets."[25] This is consistent with CCB's approach and the international response to the merger analysis during COVID-19.

V. CONCLUSION

As a public enforcement agency, the CCB must resist calls to relax its rigorous standards during the crisis period in order to make sure that it is doing its part to promote an early and vibrant recovery for the Canadian economy over the short and long term. Relaxing standards in the failing firm context to permit opportunistic strategic acquisitions that are likely to enhance the market power of the merged firm will not assist this important objective. It is even more important in this context to maintain the rigor of our standards and evidence-based decision-making. With the right information and early cooperation from merging parties, CCB can maintain its standards and meet the exigencies of businesses in true financial distress.

25 ACCC Media Release, "COVID-19 pandemic – what it means for ACCC merger clearances, authorisations, notifications and CTMs," March 27, 2020, available at https://www.accc.gov.au/update/covid-19-pandemic-what-it-means-for-accc-merger-clearances-authorisations-notifications-and-ctms.

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.

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.

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

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

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.

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].

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.

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]

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.

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*.

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.

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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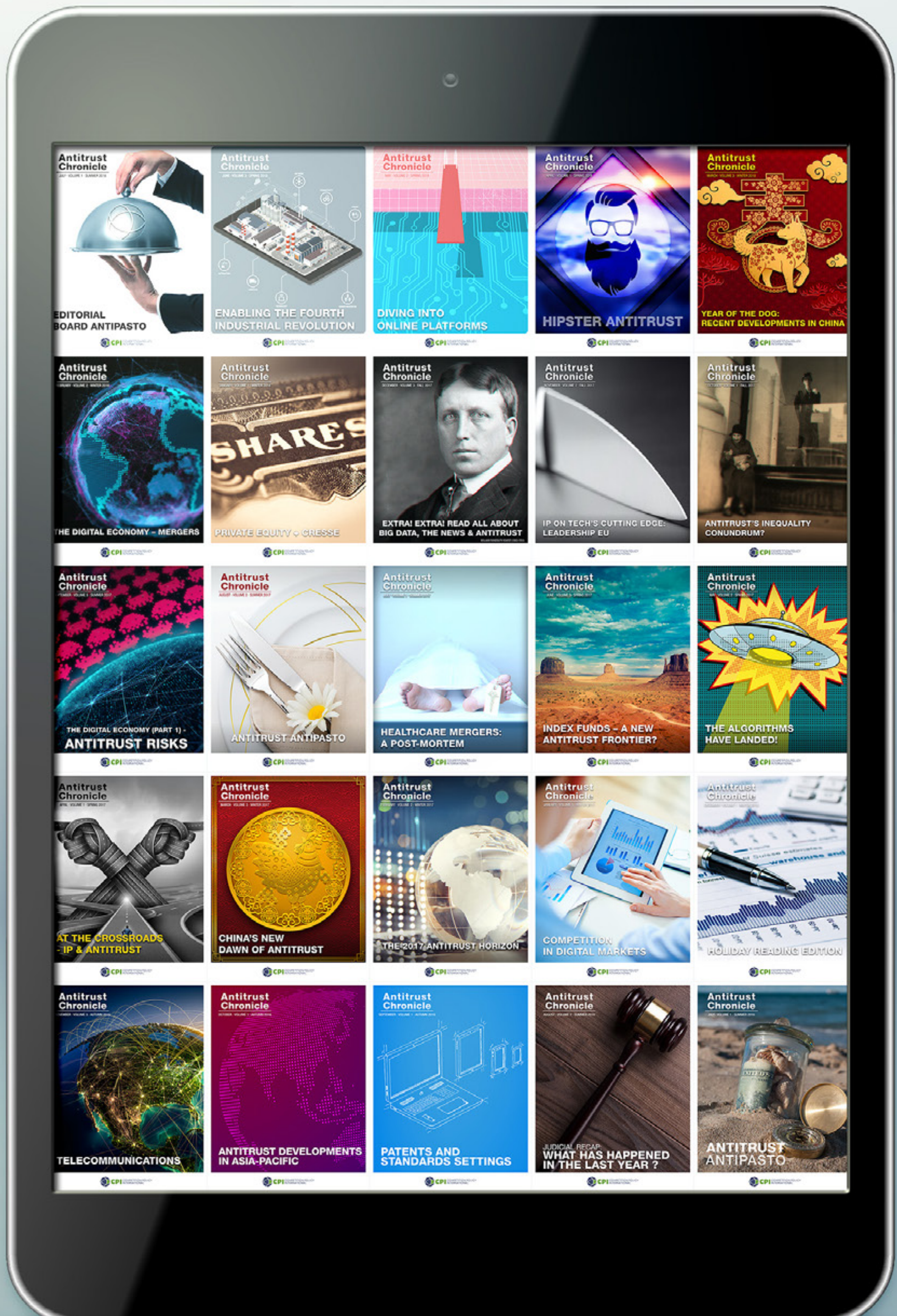

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