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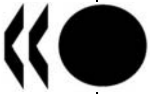

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ROUNDTABLE ON FAILING FIRM DEFENCE

-- Note by the Delegation of the European Commission --

This note is submitted by the delegation of the European Commission to the Competition Committee FOR DISCUSSION at its forthcoming meeting to be held on 21 - 22 October 2009.

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FAILING FIRM DEFENCE

-- Note by the European Commission --

1. Introduction

1. Council Regulation 139/2004 on the control of concentrations between undertakings (the "Merger Regulation") does not explicitly endorse the failing firm defence. However, according to the Commission's horizontal merger guidelines, *"the 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"* (para. 89).[1]

2. Thus the wording of the guidelines reflects that the concept of failing firm is in essence a particular application of the legal standard under Article 2 of the Merger Regulation of *causality* between any given merger and any deterioration of competitive conditions in the market that can be expected to occur in the near future.[2] The critical factor is whether the ultimate market structure without the merger would be essentially no better than that which would result from the acquisition by the prospective purchaser. Therefore, in the failing firm defence, the lack of causality between the merger and any worsening of competitive conditions is at the heart of the analysis; a merger must be at least "neutral" as regards the development of the market compared to a scenario where the merger would not take place.

2. Criteria relevant for the failing firm defence

3. In order for a failing firm defence to be accepted, three cumulative criteria are especially relevant as set out by the horizontal merger guidelines: (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 (para. 90). While especially relevant, these factors are not exclusive and exhaustive in establishing that a merging party is a failing firm. Other factors may be equally relevant depending on the circumstances of the case. The burden of proof to establish these criteria lies with the parties.

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1 Commission Communication, Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings (Official Journal C 31, 05.02.2004, p. 5-18), available at http://ec.europa.eu/competition/mergers/legislation/notices_on_substance.html#hor_guidlines

2 As explained in the horizontal mergers guidelines, "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" (para 9).

2.1 Financial difficulties

4. Under the first limb of the test, financial difficulties, it has to be demonstrated that the company is unlikely to meet its financial obligations in the near future. Such difficulties are at hand when no shareholder or other financial investor would be willing to provide the necessary capital for the business to remain in the market as a going concern. It is not required that bankruptcy proceedings or similar restructuring proceedings have been initiated for this test to be met, but rather that it is *likely* that, absent the merger, the company will enter into such proceedings in the near future. The forms of liquidation and restructuring of businesses vary significantly between the EU Member States. The Commission therefore does not follow a specific formula to assess the degree of financial difficulties but rather makes a case-by-case assessment. The evidence of acute financial distress is measured by reference to the company's balance sheet in terms of profitability, liquidity and solvency. The assessment of these parameters must depend on the industry characteristics. For example in the banking sector, evidence of acute solvability problems confirmed by a central bank may be sufficient as a clear sign of financial difficulties to exist and being material. The time horizon for this assessment will depend on the specific market characteristics.

2.2 No less anticompetitive solution

5. The second limb of the test is that that there is no less anti-competitive solution available. This is a matter of making a counter-factual assessment of what the market structure would look like in case of alternative acquirers. Thus, when assessing whether any alternative less anti-competitive solutions is available one must assess whether there are alternative purchasers available which would cause a lesser risk of restrictions to competition. Thus, a buyer which is less of a competitive constraint on the failed business would be the preferred option. In this assessment, efficiencies may also play a role; a merger between the failed business and a smaller actual competitor or a new entrant may not achieve the same efficiencies as a large competitor already active in the market.

6. The more difficult part of the assessment is to ascertain which are the credible purchasers willing to buy the failed business and what efforts were made to reach an agreement with these investors. Thus, while not going as far as to require that formal tender procedures are opened, the parties should establish that they have made all efforts to give alternative interested investors an opportunity to enter into negotiations with regard to the acquisition of the failing firm. Timing is of importance in the assessment. The requirement to enter into negotiations with other potential investors should be carefully balanced against time available before acute solvability problems arise.

2.3 Exit from the market

7. The third limb of the test concerns the question whether the company in financial difficulties would completely discontinue its business and exit the market in the absence of the merger. In other words, it has to be assessed whether the production assets are likely to remain in the market in their current use or liquidated and re-allocated for another more efficient use. The rationale for this part of the test is that the application of the two previous conditions does not address the possibility of a take-over by third parties of the various production assets of the failing firm in the course of bankruptcy proceedings. If these production assets remain in the market, the effects on competition may be similar to (or more beneficial than) the take-over of the entire failed business by an alternative purchaser. It will therefore have to be assessed whether investors would be prepared to maintain the individual assets in their current use or whether they would prefer to re-allocate them for a better use elsewhere. In this connection it would have to be assessed whether such asset transfer would cause short term supply disruptions which are such as to cause more important harm to customers (and ultimately consumers) than the transfer of the business as a going concern. This part of the test has been applied rather strictly and is in general difficult to fulfil.

3. Some key examples of failing firm analysis

8. The first case where a filing firm defence was examined in detail and where a failing firm was found to exist was the *Kali & Salz*-case.[3] This case concerned the concentration of the salt and potash activities of Kali & Salz (a subsidiary of BASF) and MdK (a company owned by the former German Democratic Republic (then transferred to a trustee, the Treuhandanstalt)). The merger would give rise to a monopoly in potash fertilisers and there were significant barriers to entry due among others to customer preferences and transport costs. The transaction was nevertheless considered not to create a dominant position (this was before the introduction of the SIEC-test in EC merger control) taking into account, first, that MdK was highly unlikely to survive given that the State trustee was unlikely to be willing to continue to inject any further capital into the loss-making business. Second, records on file clearly showed that despite significant efforts to divest the business, no other third party had made an offer for the company. The potash market was in a state of over-capacity and there was limited or no scope for efficiencies among companies other than Kali & Salz. Thirdly, it could be reasonably expected that, even in the absence of the proposed merger, all of the market share of MdK would go to Kali & Salz.[4]

9. The only case since the Kali & Salz case where the Commission found that the failing firm conditions were met was the BASF/Eurodiol/Pantochim-case.[5] This case concerned the acquisition by BASF of two subsidiaries of the SISAS group, Eurodial and Patoch, both active in the production of various specialty chemicals. The Commission's analysis showed that the merger would lead to a single firm dominant position on several markets with combined shares well above 40%, and there were high entry barriers and capacity constrained competitors. The Commission then examined whether the failing firm defence was met. First, the Commission found that it was clear that both the SISAS group and its subsidiaries were in financial difficulties. The target companies were subject to bankruptcy proceedings under Belgian law. Second, further to the restructuring efforts under the direction of the Tribunal de Commerce of Charleroi no less anticompetitive solution was found as no company other than BASF was willing to make an offer for the business. The Commission also verified in its market investigation that indeed no other buyer was interested.

10. Third, the Commission also introduced the requirement (and the parties established) that the failing firm's assets would inevitably exit the market in the absence of the merger.[6] The Commission considered the fact that the supply situation was already tight. Other suppliers would therefore not be in a position to swiftly increase production and thus capture the failing firms' share of sales. Also, the loss of the target's production capacity was unlikely to be made good through capacity expansion at least for a considerable period of time because of costly environmental standards. Finally, the Commission also took into account the importance of existing spare capacity given the economics of operating a capital intensive plant. Thus cost effective new entry would be difficult. On this basis, the Commission found that the deterioration of the competitive structure through the merger would be less significant than in the absence of the merger.

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[3] Commission Decision 94/449/EC of 14 December 1993 Kali & Salz, upheld by the Court in cases C-68/94 and C-30/95, France and others v Commission [1998] ECR I-1375.

[4] This third part of the test expresses the general requirement of causality between a merger and the deterioration: the absorption of a market share reflects that this dupolistic market was expected to deteriorate in a similar fashion absent the merger.

[5] Case M.2314 BASF/Eurodiol/Pantochim, Commission decision of 11 July 2001.

[6] This criterion was introduced since, as opposed to Kali & Salz, there were more than two main players and competitors could also be expected to gain parts of market shares. The absorption of market share by the merging party was therefore not considered appropriate.

11. In a more recent case, involving the acquisition of joint control by Johnson Controls and Robert Bosch of the automotive starter battery business of *FIAMM,*[7] the merger would lead to a SIEC on several markets raising both unilateral or coordinated effects. The parties were successful in establishing that the company was in financial difficulties and that there was no other less anticompetitive solution available. As to the first condition, the company was not yet in bankruptcy proceedings. However, the company was overburdened with debt and had posted negative results over the past years. As to the availability of alternatives less harmful to competition, the Commission found that alternative buyers had not been found in the past and that no buyer could be found within a sufficiently short time period to avoid entering into insolvency proceedings under Italian law.

12. However, the parties failed to establish the inevitable exit of the firm's production assets absent the merger. The Commission acknowledged that the assets would unlikely be maintained in business as a going concern. However, it was deemed possible that individual assets could be bought by smaller firms in the course of the liquidation process and could be brought back to the market within a relatively short period of time. These smaller producers could thus supply the market to a certain extent with the result that customers could be better off in the absence of the merger. The Commission eventually cleared the merger subject to conditions after a general causality assessment (see below).

4. Failing division

13. The Commission's horizontal guidelines do not set out specific guidance with regard to failing parts of businesses. However, the distinction to be made between accounting losses and economic losses are even more important in this context, given that there is more margin for manoeuvre to design the balance sheet of an individual division to match the criteria. In other words, it has to be assessed whether the imminent closure of a given business division is the result of a management decision to withdraw from that market or whether there is a real economic failure at stake. Mergers involving individual divisions of an otherwise healthy company therefore merit a particularly careful scrutiny. This question was examined in cases such as *Bertelmann/Kirch/Premiere*[8], *Rewe/Meinl*,[9] and *NewsCorp/Telepiu*[10] where the parties were unable to establish any of the criteria of the failing firm defence.

14. In these decisions the Commission held that "[i]n such a case of a 'failing-division defence' and not of a 'failing-company defence', the burden of proving that the defence of lack of causality is valid must be especially heavy. Otherwise, every merger involving the sale of an allegedly unprofitable division could be justified under merger control law by the seller's declaring that, without the merger, the division would cease trading."[11] While it is not excluded that a failing firm division defence might apply, the Commission's scrutiny will be particularly strict in such cases. To date, in no case have parties been successful in establishing the existence of a "failing division."

5. General causality analysis

15. As the above discussion shows, it is generally difficult to establish that a firm is failing in the above sense. However, going beyond the fulfilment of the failing firm defence, it is important to bear in mind that this defence is a particular application of the general causality test under Article 2 of the Merger

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7 Case M.4381 JCI/VB/FIAMM, Commission decision of 10 May 2007.

8 Case IV/M.993, Bertelmann/Kirch/Premiere, Commission decision of 27 May 1998.

9 Case IV/M.1221 Rewe/Meinl, Commission decision of 3 February 1999.

10 Case COMP/M.2876 NewsCorp/Telepiu.

11 See, e.g. NewsCorp/Telepiu, para. 212.

Regulation. Applying this test means that, even if it cannot be shown that each of these indicative criteria are met, a counterfactual analysis of what would be the development of the market absent the merger could still lead to the conclusion that the deterioration of competition in the market is not a causal effect of the merger. Thus, there may still be good reasons to consider that consumers are not worse off in a merger scenario based on alternative criteria or because the parties provide remedies.

16. The Commission undertook a thorough counter-factual analyse in the above-mentioned *FIAMM-case* involving a merger between two producers of car batteries.[12] In this case, the parties were unable to show that production capacity would inevitably exit the market; the third limb of the test was thus not fulfilled. As a result, the Commission undertook a general causality analysis and on this basis found that the conditions of competition could not be expected to deteriorate to the same extent in the absence of the merger, even assuming the total liquidation of the target. A counterfactual analysis was therefore undertaken on the basis of remedies offered by the parties, which led the Commission to clear the transaction.

17. This case illustrates well how the Commission will regularly undertake a thorough prospective analysis of the market conditions and compare different scenarios, with or without the proposed transaction and, where necessary, taking into account remedies. The outcome of such assessment will depend on all factors normally associated with merger control including supply and demand structure, barriers to entry and expansion, customer countervailing buying-power and efficiencies. There are many other good examples of the Commission applying the counterfactual to companies in difficulties such as, e.g. in the *Andersen-cases*[13] or the *Pirelli cases*.[14]

6. Other considerations

6.1 Economic Crisis & declining markets

18. It should be recalled that when assessing mergers the Commission will make a prospective analysis assessing various chains of cause and effect with a view to ascertaining which of them is the most likely outcome.[15] In this connection, a sudden demand decrease of a cyclical or structural kind must be factored into the competitive assessment of cause and effect. The consequence of a sudden demand decrease is that the prospective competition analysis will be more difficult as historic information on market conditions will provide less guidance (an argument which applies similarly in case of rapidly expanding markets).

19. By contrast, the proposition that a more lenient failing firm test (or more generally a more lenient SIEC test) should be applied in times of recession must be rejected; just as much as the proposition that a tougher test should be applied in good times. The failing firm test is designed to identify those limited circumstances where a firm's assets would exit the market but for the proposed merger. As noted above, a company in financial difficulties but whose production assets' value is greatest in their current use is unlikely to exit the market. Thus, to be less stringent about the exiting production asset criterion and to allow a merger in such scenario would unlikely allow for efficiencies which could counterbalance the

[12] Case M.4381 JCI/VB/FIAMM.

[13] Cases M.2810, DTT/Andersen UK, Commission decision of 20 September 2002; Case M.2824, E and Y/Andersen Germany Commission decision of 27 August 2002; and Case M.2816, E and Y/Andersen France Commission decision of 5 September 2002;

[14] Case M.2574 Pirellia/Edizione/Olivetti/Telecom, Commission decision of 20 September 2001.

[15] Case C-413/06 P Bertelsmann AG and Sony Corporation of America v Independent Music Publishers and Labels Association (Impala), Judgment of 10 July 2008, point 47.

competitive harm caused. Therefore, the proposition that the strict criteria for the failing firm defence should be softened as they might get in the way of much needed industry rationalisation must be rejected. Finally, as regards the consideration that it is currently difficult to raise capital, this is a matter of factual assessment and does not as such warrant a change of the current approach. For example, less availability of external capital might mean that fewer buyers will present themselves which means that it might de facto be easier for a company to fulfil the "no less anticompetitive solution" criterion.

6.2 Mergers between financial institutions

20. With regard to the current particular circumstances on the financial markets, in particular banks, it should be noted that they are characterised by significant externalities. If one bank collapses it may risk bringing down others with it. Thus, as shown by recent events, absent important re-capitalisation (by the state or by private actors), there could be a risk not only of failure of individual banks but also of a *systemic* failure in financial markets. This may cause competitive conditions to deteriorate to an extent similar or worse in the counterfactual, absent a rescue takeover. In particular circumstances, the potential effects of *systemic risks* are therefore a factor that should be taken into account as part of the assessment where required. Thus, where it can be established that the effects of a system failure, if they were to materialise absent the rescue merger, would have at least the same effect on competitive conditions as the merger itself, there is no need for intervention.

21. It must be stressed however that in order to maintain competitive markets, the strict inevitable business exit criterion must be fulfilled for the defence to be available. For example, it makes sense for a bank to take over another bank in financial difficulties only if that will generate efficiencies. If this is not the case, it is suggested that other means of crisis measures are preferable to rescue mergers. The inevitable business exit test thus distinguishes between banks which are fundamentally healthy and those which are not. It also builds in the efficiencies aspect following the above reasoning. Indeed, recent experience has shown that the preferred option has been to inject capital into individual banks while maintaining their current structure and autonomous commercial conduct.[16] This may be a good illustration of the fact that it simply does not make sense as a matter of crisis measure to combine one or more unhealthy banks.

22. Against this background, the failing firm defence should be applied strictly independently of short or long term fluctuations in market conditions or industry characteristics.

7. Concluding remarks

23. So far the failing firm defence has been of limited application in the enforcement history under the Merger Regulation. No particular trend towards an increase of the use of this defence as a result of the economic and financial crisis can be observed. In the financial sector, this is largely explained by the fact that bank failures have been avoided through public recapitalisation efforts. Limited practical experience has therefore been gained with regard to failing firm scenarios. It remains however to be seen whether the financial services sector or other economic sectors will give rise to an increase in this respect. The current framework for the analysis of failings firms is well balanced as it allows for the smooth restructuring of the economy without causing impediments to competition. Loosening the failing firm criteria in times of crisis is therefore not required. Rather, rapidly changing market conditions are taken into account in the competition assessment. The current strict regime should therefore be maintained and applied flexibly to the facts of each case.

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16 An exception being for example the acquisition by Lloyds of HBOS where, however, the failing firm criteria in the OFT's view were not fulfilled.