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Agenda

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Failing, or just flailing? The failing-firm defence in mergers

The failing-firm argument is a time-honoured defence in mergers and acquisitions, and most competition authorities have established clear rules for its application. It has gained renewed prominence in the current economic environment, with a number of acquisitions of failing (or at least flailing) firms. Are competition authorities beginning to show greater leniency towards such mergers? Or does the evidential burden remain high?

The scope and magnitude of the current financial turmoil are apparent in the number of bankruptcies, layoffs and bailouts across industries and economies. In light of such widespread instability, it is important to assess the extent to which the failing-firm defence can be relied on in clearing mergers.

On the one hand, the unstable economic conditions make it more likely that a firm will exit due to insolvency. On the other hand, it becomes more difficult to ascertain whether the 'failure' is inherent in the firm's fundamentals, and hence inevitable, or is caused by a temporary lack of financing.

This article presents the theory and application of the failing-firm defence, and explores its implications in the current economic environment.

What is the failing-firm defence?

In attempting to persuade competition authorities that a merger that raises competition concerns should be cleared, the merging parties have at their disposal the 'failing-firm' defence. This is based on the argument that, without the merger, the target business would exit the market, and hence any reduction in competition in the market should not necessarily be attributed to the merger.

A key issue in applying such a defence is not only that the target firm would exit, but that its productive or specialised assets would exit with it. The proposed merger is then justified on the grounds that it is the only way of maintaining the assets of the failing firm in the market.

The importance of the final whereabouts of the failing firm's assets is highlighted in the US Merger Guidelines:

> a merger is not likely to create or enhance market power or to facilitate its exercise, if imminent failure … of one of the merging firms would cause the assets of that firm to exit the relevant market. In such circumstances, post-merger performance in the relevant market may be no worse than market performance had the merger been blocked and the assets left the market.[1]

Hence, unlike in other merger cases, the pre-merger conditions of competition are not necessarily the appropriate benchmark for assessing the competitive effects. This is because in a failing-firm situation the reasoning is that the target business would exit the market anyway, and the current market conditions would not continue to hold in the counterfactual.

The entire argument consequently relies on establishing the correct counterfactual. In the absence of the merger, would the target firm exit the market? Will its assets be bought by another firm? Or will it recover, albeit with a lag, to become a viable business and competitor in the market?

As recognised by the UK Office of Fair Trading (OFT):

> [the failing firm] counterfactuals are easily the subject of self-speculation—relatively easily alleged but difficult, given the informational asymmetries, to verify independently.[2]

In addition, the Irish Competition Authority has stated that there are 'incentives for a firm to exaggerate the extent of its weakness'.[3]

Not surprisingly, the requirements for qualifying as a failing firm are quite stringent. Overall, successful failing-firm cases arise relatively infrequently. The most

Table 1 Selected successful failing-firm cases

Jurisdiction	Authority	Date	Acquiring party	Target party	Sector	Failing firm or failing division?
New Zealand	Commerce Commission	2009	Fletcher Building Limited	Stevenson Group Limited's Whangarei and Auckland businesses	Masonry	Firm
UK	Competition Commission	2009	Long Clawson Dairy	Millway (Dairy Crest Group plc)	Dairy	Firm
UK	OFT	2008	Home Retail Group	27 Focus leasehold properties	DIY retail	Division[2]
South Africa	Competition Tribunal	2006	Phodiclinics and others	New Protector Group Holdings (Pty) Ltd	Hospital and pharmacy	Firm
France	DGCCRF[1]	2003	EBSCO	RoweCom	Centralised management of subscriptions	Division[2]
EU	European Commission	2001	BASF	Eurodiol and Pantochim	Chemicals	Division[2]

Notes: [1] Direction Générale de la Concurrence, de la Consommation et de la Répression des Fraudes. [2] The targets were subsidiaries.
Sources: Commerce Commission (2009), 'Fletcher Building Limited/Stevenson Group Limited's Whangarei/Stevenson Auckland', February 13th. Competition Commission (2009), 'Long Clawson Dairy/Millway Merger Inquiry: A Report on the Completed Acquisition by Long Clawson Dairy Limited of the Millway Stilton and Speciality Cheese Business of Dairy Crest Group plc', January 14th. OFT (2008), 'Anticipated Acquisition by Home Retail Group plc of 27 Leasehold Properties from Focus (DIY) Ltd', decision on reference under Section 22(1), May 12th. Competition Tribunal (2006), Case No: 122/LM/Dec05, 'Phodiclinics (Pty) Ltd et al. and Protector Group Medical Services (Pty) Ltd et al.', October. DGCCRF (2003), Sommaire du BOCCRF no 2003-13, 'Lettre du ministre de l'économie, des finances et de l'industrie en date du 25 avril 2003 aux conseils de la société EBSCO Industrie Inc. Relative a une concentration dans le secteur des agences d'abonnements', April 25th. European Commission (2001), Case No Comp M2314, 'BASF/Eurodiol/Pantochim', July 11th.

recent major successful case presented to the European Commission was that of the merger of BASF with Eurodiol and Pantochim in 2001. Table 1 shows selected cases in recent years across various jurisdictions.

Even though all of these cases successfully used the failing-firm defence, not all of the target businesses were entire firms. In some cases, the target business was a failing division or a stand-alone business unit of a firm. The criteria applied for a failing firm or a failing division usually require the same standard of proof.

How and when to apply the failing-firm defence?

Most jurisdictions explicitly spell out, within the broader merger guidelines or as separate ones, the necessary and sufficient conditions of a successful application of the defence. The degree of stringency when applying this defence varies across jurisdictions; however, the main issues examined are broadly consistent, and can be classified into the following two conditions.

Condition 1: inevitable exit of the target business in the absence of the merger

This condition requires parties to prove that, in the absence of the merger, the target business would inevitably exit the market in the near future. This is often the case for businesses in a difficult financial situation, although it can also be due to a change in corporate strategy or to managerial inefficiency. Implicit in this criterion is the condition that the assets of the target business would exit the market as well.

The parties also need to show that the difficult financial situation is not temporary and cannot be rectified easily through restructuring the business. In economic terms this can be interpreted as there being no investor willing to provide necessary capital for the business to remain a going concern. This is an explicit criterion in both the UK and USA.[4]

As is apparent, the evidential burden in satisfying condition 1 can be considerable. One approach that might prove useful in this respect is to analyse the financial health of the target firm, using certain financial metrics and ratios that are well established in financial analysis generally—see the box below.

Condition 2: no realistic and substantially less anti-competitive alternative

As stated above, the rationale for the failing-firm defence is that the proposed merger allows productive assets to be retained in the market in a way that does not reduce competition compared with the counterfactual of exit. However, it is also necessary to show that there are no realistic alternatives that would

Financial analysis of a failing firm

Financial analysis based on a variety of metrics can be used to assess the likelihood of the firm becoming financially distressed, which in turn says something about the likelihood of exit from the market. These metrics can be separated into three broad categories.

- ***Profitability*. The relevant metrics can analyse the ability of a firm to generate economic value by realising returns required by debt and equity investors. These measures can be based on historical performance as well as projections and future expectations.**
- ***Liquidity*. The relevant financial ratios can approximate the ability of a firm to meet its short-term obligations, such as payables and interest payments, from current cash flows. An illiquid but potentially solvent firm might not be able to survive as a going concern if investors are unwilling to commit additional capital.**
- ***Solvency*. The relevant measures can approximate the firm's ability to repay its fixed financial obligations, including the principal on its debt. In this context, it might be possible to assess whether the firm could earn a required return on additional financial capital that would need to be raised to remedy temporary financial difficulties. An insolvent firm is likely to default on its financial obligations, but might be restructured if the liquidation value (recovery rate) is expected to be lower than the economic value of the assets as part of a going concern.**

The estimated likelihood of default could be a useful benchmark for these tests. Credit rating agencies use relevant financial tests to assess the risk of creditors not receiving interest and principal in a timely manner, which typically leads to default. For example, a firm with financial ratios that suggest a sub-investment-grade rating (eg, BB or lower) faces a significant possibility of default (significant from an investor's perspective). The average global corporate default rate for BB rated firms is 0.99%. By comparison, AA rated debt has a default rate of 0.03%, while 4.51% of B rated firms and 25.67% of CCC/C rated firms have defaulted.[1] Therefore, examining a failing firm's financial metrics against appropriate benchmarks can give a useful approximation of the probability of failure.[2]

The effect of the financial turmoil has been observed by increasing default rates across all ratings between 2007 and 2008. Using current default rates rather than long-run average default rates to assess a firm's current probability of default may be preferable where there have been severe macroeconomic shocks.

Notes:[1] Long-term average between 1981 and 2008. Standard & Poor's (2009), 'Default, Transition, and Recovery: 2008 Annual Global Corporate Default Study and Rating Transitions, Global Fixed Income Research', February 25th, Table 3. [2] For a survey of this approach, see Altman, E. and Narayanan, P. (1997), 'An International Survey of Business Failure Classification Models', *Financial Markets, Institutions and Instruments*, May, pp. 1–57.

achieve this objective in a less anti-competitive way. Possible alternative ways to retain the assets of a failing firm are as follows.

a. **The target business is sold to another purchaser**. This purchaser can be an existing player or a new entrant. For example, if the target firm could be sold to a new entrant, the competitive conditions are likely to be preferable to those arising from the merger, and condition 2 is therefore not satisfied.

b. **The target business sells its assets in the market**. This alternative might be better for competition for two reasons: one, the assets could potentially be sold to more than one of the existing players; second, since the target business exits and is not acquired by a single player, its previous market share is redistributed more evenly across the market.

To satisfy condition 2, parties need to show that alternatives 'a' and 'b' are not feasible or that the competitive conditions under either will not be better. For example, the EU criteria explicitly require evidence that 'with or without the merger the market shares would accrue to the proposed acquirer'.[5]

Examples

These criteria are equally applicable for entire businesses, divisions or stand-alone business units. For example, the OFT applied these criteria to stand-alone business units of the supermarket Kwik Save in clearing the Tesco/Kwik Save merger.[6] The OFT used information from all related parties and independent consultants to determine that four Kwik Save stores (out of the five acquired) were insolvent and would have closed in the absence of the merger. This satisfied condition 1. Moreover, even though all major grocery chains were invited to bid for the stores, Tesco was the only bidder, suggesting that there was no alternative buyer. The OFT also considered whether the competitive conditions in the situation where the target stores exit and their assets are sold would have been preferable. It concluded that, in the case of exit, the number of retailers in the area would not be greater relative to the merger. Moreover, the merger would allow the continuation of the store as a grocery retailer, thus preserving the local option for consumers. Hence, the second condition was also satisfied and the merger was cleared.

In the case of the BASF/Eurodiol/Pantochim merger referred to in Table 1 above, the European Commission was satisfied that all the criteria of the failing-firm defence were met. Eurodiol and Pantochim were subsidiaries of the Italian SISAS group, and both the subsidiaries and the parent firm were in the process of liquidation. Even though this merger enhanced BASF's dominant position in the market, the European

Commission failing-firm criteria were fulfilled. The Commission was satisfied that the target firms were going to exit the market and that, in spite of best efforts by the Tribunal de Commerce of Charleroi to find suitable buyers , only BASF had made an approach to acquire the targets. The criterion regarding the exit of the assets of the target business was also satisfied as both plants operated as a whole and could have not been sold independently. Hence, these assets would have exited the market had BASF not made the offer to acquire Eurodiol and Pantochim.

As a further example, Table 2 compares two recent cases that were reviewed by the UK Competition Commission, only one of which was successful.

What is the current relevance of this defence?

In the current economic environment, an increasing number of mergers involving failing firms is perhaps to be expected. Indeed, some recently publicised cases may have created the impression that competition authorities are becoming more lenient towards mergers.

One case that made the headlines was the acquisition of Halifax Bank of Scotland (HBOS plc) by Lloyds TSB Group plc in October 2008.[7] This was not in fact cleared on the basis of HBOS being a failing firm. Given the increased government intervention in financial markets in recent times, the OFT concluded that, in the absence of the merger, the government would have stepped in to support HBOS in the short term. Hence, the first condition of inevitable exit of the target business was not met by HBOS, and the failing-firm defence was not applied. The acquisition was cleared by the Secretary of State for Business, Enterprise and Regulatory Reform on the basis of its benefits to the financial stability of HBOS and the UK financial system as a whole.[8]

In a recent restatement of its guidelines, the OFT recognised that the evidence should be evaluated in the context of the prevailing economic and market conditions, since a downturn affects the financial health of the target and the availability of alternative purchasers. However, the OFT also stated that it:

> will not, regardless of prevailing economic and market conditions, relax the 'sufficient

Table 2 Pass or fail? A comparison of cases

	Passed	Failed
Date	January 2009	May 2007
Acquirer	Long Clawson Dairy Ltd	Thermo Electron Manufacturing Ltd
Target	Millway (Dairy Crest Group plc)	GV Instruments Ltd (GVI)
Market	Supply of Stilton cheese	Supply of medical instruments
Condition 1: inevitable exit	Satisfied: recent loss of many customers, loss-making for many years	Satisfied: GVI was insolvent and would have gone into administration. It was losing money, could not satisfy orders, and was under pressure from creditors
Condition 1: no restructuring	Satisfied: unprofitable for many years, significant overhead costs but insufficient volume	Satisfied: unsuccessful attempts at operational and financial restructuring. Would require significant redundancies
Condition 2a: alternative buyer	Satisfied: no other buyer	Not satisfied: would have been sold as a whole or broken up out of administration to three possible acquirers. These acquirers had enough experience to increase market share using GVI's business, and would have replicated the competitive constraint GVI imposed
Condition 2b: sale of assets	Satisfied: Millway would have exited the market with its assets. Volume of sales was low and it had few long-term contracts with suppliers. Hence, customers can switch and merger is not anti-competitive	Not satisfied: if GVI did exit the market, the sale of assets would have reduced entry barriers and increased competitive constraints
Outcome	Merger cleared unconditionally	Partial divestiture of GVI imposed

Sources: Competition Commission (2009), 'Long Clawson Dairy/Millway Merger Inquiry: A Report on the Completed Acquisition by Long Clawson Dairy Limited of the Millway Stilton and Speciality Cheese Business of Dairy Crest Group plc', January 14th; and Competition Commission (2007), 'Thermo Electron Manufacturing Limited and GV Instruments Limited Merger Inquiry: A Report on the Completed Acquisition of GV Instruments Limited by Thermo Electron Manufacturing Limited', May 30th.

> compelling evidence' standard required to demonstrate that a merger between close competitors is not itself the cause of any SLC [significant lessening of competition].[9]

Nonetheless, there is much scope for debate on the issue of whether to allow *flailing* firms in financial difficulties to merge. In considering such a decision, the inter-temporal trade-off in competition is relevant. As was discussed in an OECD Policy Roundtable on the failing-firm defence:

> In declining industry situations it is more likely that firms *flailing* today will be failing tomorrow. Consequently, declining industry conditions would make it more necessary to consider whether or not the flailing firm issue involves a trade-off between present and future levels of competition.[10]

A successful failing-firm defence, therefore, needs to answer a multitude of questions regarding the inevitable exit of the target, the permanent nature of the failure, and the absence of a less anti-competitive alternative. Moreover, these issues need to be addressed irrespective of the ongoing economic and market conditions. Hence, in a recessionary economy the failing-firm defence may not, after all, be the 'magic key' to a proposed merger.

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[1] Federal Trade Commission and Department of Justice (1992), 'Horizontal Merger Guidelines', Federal Trade Commission and Department of Justice, April 2nd, p. 30.
[2] Office of Fair Trading (2008), 'Restatement of OFT's Position Regarding Acquisitions of "Failing Firms"', December, p. 3.
[3] The Competition Authority (2002), 'Notice in Respect of Guidelines for Merger Analysis', December, p. 26.
[4] The European Commission and the French competition authorities do not make a distinction between the inevitable exit of the firm and whether the financial problem can be rectified through restructuring.
[5] OECD (1995), 'Failing Firm Defence', OECD Policy Roundtable, OCDE/GD(96)23, May, p. 6.
[6] Office of Fair Trading (2007), 'Anticipated Acquisition by Tesco of Five Former Kwik Save Stores', OFT's decision on reference under Section 22(1), December.
[7] Office of Fair Trading (2008), 'Anticipated Acquisition by Lloyds TSB plc of HBOS plc', October 24th; and Department for Business, Enterprise and Regulatory Reform (2008), 'Decision by Lord Mandelson, the Secretary of State for Business, Not to Refer to the Competition Commission the Merger Between Lloyds TSB Group plc and HBOS plc Under Section 45 of the Enterprise Act 2002', October 31st.
[8] Department for Business, Enterprise and Regulatory Reform (2008), op. cit., paras 12, 24.
[9] Office of Fair Trading (2008), 'Restatement of OFT's Position Regarding Acquisitions of "Failing Firms"', December, p. 6.
[10] OECD (1995), 'Failing Firm Defence', OECD Policy Roundtable, OCDE/GD(96)23, May, p. 22.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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