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Fine to pay? When firms cannot afford to pay the European Commission's penalties

Fines imposed by the European Commission for breaches of the competition rules have increased substantially in recent years, with some firms being required to pay hundreds of millions of euros. This has spawned a policy debate on whether such fines are warranted, or healthy for the economy. One aspect of the Commission's fining policy is the possibility that fines be reduced if firms can show that they cannot afford them

Fines levied by the European Commission on cartelists have risen sharply in recent years. In the whole of the 1990s, only around €615m of fines were imposed on cartelists by the Commission; in 2008 a single firm (Saint-Gobain) was fined €896m for its participation in the car glass cartel, among total fines of €1.4 billion across all members of the cartel. In 2009 the Commission's fines on six cartels totalled €1.6 billion.[1]

Such high fines have led to an increasing debate within the competition community in Brussels and Member States as to whether the scales of the fines are merited, and at what level fines should be capped. One aspect of this is whether the base fine is affordable for the firms in breach of competition law, a debate which has recently begun to be reflected in case law and which is pertinent in light of the current economic downturn.[2]

This article considers the circumstances in which firms found to have breached the EU competition rules (Articles 101 and 102 TFEU) can legitimately claim that they are unable to pay fines within the scope of the Commission's Fining Guidelines.

The Fining Guidelines

The Commission's most recent version of its Fining Guidelines were published in 2006.[3] Paragraph 35 of these Guidelines refers to the ability of a firm found to have infringed the competition rules to pay a fine being levied on it:

> In exceptional cases, the Commission may, upon request, take account of the undertaking's ability to pay in a specific social and economic context. It will not base any reduction granted for this reason in the fine on the mere finding of an adverse or loss-making financial situation. A reduction could be granted solely on the basis of objective evidence that imposition of the fine as provided for in these Guidelines would irretrievably jeopardise the economic viability of the undertaking concerned and cause its assets to lose all their value.

There are therefore several conditions for a fine to be reduced by virtue of inability to pay implicit or explicit in this paragraph:

- an adverse or loss-making financial situation is a necessary, but not a sufficient, condition, for a fine to be reduced;
- there must be objective evidence that a fine could lead to problems for the company in question;
- the company must be in a position where payment of the fine would 'jeopardise' its 'economic viability' and 'cause its assets to lose all their value'.

These are stringent conditions. In order to fulfil them, a firm must go well beyond demonstrating that it is currently loss-making, or indeed that it has been consistently loss-making over a period of time. Rather, it must demonstrate a strong possibility of financial failure as a direct result of the fine. In order to demonstrate this, detailed financial and economic analysis of the position of the firm will need to be undertaken. Little guidance or case law exists as to how these conditions should be interpreted exactly. In what follows, paragraph 35 will be taken as referring to situations where fines are likely to lead to the firm entering administration or liquidation if paid.[4]

Demonstrating solvency constraints

The more direct route to demonstrating inability to pay an antitrust fine is to show that the fine will directly leave the company insolvent, leaving aside any liquidity constraints which may bind the cartelist.

In general, the most serious problems in paying will emerge if the requested fine is greater than the market value of shareholders' equity. Since a company's liabilities must equal its assets, not only would shareholder equity be wiped out, but the value of its other liabilities (eg, debt) would be effectively reduced below their book value, leading to insolvency. Problems could also occur if, as a result of the fine, the firm cannot stay liquid.

For firms listed on a stock exchange, the former condition could be reflected in the fine levied being greater than the market capitalisation of a firm, because the market capitalisation of a listed company would, in general, reflect the net present value of the future payments to shareholders.

From liquidity crisis to solvency issue—capital rationing

The European Commission's Fining Guidelines appear to be grounded primarily in issues of solvency. However, as stated above, liquidity issues may rapidly come to threaten the solvency of an illiquid company. There are a number of ways in which liquidity crunches can threaten a company's survival.

- **Working capital requirements**. Many companies will require a certain amount of working capital in order to operate effectively; liquidity will be required to cover these needs.
- **Ability to cover shocks in demand**. In economic sectors that experience cyclical volatility in demand, it will be important to maintain a buffer of available cash or credit lines in order to meet costs during downturns.
- **Ability to cover near-term expected losses**. A firm will need sufficient funds to cover losses which can reasonably be expected to occur over the short term.
- **Ability to make legally required investments**. In some industries, legislative changes may mean that companies need to undertake investments to continue to operate (eg, in relation to environmental or safety requirements). An inability to access funding for these investments may result in a firm no longer being able to operate legally in some or all of its markets.

In a solvent company, all of these points are essentially about timing. In principle, if a company is solvent but has insufficient liquidity to meet both a fine and all of the requirements set out above, financial markets should be willing to provide funding to the firm in order for it to meet its expenditure needs. However, in practice, firms may often face capital rationing, which means that they cannot raise capital to finance existing or new assets, and they might be restricted in their ability to pay current liabilities from future revenue streams. It is this capital rationing which means that even solvent firms may be unable to raise funds.

There are therefore a number of reasons why, even if sufficient funds can be raised by a firm to pay a fine, doing so may lead to a liquidity crunch which imperils its survival. It therefore appears clear that when interpreting its Fining Guidelines, the Commission should take into account liquidity constraints, as well as the constraints on ability to pay which are imposed by solvency of the cartelist.

Liquidity constraints

Demonstrating liquidity constraints is a more complex analytical task than assessing solvency constraints. The process of determining the maximum fine which the firm would be able to pay in the short run (defined as the period over which the firm cannot access financial markets) could involve the following steps.

1. The total amount of cash and cash-equivalent assets available to the company at present on its balance sheet (denoted here as F) should be assessed.
2. To this should be added unused but available lines of credit which the firm has already agreed, and which can be called at no or minimal notice (CL).
3. Expected short-term losses (profits) on an EBIT (earnings before interest and tax) basis—that is, operating cash flow—should be deducted from (added to) this total (SRL).[5]
4. Funds required for short-term debt interest, debt principal repayments, and taxes due should be deducted from this total (DT).
5. The requirement of the company for working capital and capital to cover short-term demand shocks (WC) should be deducted from this total.
6. The requirement of the company for legally necessary investments in the short term (SLI) should be assessed and deducted from the total.
7. The requirement of the company for commercially necessary investments in the short term (SCI) should be assessed and deducted from the total.

The formula for calculating the short-run potential payable fine is therefore:

$$FP_s = F + CL - SRL - DT - WC - SLI - SCI$$

This would represent the maximum extent of the fine that could be paid without the firm having to access the financial markets to obtain additional funding to cover the fine—that is, the short-term sustainability of the fine.

Maximum fines payable on the basis of short-term considerations will often be relatively low (compared with those based on long-run funding considerations, as outlined below), and will to a large extent depend on a firm's capital and funding structure. Firms that retain large amounts of cash or liquid assets on their balance sheets, other things being equal, will in general be able to pay larger fines in the short run than those that have relatively low cash levels, particularly when combined with a significant need for working capital. In extreme cases the maximum fine payable based on short-term considerations may be zero.

Long-run funding considerations

Short-term considerations provide part of the overall picture of the extent of fine that is affordable. However, many firms will have scope to raise finance in order to pay fines, and there is therefore a need to determine the extent of payable fines based on long-term considerations. Whereas short-term ability to pay is based on the firm's free cash flow, without raising new finance or selling assets, long-term ability to pay considers the extent to which a firm can raise capital from the market in order to fund the fine.

There are three main ways in which a company could raise funds to increase its long-term ability to pay a fine above its short-term ability to pay, one of which involves reducing assets, and the other two increasing liabilities.

- **Divestments**. Non-core parts of the business, or individual physical assets, could be sold in order to raise funds. This would rely on there being elements of the business which can be removed without threatening the long-term stability of the remaining core business lines, and there being willing buyers for such assets.

- **Raising equity**. Many businesses will be able to raise equity finance in order to pay a fine. In general, if a company were to remain solvent after the payment of a fine, it should be possible to raise additional equity finance to pay the fine. However, in some situations, equity markets may be unwilling to provide new finance, whether for specific types of company, or in extreme circumstances, for any company at all.[6] There may also be technical reasons preventing financially weak companies from raising equity finance.

- **Raising debt**. The ability to raise additional debt, as well as the cost of this debt, is likely to be contingent upon the company's financial condition and hence its debt capacity.

Constraints on raising debt

Given the above, the ability to raise debt will in many cases be crucial in determining a firm's ability to pay a fine. This is particularly the case given that there is a (positive) correlation between the ability to raise debt and the ability to fund a business through other means—if companies have easily saleable assets, they are likely to be able to raise debt more cheaply than companies with minimal liquid assets.

When considering a company's ability to raise debt, one factor is its debt capacity and financial condition as reflected in, for example, its credit rating. The credit rating offers an independent, although indirect, view on the ability of the company to both raise and service debt. The credit rating of a company is an assessment (by an independent credit rating agency) of the likelihood of that company defaulting on its debt. As well as determining the riskiness of tranches of existing debt, a company's credit rating also acts as an important determinant of the cost of raising additional debt, and the recovery rate in the event of default. For companies with high credit ratings, raising debt can be easier.

It is possible to analyse a company's debt capacity by looking at its expected financial performance and credit rating, as well as market conditions at the time, to determine the scale of fine which might be payable.[7] Doing so requires analysis of relevant financial ratios and a comparison with market (investors') expectations.

While a robust analysis of the company-specific debt capacity can be complex, comparators can be used to approximate the impact of the fine. This can be done through a number of steps.

- **Identify a set of comparators**. Define a set of comparator companies, all of which have traded debt and available data on financial ratios and performance. These companies should ideally be in a similar industry, and with similar geographical characteristics, as the company for which the comparison is being undertaken. The aim of this is to ensure that the differences between the company being considered and its comparators are primarily their financial and managerial structures, rather than exposure to different market-based risks.

- **Group comparator companies**. These comparator companies can then be grouped according to their credit ratings. Ideally there will be a number of comparators for each credit rating. For each credit rating, the average and range of the various financial indicators can be calculated.

- **Determine the standing of the company being assessed against its comparators at the same credit rating**. Where a company has a credit rating, its ratios can be compared against other companies with the same credit rating. This can provide a proxy for firm-specific risks.

- **Determine how the firm's financial ratios will be affected by a fine**. The next step is to engage in financial modelling of the firm to determine how a fine would change its financial ratios.

- **Determine whether debt could be raised given the impact of the fine on the firm's financial ratios by comparison with its peers**. The ultimate step is therefore to determine whether a company would be able to obtain debt under these new financial conditions (ie, with the fine) by undertaking comparative financial analysis using the company's peers as a benchmark.

This then provides a framework for assessing whether there are likely to be liquidity constraints on raising debt for a company facing a fine under competition law. A complication with the framework arises where there are cyclical factors in credit markets which need to be taken into account. For example, the recent financial crisis has demonstrated that there can be occasions when an entire sector of the economy is unable to raise finance on terms which would previously have been thought normal, and where a firm raising finance would not have been thought to be in distress when doing so. Where such situations occur, it is likely that an ad hoc adjustment to the maximum size of fine payable will be required.

Overall process

There are therefore several considerations that must be taken into account when determining whether a given size of fine is payable. The broad structure of this process, as set out above, is as follows.

1. Assess solvency by reference to shareholders' equity. A fine in excess of this level is likely to be unpayable.
2. Determine the level of liquid assets on the company's balance sheet. A fine of this level may reflect the minimum that is affordable.[8]
3. Determine whether there are any assets or business lines which could be sold without jeopardising the company's core business. Add this to the free cash under (2).
4. Assess whether some form of equity capital can be raised, given the constraints—financial and, potentially, legal—facing the company after the payment of free cash under (2) and asset and business line divestments under (3). If it can, assess the maximum level of fine payable, and add to the fine payable under (3).
5. Assess the extent to which debt can be raised in the market to pay a fine. Add this to the fine payable under (4).

The fine under (5) is the maximum fine that the firm can afford.

Conclusions

This article has considered an empirical framework to assess the maximum size of competition law fine that a firm is able to pay. While there have been few previous cases where fines have been reduced on account of inability to pay, it is likely that such cases will increase in frequency given the larger fines now being levied by the Commission and the current weak financial climate. Overall, the conclusion is that both solvency and liquidity are important when considering the maximum size of fine, and as such both should be reflected in the Commission's fining policy.

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[1] 'Cartel Statistics: Situation as of 2010-01-25'. Available at http://ec.europa.eu/competition/cartels/statistics/statistics.pdf.
[2] For example, the *International Removal Services* case featured a reduction in the fine to Interdean of 70% based on 'inability to pay and particular circumstances'. See European Commission (2008), 'Antitrust: Commission Fines Providers of International Removal Services in Belgium Over €32.7 Million for Complex Cartel', press release IP/08/415, March 11th.
[3] European Commission (2006), 'Guidelines on the Method of Setting Fines Pursuant to Article 23(2)(a) of Regulation No 1/2003', OJ, C 210/02.
[4] Note that these two things are not the same—administration is less severe than liquidation. Moreover, under both administration and liquidation there may be some value left for debt-holders of the company. The guidelines are in this article taken as meaning that equity holders should not be left with any value, while debt holders and trade creditors may not face 100% losses.
[5] This first calculation is considering the ability of the company to pay the fine without needing to raise fresh finance, so long-term expected profits should not be included, as there will be a need to raise finance in the short term to pay a fine until profits have accrued to the company. EBITDA (earnings before interest, tax, depreciation and amortisation) profits are the correct measure as depreciation will have an impact on a firm only in the long-run—it does not change a firm's short-term cash flow.
[6] An example of this can be found during the recent financial crisis, when many banks, insurers and other financial institutions found themselves unable to access equity markets to restore their capital positions.
[7] Alternatively, detailed bottom-up financial analysis of the firm's debt capacity can be undertaken. While more accurate, this will also be considerably more time-consuming than the comparator-based approach outlined below, and is likely to require greater scrutiny from the European Commission. If financial analysis is being used, there would be further need to consider the role of capital rationing once the firm's debt capacity had been determined.
[8] Subject to the constraints on solvency referred to previously.

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