
Mergers and the failing-firm defence in the age of COVID-19: going out on a limb?

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The immediate impact of the COVID-19 pandemic on merger activity is not yet clear. Increased uncertainty caused by the disruption may discourage transactions, although the currently lower market value of stocks may encourage the acquisitions of smaller, innovative start-ups, such as those in the pharmaceutical or digital communication sectors. In addition, there is a prospect of a larger number of struggling or 'failing' firms being bought up by their stronger competitors, who could take the opportunity to further establish their market position.¹



The so-called ‘failing-firm defence’ is a long-established argument in mergers and acquisitions, and the majority of competition authorities have clear rules for its application, especially since the global financial crisis. The essence of the defence is that the target company would fail if it were not acquired, and in the absence of an alternative (and typically smaller) buyer there can be no substantial loss of competition as a result of the merger.

Various competition regimes around the world apply similar three-limbed tests, which assess the inevitability of exit of the relevant firm (limb 1), the lack of an alternative, less anticompetitive purchaser for the failing firm or its assets (limb 2), and whether the merger leads to a substantially less anticompetitive outcome than the exit of the firm (limb 3). The failing-firm defence is passed only if it satisfies all three limbs.

For now, satisfying the test is not easy. A limited number of companies have successfully used the failing-firm defence as a way to achieve merger clearance in concentrated markets. For example, Aegean Airlines succeeded in applying the defence in front of the European Commission during its acquisition of Olympic Air, its closest rival in Greece.² Another case where the defence was successful (and a case that I had the opportunity to work on) was Optimax’s acquisition of Ultralase (both providers of corrective eye surgery) in the UK.^{3, 4}

Is it easier to satisfy the three-limbed test in the current climate?

While there is uncertainty around the impact of COVID-19 on merger activity, economists and lawyers anticipate the relative number of attempted failing-firm defences to increase due to the short-term financial pressure on firms.

Measures imposed due to the ongoing pandemic are resulting in lower short-term demand and revenues. As a result, firms are finding it more difficult to cover both fixed and variable costs, as well as to pay off current debtors and equity holders. This, in combination with an increase in risk aversion on the behalf of lenders (such as private equity funds and banks), means that struggling firms will find it even harder to access much-needed cash.

A recent example of this effect was experienced by Deliveroo, a popular food-delivery platform, which has found itself in financial difficulty as a direct result of the current crisis, particularly in relation to short-term funding.⁵ As a result, the UK Competition and Markets Authority (CMA) accepted Amazon’s bid for the company’s minority shareholding based on the failing-firm defence.

In light of the ongoing pandemic measures, firms must take several changes in the landscape into account in order to satisfy the three-limbed test. Ironically, some of these may well have the effect of making it more difficult to pass the test. The main likely changes are discussed in turn below.

Limb I: is the exit of the failing firm inevitable?

As discussed above, it might now be easier to show that a firm is in financial difficulty. However, the reaction of governments to the pandemic has also brought about various sources of financial aid and funding for firms finding themselves in financial distress. Most countries around the world have fairly swiftly introduced a range of support tools for struggling companies.

In Europe, in addition to deploying the EU budget to bring immediate relief to the economy⁶ and setting up bespoke response measures, the European Commission has responded to the crisis by publishing guidance to member states and companies as to the channels that state authorities can use to provide support. My colleague Nicole Robins has recently written a very interesting guide about this.⁷ Assistance can be received in various forms, such as grants, tax advantages or subsidised guarantees on bank loans, with the express objective of preventing firms from failing.

Firms considering putting forward a failing-firm defence may need to convincingly demonstrate that the financial aid available through these new channels would not be adequate, appropriate, and/or timely. As a result, the burden of proof for the first limb could become heavier, as firms could need more evidence to show that they are unable to turn around their finances.

Limb II: is there an alternative, less anticompetitive purchaser for the failing firm or its assets?

The second limb of the test requires the merging parties to demonstrate that there are no alternative buyers, or that an acquisition by any other buyer would not lead to a substantially less anticompetitive outcome.

On the one hand, it could be argued that listed companies whose market share prices have fallen substantially as a result of the imposed restrictions might attract a number of buyers with deeper pockets. Some of these buyers might be in related markets, where competition concerns might be much less problematic (e.g. a non-horizontal merger) and are less affected by the pandemic.

On the other hand, time pressure could ‘force the hand’ of the competition authorities. The profound and sudden effect of the imposed restrictions could mean that the target firm is already in deep water at the merger-notification stage. Identifying an alternative buyer, concluding a new deal and notifying it to the relevant competition authority can take time, and such a delay could lead to the firm failing. Which of the two effects dominates will depend on the target’s financial situation and on the presence of a buyer in a related market.

¹ See also Oxera’s recent article on the challenges and impacts of COVID-19 for markets and public policy. Oxera (2020), ‘The coronavirus, markets and public policy: challenges and impacts’, Today’s Agenda, April, <https://bit.ly/2W209G4>.

² European Commission (2013), Case No COMP/M.6796 – AEGEAN/OLYMPIC II, October.

³ UK Competition Commission (2013), ‘Optimax Clinics Limited and Ultralase Limited – a report on the completed acquisition by Optimax Clinics Limited of Ultralase Limited’, November.

⁴ See also Oxera’s article on the failing-firm defence framework. Oxera (2014), ‘The failing-firm defence: a “get out of jail free” card in mergers?’, May, <https://bit.ly/35hklby>.

⁵ UK Competition and Markets Authority (2020), ‘Anticipated acquisition by Amazon of a minority shareholding and certain rights in Deliveroo: Provisional findings report’, April.

⁶ The Commission has announced that the EU budget will be used to support hard-hit small-to-medium-sized enterprises (SMEs), and that credit holidays will be provided to existing debtors. In addition, the Commission will provide €37bn under the Coronavirus Response Investment Initiative. See European Commission (2020), ‘Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Investment Bank and the Eurogroup, Coordinated economic response to the COVID-19 Outbreak’, COM(2020) 112 final, 13 March.

⁷ See Oxera’s article on the new state aid measures. Oxera (2020), ‘A practical guide to the state aid rules to tackle the impact of COVID-19’, April, <https://bit.ly/2YglPjm>.

⁸ UK Competition Commission (2013), ‘Optimax Clinics Limited and Ultralase Limited – a report on the completed acquisition by Optimax Clinics Limited of Ultralase Limited’, November.

⁹ UK Competition and Markets Authority (2020), ‘Anticipated acquisition by Amazon of a minority shareholding and certain rights in Deliveroo: Provisional findings report’, April.

¹⁰ Oxera (2020), ‘Dynamic counterfactuals and merger control: the old, the new and the uncertain’, *Agenda in focus*, May.

¹¹ As reported by MLex (2020), ‘Failing firms won’t get more EU leeway to plead for mergers, Vestager says’, 24 April, <https://bit.ly/3eYXR3f>.

¹² Competition and Markets Authority (2020), ‘Guidance: Annex A: Summary of CMA’s position on mergers involving “failing firms”’, 22 April, <https://bit.ly/3BNIGNL>.

Limb III: will the merger lead to a substantially less anticompetitive outcome than the exit of the failing firm?

For the third limb of the test, competition authorities assess what would happen if the merger were prohibited and the failing firm were to exit the market. They have to consider a ‘counterfactual’ scenario, in which the remaining competitors vie for that firm’s customers or assets.

Such a consideration occurred during Optimax’s acquisition of Ultralase, where the UK Competition Commission (now the CMA) considered the diversion of Ultralase’s customers. The Competition Commission reached the conclusion that the merger would not result in a less competitive outcome than if Ultralase exited the market, based on its analysis that most customers would end up with Optimax anyway if Ultralase was indeed to exit.⁸

Competition authorities might also take into account the impact on competition as a whole—for example, the loss of one supplier could, through a change in incentives, reputation and other effects, lead to a reduced level of competition or overall market shrinkage. This consideration was key in the recent Amazon/Deliveroo decision, where the CMA concluded that Deliveroo’s exit from the market would weaken competition in the market as a whole.⁹

In considering the counterfactual scenario, authorities typically assume that the competitive conditions existing at the time of the merger are appropriate. In some cases, however, the counterfactual takes into account changes in the market that can be reasonably predicted (i.e. a ‘dynamic counterfactual’). These include, for example, the entry, expansion or exit of other firms. For a discussion of dynamic counterfactuals more generally, I would recommend the upcoming article ‘Dynamic counterfactuals and merger control: the old, the new and the uncertain’ by my colleagues Ilaria Fanton and Maurice de Valois Turk.¹⁰

In the current climate, it is likely that in many cases competition authorities will have to adopt a dynamic counterfactual, which might include less entry and/or more exit in the market. This should help firms to put the case forward that the majority of a diversion of sales would go towards the proposed acquirer; therefore, letting the target exit the market would not be preferable. In addition, the possible market-wide effects from a firm’s exit could play into a competition authority’s assessment. Overall, it appears that the last limb of the test might be easier to pass in the immediate future.

Lowering the bar?

The discussion above has demonstrated that not all firms will find it easier to invoke the failing-firm defence in the current environment, given the existing framework. The specifics of each case and market will play an important role.

An interesting question that many experts have asked is whether competition authorities would be willing to relax the rules of the existing framework—especially given the eye-watering amounts that some governments have approved to provide relief to businesses. So far, however, there are no signs of this occurring.

Margrethe Vestager, the EU’s Competition Commissioner, stressed that there is no need to relax the normal rules, even in these ‘uncertain times’, and that despite the pandemic threatening to put some companies out of business, it is not necessary to soften the EU’s approach when assessing the failing-firm defence.¹¹ At the same time, the CMA’s recently published merger guidance did not include any changes to the failing-firm defence framework.¹²

This approach appears reasonable at this point in time. The economic effects of the pandemic have not yet crystallised in most countries, but they likely will in the next few months; at that point, competition authorities might decide to lower the bar somewhat.

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