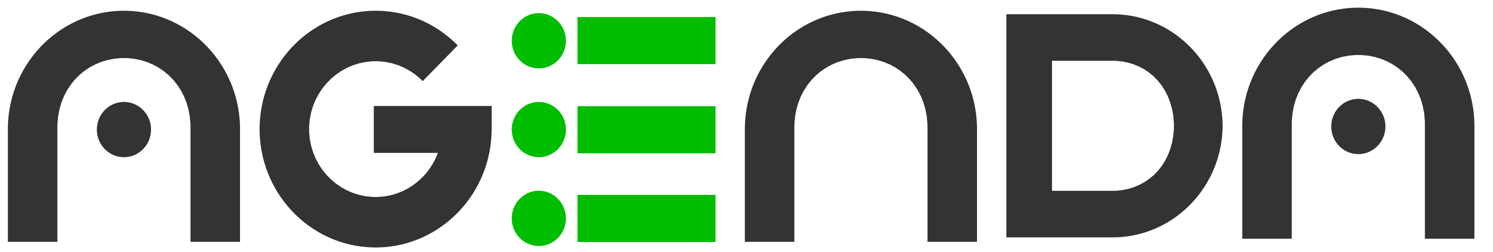

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Flying through the storm: aligning merger control and state support

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Many firms are facing financial difficulty as a result of COVID-19, and are receiving state support. However, we have not (yet) seen the predicted increase in merger activity. Is it preferable to provide state aid to companies in order to allow them to continue operating, or should we allow these 'failing or flailing' firms to be acquired by others? Which is the right tool to use, and could there be more alignment between them?

Both merger control and state aid control are long-standing tools applied by policymakers across Europe to ensure that markets remain competitive, or to limit potential distortions to competition.

One aspect of merger control that is often discussed (but rarely used) for clearing an otherwise problematic merger is the failing-firm defence.[1] The failing-firm defence is based on the idea that if at least one of the merging parties would have exited the market had the merger not gone ahead, the merger cannot be anticompetitive.[2] In other words, the market structure would be the same with and without the merger, as in either case there would be one fewer firm in the market. Therefore, a merger that would otherwise generate material anticompetitive effects could be permitted if one of the parties is considered to be a failing firm.[3] The European Commission has established three criteria that need to be met as part of the failing-firm defence, as set out in the box below.

Failing-firm defences are therefore of relevance in instances where a firm is in financial distress and would have exited the market absent the merger. One notable case where the failing-firm defence was accepted by the Commission is the merger between Aegean Airlines and Olympic Air in 2013. This was the second time that the parties had tried to gain merger approval, and it came only a few years after Olympic was privatised by the Greek government.[4]

While Olympic was part of a group, and therefore (in theory) its parent company could have continued to support it, the Commission determined that Olympic's parent company was no longer willing to bail it out, and that the parent company would shut it down if the merger did not go ahead. Also, despite previous aid provided by the Greek government to the airline when it was state-owned,[5] and the fact that the Olympic brand was actually owned by the state and licensed to Olympic, the Commission does not appear to have considered whether the Greek government would have been willing to step in to support Olympic. The Commission ultimately concluded that, absent the merger, Olympic would have exited the market due to its difficult financial situation, and therefore allowed it to merge with Aegean.[6]

As a result of the COVID-19 pandemic, firms across a variety of sectors and countries are facing financial difficulty. At the beginning of the pandemic, this led many to predict that there would be an increase in the number of mergers using the failing-firm defence. However, this has not yet materialised. In part, this is likely to be a result of the significant amount of aid provided by various governments in the form of direct grants, subsidised loans and guarantees to prevent companies from exiting the market.

Despite the fact that merger control and state aid control both have the objective of ensuring competitive markets, it does not appear that there has been much, if any, coordination between the two in dealing with the effects of the crisis. Could there be a benefit from greater coordination between these tools, not only in dealing with the effects of COVID-19, but also more generally going forward?

Failing-firm defence

The European Commission has set out the following three criteria that need to be met in order to apply a failing-firm defence.

1. The failing firm would, in the near future, exit the market because of financial difficulties if the merger does not go ahead.

2. There is no other feasible alternative that is less anticompetitive than the proposed merger. For example, there is no other purchaser that could purchase the company in question while not leading to a significant impediment to effective competition.

3. In the absence of a merger, the assets of the failing firm would exit the market.

Source: European Commission (2004), 'Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings', *Official Journal of the European Union*, 5 February, https://bit.ly/2X6ntE4, paras 90 and 91.

Weighing up the options

While COVID-19 is affecting the demand faced by a number of companies, in many cases this effect is expected to be temporary. If a company had a sound business model before the crisis, it is possible that it will be able to withstand the effects of the pandemic. In other cases a firm may significantly downsize or restructure. The first criteria of the failing-firm defence requires that the firm would permanently exit the market, and therefore it would not apply in either of these cases.

However, it may also be the case that the loss of demand is so severe and prolonged—for example, in the aviation sector—that even if a firm was financially sound before the crisis, it will permanently exit the market as a result of the pandemic. In these sectors, there may not be multiple potential purchasers, and the firm's assets may be expected to exit the market in absence of the merger. As a result, authorities may allow a failing-firm defence to be applied.

While the logic of the failing-firm defence is that the situation would be the same in the counterfactual—i.e. a situation of reduced competition in the market—the picture becomes more complicated where there is an option to provide companies with financial support. Indeed, many governments are intervening to provide aid to ensure that firms remain viable during the period of loss in demand in order for them to continue to operate in the market in the longer term on a standalone basis.

Therefore, rather than considering merger and state aid tools in isolation, it may be beneficial to take account of the potential for state support in the counterfactual scenario in determining whether to allow a merger to go ahead.

This occurred in a UK merger during the most recent comparable crisis—the 2008 financial crisis—when Lloyds TSB Group plc acquired Halifax Bank of Scotland (HBOS plc). Given the increased government intervention in financial markets, the UK Office of Fair Trading (now the Competition and Markets Authority, CMA) 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 successful. The acquisition was eventually cleared by the Secretary of State for Business, Enterprise

and Regulatory Reform. This was on the basis of its benefits to the financial stability of HBOS and the UK financial system as a whole, and despite the fact that the Office of Fair Trading advised that there was a realistic prospect that the merger would lead to a substantial lessening of competition.

The UK competition authority did, therefore, take account of government support in applying the failing firm criteria. However, it did not consider the other side of the coin—whether consumer interests would be better served by allowing the merger than they would be by providing the companies with state support.

For example, in the context of the current crisis, consider a merger between two airlines that were financially sound before the crisis, but the pandemic led one of them to face significant financial difficulty. The merger would be likely to lead to anticompetitive effects in the form of price rises if it were allowed to go ahead.

One option is that the merger is prevented and no state support is provided to the airline in financial difficulty, leading it to significantly reduce capacity and frequencies.

A second option is that the merger is prevented, but the government steps in to cover the airline's losses through government support or credit facilities in order to preserve the significant benefits that the airline contributes to the wider economy. Note that, while providing government support may ensure that both firms remain in the market going forward and may therefore appear to be the more competitive outcome, there is a question about whether the aid to these firms actually causes competitive distortions in the market. The extent of competitive distortions will depend on a number of factors, one of which is whether there are any structural or behavioural remedies accompanying the aid and, if so, how such measures are designed.

A third option is to allow the merger to go ahead on the basis that the merged entity is effectively more resilient to the crisis, and government aid might not be required, or may be lower, under the merger scenario. For instance, if the acquiring airline has significant cash reserves, the merger would enable it to cover the other airline's losses.

In deciding between these options, the savings in state support from allowing the merger can be compared with the increased prices or other types of customer harm that are likely to result from the lessening of competition due to the merger, and the wider benefits that the firm contributes to the economy. This comparison will require a welfare consideration, as there are likely to be different impacts on different groups of consumers. For instance, the government support may allow both firms to remain in the market at the expense of taxpayers as a whole. On the other hand, the price effects of the merger would be borne mainly by a smaller group of consumers that use the merging parties' services. Undertaking a trade-off between these different options would require collaboration in applying merger control and state aid control.

Remedy design

Merger cases are built around specific theories of harm based on a detailed investigation of competition in the market. It is therefore relatively straightforward to determine what remedies would mitigate the expected harm. For example, a horizonal merger always represents a structural change to a market, so any remedies that are required would undo or mitigate that change to the market structure.

Structural and behavioural measures are required for certain types of state aid. Remedies in the form of structural measures are typically required for restructuring aid that is provided to companies in financial difficulty, as it is deemed one of the most potentially distortive forms of aid. The appropriate package of structural measures depends on the amount of aid provided and the relative importance of the aid beneficiary in the market before and after the aid, among other aspects.[7]

The state aid framework introduced by the Commission to tackle the impact of COVID-19 could lead to an increase in the use of structural remedies that are similar to those typically seen in merger cases.[8] For example, the Temporary Framework introduced by the Commission as a result of COVID-19 allows companies that were not in financial difficulty as of the end of 2019 to access recapitalisation aid (i.e. aid in the form of capital injections or hybrid capital instruments). If the aid is more than €250m and the recipient is a company with significant market power (SMP), then, under the Commission's new state aid rules, the member state must impose additional measures on the company. In particular, the Commission states that the member state may impose behavioural or structural commitments as in the EU Merger Regulation.

The Commission recently approved recapitalisation aid to Lufthansa of €6bn (in addition to a state guarantee on a €3bn loan).[9] Given that it was determined that Lufthansa had SMP, Lufthansa agreed to give up a total of 24 slots at Munich and Frankfurt airports in return for the support.

Slot remedies are often imposed in merger cases based on detailed analysis of the competitive market conditions. In the Lufthansa case, while it may be clear that the aid is giving an unfair advantage to Lufthansa, similar analysis as in the merger context would need to be undertaken to assess how that advantage manifests itself in terms of market structure and impact on consumers, in order to design appropriate remedies.

The Commission's new state aid guidance under the Temporary Framework also highlights that large undertakings receiving recapitalisation aid must report on how the aid supports their activities in line with EU objectives and national obligations linked to green and digital transformations, including the EU objective of climate neutrality by 2050.[10] Therefore, while both merger control and state aid control are intended to preserve competition in the market, policymakers may also use state aid to pursue a number of other policy objectives that may not always be compatible with the objective of promoting competition.

Sticking the landing?

When competition authorities in different jurisdictions pursue the same merger case, they often coordinate with one another. This same level of coordination between different authorities (or different parts of an authority) in deciding between tools to achieve the same aim may be useful, particularly during times of crisis.

In the end, however, perhaps it is not necessarily a choice between providing state aid and allowing mergers—even if state aid is provided to a firm, it may not be sufficient to enable the company's survival, and there may yet be consolidation coming down the line.

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[1] See also Oxera (2020), 'Mergers and the failing-firm defence in the age of COVID-19: going out on a limb?', April, https://bit.ly/3jWQHyU; Oxera (2014), 'The failing-firm defence: a "get out of jail free" card in mergers?', *Agenda in focus*, May, https://bit.ly/2DirOx2; and Oxera (2009), 'Failing or just flailing? The failing-firm defence in mergers', *Agenda*, March, https://bit.ly/3gih28w.

[2] European Commission (2004), 'Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings', *Official Journal of the European Union*, 5 February, https://bit.ly/39JwhoG, para. 89.

[3] European Commission (2004), 'Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings', *Official Journal of the European Union*, 5 February, Section VIII, https://bit.ly/3149bov.

[4] After an in-depth investigation by the Commission, the merger was prohibited in 2011. Olympic was privatised in 2009 after the Greek state sought to divest Olympic four times between 1999 and 2009.

[5] European Commission (2002), 'The Commission concludes its examination of the Olympic Airways case', press release, 11 December, https://bit.ly/3fcjtbw.

[6] See the Commission's final determinations in the *Aegean/Olympic* case. European Commission (2013), 'COMMISSION DECISION of 9.10.2013 addressed to: AEGEAN AIRLINES S.A. declaring a concentration to be compatible with the internal market and the EEA Agreement (Case No COMP/M.6796 – AEGEAN/ OLYMPIC II)', https://bit.ly/3jWSsMw, para. 833, accessed July 2020.

[7] European Commission (2014), 'Guidelines on State aid for rescuing and restructuring non-financial undertakings in difficulty', *Official Journal of the European Union*, 31 July, para. 87, https://bit.ly/2XcVuT8.

[8] For further details on the changes made by the Commission to state aid rules to tackle the effects of the COVID-19 pandemic, see Oxera (2020), 'Practical guidance on the new state aid rules on public recapitalisations', 19 May, https://bit.ly/3gfGrQ9; and Oxera (2020), 'A practical guide to the state aid rules to tackle the impact of COVID-19', 19 May, https://bit.ly/2Dg0C1Z.

[9] European Commission (2020), 'State aid: Commission approves €6 billion German measure to recapitalise Lufthansa', 25 June, press release, https://bit.ly/3hNOELR. At the time of writing this article in July 2020, the Commission's final decision was not yet available.

[10] European Commission (2020), 'Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak', Communication from the Commission, 19 March, https://bit.ly/2CSL84c, para. 44.