International Insolvency Institute

The Failing Firm Defense

01 May 2021

Miguel de la Mano

THE FAILING FIRM DEFENSE

During past economic crises, regulators generally refused to expand the failing firm doctrine's reach or loosen its requirements, even though they acknowledged that general economic conditions are relevant to merger reviews and, at least in some jurisdictions, certain practical accommodations may be necessary.

The unprecedented economic conditions presented by COVID-19 may mean the failing firm defense has a greater potential to succeed, **not because the standards are lowered**, but because the economic reality means **more firms are actually failing** and have fewer options to keep their assets in the market.

This prediction, however, has not materialized. I will argue this is because the FFD as applied in the EU is flawed.

	US GUIDELINES	EU GUIDELINES
FAILING FIRM	**Basic requirement**: imminent failure of one of the merging firms would cause the assets of that firm to exit the *relevant* market 1. unable to meet its financial obligations 2. unable to reorganize successfully under Chapter 11 3. (a) unsuccessful good-faith efforts to elicit alternative offers that (b) keep its *tangible and intangible assets* in the *relevant* market and (c) pose a less severe danger to competition than does the proposed merger	**Basic requirement:** deterioration of the competitive structure cannot be said to be caused by the merger 1. firm would in the near future be forced out of the market because of financial difficulties 2. there is no less anti-competitive alternative purchase than the notified merger 3. in the absence of a merger, the assets of the failing firm would inevitably exit the market
FAILING *DIVISION*	1. applying cost allocation rules that reflect true economic costs, the division has a persistently negative cash flow on an operating basis and 2. such negative cash flow is not economically justified for the firm by benefits such as added sales in complementary markets or enhanced customer goodwill; 3. (as 3 above for Failing Firm)	No formal guidance. But in Nynas/Shell the EC extended the FFD to a Failing Division even though (1) could not be met EC was convinced that Shell would shut down the refinery. Thus basic requirement is met (i.e. counterfactual analyssi)
FLAILING FIRM	Firm is unlikely to be a significant competitor even if it were able to reorganize or sell itself to a buyer outside the market. Precedence: - Boeing's acquisition of McDonnell - T-Mobile/Sprint merger (Court decision)	No formal guidance. Would the EC be flexible, if in the counterfactual the target will cease to exert a competitive constraint? (even if the assets do not immediately exit the market). No evidence it would (except maybe T-Mobile/Tele 2 in the Netherlands).

BURDEN TO SHOW CRITERIA FOR A FFD ARE MET

In all jurisdictions the burden is on the merging parties.

However, this burden weighs more heavily in Europe for several reasons:

- The criteria are not as objective as in the US
- The EC is prosecutor and jury whilst US agencies need to challenge the Merger in Court
- The EC needs to draft a decision, which becomes public, can be appealed by third parties and could set precedence
- The EC has not issued any guidance on the type of evidence it would consider dispositive.

US: litigants have asserted the defenses roughly 50 times since 1930 and have succeeded, at least in part, on 18 occasions, a success rate of nearly 40 percent.

The EC has rejected the defense in the vast majority of cases and has indicated that it will not expand its application, even in the wake of economic recessions. FFD is rarely invoked anymore. Only 3 cases of F.Firm and 1 F.Division:

- Last case Olympic/Aegean. First prohibited
- F.Division – The parties did not even invoke the FFD

US: FINANCIAL DIFFICULTIES (CONDITIONS 1 AND 2)

First, the firm must establish, based on past performance, that it would not be able to meet future obligations.

- Declining sales and net losses are not sufficient.
- Mismanagement is not sufficient if the mismanagement can be corrected.
- Purely temporary liquidity problems are not sufficient if external support (including public support) is available to finance a restructuring

Second, the firm would not be able to reorganize successfully under Chapter 11 of the Bankruptcy Act.

- The firm must establish that it attempted and failed to resolve its debts with creditors.
- The firm could not emerge from bankruptcy after discharging its debts.

EU: FINANCIAL DIFFICULTIES -> FIRM EXITS THE MARKET

Largely a subjective assessment:

- No direct reference to bankruptcy or legal requirements, but often interpreted as meaning the firm needs to prove it is likely go into bankruptcy but for the merger. But bankruptcy laws and proceedings can differ significantly between EU member states
- No clarity on the relevant time horizon: “in the near future”.
- No guidance on how to treat temporary liquidity problems
- Any possible restructuring, however credible, may be invoked to reject the FFD as it would be an alternative to bankruptcy
- Often impossible to prove because:
  - the failing firm seeking a buyer: does not want to admit it will go into bankruptcy
  - Or does not want to discourage customers (e.g. airlines, cars manufacturers or any market where after sales service is critical)

ALTERNATIVE BUYER

US:

- Due diligence required at least as thorough as the firm would normally use to sell itself or some of its assets.
  - E.g keep good and accurate minutes reflecting that the board and management directed advisers (such as investment bankers, lawyers and consultants) to pursue and explore alternatives and that the board determined those alternatives were unavailable or unrealistic.
- Any offer above liquidation value to purchase the firm or its assets must be accepted even if substantially less than the offer of the proposed buyer (“the liquidation value requirement”).

EU:

- No “liquidation value requirement”: any less anticompetitive buyer advancing an offer can be considered to dismiss the FFD.
- Credibility of the alternative purchaser: EC weighs much more heavily evidence submitted by the alternative buyer than the merging parties
- Fixed and short merger control deadlines justify taking an extremely conservative approach

US: “ASSET EXIT THE MARKET”
SUBTLE DIFFERENCES WITH PRACTICAL CONSEQUENCES

US: If conditions 1 and 2 are met, the default is that the assets will exit the market (irrespective of who purchases the assets in liquidation)

- But condition 3 (alternative purchaser) introduces a caveat: assets are kept in the relevant market ***if there*** is an alternative less anticompetitive purchaser (willing to pay above liquidation value – even if the offer is below that of the acquirer)
- Condition 3: to show the Target has made all reasonable efforts to secure alternative offers that would keep the assets in the market. Condition is met in 3 scenarios:
    1. No such offers exist
    2. The alternative offer would be as anticompetitive or more
    3. There are offers but the alternative buyer would redeploy the assets to other relevant markets (even if the assets remain in the industry) as opposed to keeping them in the problematic markets.

EU: "ASSET EXIT THE MARKET" SUBTLE DIFFERENCES WITH PRACTICAL CONSEQUENCES

In Europe, by contrast meeting condition 1 (financial difficulties) and even condition 2 (no alternative buyer) are *technically* unrelated to condition 3 (assets exit).

Thus condition 3 ***will not be met*** and the ***FFD rejected*** even if:

- The alternative buyer redeploys the assets to another relevant market
- Some assets (tangible or intangible) are acquired in liquidation (at a price lower than if the firm remains a going concern) by firms that operate "in the market".

Some assets only have any value at all in the market: example airport slots, brand names or IPR. Thus, if sold in liquidation the assets will not exit the market.

US AGENCIES: FLAILING FIRM DEFENSE

Economic rationale:

A struggling firm may have sufficient cash reserves to fund operations and its revenues cover expenses in the short term.

But an anticompetitive merger may be allowed to proceed if the evidence shows that it lacks sufficient reserves to make identified capital improvements, *resulting in declines in its competitive significance.*

To evaluate parties' claims, agencies rely on documents, interviews with investors, and evidence of financial struggles such as staff layoffs, closed service lines, declining customer service, declining revenues and increased losses, compromised (or potentially compromised) quality, or downgraded credit scores from the rating agencies.

In these cases, many payers would prefer to see the acquisition occur so the struggling hospital can stay in the market rather than face the prospect of the hospital shutting its doors.

Furthermore:

Congress has enacted a handful of statutes that apply a less stringent standard for industries deemed particularly important, including banking and newspapers. For those industries, a smaller risk of failure can help justify the transaction.

PRAGMATISM VS IDEOLOGICAL ORTHODOXY

Marked differences between the approach in State aid and in merger control cases.

The Commission has shown flexibility in approving State aids en masse both during the sovereign debt and banking crisis and in the aftermath of COVID-19.

This flexibility has not been evident in accepting the FFD in merger control.

For the EC it is preferable to accept artificially keeping competitors on the market at the expense of taxpayers (because of State aid measures)…

…than allowing companies to acquire failing firms at the expense of a much narrower group of taxpayers, the consumers of the specific products/services,

But is it more acceptable that the burden of keeping failing firms afloat is borne by all taxpayers rather than by that firms customers?

THE EU FFD IS NOT SUFFICIENTLY FLEXIBLE OR CLEAR.

Flexibility is particularly important given the nature of the pandemic:

- firms may rapidly fail
- the competitive landscape may quickly change
- there is little or no time to meet all the failing firm requirements, let alone to prove all conditions are met.

The EC cannot presume that it has a year to investigate, which it often does when reviewing a complex merger