



The Competition Authority

An tÚdarás Iomaíochta

Failing Firm Defence: Theoretical and Practical Problems

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Outline

The Rationale of Failing Firm Defence

Conditions for Failing Firm Defence

Failing Firm Division

Failing Firm Defence in Troubled Economic Times



Rationale for Failing Firm Defence (FFD)

A merger or acquisition where one of the merging parties is “failing” can result in adverse effects on competition that is non-merger specific

- Competition provided by a failing firm would be lost even without the merger
- The loss of competition is not merger-specific
- The merger may result in a less anti competitive outcome than the counterfactual
- A failing firm defence starts from the assumption that the proposed merger has adverse competitive effects



Counterfactual

What is the appropriate counterfactual scenario?

- Merger analysis involves comparing the post-merger scenario with an alternative scenario which is usually the pre-merger scenario
- In a failing firm situation, the pre-merger scenario is not appropriate since the pre-merger scenario describes the competitive situation in which the alleged failing firm was an effective competitor
- It is improper to assume that the alleged failing firm would be an effective competitor absent the merger
- The challenge is to describe the appropriate alternative scenario(s)



Issues with FFD

1. What does “failing” mean?

- Unprofitable?
- Insolvent?
- Bankruptcy protection (restructuring)?

2. Scope – What is “failing”?

- What is “failing”?
- A firm (legal entity) or division or business?

3. Timing: “Imminent Future”

- Time horizon



Conditions for a FFD

In assessing merging parties' claims the following conditions for a FFD should be met:

- (a) the firm is unable to meet its financial obligations in the imminent future
- (b) there is no serious prospect of re-organising the business
- (c) the firm and its assets would exit the market in the imminent future absent the merger
- (d) there is no less anti-competitive alternative outcome than the merger in question

(from *ICN Merger Guidelines Workbook 2006*)



(a) Unable to meet its financial obligations in the imminent future

Analysis of financial information:

- Current and historical
- Forecasts
- Do documents prepared in the ordinary course of business reveal an imminent financial failure? Are forecasts produced solely for the agency?
- Are conditions likely to improve in the imminent future? Are difficulties temporary or part of an irreversible downward trend?
- Available expertise to assess financial information and forecasts



(b) No serious prospect of reorganizing the business

1. Have all reasonable restructuring options and re-financing options been explored and exhausted?

- even firms in restructuring often survive and recover

2. Why is restructuring not practically feasible?

- E.g.: the prevailing market conditions or the prohibitive level of investment (see *COMP/M. 2314 - BASF/Eurodiol/Pantochim*, 2001)

3. Source of evidence

- board documents or other strategy documents produced by the firm when considering various ways to improve its situation



(c) Exit the market in the imminent future absent the merger

Issues to consider:

- Value of the failing firm/business or assets in the current use
- Are exiting assets economically viable on their own?
- Costs of closure of business/costs of exiting of assets
- Are there significant efficiencies that can be realised with the merger?
- Is competition stronger if the assets exited the market? (see *UK OFT, ME/4036/09 HMV/Zavvi*, 2009)



(d) No less anti-competitive alternative outcome

1. Is there any reasonable alternative offer that keeps the business or assets in the market and is less anti-competitive?

- Reasonable: the lower bound is any offer above the liquidation value of those assets (net of the costs associated with the liquidation process) and not any offer commercially at least as preferable as to that of the merging parties
- Barriers/constraints: for instance, legislative requirement on the nationality of alternative purchaser
- Timing of the bankruptcy proceedings can constrain the ability to find a reasonable purchaser



Burden of Proof

Burden:

- Burden of establishing the defence is imposed on the merging parties
- In some jurisdictions (e.g., US, Ireland), merging parties must undertake reasonable steps to seek alternative options (“good-faith and verifiable efforts” in Irish guidelines)
- Burden on the parties to show that the merger is the “only” offer (see *US FTC v Harbour Group Investments*, 1990)



Failing Firm Division

1. Conditions of a Failing Division Defence :

- (a) the division has a negative cash flow on an operating basis such the division and its assets would exit the market in the imminent future absent the merger; and,
- (b) there is no less anti-competitive alternative outcome than the merger in question.

2. In assessing condition (a), care should be taken to ensure that the correct revenues and costs are considered given the ability of the parent company to allocate costs, revenues, and intra-company transactions among itself and its subsidiaries and divisions



FFD and Troubled Economic Times

1. In troubled economic times, there are likely to be more “failing firm defence” claims for mergers

- Are the usual conditions for a FFD applicable in assessing a merger in difficult economic times?

2. Issues:

- Certain conditions of the FFD may be difficult to be proved: e.g., credit restrictions or unavailability may exclude otherwise alternative reasonable buyers of the failing firms or its exiting assets
- Analysis of the counterfactual scenarios may be more difficult to assess: need a more effects-based approach
- Burden on the merging parties may not be appropriate



References

- 1. 2006 ICN Merger Guidelines Workbook:**
 - Worksheet G “Failing Firm”
 - Case studies in Appendix, pp. 99-100.
- 2. *Competition Policy in Distressed Industries*, Carl Shapiro, Deputy Assistant Attorney General for Economics, United States Department of Justice, Antitrust Division, May 13, 2009**
- 3. OECD October 2009 Roundtable on Failing Firm Defence - Background Note by the Secretariat**

