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DISTRESSED BUSINESSES AND MERGER CONTROL

In the current economic climate many businesses may wish to negotiate rescues other than by State aid, for example through acquisitions, mergers, buyouts and/or emergency investments.

Equally, there may be opportunities for businesses to acquire competitors on more attractive terms than would be available in normal circumstances. Although there is no indication that merger control requirements will be relaxed by competition authorities, mechanisms exist in the merger control process which can facilitate the acquisition of interests in distressed businesses. These mechanisms can include requesting a derogation from an obligation to obtain prior clearance from a competition authority and invoking a failing firm defence.

> “…prevailing economic conditions may mean that it is easier to demonstrate that exit is inevitable or that there are no realistic alternative purchasers”

Derogation from obtaining prior clearance

Although most merger control jurisdictions (other than the UK) require transactions involving parties meeting relevant thresholds to be notified in advance to the competition authority and to be cleared before completion/closing, in exceptional circumstances clearance may be able to be obtained without penalty after the transaction has been completed/closed. This may be permitted, for example, where the target business would have gone into administration or liquidation had the transaction not been completed/closed before clearance had been obtained.

For example, the EU Merger Regulation provides[1] that the European Commission (“Commission”) may, on reasoned request, grant a derogation from the obligation to obtain prior clearance. In deciding on the request, the Commission must take into account amongst other things the effects of the suspension on the parties or on a third party and the threat to competition posed by the transaction. Such a derogation may be made subject to conditions and obligations in order to ensure conditions of effective competition, for example the businesses may be required to be held separate pending clearance. A derogation may be applied for and granted at any time, whether before the notification or after the transaction. Examples of where the Commission has granted a derogation are as follows:

- Responses to the global financial crisis in 2008;
- To prevent a company entering administration with major adverse consequences;
- To avoid adverse tax implications;
- To allow a financial rescue package to proceed swiftly;
- To enable competition against an incumbent monopolist;
- To prevent substantial damage to operating companies as their parent company was in administration;
- In the absence of competition concerns;
- To close the transaction in some non-EU jurisdictions;
- To facilitate a bid at auction for certain assets, as without the derogation the parties would have been significantly disadvantaged;
- To prevent further deterioration of assets;
- To avoid serious harm to the target which was in serious financial distress, its customers and creditors;
- To prevent repossession of assets;
- To enable immediate issue of new bank guarantees and avoid termination of contracts.

Failing Firm Defence

A failing firm defence can be invoked to seek to justify the acquisition of a distressed business by a competitor where significant competition issues may arise. The three elements of the failing firm defence are as follows (there may be variations between jurisdictions):

- The failing firm would exit the market if the transaction did not take place;
- There is no less anti-competitive alternative purchaser;
- The loss of the firm and its assets would not have a less anti-competitive effect than the transaction.

The basic requirement for the failing firm defence is that the harm to competition following the transaction cannot be said to be caused by the transaction. This arises where the harm to the competitive structure of the market would be at least to the same extent if the transaction had not taken place.

1 Article 7(3), Regulation 139/2004/EC

Previous cases have shown that the Commission or national competition authority consider the following points as evidence supporting that the failing firm grounds are met:

- Financial status of the company, eg administrators or liquidators appointed.
- Audit reports which show cash flow difficulties.
- Inability to raise capital and secure credit, and frequent breaches of banking covenants.
- Lack of new customer orders and obsolete stock.
- The failing company made good faith effort in eliciting offers from other competitors other than the proposed acquirer, eg information memoranda distributed to competitors and advice from accountants.
- The market being worse if the company was allowed to fail, eg customers with outstanding orders that would lose their deposits.
- Internal correspondence and documents, prior to merger negotiations, which show that the prospect of re-organising the company has been realistically considered and dismissed.

It is important for parties planning a transaction, and considering use of the failing firm defence, that relevant documents and correspondence should be filed safely and not discarded. Negotiations with other potential acquirers should be well recorded. Notifying parties should be aware that parties will rely heavily on evidence from third parties.

Comment

The requirements for the derogation from obtaining prior clearance (in jurisdictions where prior clearance is required and the derogation is available) and the failing firm defence are onerous to satisfy and there is no indication that competition authorities will loosen the requirements in the Covid-19 crisis. But prevailing economic conditions may mean that it is easier to demonstrate that exit is inevitable or that there are no realistic alternative purchasers. To avoid the risk of infringing merger control rules and potentially incurring penalties for gun jumping, legal advice should be sought as soon as possible.

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