Merger Control

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COVID-19: Avoiding the failure of the failing firm defence

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Introduction

Agencies reviewing mergers recognise that, in some circumstances, a merger between competitors that would otherwise give rise to competitive harm should not be blocked, because one of the parties would, in the absence of the merger, have exited the market in any event. In these circumstances, the merger may not cause harm (or additional harm) to customers. The tests for establishing the so-called "failing or exiting firm scenario or defence" are, understandably, stringent, as we explain below.

There may also be variants of this scenario where, short of exiting the market, the competitiveness of one of the merging parties is likely to reduce as it will scale back its activities or otherwise be a less effective competitor in the absence of the merger. This might be referred to as a "flailing firm defence".

At first sight, the exiting firm scenario should be of widespread relevance as we head beyond the COVID-19 healthcare crisis into an economic crisis, given the disruption to many consumer-facing businesses (and the businesses that supply them), and the impact of continued social-distancing measures that are likely to be in place once lockdown measures are removed. Indeed, *Amazon/Deliveroo* has been provisionally cleared by the Competition and Markets Authority (CMA) based on Deliveroo becoming a failing firm due to COVID-19.

However, a closer review of *Amazon/Deliveroo* does not provide any specific basis for optimism that the bar for the failing firm defence has been lowered. However, several third parties have criticised the CMA's provisional findings, including observing that the CMA did not market test more widely as to whether alternative funding would have been available (as opposed to asking those who participated in the last funding round) and questioning whether the position of Deliveroo was so perilous given that overall demand for takeaways had apparently recovered.

This view that the bar for the failing firm defence has not been lowered is also supported by the public statements of the CMA and European Commission. On 22 April 2020, the CMA published a "refresher" of its position on mergers involving failing firms (the CMA's Refreshed Guidance),[1] which emphasises that the conditions for the failing firm scenario are "stringent" and few cases have met these criteria. The CMA's Refreshed Guidance explicitly states that:

> "The Coronavirus (COVID-19) pandemic has not brought about any relaxation of the standards by which mergers are assessed or the CMA's investigational standards."

Similarly, on 24 April 2020, Mlex reported that that EU Commissioner Margrethe Vestager said that there was no need to relax the normal rules on the failing firm scenario, even in these "uncertain times".

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This chapter considers issues raised by the exiting firm scenario by addressing three key questions:

- the exiting firm – seller and buyer beware? This section emphasises why the parties to mergers should be mindful that merger control applies in a wide range of scenarios, including to partial acquisitions and the acquisition of assets. Consequently, purchasers should take care before agreeing to purchase stakes in exiting firms or their assets;
- why is the exiting firm scenario typically rejected?; and
- what factual evidence is required to satisfy the exiting firm test? This section provides an overview of the restructuring process and considers what evidence is required from a turnaround and restructuring perspective to demonstrate that, regardless of the merger, the firm and its assets would inevitably exit, and there are no alternative, less anti-competitive purchasers of the otherwise failing target business or assets.

The exiting firm scenario – seller and buyer beware?

Both buyers and sellers should be highly cautious about relying on the exiting firm defence, for several reasons.

First, and perhaps most importantly, the exiting firm scenario usually fails. The exiting firm scenario has rarely been argued before the European Commission, and even when the defence (or variants of) have been argued, they are rarely accepted. The last notable case where the European Commission accepted the exiting firm defence was *Aegean/Olympic II* (2013), although the Commission has accepted variants of this defence in *Nynas/Shell* (2013) (which was cleared on the basis of a combination of a variant of the exiting firm defence and merger efficiencies)[2] and *T-Mobile/Tele 2* (2018) (which was cleared on the basis that the merger was unlikely to lead to significant price increases, particularly given Tele2's market share was small and its competitiveness was declining).

A similar position applies in the UK, albeit the exiting firm scenario has been considered more frequently. As noted in last year's chapter, the Office of Fair Trading/CMA considered the exiting firm scenario in 73 Phase 1 cases between 1 April 2010 and 31 March 2019, but accepted this scenario in only seven cases. Rolling forward to decisions published as at 10 June 2020, there is only one more Phase 1 case that considered the exiting firm scenario (*Danspin/LY Realisations* (2019), where the scenario was rejected) and *Amazon/Deliveroo* is the only additional case in which the exiting firm scenario has been (provisionally) accepted at Phase 2.

Second, both EC and UK merger control apply to the acquisition of partial shareholdings, albeit the standard for UK merger control is whether "material influence" is acquired, which is a substantially lower standard than the EU standard of "decisive influence".

In this regard, the CMA found that Amazon would have material influence over Deliveroo by virtue of it having a minority shareholding (which would not allow it to block a special resolution), limited minority investor protection rights (there was no suggestion that any of these rights would confer decisive influence, such as by giving veto rights over the appointment of senior management or the determination of the budget or business plan), and to appoint only one board director (and in circumstances where there were other knowledgeable directors). This is a low threshold to find material influence. (In its reply to the provisional findings, Amazon cited other cases where a similar fact pattern was viewed as being insufficient to confer material influence.)

In addition, assets and even non-trading assets may be an "enterprise" under UK merger control. Perhaps the best example of this is the 2013 Phase 2 decision of the Competition

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Commission to prohibit the acquisition by Eurotunnel of certain assets from SeaFrance, seven months after SeaFrance had gone into liquidation and ceased trading in November 2011. This decision was subject to extensive litigation right up to the Supreme Court, which in 2015 upheld the CMA's 2014 remitted decision.

Third, the buyer often has limited visibility on how good the defence is by reference to the target firm's internal documents, including, in particular, the magnitude of its losses, its ability to fund those losses, its efforts to restructure itself or to sell itself to alternative purchasers. Indeed, prior to a binding offer being made, the seller often has no commercial interest in signalling that the target business is failing, or that there are no alternative purchasers who would be less anti-competitive, since this is likely to depress the purchase price. This evidence may need to be particularly compelling to secure a clearance at Phase 1 given the difference in legal standards between Phase 1 and 2.

Fourth, there may also be a failing firm "offence" where the acquirer does not acquire the totality of a business, but instead part of a business or its assets and the remainder of the business exits the market. In this situation, the CMA may be concerned if the exit of the remainder of the business is attributable to part of the business or its assets being sold. In this situation, the CMA may wish to assess whether the counterfactual to the merger is the whole business continuing to compete independently, or another purchaser acquiring all of the business or its assets.

This issue arose in *Medtronic/Animas* (2018). In that case, Medtronic acquired customer lists and patient records and some limited assets, and there was consequently some debate as to whether this amounted to the acquisition of an enterprise (the CMA concluded that it did). However, the CMA noted that the transaction did not involve the transfer of any physical assets (e.g. insulin pumps or consumables), fixed assets (e.g. manufacturing facilities), intellectual property, R&D assets and information, or employees.

The CMA accepted that Animas's parent (J&J) had internal documents that confirmed that formal approval had been granted to close the Animas business before Medtronic had been approached. As regards whether there was a less anti-competitive purchaser, the CMA also accepted that J&J had extensively marketed the Animas business and no purchaser had been found for the business as a going concern. This is important since otherwise, the CMA might have attributed Animas's exit to the merger, and its assessment of competitive effects would have been against this counterfactual.

Nevertheless, in the course of the CMA's investigation, other insulin pump suppliers had expressed an interest in the customer and patient records and limited assets that J&J had transferred to Medtronic, and this lesser disposal had not been market tested with alternative purchasers. Given its finding that the Animas business would neither have continued nor been sold, the CMA cleared the merger on the basis that there would be no adverse effects on the NHS or patient choice. This was because there would be no reduction in the number of suppliers, as Animas would have exited the market in any event, and the allocation of UK customers to Medtronic would not adversely affect competition for patients as the number of bidders and their competitive strength would be unaffected, and nor would the merger adversely affect Medtronic's ability and incentives to compete for patients on non-price grounds.[3]

Fifth, the CMA's Refreshed Guidance emphasises that there are real execution risks for both sellers and buyers associated with mergers involving failing firms if these otherwise raise competition issues. In particular, the Guidance highlights that in completed mergers, the CMA's initial enforcement orders require the acquirer to provide sufficient resources to the target to enable it to operate on the basis of its pre-merger business plan. This raises the real

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concern as to whether this amounts to an obligation on the purchaser to write a blank cheque, and to keep a failing or flailing firm on life support for the duration of a forced sale process.

Sixth, the CMA's Refreshed Guidance also states that an exiting firm scenario is unlikely to exist where the merger under review is a contributing factor to the target firm's exit. It does not cite any illustrative examples of why this might occur, but it is possible that other funding sources of similar or greater scale might have been available absent the merger, with the CMA investigating and provisionally ruling this out in *Amazon/Deliveroo*.

Similarly, the CMA's Refreshed Guidance states that it will typically look at whether there were alternative purchasers for the business around the time that the merger agreement was entered into, whereas post-merger interest in buying the target may have reduced.

The practical consequence of the above is that potential purchasers may be deterred from acquiring failing firms unless they can be highly confident that there are no material merger control risks. Such risks may not be straightforward to assess. For example, some observers considered that the competition concerns identified in *Amazon/Deliveroo* seemed speculative and insufficient to sustain an adverse finding at Phase 2. This is particularly the case as Amazon had previously exited the market, and Amazon's incentives to re-enter may not be substantially changed by virtue of it having a minority stake in a firm with only a 20–30% share, and where that business would face a much larger competitor with a 50–60% share (Just Eat). Nonetheless, various competitors have complained about the CMA's provisional clearance decision, including Just Eat, as have various restaurant groups, particularly having regard to the various competitive advantages that Amazon enjoys as an e-commerce platform (including its large installed base of customers).

The CMA clearly intends its Refreshed Guidance to have such a deterrent effect. This will deter anti-competitive mergers, but also ones that preserve jobs and output and which thus may be pro-competitive. An alternative purchaser that is not active in the market, and one which thus places a much lower value on the business as it cannot achieve material cost synergies, may have a business plan that involves the acquired business being run down and its assets being sold off for use in unrelated markets. In addition, in some cases, a merger with an exiting firm may enable both of the merging parties to lower costs and increase output, as was the case in *Imerys/Goonveen* (2013), where the Competition Commission found that the merger would lead to relevant customer benefits.

In addition to this deterrent effect, a CMA reference decision may trigger market exit, which has been the case as regards two of its reference decisions since 1 January 2017. In *Capita/Vodafone* (2017), as discussed in last year's chapter, Vodafone told the CMA that it was planning to exit its pager business in the near future. This was despite positive cashflows, mainly due to obsolete technology that would require upgrading, declining customers and Vodafone changing its strategy to focus on next generation products. Vodafone also observed that there was no country in Europe with more than one pager service. The CMA disagreed and referred the merger for a detailed Phase 2 investigation, with the merger seen as creating a monopoly. Following the reference decision, Vodafone then announced its decision to close the business entirely, with this occurring a few months later in March 2018.

A similar outcome occurred in *Mole Valley/Countrywide* (2018), where the CMA's Phase 1 decision found that the merger would lead to a substantial lessening of competition as regards 45 out of Countrywide's 48 stores.[4] The CMA rejected the exiting firm scenario as it considered that the available evidence was mixed as to whether Countrywide would inevitably exit the market, and the CMA considered that there were alternative, less anti-competitive purchasers.[5] However, two weeks after the CMA's decision, Countrywide

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collapsed into administration, and ultimately only 14 of its stores were sold and eight of these were sold to Wynnstay, one of the main competitors identified by the CMA.[6] The CMA also concluded that, even if Countrywide exited, the resulting dispersal of its sales to competitors would have been a more competitive outcome than Mole Valley acquiring all its sales.[7] This latter point is considered in the section below.

Why is the exiting firm defence typically rejected?

The CMA's Refreshed Guidance sets out a three-limb framework for assessing the exiting firm scenario:

- Limb 1: whether the firm would have exited (through failure or otherwise)[8] absent the transaction;
- Limb 2: whether there would have been an alternative (i.e. less anti-competitive) purchaser for the firm or its assets; and
- Limb 3: what the impact of exit would be on competition compared to the competitive outcome that would arise from the acquisition.

Limb 3 is not one of the criteria identified by the European Commission's Horizontal Merger Guidelines for the failing firm defence to apply.

Limb 3 has been restated by the CMA from the wording in the Merger Assessment Guidelines, which the CMA describes as giving "undue emphasis" to the redistribution of sales from the exiting firm for the purposes of competitive assessment.

In some markets, in the event of exit, the bulk of the sales from the exiting firm would likely transfer to the other merging party if it is the market leader pre-merger. Accordingly, in this situation, market structure post-merger may be very similar to market structure absent the merger. However, where strictly applied, this requirement could yield the somewhat perverse result that the acquisition by the largest player in a concentrated market is more likely to satisfy Limb 3 than a smaller player in a fragmented market (where sales can be expected to disperse more widely). It is difficult to see how the former outcome is better for competition than the latter.

In this regard, it is welcome that the CMA acknowledges that it has applied Limb 3 more flexibly in practice and it will consider the impact that the exiting firm would have on competition within the markets at issue, compared to the competitive outcome that would arise from the acquisition.

In our view, if the requirements of Limbs 1 and 2 are met, Limb 3 should only rule out the exiting firm scenario in exceptional circumstances. In markets where there are multiple competitors, the exiting firm's market share would often be dispersed among multiple firms. However, there is still no general reason for believing that exit would be a more competitive outcome, particularly as the reduction in the number of competitors would not be a consequence of the merger. Moreover, if the merger would preserve the exiting firm's output and capacity in the market, then this might be expected to limit the price increases that might otherwise occur and be valued by its existing customers.

Competitors complaining about mergers involving the exiting firm defence should consider carefully how their concerns translate into consumer harm and why exit is more competitive than the merger, particularly as the number of competitors would fall in any event.

If the exiting scenario otherwise applies (i.e. Limbs 1 and 2 are met), the main difference between the merger proceeding and market exit is that if the merger proceeds, more of the exiting firm's sales would be retained by the acquiring firm; whereas in its absence, more of

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these sales would be dispersed to other rivals. (The precise pattern of the redistribution of the exiting firm's sales with or without the merger is, of course, a factual question.) As noted above, if it were to be the case that other rivals have a small combined market share, then market structure would be very similar with and without the merger, such that a substantial lessening of competition under Limb 3 can be dismissed.

However, where the acquiring firm would not be the market leader post-merger, more of the exiting firm's market share might be dispersed to competitors, and the impact of this on market concentration may depend on pre-merger market shares. One possibility is that the acquiring firm faces a larger rival (or rivals), who would increase their market share in the absence of the merger. In this situation, it seems unlikely that this would be a more competitive outcome than allowing the merger to proceed as, in the absence of the merger, market concentration would be higher than if the merger proceeds.

The second possibility is that the merged business would continue to face competition from one or more non-*de minimis* rivals, and the dispersal of the exiting firm's market share might lead to market concentration falling. However, in this scenario, it is still difficult to see how the greater dispersal of some of the exiting firm's market share to these rivals would lead to a more competitive outcome. This is particularly the case in markets where competition predominantly depends on the number of effective competitors, rather than their precise market shares, since the number of rivals would fall regardless of whether the merger proceeds.

If smaller competitors would have a higher market share in the absence of the merger, it is theoretically possible that they might pose a greater competitive constraint on the remaining rivals, including the acquirer. However, this would depend on this higher market share leading to them having appreciably lower incremental supply costs *and* them having an incentive to pass these lower costs onto their customers – and in a market environment where a sizeable rival has exited the market. Such arguments would generally seem speculative.

Finally, if the exit of the firm would otherwise prompt entry and expansion by new and smaller rivals, then one would need to explain why this would not occur in any event if market prices were to rise above the competitive level. (If barriers to entry and expansion are low, then the merger should not lead to a substantial lessening of competition in any event.) Accordingly, in our view, only in exceptional circumstances should Limb 3 alone justify the prohibition of a merger involving an exiting firm.

As a consequence of these and related considerations, there are several Phase 2 cases where the CMA has accepted the exiting firm scenario, even where in the absence of the merger the exiting firm's market share would have been dispersed amongst multiple players. Phase 2 cases where this is the case include *Amazon/Deliveroo* (2020) (provisionally), *Euro Car Parts/Andrew Page* (2017), and *Alliance Medical/IBA Molecular* (2014).

Turning more specifically to why the exiting firm scenario typically fails, it is instructive to consider the 11 Phase 1 cases since 1 January 2017 where the CMA has considered this scenario,[9] with the exiting firm issue only arising at Phase 2 (due to COVID-19) in *Amazon/Deliveroo*. Rather than seeking to draw overall conclusions on the relative importance of Limbs 1, 2 and 3 across these cases, it is perhaps most helpful to summarise these cases, not least as the CMA can reject the exiting scenario on the basis of one Limb without concluding on the others.

These cases can be summarised as follows:

- *East Coast Buses/First Scotland East* (2017). This was a successful exiting firm defence.[10]

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- *Capita/Vodafone* (2017). The CMA was not satisfied that Limb 1 was met, with this case being discussed above.[11]
- *Steven Eagell/Toyota Dealerships* (2017). The CMA briefly observed that the parties could neither provide any evidence that the LMC dealerships would have exited the market (i.e. Limb 1 was not met), nor that there were any less anti-competitive purchasers (i.e. Limb 2 was not met either).[12] This merger was nevertheless cleared unconditionally.
- *Euro Car Parts (ECP)/Andrew Page (AP)* (2017). At Phase 1, the CMA accepted that Limb 1 was met (ECP purchased AP out of administration and the CMA accepted that absent a sale of AP, it would have become insolvent and ceased operating). At Phase 1, the CMA also accepted that there were no other bidders for the whole of the business, but there were overlapping bids from two other rivals for some parts of the business, which served both local customers and national accounts, such that Limb 2 was not satisfied in many areas and as regards national accounts. The CMA also concluded that Limb 3 was not satisfied at Phase 1 as regards the 47 sites where there was no third-party bidder, because the dispersal of market shares would have allowed other competitors to compete more effectively with ECP.[13] At Phase 2, the CMA reached the opposite conclusion as regards Limb 3 for these 47 sites where the counterfactual was the exit of the AP depot. This is because competition would not be greater in the absence of the merger as it mainly depended on the number of local rivals (which would fall in any event), and the merger would not affect ECP's or third-party suppliers' ability to compete in local areas, including bearing in mind that it would not have any material impact on ECP's or rival suppliers' operational costs. As regards national accounts, the CMA concluded that: (i) the redistribution of the sales of the AP depots where there was no competing bid would not have enabled other suppliers to compete more effectively; and (ii) as regards ECP's largest other rivals who had also bid for other depots, any resulting efficiencies that might otherwise have been realised were either not sufficiently material, or not sufficiently likely to be passed on to consumers, to increase significantly the constraints that ECP faced.[14] As a result, the extent of the CMA's adverse finding at Phase 2 was substantially reduced to only nine local areas and there was no adverse finding as regards national accounts.
- *Mole Valley/Countrywide* (2018). As discussed above, the CMA was not satisfied that any of Limbs 1, 2 or 3 would be met. The CMA's decision suggests that it considered that the most likely outcome would have been the sale of Countrywide business to other firms, and there were apparently offers for the whole of this business at above liquidation value (such that Limb 2 would not be met). However, in practice, the CMA's reference decision led to the bulk of Countrywide's business exiting the market. The CMA explicitly found that Limb 3 would not be met as Countrywide had submitted that the majority of the sales would have been lost to other competitors rather than to Mole Valley. The CMA's rejection of Limb 3 seems harsh for the reasons given above, particularly as the CMA's theory of harm was based on a reduction in the number of local competitors and, if the Countrywide business had exited the market, a fall in the number of competitors was inevitable. The CMA did not otherwise consider whether exit would have been a more competitive outcome.[15]
- *Medtronic/Animas* (2018). As noted above, the CMA accepted that Limb 1 was met. As regards Limb 2, the CMA accepted that J&J had extensively marketed the Animas business and no purchaser had been found for the business as a going concern, but that other less anti-competitive purchasers would have existed as regards the customer and patient records and limited assets that were transferred. This meant that the CMA's

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competitive effects assessment focused solely on the records and limited assets that Medtronic acquired. This led to the merger being cleared unconditionally.[16]

- *Gardner Aerospace/Northern Aerospace* (2018). Northern argued that if the merger did not proceed it would face "severe harm", but all detail as to why was redacted. The CMA simply concluded that it had insufficient evidence that the requirements of the exiting firm scenario had been met.[17] This merger was cleared unconditionally.
- *Post Office/Payzone* (2018). The CMA was not satisfied that Limb 1 was met, but it did accept that Payzone did not currently exercise a strong constraint and that this constraint would be likely to reduce further in the absence of the merger.[18] This merger was cleared unconditionally.
- *Aer Lingus/CityJet* (2018). This was a successful exiting firm scenario.[19]
- *Baxter/Hospira* (2018). The CMA did not formally conclude on the exiting firm scenario as it cleared the merger in any event, but another bidder had offered a sum that had a negative number at the lower end of the range and another needed more time and thus it was not clear if Limb 2 would be met.[20]
- *Danspin/LY Realisations* (2019). In this case, the CMA rejected the exiting firm scenario under Limb 2 as the sales process for the target business had revealed that there was at least one other prospective purchaser willing to pay more than the liquidation value, and that purchaser told the CMA that it was in a position to secure the necessary financing and promptly complete.[21] Danspin subsequently gave undertakings *in lieu* of reference to divest to Breal Capital.

A turnaround and restructuring perspective on why businesses exit or reduce their presence in markets

<u>Introduction</u>

This section considers the factual evidence necessary to advance a compelling case that the exiting firm scenario applies, focusing on Limb 1 (i.e. the inevitability of exit) and Limb 2 (i.e. whether there is a less anti-competitive purchaser of the target firm or its assets). This will inevitably require extensive information on the exiting firm, as emphasised by the CMA's Refreshed Guidance, including its profitability over time, cash flows and balance sheet, actions taken by management to preserve viability, and a review of contemporaneous internal documents as well as reports by external advisors and the firm's auditors. The CMA Guidance also indicates that it may also require evidence from shareholders and finance providers.

In this regard, it is important to understand the turnaround and restructuring process, and thus to consider where potentially exiting firms may be in that process, how their prospects can be assessed, and what proactive steps may be taken to improve their prospects or to sell all or parts of the business. These are the core tasks of turnaround and structuring specialists, with this being one of AlixPartners' core businesses.

<u>Why do businesses exit markets?</u>

There are multiple, non-financial reasons why businesses might end up exiting markets or reducing their market presence, particularly when the target business is part of a larger group. Outside of stress/distress, these may include:

- Capital allocation considerations, including whether the wider business makes superior returns in other activities or to meet the capital needs of other, priority businesses.
- Strategic repositioning, including disposing of non-core businesses, so that management focus is improved on core businesses.
- Market evolution, such as where the future prospects of a business may be poor or risky.

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Where a business is part of a larger, profitable group, it is possible that a parent company would be able to continue to provide financial support, and the CMA's Refreshed Guidance makes this point.[22] However, this does not mean that the parent company would choose to do so in perpetuity.

As noted above, the CMA rejected Vodafone's arguments that it made a strategic decision to exit in *Capita/Vodafone* (2018), but Vodafone then exited following the CMA's reference decision. However, the CMA has accepted that a strategic decision to exit has been taken in other cases, including by CityJet in *Aer Lingus/CityJet* (2018). The CMA considered that CityJet's route level losses would not have led to exit, and noted that this was not argued by CityJet. Instead, the CMA accepted that CityJet's contemporaneous internal documents showed that it would exit its scheduled operations by the end of 2018, including on the London City-Dublin route that was the focus of the transaction, and that it would have used the aircraft/crew on other routes absent the merger. The CMA found that this strategic exit decision reflected CityJet's decision to focus on its wet lease business, and this was its last scheduled route.[23]

The key difficulty – and one highlighted by *Capita/Vodafone* – is proving that a strategic exit decision has been made pre-merger. Often contemporaneous pre-merger internal documents may not be written in sufficiently unambiguous terms for the CMA's purposes, and exit decisions may also be taken at a similar time to when mergers are being contemplated (thus raising questions as to whether exit decisions are linked to the merger).

Where strategic reasons are a key driver of the exit decision, rather than financial underperformance, it will also be particularly important to evidence that there is no less anti-competitive purchaser.

The remainder of this section focuses on companies in stress or distress, and whether such distress is likely to result in steps being taken to restructure the business. Triggers of restructuring situations include:

- Financial covenant breach or other events of default in funding agreements, such that the banks may demand repayment of funding.
- Audit sign-off and challenges in persuading the auditor that the business can continue to trade as a "going concern".
- Short-term funding requirements, and an inability to secure additional funding to cover losses.
- Restriction of trade due to regulatory changes or other similar events that reduce revenues or increase costs.

The most common cause of a business ending up in a restructuring situation is a serious profit decline, which can be caused by several factors. This often leads them to a situation where they have insufficient cash to meet their liabilities when they become due, or to fund the necessary investment in the business. In this regard, it is common to consider whether a firm's earnings before interest, tax, depreciation and amortisation (EBITDA, a common proxy for free cash flows before financing costs) are sufficient to fund necessary capital expenditure and debt financing costs.

Businesses may also fail when fixed assets come up for renewal if investors do not consider that they will make sufficient profits to justify further investment. On the other hand, firms may retain loss-making divisions where this enables them to avoid substantial restructuring costs (at least until capital expenditures are required) or where they are otherwise of strategic importance. Assessing the profitability of divisions of larger companies may also require careful analysis of cost allocations.

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The extent of any restructuring will be impacted by whether underperformance is temporary or likely to continue. This requires a consideration of the reasons for underperformance and the scale of the funding shortfall, as discussed further below.

The latter consideration is particularly challenging in the current economic environment, where the medium-term economic outlook, both for many businesses and the country as a whole, is both negative and highly uncertain due to the impact of the COVID-19 pandemic and the government measures put in place to address it, such as social distancing. The next sub-section provides an overview of the restructuring process.

Overview of the restructuring process

As a result of a covenant breach and/or event of default, a lender usually has the opportunity to revisit the risk/return assessment of its exposure to the business. This often takes the form of an assessment of the business and its outlook, such as an Independent Business Review (IBR). Such reviews can also be undertaken by management or its shareholders if they consider that the business requires restructuring, even if there is no covenant breach or default (for example, they may anticipate one).

As part of this process, a restructuring advisor is often engaged to review the business and its financial outlook. Key outputs of such a review include:

- A current view on the expected short- to medium-term outlook for the business (pre-restructuring) (A).
- An assessment of how a sustainable business would look, both from a profit and loss (P&L), cash flow and balance sheet perspective (B).
- Actions required to get from A to B, including measures to improve operational efficiency and the necessary funding requirements.

As profit underperformance is often the key driver of a restructuring situation, steps to operationally restructure the business (i.e. improve the P&L) are usually required, which may include:

- Exiting markets/products/geographies (e.g. ceasing sales to unprofitable customers).
- Scaling back of operational footprint (e.g. closing stores, depots, etc.).
- Cost-cutting (e.g. reduced marketing).
- Management changes.

Even if there is not an insolvency or sale of the business (discussed further below), operational restructuring steps, which lead to changes such as sales reductions (due to exiting markets, products, customers, geographies, etc.) and cost-cutting, may also reduce the competitiveness of firms. Accordingly, this may be highly relevant to competition authorities' assessment of whether the competitiveness of a business is likely to decline.

Balance sheet changes may be required to ensure that the capital structure is appropriate for the size of the sustainable business, or because its lenders conclude that they need to reduce their risk/exposure (i.e. reduced debt levels and/or different debt structure). A business that is failing due to high debt levels may be viable – potentially with or without insolvency – but would require changes to the size/terms/owners of the equity and debt of the company.

The funding requirement for getting from A to B may include:

- Short-term funding to pay liabilities and, thus, continue trading.
- Medium-term working capital funding.
- Restructuring costs, including costs to implement operational changes.
- Balance sheet right-sizing (e.g. debt reduction/write-off).

A critical factor is whether and how restructuring implementation costs can be funded and how risky the restructuring appears to be (see below for further consideration of this point).

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Implementing a restructuring

At a high level, implementation costs could be funded by equity holders, debt providers (e.g. banks) or from the free cash flows of the business (albeit that the latter is generally unlikely given the business is restructuring). The extent to which the equity and/or debt holders are willing to do so will be driven by a wide range of factors, including views on risk and the potential return from any new funding.

If these existing stakeholders are not willing to fund the restructuring, it may be necessary to put the business up for sale. If the business is distressed, potentially with cash flow challenges (which is common in such situations), this may require an accelerated M&A process (AMA) to find a purchaser for the business (or its assets) in a truncated timeframe.

Key considerations for potential acquirers as part of this process will include:
1. How big the funding shortfall is (i.e. how much is required).
2. What the sustainable business (B) is and how much it is worth.
3. Restructuring implementation risk.

In distressed situations (particularly in declining industries), 1. may be too high when viewed alongside 2. and 3. (i.e. no one wants to bear the costs or the risk of the restructuring), which means that a buyer for the whole business is not forthcoming.

In the event that there is no buyer for the whole business, there is a real risk that this would lead to insolvency. Appointing an insolvency practitioner allows the sale of parts of the business, rather than the acquirer needing to take on all its liabilities and therefore the cost of making it sustainable. The negative impact of insolvency on the operations can be mitigated by using a prepackaged sales process, which allows the insolvency and sale of the business to be executed simultaneously. An insolvency process may allow significant changes to be made to the operations of the business without the associated costs, such as exiting leases and making staff redundant.

When developing a failing firm argument, one needs to also consider the potential buyers for the business (or its assets) as this will affect Limb 2. An assessment of how the hypothetical, next most-attractive buyer might run the business merger may also be important as this may demonstrate that the business would have been a reduced competitor but for the merger.

In assessing whether there are alternative less anti-competitive purchasers, the CMA's Refreshed Guidance indicates that such purchasers only need to be willing to pay more than the business's assets liquidation value, namely the value of the underlying assets if they were to be sold for use outside the relevant market. However, in some cases the underlying assets may be valuable in other uses, such that the liquidation value may be material. For example, in *East Coast Buses/First Scotland East* (2017), the CMA found that internal documents showed that, before any sale prospect of a sale to East Coast Buses, First Scotland East had planned to close the target business, and it had taken active steps to close and progress the sale of the bus depots used to a property developer.[24]

The CMA's Refreshed Guidance emphasises that it will consider the marketing process by which an exiting business was put up for sale, including whether other realistic purchasers had a sufficient opportunity to submit a bid.

Somewhat surprisingly, the CMA adds that the absence of bids may *not* support the conclusion that there are no alternative purchasers for the firm or its assets. This later statement should not be misconstrued as the absence of other bids would normally be compelling evidence. For example, as noted above, in *Medtronic/Animas* (2018), the CMA's clearance decision emphasised that J&J had extensively marketed the Animas business and no purchaser had been found for the business as a going concern.

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Indeed, in some distressed situations, firms may not market the exiting business, because either they consider it pointless or simply want to avoid adverse publicity. The fact that an exiting business has not been actively marketed may not preclude the CMA from concluding that there would not be a less anti-competitive purchaser.

Indeed, in two cases since 2017, the CMA has accepted the exiting firm scenario even where there was no formal marketing of the exiting business. In *East Coast Buses/First Scotland East* (2017), the CMA concluded that, although there was no formal marketing of the business, the proposed closure was actively publicised, such that any less anti-competitive purchasers could have emerged. One other bus operator had made an offer, but this was well below the liquidation value of the acquired assets. The CMA also noted that another operator had indicated it was not aware of the possibility of buying the business or its assets and it might have made a partial offer, but the CMA concluded that there was not a realistic prospect of such an offer being above liquidation value.[25]

Similarly, in *Aer Lingus/CityJet* (2018), CityJet indicated that it did not market the London City-Dublin route to other airlines as it considered that only Aer Lingus would have had the requisite capabilities or strategic interest to acquire the route. The CMA then contacted a range of airlines, and none expressed any credible interest in acquiring the route and airlines would have limited incentives to invest in a single route, and thus it accepted that there was no less anti-competitive purchaser.[26]

There may also be non-trade purchasers which might be interested in acquiring the business or assets of the exiting firm. In distressed situations, firms are often reliant on specialist distressed investors who will seek to buy businesses/assets at depressed prices. Such investors are likely to implement cost-cutting/scaling back of operations. Alternatively, if possible, they may seek to "cherry-pick" assets (and, at the buyer's discretion, certain liabilities) if the acquisition is made out of insolvency. Depending on the business and the industry, either scenario may lead to a reduction in the competitive presence of the business.

Even absent a sale of the business, distress and the threat of insolvency is usually toxic for a business, impacting suppliers, customers, management, etc. All of the above would need to be considered and evidenced based on contemporaneous documentation in order to present a counterfactual which shows that the failing firm Limbs are met, with the scope of such documentation that may be available being considered at the end of this section.

Restructuring with COVID-19

Aside from the general economic challenges caused by the pandemic and the government measures put in place to address it, the current environment makes completing a restructuring particularly challenging.

As outlined above, understanding the current position and outlook for the business, and the changes required to make it sustainable, are critical inputs into any restructuring situation. The short- to medium-term economic outlook, both on a macroeconomic basis and for individual industries/companies, remains highly uncertain and will be impacted by multiple factors, including:

- The speed and shape of the exit from lockdowns.
- Any economic recession and the impact on overall demand.
- Ongoing social distancing measures, which will impact consumer habits, such as the extent to which consumers purchase from online retailers rather than physical stores.
- Broader structural economic changes in the relevant industry.
- The extent and success of government support measures for businesses, including emergency loans.

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As such, restructurings currently need to be implemented with an unprecedented degree of uncertainty as to what a sustainable business will look like in the medium term. In addition, the dynamics of restructurings are hard to predict due to, amongst other factors, changes to insolvency and restructuring legislation, including directors' duties, and the pressure on banks to give forbearance to businesses impacted by the pandemic. Given the state of flux and high degree of uncertainty, in many cases the tough decisions on restructuring are being postponed until there is further clarity.

However, firms running out of cash to fund losses may not have this luxury, and prudent management teams (and their auditors as part of going concern assessments) should be running sensitivity testing and scenario planning analysis to assess viability in the year ahead. Indeed, current challenging economic conditions are seeing businesses scale back operations, both in insolvency situations and outside of insolvency.[27, 28]

Pre-merger evidence

When looking to evidence an exiting firm counterfactual, the CMA's practice is to attach considerable weight to contemporaneous, internal and external documents. Relevant documents include:

- Management documentation (e.g. presentations, minutes, emails) highlighting stress/distress and any mitigation strategies.
- Management documentation discussing strategic options or M&A, including any assessments of potential buyers of the business.
- Adviser reports.
- Audit discussions, including sensitivity analysis and going concern considerations.
- Correspondence/meetings with lenders.
- Finance function documents, including budgets and presentations.

It may be that advisors to lenders of the business had previously produced a review similar to an IBR during the relevant period. This would potentially contain key evidence to support an assessment of the counterfactual absent the merger.

Coupled with the above, contemporaneous source data can be used to produce a hypothetical counterfactual IBR to show the likely outcomes absent the merger.

Conclusions

The economic crisis that is arising due to COVID-19 is likely to lead to many firms and their advisers considering mergers as a means of safeguarding their survival. Given the scale of the state aid being granted globally to failing firms due to COVID-19, policymakers may consider whether mergers might provide some less costly "self-help".

However, the CMA and European Commission have indicated that they are not planning to lower the bar for the exiting firm defence, and the main precedent from past cases is that such defences usually fail.

The CMA's Refreshed Guidance also emphasises that there are substantive merger control risks for both buyers and sellers associated with exiting firms. This is likely to deter both anti-competitive mergers, and also mergers that involve genuinely failing firms. It is also clear that CMA reference decisions may trigger market exit, as was the case in *Capita/Vodafone* (2017) and *Mole Valley/Countrywide* (2018).

Nevertheless, in our view, the main reason that the exiting firm defence fails is that the competition authorities lack compelling evidence, and this is where turnaround and restructuring expertise may be particularly important along with detailed knowledge of the

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relevant markets. It is also welcome that the CMA's Refreshed Guidance has restated Limb 3 to focus on whether exit is less anti-competitive than allowing the merger to proceed. In our view, Limb 3 alone should only justify a merger being prohibited in exceptional circumstances.

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Endnotes

1. Available at https://www.gov.uk/government/publications/merger-assessments-during-the-coronavirus-covid-19-pandemic/annex-a-summary-of-cmas-position-on-mergers-involving-failing-firms.
2. These cases and a UK Phase 2 (*Imery/Goonvean* (2013), which was cleared subject to limited price controls on the basis of the failing firm defence and merger efficiencies) are discussed in some detail in "The Quest for the Higgs Boson? Failing Firm and Efficiency Defences in EU and UK Merger Control", *ICLG – Merger Control 2015*, by Pablo Florian and Mat Hughes.
3. *Medtronic/Animas* (2018), paragraphs 45–81 and 97–111.
4. *Mole Valley/Countrywide* (2018), Annex 6.
5. *Mole Valley/Countrywide* (2018), paragraph 15.
6. *Mole Valley/Countrywide* (2018), paragraph 102(a). Insider Media Limited reported on 7 March 2018 that administrators were appointed, and on 13 March 2020 that 14 of Countrywide's 48 stores were sold. *WalesOnline* reported on 30 April 2018 that Wynnstay had acquired eight of the stores sold.
7. *Mole Valley/Countrywide* (2018), paragraph 15.
8. The European Commission's Horizontal Merger Guidelines only refer to firms exiting due to "financial difficulties"; see paragraph 90.
9. These 11 cases omit *Tesco/Booker* (2017), where the CMA accepted that one store would close in any event (paragraph 39), with this being irrelevant to the overall merger assessment. However, this case does serve to illustrate that the exiting firm scenario may apply at the level of individual outlets.
10. *East Coast Buses/First Scotland East* (2017), paragraphs 6–8.
11. *Capita/Vodafone* (2017), paragraphs 24–33.
12. *Steven Eagell/Toyota Dealerships* (2017), paragraphs 16–17.
13. *Euro Car Parts/Andrew Page* (2017), Phase 1 decision at paragraphs 65–113.
14. *Euro Car Parts/Andrew Page* (2017), Phase 2 decision at paragraphs 23–28 and 43–45.
15. *Mole Valley/Countrywide* (2018), Annex 1.
16. *Gardner Aerospace/Northern Aerospace* (2018), paragraphs 23–25.
17. *Medtronic/Animas* (2018), paragraphs 45–81 and 97–111.
18. *Post Office/Payzone* (2018), paragraphs 21–23 and 97.
19. *Aer Lingus/CityJet* (2018), paragraphs 51–75.
20. *Baxter/Hospira* (2018), paragraphs 18–26.
21. *Danspin/LY Realisations* (2019), paragraphs 35–61.

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22. The CMA's Refreshed Guidance states that in previous cases it has not found Limb 1 to be met where the parent company would be able to provide financial support, albeit that it may accept that the business would have exited for strategic reasons.
23. *Aer Lingus/CityJet* (2018), paragraphs 56–62. The CMA also accepted that a strategic decision to exit has been made in *Chemring/Wallop* (2016), paragraphs 5–6.
24. *East Coast Buses/First Scotland East* (2017), paragraph 6(a).
25. *East Coast Buses/First Scotland East* (2017), paragraph 6(b).
26. *Aer Lingus/CityJet* (2018), paragraphs 63–73.
27. Available at https://www.bbc.co.uk/news/business-52899624.
28. Available at https://www.ft.com/content/159bfd38-6d44-4e88-9734-13ea254114d1.

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