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EU MERGER CONTROL AND THE ACQUISITION OF DISTRESSED BUSINESSES IN THE WAKE OF COVID-19

To Our Clients and Friends:

As a result of the current pandemic and the work-from-home restrictions throughout much of the world, the European Commission has adjusted how it deals with merger reviews. The Commission continues to process already filed merger notifications (notwithstanding difficulties in getting feedback from third parties for the purpose of market testing). By contrast, for mergers that have yet to be filed, the Commission encourages parties to *“delay [new] notifications, where possible”*. Nevertheless, the Commission has confirmed that it stands ready to deal with cases where the parties can show *“very compelling reasons”* to proceed with a merger notification without delay.

One type of case where *“very compelling reasons”* are likely to be present is the acquisition of financially distressed assets for which the injection of resources and strategic control by new owners is urgent. In such cases, the Commission is likely to accept notifications, particularly if the competition analysis is both straightforward and clearly explained.

There are two other issues that potential acquirors may also need to consider in such cases: (i) the suspension of the ‘standstill’ obligation; and (ii) the possible use of “failing firm” arguments. The legal grounds for both of these issues are explained in this Alert.

It is also worth noting comments from Margrethe Vestager, Vice President of the European Commission in charge of Competition Law, who recently warned an online panel at the American Bar Association Antitrust Virtual Spring Meeting that: *"[t]his crisis certainly shouldn't be a shield to allow mergers that would hurt consumers and hold back the recovery"*. While she acknowledged that the Commission has rarely accepted arguments about “failing firms”, she said that her staff would take such arguments into consideration, but that the long-standing test would remain the same. She added that: *“The failing firm defence is a very well-known concept. It is also important that some things are stable in these very uncertain times”*.

1) Derogation from the suspensory requirement

Despite the impact of the COVID-19 crisis on timelines and procedures, companies are still bound by the notification and standstill obligations laid down in the EU Merger Regulation (“**EUMR**”). Under these rules, and in the absence of a specific derogation from the Commission, firms cannot implement notifiable transactions prior to receiving clearance.

However, Article 7(3) EUMR provides that it is possible to obtain a derogation from the standstill obligation in exceptional cases where the negative effects of the suspension outweigh the threat to

competition posed by the transaction. For this to happen, two conditions must be satisfied: (i) the suspension of the transaction must give rise to a risk of serious damage to the parties or third parties; and (ii) the transaction must not raise *prima facie* competition concerns.

As regards the **first condition**, the financial distress of the target company is the most commonly cited reason for seeking a derogation. During the 2008 financial crisis, the Commission granted derogations for the acquisition by **Santander** of **Bradford & Bingley** and the acquisition of **Fortis** by **BNP Paribas**. The Commission's reasoning in these cases suggests that systemic risk threatening financial stability as a whole was a decisive factor in the assessment of the risks related to the suspension of the transaction (see Case No COMP/M.5384 – *BNP Paribas/Fortis*, Decision of 27.10.2018; Case No COMP/M.5363 *Santander/ Bradford & Bingley Assets*, Decision of 28.09.2008).

The **second condition** limits the application of the derogation to those transactions that do not pose a threat to competition, such as cases where there is a minimal overlap of the parties' activities.

Where these conditions are satisfied, the Commission may allow the parties to proceed with the transaction before authorisation is received, potentially subject to conditions and obligations. Generally speaking the derogation will only allow the transfer of the minimum amount of control that is required to avoid the risk of serious economic damage (such as the transfer of funds and limited management control).

2) The failing firm/division defence

In the context of transactions involving distressed targets, the failing firm defence ("**FFD**") is often raised but is rarely successful in practice. The **Horizontal Merger Guidelines** (at paragraph 89) explain that an otherwise problematic merger may nevertheless be authorised if one of the merging parties is a failing firm. The reasoning behind this important principle is that the deterioration of the competitive structure of the market that follows the merger is not caused by the transaction, but by the prevailing economic conditions affecting the target. In other words, the competitive structure of the market would deteriorate at least to the same extent in the absence of the merger.

There are three criteria which are relevant in the assessment of whether an FFD is likely to succeed: (i) the failing firm would in the near future be forced to exit the market due to financial difficulties if it is not taken over by another firm; (ii) there is no less anti-competitive alternative than the proposed merger; and (iii) in the absence of the proposed merger, the assets of the failing firm would inevitably exit the market. (See Joined Cases C-68/94 and C-30/95, *Kali and Salz*. See also Commission Decision 2002/365/EC in Case COMP/M.2314 - *BASF/Pantochim/Eurodiol*, at points 157-160). These conditions are cumulative.

The **first condition** requires sufficient evidence of the failing firm's financial difficulties. While it is not required that the target is subject to a formal bankruptcy procedure, the notifying parties must demonstrate that the target would be forced to exit the market within a short period of time. The argument must be supported with data and evidence, particularly on various counterfactual scenarios. Internal documentation showing denied access to finance or failed attempts at restructuring constitutes particularly relevant evidence.

In 2013, the Commission cleared Aegean Airlines' acquisition of Olympic Air, both Greek air carriers, after having previously blocked the same proposed transaction in 2011. The failing firm defence was invoked in both cases. In **Aegean/Olympic II,** the changed market conditions (prompted by the on-going economic crisis in Greece), the rapid decline in the target's competitiveness and financial situation, and the parent company's lack of ability and incentive to support Olympic, led the Commission to conclude that Olympic would soon exit the market in the absence of the transaction.

The **second condition** is fulfilled where it can be demonstrated that there are no credible alternative buyers for the target company, which would otherwise result in a more competitive outcome. In this regard, the Commission requires evidence of serious and credible efforts to seek alternative options. In **Aegean/Olympic II**, the Commission relied on past tender processes for the sale of Olympic and internal documents demonstrating the absence of alternative buyers.

The **third condition** requires the parties to demonstrate that, should the target company fail, its assets would inevitably exit the market absent the merger.

In **Aegean/Olympic II**, the Commission's market investigation showed that there were no operators interested in acquiring Olympic's assets in the event the firm would leave the market. Moreover, Olympic's market shares on the relevant air routes would, in any event, accrue to Aegean since the parties were already in a quasi-duopoly situation, and entry by a third operator was considered to be unlikely in the foreseeable future.

The standard of proof that the parties must meet for a successful FFD is thus very high and the Commission's economic analysis is necessarily complex. In fact, an FFD has only been accepted in three cases, namely: Cases C-68/94 and C-30/95, *Kali and Salz*; Case COMP/M.2314 - *BASF/Pantochim/Eurodiol*; and COMP/M.6796 – *Aegean/Olympic II*. Furthermore, the Commission has made it clear both in the context of the 2008 crisis and that of the present that it would continue to apply strict merger control standards in times of crisis. Thus, it is very unlikely that the Commission will lower its formal legal standards for the FFD in the context of the current pandemic.

However, even where an FFD argument is likely to fail, the decisional practice of the Commission suggests that clearance may nevertheless be available where the alternative counterfactual scenario clearly demonstrates that the exit of the target's assets from the market would be *more harmful to competition than allowing the transaction to go ahead*. This might occur, for example, where only part of a firm is threatened with closure.

Thus, in **BASF/Pantochim/Eurodiol**, the Commission did not require that the market share of the failing firm must in any event accrue to the other merging party. Instead, the Commission applied an overall economic assessment and compared the effects the clearance would have on the market structure compared with the effects of a prohibition. The Commission concluded that a clearance in such circumstances would have fewer anti-competitive effects than a prohibition, particularly because the exit of the assets from the market would have led to capacity bottlenecks, thereby increasing prices even more and therefore operating more strongly against customer interests.

In **Nynas/Shell/Harburg Refinery**, the Commission allowed Nynas to acquire Shell's refinery assets in Harburg, Germany, on the basis of the failing firm criteria despite the fact that the remainder of the firm was not financially challenged. It concluded that Shell would close the Harburg refinery, absent divestiture, and that the assets would in the near future be forced out of the market if not taken over by another undertaking, because of their poor financial performance and because of Shell's strategic focus on other activities. (Case No COMP/M.6360 - *Nynas/ Shell/ Harburg Refinery*, Decision of 02.09.2013). The application by the Commission in its Decision of reasoning which facilitated the purchase of a single refinery without an explicit reference to the reasoning underpinning the FFD suggests that the case would *not* have met the formal FFD standards, especially regarding the satisfaction of the first condition. In fact, Shell's decision to close the refinery was strategic in nature, because it could have chosen to maintain the business. By contrast, in **Aegean/Olympic II**, the parent company had neither the *incentive* nor *the ability* to continue to support Olympic.

In **NewsCorp/Telepiù**, the FFD was not accepted because the first and second criteria were not fulfilled. Notably, as regards the first condition, the Commission noted that the exit of the target from the market in the absence of the transaction was seen as a "*management decision to abandon a business activity whose development has not lived up to the expectations of the firm's managing boar*d". Even so, the Commission proceeded to employ a counterfactual analysis and concluded that the authorisation of the merger would be *more beneficial than the disruption* caused by a potential exit of the target from the market. (See Case No COMP/M.2876, *NewsCorp/Telepiù*, Decision of 02.04.2003).

Finally, in the **T-Mobile/Tele2 NL** and **KLM/Martinair** Decisions, the Commission cleared the mergers on the grounds that, in the absence of the mergers, the targets' future competitive positions would inevitably deteriorate, which would be more detrimental to effective competition overall. (See Case M.8792 *T-Mobile NL/Tele2 NL*, 27.11.2018; Case No COMP/M.5141 *KLM/ Martinair*, 17.12.2008).

Hence, the precedents suggest that the Commission can be persuaded through an appropriate counterfactual analysis to take into consideration the financial difficulties of a target firm, whether by applying a formal FDD analysis or a more relaxed version of the FFD. The economic difficulties raised by the COVID-19 pandemic suggest that the time may be ripe for the more flexible use of that doctrine.

Gibson Dunn's lawyers are available to assist with any questions you may have regarding developments related to the COVID-19 outbreak. For additional information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Coronavirus (COVID-19) Response Team or its Antitrust and Competition Practice Group, or the following authors in Brussels:

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