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Which Role for State Aid and Merger Control During and After the Covid Crisis?

Chiara Fumagalli [1]
Massimo Motta [2]
Martin Peitz [3]

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[1] Bocconi University
[2] ICREA-Universitat Pompeu Fabra and Barcelona Graduate School of Economics
[3] University of Mannheim and MaCCI

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Which role for state aid and merger control during and after the Covid crisis?[1]

Chiara Fumagalli
Bocconi University

Massimo Motta
ICREA-Universitat Pompeu Fabra and Barcelona Graduate School of Economics

Martin Peitz
University of Mannheim and MaCCI

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Abstract: *In response to the severe economic crisis triggered by Covid-19, state aid and a relaxation of competition rules, including merger control, have been proposed as policy options. We argue that there is a clear role for state aid in sectors experiencing a temporary shock, whereas state aid in sectors affected by a permanent long-term shock is more problematic. We also argue that merger control should not be relaxed and that in particular any merger proposal invoking the failing firm defence requires close scrutiny.*

Keywords: *competition policy, state aid, merger control, Covid-19, failing firm defence*

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I - Introduction

The Covid crisis has not only deeply affected our economies and disrupted markets, but also led to unprecedented state intervention. The role of competition policy at this juncture has been put into question. In particular, some commentators have called for a relaxation of competition rules, especially with respect to merger control.[2] There also voices which increasingly argue in favour of a bigger role for government intervention in the economy; and state aid has become an important support measure for many firms and sectors to weather the crisis.[3]

In this article, starting from the observation that the crisis has affected sectors in different ways, we argue that policy responses should reflect the conditions of the sector at hand. In sectors in which the crisis has no negative impact (see Section II), there is no reason to resort to state aid, to sector-specific demand side measures, or to relax competition rules. In fact, for certain products which experienced exceptional price hikes in response to a positive demand or negative supply shock, excessive price actions – a rarely used instrument in competition law – might be a 'last resort' tool to prevent prices from increasing beyond socially acceptable levels, at least when supply is not responsive, and in those jurisdictions where anti-price gouging or consumer protection provisions were not available. Furthermore, for some services, the temporary boost in demand due to confinement and home working may turn out to have permanent *positive* effects. Among these expected winners of the Covid crisis there are the big digital platforms, which reinforces the need for competition policy to deal with their increasingly dominant positions.

In those sectors in which the crisis is likely to have temporary negative effects (see Section III), state aid, if well-designed (and possibly as part of a portfolio of sector-specific measures), should be welcome, as it prevents the exit of liquidity-constrained but efficient firms hit by a crisis which is completely exogenous to them. Relaxing competition rules in the form of allowing competitors to temporarily coordinate their actions so as to better provision essential goods and services would also make sense, provided agreements are necessary and proportional to the objectives. But relaxing merger control would be counterproductive, as this would create an often-irreversible loss of competition that would have permanent negative effects.

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[2] See "OECD competition policy actions: Mergers in times of COVID-19 crisis", 24 May 2020, which asks to what extent the crisis and the resulting uncertainty should affect merger control. Jorge Padilla and Nicolas Petit (2020) "Competition policy and the Covid-19 opportunity", Concurrences N° 2-2020, pp. 1-5, answer this question advocating for relaxation of merger rules.

[3] State aids are support measures that are selective, i.e. are available only to some firms or some sectors. They may consist of direct subsidies, loans at below-market interest rates, credit guarantees, tax credit, among others. As soon as the crisis hit, the European Commission announced that state aid control would be adapted so as to allow a swift response by Member States. While presenting the Temporary framework, Margrethe Vestager, Executive Vice-President and Competition Commissioner, declared: "*This new Temporary Framework enables Member States to use the full flexibility foreseen under State aid rules to support the economy at this difficult time*."

Finally, in those sectors in which the crisis is likely to have a negative long-run impact and one would expect some consolidation will take place (see Section IV), we see less role for state aid (but of course public policies such as requalification of human capital, investment in infrastructure and measures to smooth adjustment may well be desirable). Both state aid and the relaxation of competition rules carry big risks and often lead to inefficient outcomes and thus a misallocation of resources in the economy. Mergers may make the transition to a new consolidated equilibrium faster, but a relaxation of the merger control regime would likely come at a significant cost: mergers may be seen as a quick fix by some firms (and politicians) but if any restructuring occurs, it will be at the expenses of competition; they may preclude buyers and consumers from enjoying the benefits of competition during the period of transition to a new industry equilibrium; there is no guarantee that mergers would select the most efficient firms to stay: the privately most profitable mergers are not necessarily the socially most desirable. Since it is likely that "Failing Firm Defence" (FFD) arguments will be invoked to justify mergers in these sectors, we shall briefly discuss why competition agencies should not lower their standards when dealing with FFD claims and how a proper assessment of the FFD should be carried out. If anything, FFD should be viewed more critically.

II. Industries that did not suffer during the pandemic

Some industries have not suffered a drop in demand during the pandemic, nor have they been affected by major supply chain disruptions. Think for instance of firms selling food and groceries. Not only have they generally not experienced a decline in demand and have continued to operate in a remarkably normal way (along with internet infrastructure, the ability of the food chain to provision entire countries despite confinement are among the main success stories of the period), but they may also have benefited from decreased competition during confinement: as consumers could not shop around, or did not want to visit several shops (to reduce risk of contagion), their market power might have temporarily increased.

Another obvious – although quite specific – example are firms selling health-related products that have become essential, such as face masks (and other protective gear), ventilators, and certain drugs. Their demand has boomed, and prices have consequently increased, sometimes to socially unacceptable levels, resulting in the public calling for policy interventions. Of course, price controls may be counter-productive in that they discourage a supply response, but in some cases supply may not be responsive enough, and there may be legitimate reasons for price interventions anyhow.[4] In some jurisdictions, there exist consumer protection or anti-price-gouging laws; in others, the government may resort to price controls by making use of state emergency laws. But in jurisdictions in which those instruments of price control were not available, and competition law contemplates exploitative abuse of dominance, excessive price actions were a possible (albeit imperfect and 'last resort') tool to deal with price tensions. South

[4] See Massimo Motta (2020), "Price regulation in times of crisis", Daily Maverick, 22 April 2020.

Africa is a case in point. After the declaration of the State of Emergency and the issuing of a regulation facilitating the use of excessive price actions, the South African Competition Commission has dealt with a large number of excessive price cases, for products deemed essential.[5]

In yet other industries, the temporary boost in demand due to confinement and home working may turn out to have permanent positive effects. Think of online retailing: many people experimented it during the confinement period, but having familiarized with it, they may decide to continue using this service even when the confinement finishes. Video-call technologies (how many of us were aware of platforms such as Zoom, Teams, Houseparty, Webex, Collaborate, etc. before the Covid crisis?) and online media services are other likely beneficiaries.

In most such cases, there is no reason for changing competition enforcement in either direction. However, among the few winners of the Covid crisis there are the big digital platforms: in the period of confinement, people have intensified their use of digital technologies, and their dependence on Amazon, Apple, Facebook, Google, and Microsoft has increased. Furthermore, these companies can now make use of their huge cash holdings to engage in more acquisitions, also made easier and cheaper by the situation of uncertainty that limits the availability of credit for start-up and young companies.[6] If anything, therefore, the Covid crisis has increased the necessity for competition policy to deal with digital industries,[7] and the urgency to change policy so as to prevent the big technology firms from continuing to acquire companies without any challenge from competition agencies[8] Regarding their current gatekeeper role, the discussion of whether moving to a different intervention standard or to ex-ante regulation is ongoing.

[5] Between 20 April and 2 June 2020, the South African Competition Tribunal approved sixteen consent agreements relating to Covid-19 excessive pricing matters (cases which had been prosecuted by the Competition Commission and concluded with remedies), and in the thus far only contested case, found Babelegi Workwear and Industrial Supplies CC (Babelegi) guilty of excessive pricing. See https://www.comptrib.co.za/info-library/case-press-releases.
For cases in the EU, see: George S. Cary, Maurits Dolmans, Bruce Hoffman, Thomas Graf, Leah Brannon, Richard Pepper, Henry Mostyn, Alexis R. B. Lazda, Savannah Haynes, Kristi Georgieva, Jan Przerwa, "Exploitative abuses, price gouging & COVID-19: The cases pursued by EU and national competition authorities", 30 April 2020, e-Competitions Competition Law & Covid-19, Art. N° 94392.

[6] See e.g. "Big Tech goes on pandemic M&A spree despite political backlash", Financial Times, May 28, 2020.

[7] Prior to the crisis this need was recognized in a number of reports; see J. Furman, D. Coyle, A. Fletcher, D. McAuley, and P. Marsden (2019). "Unlocking digital competition. Report of the Digital Competition Expert Panel", March 2019, ; Crémer, J., Y.-A. de Montjoye, and H. Schweitzer (2019). "Competition policy for the digital era. Final report presented to the European Commission"; and F. Scott Morton, P. Bouvier, A. Ezrachi, B. Jullien, R. Katz, G. Kimmelman, D. Melamed, and J. Morgenstern (2019). "Committee for the Study of Digital Platforms, Market Structure and Antitrust Subcommittee, report". Stigler Center for the Study of the Economy and the State.

[8] See e.g. Massimo Motta and Martin Peitz (2020), "Big tech mergers", Information Economics and Policy, forthcoming.

III. Industries that suffered a temporary shock

In many industries the Covid crisis has caused a dramatic drop in demand (or a major supply chain disruption) but this is likely to return to the pre-crisis levels once restrictions to movement of people are reverted.

In these industries, many firms have suffered from a drop in revenues and experienced liquidity problems. As a consequence, they may be unable to pay wages to their employees and fulfil their debt obligations, both trade credit from suppliers and short-term loans from banks and other financial institutions.

Therefore, firms that are efficient and solvent in normal times may be obliged – due to temporary liquidity problems – to downsize or close down completely their activity, thereby dissolving crucial employer-employees relationships as well as the accumulated firm-specific human capital. Even if affected firms survive until the moment demand picks up again, those firms may struggle to fully recover, because the process of re-matching of workers and jobs will be costly and slow; also, necessary investments may be delayed reducing the long-run prospects of these firms. The liquidity problems may also break crucial buyer-supplier relationships, adding a hurdle to future recovery.

Note that a contagion effect may take place along the supply chain, if firms which at first have significant liquidity buffers are not paid in time by their business customers, or if upstream or downstream the vertical chain other firms go bankrupt.

It is important to stress that in these industries in which the shock is in principle of a temporary nature, financial distress is not due to firms' structural poor management or inefficiency. Those firms were viable before the shock, and will be viable again once demand has recovered, if they managed to keep their relationships with employees, suppliers, and buyers alive. The shock is completely exogenous to them, and largely unrelated to their past managerial decisions, business strategy and performance.[9] As a caveat, supply chain disruptions are partly related to the firms' decisions of how to organize their supply chain.[10]

[9] In this respect, the current crisis is extremely different from the 2008 financial crisis, which first hit banks that had engaged in extremely risky behaviour. However, also in the financial crisis there are contagion effects because firms were denied credit, which in normal times they would have received.

[10] The management literature on supply-chain resilience is dedicated to the privately optimal organisation of supply chains if there is a risk of disruption. Here it is acknowledged that firms face a trade-off between lower costs in normal times and a more resilient organisation that is less prone to suffer from disruptions. For a survey, see Santanu Mandal (2014), "Supply chain resilience: a state-of-the-art review and research directions", International Journal of Disaster Resilience in the Built Environment 5, 427-453.

For this reason, state aid providing firms with the liquidity they need, for instance to preserve their relationships with employees and suppliers during the restriction period, seems entirely appropriate in these circumstances.[11] Such aid allows efficient firms to keep their key relationships alive and to recover swiftly once restrictions are reverted in a situation in which imperfect financial markets would fail to achieve such an outcome: given the enormous economic uncertainty, and the quick depletion of their assets due to the lack of revenues, those firms would be likely to be credit constrained and it would be impossible for them to obtain additional liquidity from the financial channels.

An additional element to consider is that, absent state aid measures, the firms that are more likely to survive are not necessarily the more efficient ones, but those that, for reasons not correlated to efficiency, may have an easier access to additional liquidity. Quite simply, they may be firms that are part of diversified groups/conglomerates, and receive liquidity injections through their internal capital markets; or they may be those firms having privileged access to measures to preserve employment;[12] or those firms that financial markets may believe are too big to fail, and therefore enjoy implicit state guarantees.

In fact, there is an extensive empirical literature showing that in times of crises the banking sector may misallocate funds by providing additional credit or loan extensions to less efficient firms at the expense of more efficient ones. This apparently paradoxical result is the result of banks' incentives. Banks have to satisfy capital requirements, and in times of crisis, when non-performing loans increase, raising capital also becomes more difficult. As a result, banks prefer to avoid writing off their capital. When faced with the choice between rolling over the loan to otherwise insolvent (or "zombie") firm or recognising this loan is non-performing and hence writing off capital, the bank will tend to prefer the former.

This phenomenon was first uncovered empirically by Caballero et al. (2008) which studied the Japanese depression of the 90's,[13] and then confirmed by other authors in other crises. Notably, a recent paper by Schivardi et al. (2017) shows – by making use of a rich dataset on bank-firm relationships in Italy – that during the Eurozone financial crisis, under-capitalised banks misallocated credit by disproportionately lending to non-viable firms. Credit misallocation increased the failure rate of healthy firms and reduced the failure rate of zombie firms.[14]

Hence, one cannot argue that the market, if left alone, would select the most efficient firms in times of crisis. In these circumstances, therefore, state aid measures are well justified, and we believe that it has been a good thing that most

[11] Other measures include a temporary boost in demand; however, given the nature of the shock such demand boosts are often ineffective.

[12] For instance, in Italy only firms whose employment exceeds a given threshold can have access to subsidies to preserve employment (Cassa Integrazione Guadagni). Access to those subsidies has been extended because of the Covid crisis.

[13] Ricardo J. Caballero, Takeo Hoshi and Anil K. Kashyap (2008), "Zombie lending and depressed restructuring in Japan", American Economic Review, 98(5), 1943-77.

[14] Fabiano Schivardi, Guido Tabellini and Enrico Sette (2017), "Credit Misallocation during the European Financial Crisis", CEPR Discussion Paper 11901, London.

governments have intervened promptly to guarantee firms the liquidity they needed to survive.

Of course, it is crucial that aid measures are not only temporary but also proportional and the least distortive to competition as possible.

The European Commission's Temporary Framework of 19 March, and following amendments,[15] does a reasonably good job in this respect, at least on paper. Indeed – and beyond employment support measures which are accessible to all firms and sectors in the economy and are therefore not even considered state aid – the Commission authorises state aid schemes provided they are temporary, effective and incentivising. For instance, firms which were already in difficulty by 31 December 2019, and hence *before* the crisis, are excluded from most measures; credit guarantees for loans beyond EUR 800,000 cannot apply to more than 90% of the loan; the loan principal should normally not go beyond certain amounts (25% of yearly turnover, or twice the yearly wage bill); and wage subsidies given to workers which would have otherwise been laid off because of the crisis should not exceed 80% of the monthly gross salary.

As the emergency continued, it became clear that the losses reduced firms' capital and their ability to borrow. As a consequence, on May 8 the European Commission expanded the Temporary Framework to allow for public recapitalisation, in order to avoid "market failure due to significant loss of employment, the exit of an innovative or a systemically important company, or the risk of disruption to an important service", as well as major social consequences. However, such state interventions should satisfy a number of conditions, including: sufficient remuneration for the State; temporary nature of the intervention (the state should exit from the capital of listed companies after six years at most, and other companies after seven years); bans on dividends and share buybacks until the State has exited capital; limitations to managerial remuneration; prohibition of cross-subsidisation of affiliated companies that were in economic difficulties prior to 31 December 2019; prohibition (until 75% of the recapitalisation is redeemed) from acquiring other firms in the same line of business.

Given the conditions attached, allowing for such state interventions sounds reasonable. However, the big risk for the EU Single Market is that due to their different budget availabilities, some member states will provide domestic companies with recapitalization opportunities that other states cannot offer, thereby distorting competition.[16] This risk applies to all sectors in which firms compete across different member states and thus concerns tradable goods and

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[15] European Commission (2020a). "Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak", Communication of 19 March 2020, C(2020)1863, OJ C 091I of 20.3.2020, p.1. European Commission (2020b). "Amendment to the Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak". Communication of 3.4.2020 C(2020) 2215 final.

[16] See Massimo Motta and Martin Peitz (2020), "EU state aid policies in the time of COVID-19", in: A. Bénassy-Quéré and B. Weder di Mauro (eds.), Europe in the Time of Covid-19, CEPR Press, pp. 73-77, and Massimo Motta and Martin Peitz (2020), "State aid policies in response to the COVID-19 shock: observations and guiding principles", CRC TR 224 Discussion Paper.

services. This is an argument for having a comprehensive, EU-level aid scheme with equal opportunities for all EU firms; or at least to supplement national programs by a EU program targeted to firms in less generous jurisdictions. An aid scheme managed by the EC would also limit political biases in the provision of state-aids, thereby making it more likely that funds are channelled to firms that really need them to survive. Unfortunately, support to EU firms is mostly a prerogative of the member states, and it is unclear to what extent the EU Recovery Fund – an otherwise important initiative which establishes forward-looking criteria – may contribute to restore the level-playing field in the single market.

If the temporary shock is fully absorbed by state aid, there is obviously no reason to relax merger control. However, as we will argue, this continues to hold even when the shock is absorbed only partially: a relaxation of merger control, which facilitates the acquisition of firms that struggle in the recovery phase (possibly implicitly or explicitly invoking failing firm defence claims) does not seem a good measure, as it might keep those firms "alive" (as part of merged entities) but at the cost of weakening competition in the market in a permanent way, with the static and dynamic inefficiencies that this may cause. This concern applies in particular to industries which already exhibit a high degree of concentration and that are subject to important barriers to entry.

In line with this reasoning, firms benefiting from recapitalisation measures should generally be prohibited from acquiring other firms. Otherwise, they may benefit of state support to buy out rivals, thereby distorting the market permanently.[17]

Padilla and Petit (2020)[18] advocate for governments not to be generous in terms of state aids, because that would interfere with the creative destruction process of recessions. Also, antitrust authorities should be lenient towards M&As because they would allow efficient survivors to acquire inefficient firms (that would exit the market otherwise) save their assets and restructuring them.

Our reasoning is in stark contrast with their proposal. First, as we explained at length, recessions in general, and the Covid crisis in particular, do not necessarily select the best firms. Consequently, lack of government support would lead to exit of efficient firms (without getting rid of the inefficient ones). Second, contrary to their claim, relaxation of merger control would be the last thing we need to improve firms' efficiency. Rather, a vigilant and well-enforced competition policy is necessary to make sure that vigorous competition will push firms to innovate, invest and become more productive. It is competition that promotes productivity growth through the selection effect that the authors advocate. Instead, allowing

[17] However, this has implication for the use of failing firm defence (FFD) in merger control. When invoking FFD by a different firm not receiving state support, it is then important to take into account that other firms which currently do not have the means to be an acquirer or are restricted from being one (because of the state support they receive) may become an acquirer once the temporary shock has passed. This means that applying FFD has to be forward-looking and the FFD should not be accepted by the Competition Authority if it is clear that in the near future an alternative merger becomes feasible and profitable that has better consumer welfare properties. See below the discussion at the end of Section IV.

[18] See *supra* for the complete reference.

firms to expand through external growth will not allow this selection process to function. Our view should not be understood as moratorium on mergers, but as a plea not to relax merger control.

IV. Industries hit by a permanent shock.

Some industries (e.g., hospitality, airlines, cinemas, trade fairs) may have to undergo a deep market restructuring because an important part of the shock may be more than transitory. The permanent shock may be directly caused by Covid-19 or indirectly through subsequent policy changes e.g. related to green policy goals.

State aid as a lifeline for firms which would struggle in the long-run does not seem an appropriate tool in the face of permanent shocks. If a sector is in decline, some firms and assets will have to leave to reduce excess capacity.[19]

If there is a refocusing in the broader industry, specific state aid measures may still be used, if the aim is not to prolong the life of firms whose fate is already clear, but rather to facilitate refocusing the activities of parts of the industry in line with broader policy goals. The bus industry may be a case in point. For example, an EU or national program may support the replacement of old buses running on carbon fuel by new buses running on renewables.

While it is possible to identify sectors that are likely to experience a negative long-term effect, there remains uncertainty about the likely future demand conditions. If retiring or reallocating assets is very costly, while keeping capacities on hold is not, there is some logic to maintaining capacities somewhat above the expected level in the short run. In the opposite case, a more drastic adjustment is warranted.

In some industries, the size of the long-term shock is endogenous and may depend on the economic policy measures that are implemented. For example investing in new clean-energy buses and trains, or creating reserved bike lanes in cities may encourage people not to switch to private cars as a response to the fear from infections on public transport.[20]

Admittedly, if the industry will eventually be a more consolidated one, there is no guarantee that the market process will reach an efficient outcome, as discussed in Section III.

However, the likelihood of selecting the efficient firms is no higher if consolidation occurs through a merger-led process. In general, a more relaxed merger policy is likely to favour mergers that are privately profitable, but such mergers are not necessarily socially beneficial. Even if it is socially optimal that certain assets do

[19] When the temporary effect is stronger than the permanent one, the measures implemented for sectors in which the shock is only temporary can equally be considered for this differential.

[20] Note that a demand-side stimulus for the car industry that also encourages cars running of fossil fuels may have the opposite effect.

not exit the industry, this does not mean that the bundle of those assets should go to the highest bidder. Indeed, bigger firms are more likely to have a larger benefit from relaxing competition. Therefore, it is important to have a robust merger policy in place that makes sure that only pro-competitive mergers, or the least anti-competitive ones, are approved.[21]

There are also other motivations behind a strict attitude towards mergers in declining industries. Firstly, caution in such industries is particularly important because one cannot count *on future entry disciplining market power* in a sector in decline.[22] Secondly, firms in crisis may downsize, restructure, and become efficient again. By allowing a merger, if any such restructuring still occurs, it will be at the expenses of competition. Thirdly, during the period of transition towards a new consolidated industry equilibrium, firms would still compete in the market and buyers (ultimately consumers) would benefit of lower prices and availability of products (which may instead disappear with the merger).

Consumers and society may well be better off if a firm exits the market than if it is absorbed by a competitor. This is the case because firm exit is not equivalent with all values associated with the exiting firm being destroyed. For example, high-skilled workers may find employment in other firms, some physical assets and IP may be sold to other firms.[23] More broadly, some assets may be efficiently reallocated to other sectors of the economy. If a firm acquiring some assets operates in a different market, this alternative use does not directly affect consumer welfare in the market under consideration (and will thus be difficult to include in a merger evaluation). However, it should also be acknowledged that some assets that are withdrawn in one market may find valuable use in other markets and thus have positive consumer welfare effects in other markets. This is partly behind the idea of creative destruction.

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[21] A forward-looking approach by competition agencies should be welcome. When a merger is proposed, the right counterfactual may well be a different merger, rather than the status quo or a market configuration in which the takeover target has disappeared. See Massimo Motta and Helder Vasconcelos (2005), "Efficiency gains and myopic antitrust authority in a dynamic merger game", International Journal of Industrial Organization, 23 (9-10), 777-801; and, if we give their findings a dynamic interpretation, Volker Nocke and Michael D. Whinston (2013), "Merger policy with merger choice", American Economic Review, 103 (2), 1006-1033. We understand that under current law each merger should be looked at in isolation, but the idea of a more forward-looking perspective would belong to a more general push towards giving more prominence to dynamic effects in merger cases; see, e.g., Giulio Federico, Fiona M. Scott Morton, and Carl Shapiro (2020), "Antitrust and Innovation: Welcoming and Protecting Disruption", Innovation Policy and the Economy 20, 125-190. Incidentally, the idea of considering alternative mergers to the one under investigation is already accepted in the treatment of failing firm defence claims, discussed below.

[22] Even in 'normal' industries, Antitrust Agencies tend to overestimate the role of potential entry/competition as a disciplining device to merger-induced market power. See e.g. the recent Competition and Markets Authority paper on "Evaluation of entry and expansion in UK merger cases", London, 2017.

[23] If these firms operate in the same market, this should be acknowledged in a case in which the merging parties invoke the failing firm defense; namely, some assets will not disappear from the industry even if the merger does not take place.

Since it is possible that the merging firms will invoke a *Failing Firm Defence (FFD)* in the context of a merger investigation in an industry in decline, we briefly discuss how these defence claims should be treated in our view.

According to the EU Horizontal Merger Guidelines (but in other jurisdictions very similar principles apply), an otherwise problematic merger may be approved if it involves a failing firm and in the counterfactual, that is, absent the merger, the market would not be in a more competitive situation.[24] In particular:

> *"90. The Commission considers the following three criteria to be especially relevant for the application of a 'failing firm defence'.* ***First****, the allegedly failing firm would in the near future be forced out of the market because of financial difficulties if not taken over by another undertaking.* ***Second****, there is no less anti-competitive alternative purchase than the notified merger.* ***Third****, in the absence of a merger, the assets of the failing firm would inevitably exit the market."* (our emphasis)

Importantly, note that the burden of proving that the deterioration of the competitive conditions under the merger would not be worse than in the counterfactual falls upon the merging parties.

In what follows, we briefly comment upon each of the three criteria above.[25]

(i) On the allegedly failing firm's exit because of financial difficulties: In order to satisfy the first criterion, namely that the target will be forced out of the market absent the merger, several conditions need to be fulfilled. In general, we believe that merging parties should demonstrate that: (a) the allegedly failing firm would continue to be loss-making; (b) it has no prospect of implementing a restructuring plan that could transform it into a profitable business, and (c) financial markets would not provide further funding to it. In addition, in case of the failing firm has a parent company, it should show that (d) its parent company would not have the incentives and/or the ability to fulfil the target's funding requirements.

In principle, it is conceivable that the affiliate of a parent company may be a genuinely failing firm. However, the parent company may also have other reasons to sell out an affiliate which have little to do with its failing prospects. For instance, it may prefer to focus its corporate strategy on other markets, or it may want to have an even higher remuneration than the one coming from the affiliate, or the offer made by the acquirer is irresistible (for instance because it eliminates competition and raises profits well above the current ones). It is therefore clear that the parent company would have incentives to misreport the extent to which it would have ability and incentive to finance the affiliate. There must therefore exist clear evidence that does not rely on unsubstantiated claims made by the parent company, in order to accept a FFD in case a parent company exists.

[24] See EU Horizontal Merger Guidelines, paragraph 89ff.

[25] Our view contrasts with the view expressed by Jacques Buhart and David Henry (2020), "Covid-19 and EU merger control: Time to loosen the FFD straitjacket?", Concurrences N° 2-2020 On-Topic "Competition law and health crisis", pp. 39-43, who suggest to apply a lighter burden of proof on each of the three elements that are required for a successful defence.

Generally, beyond the case of the failing firm belonging to a parent company, given the scope for companies to engage in self-serving claims that cannot be verified by the authority (about their financial situation, their options for restructuring, for finding further finance, their options for finding other acquirers, etc…), it is normally preferable for antitrust authorities to rely on evidence *pre-dating* the investigation or evidence of official proceedings confirming the inevitability of such an outcome (such as the initiation of bankruptcy proceedings). This may be more difficult in current circumstances, if the target firm is allegedly in difficulties because of the Covid crisis (because the crisis is simultaneously the cause of the difficulty and of the merger).

Still, an antitrust authority should rely as much as possible on objective information, and at the very least it should look for evidence of genuine attempts to survive independently. Absent evidence of such *bona fide* attempts, we would doubt condition (i) is satisfied.

There are widespread anecdotes of cases where 'failing' or 'flailing' firm defence arguments were attempted,[26] despite lack of evidence of difficulties and despite a very high price being offered for the takeover. This begs the obvious question: if the target company is really failing, why paying a large amount of money for it?

Conceivably, there may exist reasons for a high transaction price, for instance related to the existence of strong synergies and complementarities between the target and the acquirer. One may think that there is value added from the complementarity among workers (or more rarely between workers and some assets) and that if the company is liquidated this value added may be lost (for instance because workers spread around and the team is broken).

However, this means the antitrust authority should proceed as follows: (1) check whether there is a significant premium over the liquidation value of the target company; (2) if there is, then the acquirer should explain why paying such a premium for a supposedly failing firm; (3) the antitrust authority should also understand why this value added may exist only for the acquirer and not for other companies (which would result in a less anti-competitive merger).

(ii) There exists no less anticompetitive merger. Similar to condition (i), the credibility of a FFD argument should depend in our view on the target company being able to show genuine unsuccessful attempts to look for other buyers. Looking into internal documents may help, in order to see if there were other prospective buyers which were discarded because they would pay less (the more anticompetitive the merger, the higher the potential for a higher acquisition price).

[26] See Ian Conner (2020), "On "Failing" Firms — and Miraculous Recoveries", FTC, Bureau of Competition, May 27, 2020 , at: https://www.ftc.gov/news-events/blogs/competition-matters/2020/05/failing-firms-miraculous-recoveries.

Sometimes the authority may do a 'market test', and ask other firms whether they may have an interest in buying the target firm. Asked at short notice, those firms may not have the time to react. Sometimes they may also not have a strong incentive to oppose the merger, e.g. because they believe that the dominant company may become a softer competitor, or would get rid of the assets purchased.

As a caveat, we note that even if at the time no other viable merger is shown to be available, in times of a demand or supply shock this is less informative than in normal times. Suppose that in a particular merger case, it has been proven that the takeover target is not viable (and that the firm's exit is worse than the proposed merger from a consumer welfare perspective). Then, because of temporary shock, very few firms may be in the position to consume a merger. This may be so because the consummation of a merger requires scarce management resources of the acquirer that could be better employed to steer a firm through difficult waters. In general, mergers tend to be costly in the short term.

Furthermore, in case state aid is in place with the string attached that firms receiving any or a particular type of support are not allowed to acquire other firms, then such firms cannot appear as acquirers in the short term by default. This makes the firms with the deepest pockets to be the only ones which are eligible to obtain clearance of the merger.

This suggests that only the most profitable firms in an industry are likely to be in a position to propose a merger. These tend to be the firms with more market power and thus a proposed merger is more likely to raise competition concerns. If the takeover target survived the temporary shock (as do other firms) – perhaps under bankruptcy protection – other less problematic merger proposals may appear in the near future. Therefore, it is important to assess that other less problematic merger proposals are very unlikely to appear in the near future.

(iii) The assets of the failing firm would inevitably exit the market. We believe that condition (iii) in fact contains two conditions: not only that (a) absent the merger the failing firm's assets would inevitably exit the "market",[27] but also (b) that the permanence of these assets in the market is valuable from the competition point of view. (The idea being that the counterfactual to the merger should be worse for consumers than the merger itself.)

The failing firm will have tangible and intangible assets. Most of them, if they are valuable, will be liquidated and be used either in the current market or (if in the market they are of no valuable use) elsewhere. This is true for tangibles such as buildings, land, machines, vehicles, planes etc. But it may also be the case of intangibles, such as the brand, usage rights, and IPRs. (The owner may keep them dormant but who knows, they may be bought by an entrant that may be interested in the brand being known?)

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[27] In fact, it would make sense to restate the condition to say that assets should inevitably exit the "economy" rather than the "market": some assets may no longer have any use in the market under consideration but may be valuable in other parts of the economy (e.g., unused spectrum initially dedicated for certain purposes can be used for other purposes).

Valuable assets may consist of human capital. (See the discussion above at point (ii), on the value added from the complementarity among workers.) But again, we are back to the question of why they would leave the market if they are so valuable, and why they cannot be the base for restructuring (a smaller part of the 'failing' company, perhaps) or can be bought by another firm.

Finally, keep in mind the overall assessment should be based on the (expected) effects of the merger on consumer welfare (or total welfare, depending on the jurisdiction), so the question is, to repeat: would the fact that the assets leave the industry (if they do) really be bad for welfare?