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The Failing Firm Defence Can Be a Match Winner

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A helpful counterfactual can be a powerful argument when making merger control filings. The counterfactual essentially asks "what would have happened in the absence of the merger?" and is the base line against which the effects of a transaction must be measured.

The so-called "failing firm defence", a type of counterfactual, has in particular become increasingly important in current economic conditions. Indeed, presumably prompted by an upswing in the use of the defence, or perhaps anticipating this, right at the outset of the financial crisis the UK's first phase regulator (the Office of Fair Trading (OFT)) rushed out an emergency restatement of its approach to the defence[1] . More recently, the joint OFT and UK Competition Commission (CC) (the second phase regulator) merger assessment guidelines include a detailed consideration of the use of counterfactuals in general, including the failing firm defence[2].

During 2011 there have been several examples from the OFT and CC of the use of this defence, or one of its variants, demonstrating that it remains alive and well. Indeed, the frequency of its acceptance at CC level could suggest that in the UK the regulators are becoming too easy on the issue.

Counterfactual analysis in the UK

The most notable examples of situations where the UK authorities may use a counterfactual different from the prevailing conditions of competition (in which it is assumed that, absent the transaction, both businesses would have remained competitors) are:

- the "failing" or exiting firm scenario (giving rise to the "failing firm defence");
- the loss of potential entrant scenario; and
- where there are competing bids and parallel transactions.

There are, however, endless other possibilities, including not least flailing firm counterfactuals (one party is likely to weaken dramatically in the absence of the merger) or cases in which there is a fast-growing market or merging party (so that, in particular, current market shares are not representative of the likely position absent the transaction).

The position in the UK is complicated by the (current[3]) split of merger control analysis between the OFT and (where a phase two analysis is required) the CC. Convincing the OFT to accept a failing firm argument, or other counterfactual, is more difficult than convincing the CC to do so, principally because the CC has more time to consider the position.

The OFT considers the effect of the merger compared with the most competitive counterfactual, providing always that it considers that situation to be a realistic prospect. In other words, the OFT considers the "worst case" counterfactual (from the parties' point of view). The CC by contrast will compare the post-merger situation against only the most likely scenario. It will therefore actively select the most likely counterfactual and compare the post-merger situation against that. In order to accept a failing firm defence, for example, the OFT therefore needs (on the basis of "compelling evidence") to believe that it was inevitable that the firm to be acquired would exit the market and be confident that there was no substantially less anti-competitive purchaser for the firm or its assets. It will only alter its default position that, absent the transaction, both businesses would have remained competitors, if the target would "inevitably" have exited (i.e. exit was entirely certain).

These differences in approach, dictated by the split regime in the UK, need to be borne in mind when considering UK precedents in this (or most other) merger topics. Broadly, however, in front of both regulators the exiting firm scenario (failing firm defence) is most commonly considered when one of the firms is said to be failing financially. However, exit may also be for other reasons, for example because the selling firm's corporate strategy has changed.

Recent UK examples

At the time of writing, the most recent OFT use of the failing firm defence was in its clearance at phase one of the acquisition by Kingfisher of 30 Focus "do-it-yourself" (DIY) stores from Cerberus (the private equity owner[4]) . The 30 stores formed part of Focus' portfolio of 177 DIY stores across the UK until Focus went into administration (bankruptcy proceedings) in May 2011.

The OFT concluded:

" . . . that all of the [30 stores] ([and] for sake of completeness, the entire Focus business) would have failed for financial reasons and/or commercial strategic reasons . . . realistically there was no substantially less anti-competitive purchaser for [the eight stores in which prima facie competition concerns arose] despite the fact that the Administrator sold the stores to Kingfisher soon after the entry into administration."

Therefore, despite prima facie concerns in relation to eight stores resulting from local overlaps, the merger was cleared.

The CC had at the time of writing used the failing firm defence three times already in 2011 in merger cases. The most interesting of these three is the most recent, in which the CC concluded that, if not sold, the target business would have been closed, even though this would not have been for financial reasons[5]:

"Butlers was not failing financially. However, the evidence showed that ICAP faced wide-ranging regulatory pressures that, in combination with other strategic issues facing the Butlers business and in these particular and exceptional circumstances, made it commercially rational for ICAP to close Butlers rather than retain it, in the absence of a sale to STS. We therefore concluded that the counterfactual was that ICAP would have immediately made a decision to close Butlers, and would then have gradually wound down its contracts with a view to full exit in the foreseeable future."

The CC does not consider many merger cases and in 2011 it has only completed one other merger investigation without the transaction being abandoned by the parties.

The percentage in which the failing firm defence has been used in 2011 to clear (in whole or in part) a transaction is therefore very high (three out of four cases)[6].

Practical implications

The UK is of course not alone in using counterfactual analysis and indeed it is, or should be, used in any jurisdiction which analyses the competitive effects of a transaction. It is certainly used by the European Commission when analyzing transactions under the EU Merger Regulation. Recent UK experience is therefore of interest to parties' seeking merger clearances world-wide.

Counterfactual analysis, and in particular the failing firm defence, is not a panacea, even where the case appears to be strong. As the OFT stated in the fevered conditions of December 2008 when publishing its restatement of the legal position concerning the defence: "[This] does not constitute new guidance that departs from or relaxes the OFT's basic approach."

The run of recent "successes" in the UK by parties using the argument (and in particular the proportion of such successes during 2011 before the CC) could however give rise to the suggestion that, as the difficult economic conditions continue, the resistance of the OFT and CC to the arguments is reducing. However, in reality this is not the case. A close reading of the decisions in each of these cases makes it clear that they were, as is all merger control, heavily fact-dependent. A large amount of evidence was required, submitted and analysed before the conclusions on the counterfactual were reached. It remains clear that the UK regulators continue to set a high bar when analyzing claimed failing firm defences.

In order to reach this bar, evidence remains key. This in particular means evidence that was not prepared in contemplation of the merger. A board paper that says the wrong thing can ruin an otherwise good failing firm argument. Equally, an independent study prepared before discussions with any purchaser start and which concludes that a division should be shut down (if it cannot be sold) will be very difficult for a regulator to ignore. As ever, the paper trail needs to be very carefully managed by in-house and external counsel, ideally from well before a transaction is contemplated.

End Notes

1. See "Restatement of OFT's position regarding acquisitions of 'failing firms'", December 2008 (OFT1047).

2. See "Merger Assessment Guidelines", September 2010 (CC2 (Revised) and OFT1254).

3. The UK Government is consulting on a proposal to merge the competition functions of the OFT and the CC to create a single Competition and Markets Authority (CMA). See "A competition regime for growth: a consultation on options for reform", March 2011 (Department for Business Innovation and Skills).

4. See "Anticipated acquisition by Kingfisher plc of 30 stores from Focus (in administration)", August 2011 (ME/5043/11).

5. See "Sector Treasury Services and Butlers: A report on the completed acquisition by Sector Treasury Services Limited of ICAP PLC's treasury management advisory services business (Butlers)", August 2011.

6. In the first case, the CC looked at whether the vendor's decision to close down a vehicle tail lift business related to that to be sold (a tail lift spare parts business) was connected to the sale. It concluded that it was not (see "Ratcliff Palfinger/Ross & Bonnyman (Commercial Vehicles Tail Lifts Spare Parts Business): A report on the anticipated acquisition by Ratcliff Palfinger of the commercial vehicles tail lifts spare parts business of Ross & Bonnyman", June 2011). The second case concerned a similar issue, this time in the ferry transport sector on the Irish Sea. See "Stena AB and DFDS A/S merger inquiry: A report on the completed acquisition by Stena AB from DFDS A/S of certain vessels and assets operated on the Irish Sea", June 2011.