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United Kingdom Merger Control: Recent Developments in the Failing Firm Defence

Matthew O'Regan (St Johns Chambers, United Kingdom) · Thursday, September 11th, 2014

On 15 August 2014, the Competition and Markets Authority ("**CMA**") approved Alliance Medical Group's completed acquisition of IBA Molecular's radioactive medical tracer business. Although IBA's business was loss-making, would have exited the market and there was no other credible buyer for it, the CMA refused to apply the 'failing firm' (or 'exiting firm') defence, as it was not inevitable that, in the event of IBA's exit, all or most of its existing customer contracts would have passed to Alliance. The CMA did, however, find that the merger did not substantially lessen competition, as there would remain two strong competitors, so ensuring continued customer choice.

Given the difficult economic circumstances of the last few years, a significant number of mergers have involved businesses in financial difficulty. Although the British economy has now emerged from recession, it is to be expected that merging parties will continue to rely on the 'failing firm' defence in the future, although, as this article shows, successfully doing so is not straightforward.

This article considers the CMA's application of the 'failing firm' defence in *Alliance/IBA* as well as in a number of other mergers considered recently by the CMA and its predecessor authorities, the Office of Fair Trading ("**OFT**") and Competition Commission ("**CC**"), which formerly carried out Phase I and Phase II reviews, respectively (the CMA undertakes both Phase I and II reviews).

CMA Merger Assessment Guidelines

In their Merger Assessment Guidelines, which the CMA has subsequently adopted, the OFT and CC explain that a merger's effects on competition must be assessed against the appropriate counterfactual. Ordinarily, this will be the prevailing, pre-merger situation. However, a different counterfactual may be used, which is referred to as the 'exiting firm scenario'. For this scenario to be satisfied, and for the merger to be approved, three cumulative factors must be satisfied:

- exit of the firm from the market must be inevitable, whether through financial failure or otherwise, which requires an assessment of its financial situation, whether it can be successfully restructured and decisions taken by its owners and management
- there is no alternative and substantially less anticompetitive purchaser of the firm or its assets
- whether exit of the firm would be a substantially less anti-competitive outcome than the merger, which requires an assessment of what would have happened to the firm's sales after exit to determine whether they would have passed to the acquirer in any event

With the recent reforms to UK merger control (which are considered by me here, where a merger is notified to the CMA, a standard Merger Notice form must be used. If the parties wish to rely on a counterfactual other than the pre-merger situation, including a 'failing firm' defence, this should be set out in the notification and appropriate financial and other internal documents relating to the target's financial position, attempts taken to restructure and market it, and any decision taken to close it must be disclosed. As notification remains voluntary, the parties will also need to provide this information where the CMA investigates a merger on an 'own initiative' basis; where the merger has already been completed, this will require the cooperation of the vendor (who will likely have retained relevant documents relating to the target firm or business) and the vendor should bear this in mind when negotiating the transaction documents.

Phase II: *Alliance Medical/IBA*

In *Alliance/IBA Medical,* the CMA had to consider a completed acquisition of a business that had already mothballed one plant, had been consistently loss-making with negative cashflow and had lost customer contracts. The parties were two of the three principal commercial manufacturers of 18F-fluorodeoxyglucose ("**FGD-18**"), a radioactive tracer used in PET-CT scans, which are used to diagnose cancers; because of its very short half-life, FDG-18 must be used within hours of its production, so limiting geographic markets, such that the parties were competitors in certain areas.

The OFT had refused to apply the failing firm defence and had referred the merger to the CC: in its view, IBA's exit was unlikely, as there appeared to be some scope for restructuring the business and there may have been an alternative purchaser.

By analysing various financial data and other evidence, including views of customers, the CMA found that the target business was unsustainable on a standalone basis and, given its comparatively weak market position, could not be returned to profitability in the future. As a result, absent the sale to Alliance, IBA's shareholder (a private equity company) would have decided not to continue incurring the losses incurred by its FDG-18 business and would have exited the business as quickly as possible.

The CMA was also satisfied that, despite the vendor not undertaking an auction process to sell the business, it was unlikely that there would have been an alternative purchaser, given market conditions (high fixed costs and weak demand and pricing) and the target's lack of profitability. In particular, a hypothetical acquisition by the most likely alternative purchaser, the other main commercial producer of FDG-18 (PETNET, which was in any event not interested in acquiring the target), would not have produced a better outcome for competition than the merger.

In applying the third limb of the test, the CMA was not satisfied that the majority of IBA's FDG-18 sales would have passed to Alliance in the event of IBA's exit, given PETNET would likely have won some of IBA's contracts upon retendering by hospitals. The CMA was therefore unable to apply the exiting firm defence to approve the merger and instead considered the merger's effects on competition. It concluded that the merger did not substantially reduce competition, as there would remain two strong competing suppliers and Alliance did not obtain an incumbency advantage through acquiring IBA's business.

Phase II: *Optimax/Ultralase*

In November 2013, the CC approved the *Optimax/Ultralase* merger, which reduced the number of national providers of laser eye surgery from three to two.

The CC found that Ultralase would have failed financially: its cost base was too high and it had lost sales, leading to negative cash flow; as a result, it had breached its banking facilities and was unable to secure new financing. In reaching this conclusion, the CC analysed internal Ultralase documents, its accounts and independent accountant reports prepared for its former shareholders. It also heard evidence from its former shareholders, bankers and management.

The CC also found that there was no other credible purchaser beside Optimax: other parties had participated in an auction process, but had not submitted bids, whilst other possible bidders were not credible, as they lacked funding and had not undertaken full due diligence, so could not have completed a sale within the limited period before Ultralase would have become insolvent and entered administration or liquidation.

The CC then assessed the competitive effects of the merger, including what would have happened in the event of Ultralase's exit. It found that Optimax had retained only a proportion of Ultralase's sales, with other suppliers capturing the remainder. The CC's econometric analysis showed that, had the merger not proceeded and Ultralase had exited the market, Ultralase's sales would have been distributed between Optimax and Optical Express (the other and largest national provider) in a similar manner as they had been as a result of the merger, which had been completed and thereby provided a 'natural experiment'. Therefore, the merger did not substantially lessen competition as it did not result in a less competitive outcome than the counterfactual of Ultralase's exit.

Phase I: recent OFT and CMA practice

In a considerable number of recent decisions, the OFT and CMA have been unwilling to apply the failing firm defence in Phase I. In many cases, the parties have been unable to demonstrate, with appropriate evidence – including strategic documents and documented decisions – that exit was inevitable. In others, they were unable to demonstrate that there were no possible alternative and less anti-competitive purchasers, usually because the target had not been openly marketed to third parties.

In *Diamond Bus/First Redditch and Kidderminster*, the OFT rejected claims that both the seller's own business in the town of Redditch and that of the target were failing firms. Although both businesses were loss-making, there was no evidence that the exit of either business had been considered, let alone was inevitable. However, although the merger removed 'head to head' competition between the parties on various routes in Redditch, it was approved under the 'de minimis' exception.

In *Lafarge Tarmac/Tarmac Building Products*, the CMA rejected the failing firm defence, as there was no evidence that the target would be unable to meet its financial obligations or that it could not be further restructured. In addition, no internal documents to the contrary were produced. The OFT took the same approach in *Ridgeway/Parkview Skoda*: even though Parkview had a negative net worth and was loss-making, there was no evidence of what restructuring was or could have been planned by Parkview to avoid insolvency. Similarly, in *First Manchester/Finglands* the OFT refused to apply the defence even though there was evidence that the target was insolvent after many years of losses: although Finglands' parent company had identified its closure as one strategic possibility, no final decision had been taken to close it and the OFT could not be satisfied that the parent would not continue to fund the business, such that Finglands' exit was not inevitable.

In *Adams Foods/Milk Link Cheese*, the OFT considered that exit was not irreversible: whilst the loss of key customer contracts had caused the vendor to decide to exit its cheese marketing and sale business and to close its cheese packing site, the site was still operational and there was a possibility that the decision could have been reversed, for example if a new customer were to be won. The OFT took the same approach in *Boparan/Vion*, as restructuring of the target business remained possible and the business could have won new business to replace lost contracts.

Even where a strategic decision has been taken to close a business if it is not sold, the defence will not be accepted if there is evidence of an alternative and less anti-competitive purchaser. In *European Metals Recycling/Sita*, although the OFT accepted that the target scrap metal recycling business (which has been loss-making for five years) had ceased trading, there was evidence of other, less anti-competitive purchasers, who had each submitted bids for some, but not all, of the recycling sites acquired by EMR. Accordingly, the OFT was not satisfied that the exiting firm scenario was applicable, although it did approve the merger, given low markets share and sufficient competitors in all markets assessed by it.

In *BT/ESPN*, the OFT considered that the second criterion was not satisfied, even though the other potential buyers were unwilling to meet the seller's asking price.

Conclusions

The threshold for satisfying the 'failing firm' defence is high, although mergers in which the defence has been unsuccessfully raised have been approved on other grounds (whilst the prohibited *Eurotunnel/Seafrance* merger involved a business that had been liquidated, the defence was not raised as there had been an alternative credible bidder for it, DFDS).

In particular, it would appear to be extremely difficult to successfully rely on the defence in Phase I; this may reflect the relatively low threshold for referring a merger for a Phase II investigation (i.e. that, as confirmed by the Court of Appeal in *OFT v. IBA Health* the CMA need only hold a reasonable and more than fanciful belief that the merger may substantially lessen competition), the short duration of a Phase I investigation and the need to provide compelling evidence to satisfy the CMA that all three limbs of the test are met.

To have any prospect of obtaining a Phase I clearance on the basis of a failing firm defence, the parties (both acquirer and seller (or target)) must carefully lay the appropriate foundations when planning, documenting and implementing both the closure of the target business and their transaction, to demonstrate that each of the three criteria are clearly and without any doubt satisfied. This is a high burden, requiring both a definitive and irreversible decision to close the target and an unsuccessful attempt to market it to third parties.

In Phase II, as in both *Alliance/IBA Medical* and *Optimax/Ultralase*, the CMA has more time to explore the issues, obtain evidence and undertake, where possible, economic and other analyses to satisfy itself that the 'failing firm' defence is satisfied. However, even then it is very difficult to satisfy the defence, in particular the third limb of the test, given that when companies cease trading their sales will ordinarily be distributed between a number of competitors and not simply be obtained in any event by the purchaser.

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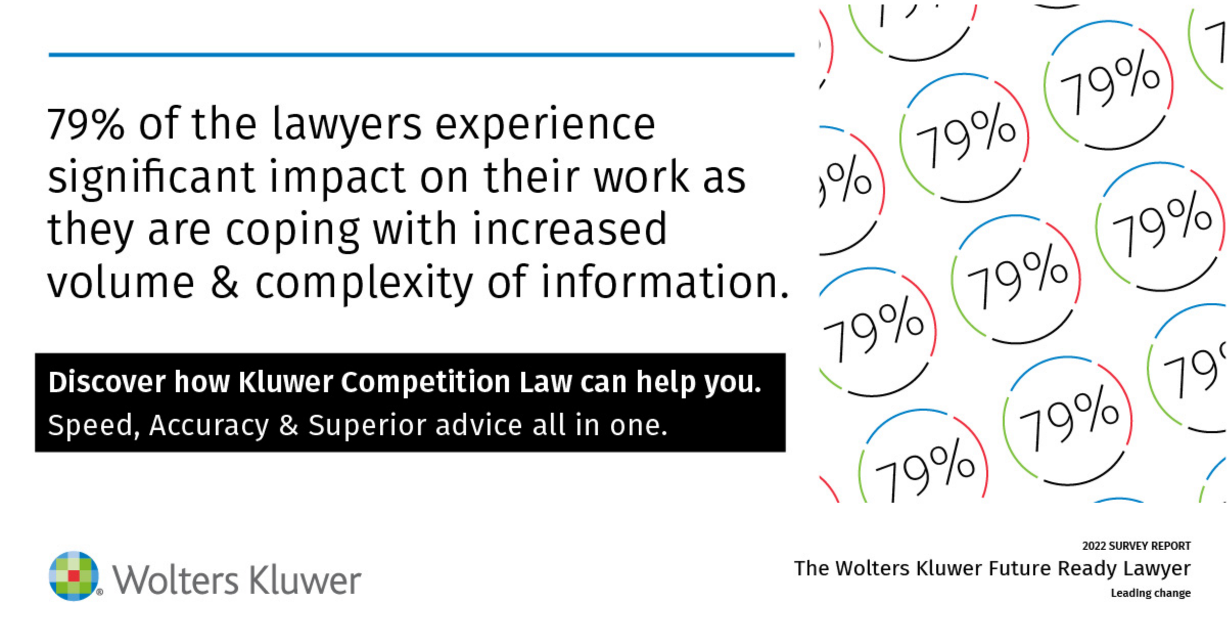

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