

Merger control: distressed M&A in the time of Covid-19



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Several antitrust issues have taken center stage during the coronavirus disease 2019 (COVID-19) pandemic. Issues such as price gouging, state aid, and competitor collaborations are top of mind. But another antitrust issue is likely to share center stage as countries slowly begin to re-open – the failing firm defense. Most jurisdictions have provisions establishing a failing firm defense in merger control, but the defense often involves a high standard and is rarely triggered. In the current environment, we are likely to see an increase in the application of the defense.

This article provides a brief overview of the main elements of a failing firm defense or exemption focusing on the standards applicable in the United States, Europe, Argentina, Brazil, Chile, Colombia, Mexico and Peru.

Failing firms

One of the main goals of competition law is to ensure the efficient allocation of resources. In general, struggling companies that cannot keep up with evolving market conditions and consumer trends tend to be replaced by new or better firms. Consumer welfare benefits greatly from companies' need to be efficient to stay in business and compete, which lowers prices and increases product quality and innovation.

However, in certain exceptional cases consumers may benefit more from companies keeping the assets of a failing firm alive than from shutting it down, despite any competition concerns, such as the likelihood of increased consolidation or higher prices. In such cases, the typical antitrust cure (enjoining an anticompetitive merger) may become worse than the disease (allowing a presumably anticompetitive merger go forward), because the assets may exit the market for good.

The "failing firm defense" potentially offers some flexibility to companies that wish to merge in the extreme circumstances related to the COVID-19 pandemic. If the relevant elements are present, financially strained companies (and their buyers) may be able to put forward failing firm arguments to obtain clearance from antitrust agencies around the world.

Applicable standards

In the **United States**, the bar set by the failing firm defense is high. Courts have confirmed that parties face a difficult burden when trying to insulate an otherwise potentially anticompetitive merger based on the failing firm defense. The failing firm

defense not only requires proof that the company is in danger of imminent business failure, but also that it cannot successfully reorganize or be sold to a different buyer. In practice, each of these factors can be difficult to prove, and establishing all three of them can be close to impossible.

Specifically, as stated in Section 11 of the US Horizontal Merger Guidelines of the US Department of Justice and the Federal Trade Commission: “the Agencies do not normally credit claims that the assets of the failing firm would exit the relevant market unless all of the following circumstances are met:

- the allegedly failing firm would be unable to meet its financial obligations in the near future;
- it would not be able to reorganize successfully under Chapter 11 of the Bankruptcy Act; and
- it has made unsuccessful good-faith efforts to elicit reasonable alternative offers that would keep its tangible and intangible assets in the relevant market and pose a less severe danger to competition than does the proposed merger”.^[1]

In **Europe**, under special circumstances an otherwise problematic merger may be blessed by the European Commission where the deterioration of the competitive structure of the market that would follow the merger involving a failing firm would not be caused by the merger. Protracted adverse economic conditions coupled with low demand and no conceivable prospects for reversal in the near future have supported exceptionally the application of the defense in Europe.^[2]

As set forth in paragraph 90 of the Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings: “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.”^[3]

In **Argentina**, the 2018 Merger Control Guidelines provide that “a firm is considered to be failing when, due to financial or economic difficulties, it will almost certainly be forced out of the markets where it is currently operating.” The enforcement authority “may authorize [an] acquisition even though it generates anticompetitive effects[,] [...] if the exit of the failing firm [would cause] a greater harm to competition than the acquisition itself.”

Such exemption applies if:

- “the difficulties experienced by the failing firm will cause its immediate exit of the market, in a context where its tangible and intangible assets will also disappear;
- there are alternative purchasers that would raise lower anticompetitive effects in the market; and
- the failing firm’s exit will generate a greater harm to consumers than its acquisition by a competitor.”^[4]

The enforcement authority in Argentina has made use of this exemption in the past and is likely to continue doing so.

In **Brazil**, although the Brazilian statute does not expressly set forth a failing firm defense, the provisions of the Horizontal Merger Guidelines issued by the Brazilian Antitrust Authority (the Administrative Council for Economic Defense (CADE)) ^[5] and certain decisions issued by CADE have expressly addressed the merger of insolvent companies based on the failing firm defense doctrine. Such decisions have approved transactions based on the argument that the anticompetitive effects of the merger would be more beneficial to the involved companies and to the market than the bankruptcy of one of them, while also considering a whether other alternatives less harmful to competition and to the market had already been attempted by the company before considering the merger.

According to the Horizontal Merger Guidelines issued by CADE, the application of the failing firm defense is restricted to transactions in which the applicants provide evidence of the satisfaction of all of the following requirements and events:

if the transaction is not approved, the company would either leave the market or could not meet its financial obligations due to its economic and financial difficulties;

if the transaction is not approved, the company’s assets would exit the market, which could mean a reduction in supply, a higher level of market concentration and a decrease in economic welfare (CADE also recommends the submission of evidence as to the company undergoing financial difficulties such as bankruptcy process or judicial or extrajudicial recovery filings); and

the company must demonstrate that it has made efforts in search of alternatives less harmful to competition (for example, through alternative buyers or through a judicial recovery process) and that there is no option to maintain its economic activities other than the approval of the transaction.

Furthermore, during the analysis of the transaction, CADE must conclude that the antitrust effects arising from the disapproval of the transaction (and, the probable bankruptcy of the company) would be worse than the market concentration generated by the transaction.

The burden of proving the existence of the above-mentioned requirements lies with the applicants. CADE has made use of the failing firm defense in the past and is likely to continue doing so, provided that the above-mentioned requirements are met.

In **Chile**, while the competition statute does not provide for the failing firm defense, it is included in the merger control guidelines of the antitrust authority, the Fiscalía Nacional Económica (FNE).^[6] Pursuant to such guidelines, the acquisition of a company that is in crisis may affect the substantive analysis of a transaction and be entitled to an exemption. In these cases, the FNE will undertake a prospective analysis to evaluate whether the disappearance of the assets will have the result of making consumers worse off than if the concentration was approved, even when it presents competition risks.

To assert a failing firm exemption, the parties must prove that:

- The company in crisis, due to its economic problems, will exit the market in the near future if it is not absorbed by another company;
- Such exit would result in the inevitable disappearance of the assets of that company from the market; and
- There is no other less harmful option in competition terms to preserve the assets of the company in the market, and the company has made efforts to find such alternative options.

The parties are expected to attach convincing evidence, mainly through internal supporting documents, to claim the exemption.

However, there have been very few cases where the failing firm defense has been accepted by the competition authorities (most recently in 2011 in the retail industry^[7]), and we anticipate that it will still be accepted only as a last resort exemption during phase 2 cases, after the preliminary review has taken place, if the above circumstances are present.

In **Colombia**, the failing firm defense has been developed by the competition authority through decisional practice and there are no specific guidelines or any legal definition of this defense. The competition authority's failing firm doctrine is deemed an exemption to the general merger control standards, and the bar set for its application is high.

The doctrine refers to three conditions which must be jointly met to be able to successfully argue the defense, as follows:

- The company allegedly in crisis should be condemned, due to its economic problems, to abandon the market in the near future, specifically, proof that the company's exit from the market is imminent, generally in less than a year, is required;
- There is no real or achievable alternative which implies less anticompetitive effects; which requires the absence of any other potential transaction by a third party that would be less harmful to competition; and
- The damage to competition likely generated by the merger is comparable to the effects that would have been caused by the exit from the market of the failing company's assets; and the likelihood of damage to competition is higher in the case of exit of the failing firm.

The failure to satisfy any of these conditions will lead to rejection of a failing firm argument and ultimately to rejection of the exemption.

In **Mexico**, neither the competition law nor the guidelines published by the merger control authority, the Comisión Federal de Competencia Económica (COFECE), provide a specific mechanism for the filing of a failing firm acquisition that may give rise to significant market concentration.^[8] However, the COFECE guidelines require that in such cases the failing firm must provide reliable information regarding:

- its deteriorated financial position resulting in its inability to meet its financial obligations;
- its inability to successfully reorganize;
- the imminent risk of its exit (and of its assets exiting the market); and
- its unsuccessful good-faith efforts to transfer the assets to another company.

Therefore, even though a failing firm is not entitled to any exemption or special merger control procedure, the above information would be important to the substantive review of the transaction, with a view to keeping the assets alive. Although not the subject of this note, it is worth noting that the COVID-19 pandemic has enabled certain collaboration agreements between economic agents that could be questionable under normal circumstances.

In **Peru**, the new Merger Control Law, which will become effective on March 1, 2021, provides that the enforcement authority

(INDECOP), in order to authorize a merger or acquisition, will take into consideration, among other factors, “the situation of severe stress of the firms involved in the transaction, and their urgency to undergo a merger.” Therefore, we expect that in the case of failing firms or companies undergoing extreme financial circumstances, the authority could waive or relax the general standards and procedures for approval of mergers.^[9]

Conclusion

Failing firm defenses and exemptions are expected to become relevant in distressed firm merger control analysis in this time of the COVID-19 pandemic. However, we do not anticipate that competition authorities will relax their generally applicable standards (which are usually hard to satisfy) but rather will use existing tools to factor in the effects of this unprecedented crisis.

Even outside the scope of the failing firm defense, the parties to a merger may wish to bring into play the discussion of their financial distress and current macroeconomic factors in the substantive assessment of their transaction. Competition authorities may ultimately find that the long-run benefits of keeping businesses open outweigh any temporary harm to competition.

When contemplating a global merger during these trying times, parties should be mindful that the rules of the several jurisdictions that are involved may differ. Please reach out with any questions about how the general concepts discussed in this note may apply to your case.

If you have any questions regarding these new requirements and their implications, please contact the author or your DLA Piper relationship attorney.

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Source: [DLA Piper Latam Law Blog](#)

[1] See, <https://www.justice.gov/atr/horizontal-merger-guidelines-08192010>.

[2] See, Aegean/Olympic II, [Case COMP/M.6796, Aegean/Olympic II, European Commission Decision of October 9, 2013](#)).

[3] See, EC’s Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings, available at: <https://op.europa.eu/en/publication-detail/-/publication/14f16a94-fefa-4732-b0be-375860f63be3/language-en>.

[4] See, Argentine Merger Control Guidelines (2018), available at: https://back.argentina.gob.ar/sites/default/files/english_version_guidelines_0.pdf.

[5] See, Horizontal Merger Guidelines issued by CADE (2016), available at: http://www.cade.gov.br/aceso-a-informacao/publicacoes-institucionais/guias_do_Cade/guia-para-analise-de-atos-de-concentracao-horizontal.pdf/view

[6] See, FNE Guidelines on the analysis of concentration transactions, available at: <https://www.fne.gob.cl/wp-content/uploads/2012/10/Guia-Fusiones.pdf>.

[7] See, closed investigation on the Cencosud/Johnson concentration, available at: <https://www.fne.gob.cl/operacion-de-concentracion-cencosud-johnson%C2%B4s/>.

[8] See, Section 3.6 of the Mexican Merger Notifications Guidelines (Page 25), available at https://www.cofece.mx/wp-content/uploads/2017/12/guia-0042015_not_concentraciones.pdf

[9] Because Peru's new law is not in effect yet, as a general rule antitrust clearance is not currently required in connection with acquisition transactions except for companies in the electric sector, where prior authorization of INDECOPI is required before executing a merger or an acquisition. In addition, (i) rights granted by the government (concessions, authorizations or registrations) in favor of companies in the telecommunications sector are non-transferable unless the transfer is previously authorized by the Ministry of Transport and Communications (MTC); (ii) the Superintendence of Banking, Insurance and Private Pension Funds Management Companies (SBS) issues authorizations for the organization, operation, transformation, conversion, merger or division of any entity in the financial or the insurance sector; and (iii) for reporting/transparency purposes, any company regulated by the Superintendence of the Securities Market (SMV) must inform such authority (and the corresponding entity of securities clearing and settlement, if applicable) of its participation in an acquisition transaction.