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COMPETITION **ALERT**

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The failing firm doctrine during COVID-19: old medicine or a new cure?

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The failing firm doctrine during COVID-19: old medicine or a new cure?

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Almost all sectors of the economy have been infected by COVID-19. Those more fortunately situated will have the opportunity to acquire businesses requiring lifelines. Given escalating economic turmoil, an increase in reliance on competition law's established 'failing firm doctrine' is expected. This doctrine essentially proposes that the failure or imminent failure of a merging firm may support the approval of a merger by the competition authorities.

The doctrine notoriously carries the heavy burden of proving strict requirements before it can be successfully invoked. In times of good economic health, it has only rarely been relied upon as a means to secure merger clearance.

In the light of the spiralling crisis, the question arises as to whether COVID-19 will result in a relaxation of the strict failing firm doctrine requirements or whether South Africa's merger dispensation is sufficiently flexible, in its current form, to fight the pandemic. Below we highlight why the latter may hold true.

The failing firm doctrine

In assessing whether or not a merger is likely to substantially lessen or prevent competition, the Competition Act 89 of 1998 (as amended) (Act) prescribes the consideration of a non-exhaustive list of factors, one of which is "*whether the business or part of the business of a party to the merger or proposed merger has failed or is likely to fail*". The prescribed balancing act means that, even if a merger has some anti-competitive effects, allowing the merger may still tip the scales, because of the weight of its pro-competitive effects.

This doctrine is most relevant to mergers which, absent the dire economic state of one of the merging parties, may be at risk of a protracted and costly investigation period or may face prohibition. For example, transactions between direct competitors who already (pre-merger) each enjoyed significant levels of market share or concentration in the relevant market. In such cases, a potential theory of harm is the establishment of heightened market power, which in turn may result in higher prices, reduced quality and/or less choice for consumers.

When seeking to invoke the failing firm doctrine, merging parties are required to evidence that the strict requirements of the doctrine are met. Most notably, it must be shown that the allegedly failing firm:

(i) is unable to meet its financial obligations (whist it is not a prerequisite that the firm already be insolvent, it must be shown that the firm is likely to fail in the short- or medium-term); and

(ii) has made unsuccessful good-faith efforts to elicit reasonable alternative offers that would keep the firm in the market and pose a less severe danger to competition than the proposed merger (it must be shown that these alternatives were properly explored prior to concluding the merger).

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The failing firm doctrine during COVID-19: old medicine or a new cure?*...continued*

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A third requirement, which would assist in successfully invoking the failing firm doctrine, albeit which is not a prerequisite, is the reasonable expectation that the failing firm's assets would exit the market, but for the merger.

The failing firm doctrine requires a consideration of the post-merger world versus life without the merger. This means that the competition authorities must consider whether rescuing a failing firm is the least adverse outcome for the relevant market, when compared to the counterfactual of the failing firm's imminent failure.

How will this doctrine likely be applied in a COVID-19 market?

At the commencement of the lockdown, the Competition Commission (Commission) announced that it was "*discouraging*" (albeit not prohibiting) the filing of mergers, except those involving failing firms or firms in distress. It is assumed that the Commission, flooded with COVID-19-related excessive pricing complaints and adapting more generally to the lockdown, was trying to ensure efficient use of its resources. This announcement, even at the very early stages of the lockdown, also signalled a welcome prioritisation of transactions involving firms facing economic challenges. When adjudicating mergers involving failed or failing firms, swift decision-making is obviously critical to the sustainability of the merged entity.

The South African competition authorities have however not yet confirmed any COVID-19 relaxation of the standards by which failing firm mergers will be assessed. This aligns with a general position taken by competition regulators during past global economic crises, where regulators refused to loosen the failing firm defence requirements, although prevailing economic conditions were acknowledged as being relevant to merger assessments. The United Kingdom's Competition and Markets Authority (CMA) has recently published guidance confirming that COVID-19 will not result in a relaxation of its current approach to merger control.

The CMA also very recently announced its provisional clearance of Amazon's proposed acquisition of a stake in Deliveroo in one of the first applications of its failing firm defence during the COVID-19 pandemic. The CMA applied the failing firm defence "*in light of a deterioration in Deliveroo's financial position as a result of coronavirus*". Although the CMA took into account changes to the competitive environment that had a direct and material impact (i.e. the COVID-19 pandemic) on the parties, Deliveroo was still required to provide evidence that, without the Amazon investment, it would fail financially and inevitably be forced to exit the market.

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There must be a safeguard against those few transactions where it is better for the market that failing firm exit or merge with an available and less anti-competitive suitor.

In our view, the South African failing firm doctrine also allows for the assessment of prevailing economic conditions and the Act presents with sufficient flexibility to "*rescue*" complex mergers. By way of example:

- In addition to an assessment of the competition effects of a merger, the Act requires an analysis of the public interest effect of each merger. A merger between competitors which also gives rise to retrenchments may at first glance raise significant public interest concerns. However, if upon closer inspection, it is apparent that the counterfactual, in terms of which the merging firm fails, will result in even more job losses, then the merger in fact serves the public interest.
- Interestingly, based on our reading of the Act, if it can be shown that, absent the merger, the failing firm's market share would in any event be subsumed by the acquirer, then arguably there is no causal link between the merger and any anti-competitive effects in a market. Absent any additional concerns caused by the merger per se, this argument, without more, should assist in obtaining approval for the merger.

Whilst the failing firm doctrine evidential requirements are strict, this is arguably still reasonable in the time of COVID-19. There must be a safeguard against those few transactions where it is better for the market that the failing firm exit or merge with an available and less anti-competitive suitor (assuming that merging firms will not be unreasonably required to find suitors that are no match for the current offer on the table, especially when time is of the essence in saving the business). If the requirements are loosened too much, the doctrine opens itself to abuse. On the flipside, firms that are genuinely failing, should be able to prove the requirements.

It is our prediction that, instead of seeing a significant slackening of the existing failing firm doctrine requirements by the competition authorities, we are likely to encounter an uptake in the number of firms seeking to rely on the doctrine, as well as a potential increase in the number of firms who are able to meet the evidential hurdles due to the prevailing economic reality.

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Merger analysis is prospective and predicting the future, even when markets are operating under "*healthy*" circumstances, is challenging.

Conclusion

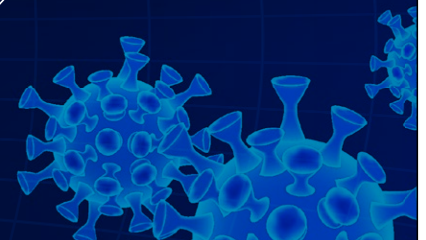
The failing firm doctrine may be a saving grace for financially distressed firms, particularly if the risk of ceasing operation is more detrimental than a merger with limited anticompetitive effects. Whilst the time is ripe for businesses to consider invoking the failing firm doctrine in pursuit of acquisitions that otherwise may not be possible, the doctrine should not be assumed to be a sure-fire defence. Parties relying on the failing firm doctrine must still present sufficient evidence to meet each of the doctrine's requirements – the prevailing pandemic will not in and of itself pave the way for the approval of any merger. Our competition authorities will remain wary of attempts to cloak anticompetitive mergers under the guise of a failing firm.

Merger analysis is prospective and predicting the future, even when markets are operating under "*healthy*" circumstances, is challenging. Market circumstances are currently changing rapidly as we receive daily news of firms announcing varying positions of distress. Prophesying how the business landscape will look post COVID-19 will be a particularly taxing task in proving the counterfactual, for both the competition authorities and merging firms.

Despite the aforesaid challenges, our competition authorities do possess the necessary statutory flexibility to respond effectively to failing firms. Dosed with sufficient pragmatism, as South Africa seeks to rebuild the economy, this old medicine may indeed be a vital part of the treatment plan.

Susan Meyer, Preanka Gounden and Charissa Barden

CDH'S COVID-19
RESOURCE HUB



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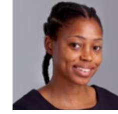

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