

Restatement of OFT's position regarding acquisitions of
'failing firms'

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Introduction and summary

1. This restatement publicises the OFT's position regarding its approach to cases where merging parties seek to persuade the OFT that a merger raising competition concerns should be cleared on 'failing firm' grounds, or reasons similar to it.
2. The following codifies the OFT's position as set out in its existing guidance and decisional practice. It does not constitute new guidance that departs from or relaxes the OFT's basic approach, because the applicable principles are capable of being applied whatever the economic and market conditions.
3. The OFT considers that consistent and transparent application of the criteria it uses to approach such cases is the best means of ensuring that businesses can continue to assess regulatory risk whatever the economic and market conditions. This statement is designed to assist that process and to confirm that the OFT will provide informal advice (IA) in appropriate cases on the application of the 'failing firm' criteria.

OFT's approach to analysing 'failing firm' claims

4. 'Failing firm' claims are, in essence, ones that the target business¹ will exit the market without the merger; any harm to competition should therefore not be attributed to the merger. As the substantial lessening of competition, or 'SLC', test requires that the merger be the cause of competitive harm, the OFT has always believed that meritorious 'failing firm' cases should be allowed to proceed relatively swiftly through clearance by the OFT.
5. Statistically speaking, meritorious cases have been relatively few to date.² However, the fact that the OFT has in practice applied the defence four times under the Enterprise Act 2002 (the Act) suggests the standard applied by the OFT is attainable in practice if the necessary facts and evidence are produced.
6. For example, the OFT will consider application of the 'failing firm' defence to situations where the target business was not yet in liquidation or administration, subject always to satisfaction of the general criteria by which the OFT assesses this standard.

¹ 'Failing firm' arguments may alternatively apply to the acquiring business. Whether referring to the target or the acquiring business, 'failing firm' arguments may apply to an entire business or to divisions or stand-alone business units (for example, individual retail stores). The term 'target business' is used as shorthand in this restatement.

² The OFT has applied the 'failing firm' defence four times under the Enterprise Act 2002: (i) *Anticipated acquisition by First West Yorkshire Limited of Black Prince Buses Limited* 26 May 2005 (failing firm defence met in respect of a bus business as a whole); (ii) *Anticipated acquisition by Tesco Stores Limited of five former Kwik Save stores (Handforth, Coventry, Liverpool, Barrow-in-Furness and Nelson)* 11 December 2007 (failing firm defence met in respect of individual local grocery stores); (iii) *Completed acquisition by the CdMG group of companies of Ferryways NV and Searoad Stevedores NV* 24 January 2008 (failing firm defence met in respect of target business); and (iv) *Completed acquisition by Home Retail Group plc of 27 leasehold properties from Focus (DIY) Ltd* 15 April 2008 (failing firm defence met in respect of an individual DIY store).

Criteria to assess absence of causal link between the merger and any competitive harm

7. The OFT's position on how it approaches the counterfactual – including 'failing firm' claims – is set out in detail in the OFT's existing guidance and decisional practice in this area.³
8. Where merging parties argue that prevailing conditions of competition are not the appropriate benchmark to assess merger effects because the target business would have exited the market absent the merger in any event, the OFT has explicitly adopted a stringent approach in such cases out of recognition that counterfactuals are easily the subject of self-serving speculation – relatively easily alleged but difficult, given the information asymmetries, to verify independently.
9. The OFT's duty under the Act (as clarified in *IBA Health v OFT*⁴) to refer a merger to the Competition Commission (CC) for further investigation where the merger creates the realistic prospect of a substantial lessening of competition requires the OFT to take a cautious approach to claims by merging parties that the loss of competition would have occurred anyway independent of the merger. This explains the OFT's requirement for compelling evidence where merging parties present arguments on a counterfactual other than the prevailing conditions of competition (including 'failing firm' claims).

³ See in particular OFT *Mergers - Substantive assessment guidance* OFT 516 May 2003 paragraphs 4.36 – 4.39 and *Tesco/Kwik-Save* and *Home Retail Group/Focus*. The issue of the counterfactual will also be covered in the *Joint OFT / CC Substantive Merger Guidelines* which are expected to be published during 2009.

⁴ *IBA Health Ltd v OFT* [2004] EWCA Civ 142.

10. The OFT has made it clear that it will only clear a transaction based on 'failing firm' claims where it has sufficient compelling evidence that all of the following conditions are met.

- **Inevitable exit of the target business absent the merger**

- The target business would inevitably have exited the market in the near future. This will often be because the business in question is in a parlous financial situation, even if not yet in liquidation, but may be for some other reason such as a change in the seller's corporate strategy.
- Having demonstrably explored such options, there is no serious prospect of the target business being reorganised; this takes account of the reality that even businesses in receivership often survive and recover.

- **No realistic and substantially less anti-competitive alternative**

- There are no other realistic purchasers whose acquisition of the target business would produce a substantially better outcome for competition. Even if such a purchaser may not pay the seller as high a purchase price or otherwise benefit the target business, the OFT will take into account any realistic prospect of alternative offers above liquidation value.
- Alternatively, in some cases it may also be better for competition that the target business fails and the remaining players compete for its market share and assets rather than being transferred wholesale to a single purchaser.

11. The above criteria demonstrate clearly that what is important for the OFT in its merger assessment is not merely that the target business would have exited the market, but also that the merger in question does not

result in a SLC compared to other realistic scenarios following exit of the target business.

12. Moreover, as is its usual practice, the OFT will not treat completed acquisitions more favourably than anticipated transactions for these purposes. The OFT will not let a 'done deal' colour its judgment on whether to investigate a transaction not notified to it, and on the substantive questions of whether exit was inevitable and what options other than the merger in question were available. As the OFT and CC decisions in the *Thermo/GVI* case⁵ (involving 'failing firm' claims) show, completed mergers may be referred and unwound by the CC in appropriate circumstances. As noted in the CC's remedies guidance,⁶ costs to the parties of such action are not normally taken into account in determining whether divestment remedies are proportionate.

Application of the 'failing firm' criteria in prevailing economic and market conditions

13. The OFT will take account of prevailing economic and market conditions when assessing evidence put forward by merging parties. A contextual evaluation of evidence will be important in relation to, for example:
- the inevitability of the target business exiting the market because of, for example, cash flow difficulties or an inability to raise capital; and
 - the realistic availability of alternative purchasers for the target business as a result, for example, of difficulties in raising investment finance.

⁵ OFT Decision *Completed acquisition by Thermo Electron Manufacturing Limited of GV Instruments Limited* 15 December 2006 and CC Report: *A report on the completed acquisition of GV Instruments Limited by Thermo Electron Manufacturing Limited* (2007).

⁶ CC - 8 *Merger Remedies: Competition Commission Guidelines* (November 2008).

14. However, as a legal and policy matter, the OFT will not, regardless of prevailing economic and market conditions, relax the 'sufficient compelling evidence' standard required to demonstrate that a merger between close competitors is not itself the cause of any SLC.
- Although merging parties may find their businesses under financial pressure as a result of changing conditions, their customers may well be in a similar position. Weakening evidentiary standards to allow anti-competitive mergers is likely to bolster operators with market power at one level of the supply chain, only to increase pressure downstream as a result of anti-competitive price increases, or other anti-competitive conduct, resulting from the merger. The creation of, or increase in, market power in UK markets, where this is far from inevitable, will also fail to serve productivity of the UK economy well in the longer term.
 - There is no good reason why owners of struggling businesses should be permitted to sell to another close competitor in the market simply because it is prepared to pay the highest price for the target business. Businesses wishing to exit the market must be aware of the implications of choosing to try to sell to a close competitor. To advance a 'failing firm' argument, they will need to adduce evidence to demonstrate the absence of any realistic and substantially less anti-competitive alternative purchaser. In terms of execution risk for a deal, the quickest and least risky sale is to a purchaser that raises no competition issues, if such a purchaser exists, even if the price that purchaser offers is lower than that which was offered by a close competitor.
 - In situations where the target business is failing and there is genuinely only one purchaser for the business in question, merging parties must be aware that they will need to provide compelling evidence of this to the OFT if they are to avoid a reference to the CC. Mere assertion that this is the case will not suffice.

Provision of informal advice on 'failing firm' situations

15. The OFT fully appreciates the significance of changing economic and market conditions for firms operating in the UK. In such circumstances, the OFT considers it important to provide assistance and guidance to businesses in terms of their regulatory risk assessments where appropriate. The OFT has this year provided IA on a number of occasions, including in relation to struggling businesses.
16. The OFT therefore emphasises its willingness to provide IA on the specific issue of whether the target business can be regarded as a 'failing firm', provided always that the normal conditions for IA are met – including that the case is a credible candidate case for reference.⁷
17. However, the OFT notes that the normal limitations that apply to the provision of IA – principally that it is non-binding on the OFT and that its accuracy is wholly dependent on the information provided by the merging parties – are particularly relevant in the context of IA concerning 'failing firm' situations.
18. Specifically, the OFT will rarely be in a position to confirm that there is no realistic and substantially less anti-competitive purchaser for the target business outside the context of a market test involving third parties. It will therefore be more realistic for the OFT to give guidance on whether the sales process anticipated (or conducted) by the seller of the business suffices to provide the necessary evidentiary comfort to the OFT on this point.⁸ Providing IA to the seller alone, or in conjunction with a proposed

⁷ The OFT's position on when it will provide IA is set out in detail in the OFT's existing guidance in this area. See in particular OFT *Interim arrangements for informal advice and pre-notification contacts* April 2006 and OFT *Mergers - jurisdictional and procedural guidance - Draft guidance consultation document* March 2008.

⁸ For example in OFT Decision *Completed acquisition by Home Retail Group plc of 27 leasehold properties from Focus (DIY) Ltd* 15 April 2008, the OFT was able to place weight on the fact that the process under which the relevant stores had been offered for sale had been open and

acquirer, is therefore likely to be more beneficial, all else equal, than an application from an acquirer alone, who is unlikely to have the best-available evidence on the financial situation of the target, and the degree to which less anti-competitive options than the merger have been exhausted by the seller.

involved retailers of many different kinds, including each of the other three national DIY sheds (paragraph 91).