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Guidance

Annex A: Summary of CMA's position on mergers involving 'failing firms'

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Introduction

This summary is an Annex to the CMA's guidance on merger assessments during the Coronavirus (COVID-19) pandemic (<https://www.gov.uk/government/publications/merger-assessments-during-the-coronavirus-covid-19-pandemic>) and it should be read in conjunction with that document. It is intended to act as a short reference guide for how the CMA will assess mergers involving 'failing firm' claims. The CMA is aware that the current market environment may lead to additional submissions that firms involved in mergers are failing financially and would have exited the market absent the merger in question. It is important that these submissions are treated in a fair and transparent way that appropriately protects the interests of consumers. Such an approach is also the best means of ensuring that businesses can continue to assess regulatory risk whatever the economic and market conditions.

Accordingly, while 'failing firm' scenarios will be carefully considered on a case-by-case basis, this summary reiterates the principles, outlined in the CMA's existing guidance and decisional practice, that govern how the CMA will assess mergers in which such 'failing firm' claims are raised.

The CMA's approach to the analysis of 'failing firm' claims

Framework for assessment

'Failing firm' claims are typically considered as part of the CMA's assessment of the counterfactual. The counterfactual is an analytical tool used to help answer the question of whether a merger has or may be expected to result in a substantial lessening of competition (SLC).¹ It does this by providing the basis for a comparison of the competitive situation on the market with the merger against the future competitive situation on the market without the merger.² The latter is the counterfactual.³ The CMA may examine several possible scenarios to determine the appropriate counterfactual, one of which may be the continuation of the pre-merger situation (i.e, the prevailing conditions of competition).

One example of a situation where the CMA may select a counterfactual different from the prevailing conditions of competition is where one of the merging parties is likely to exit the market absent the transaction under review. The exiting firm scenario is most commonly considered when one of the firms is said to be failing financially,⁴ and would have exited the market without the merger because of financial failure.⁵ This is commonly referred to as a 'failing firm' scenario.

The CMA seeks to avoid importing into the assessment of the appropriate counterfactual any spurious claims to accurate prediction or foresight. Given that the counterfactual incorporates only those elements of scenarios that are foreseeable, it will not in general be necessary to make finely balanced judgements about what is and what is not included in the counterfactual.⁶

Events which occur during the CMA's review of a transaction (such as the business impact of Coronavirus (COVID-19), but which are not a result of the merger, can be incorporated into the counterfactual.⁷ Where future events or circumstances are not certain or foreseeable enough to include in the counterfactual, the analysis of such events can take place in the assessment of competitive effects.⁸ Accordingly, where a business's financial difficulties do not meet the conditions of the exiting firm counterfactual (as described further below), the implications of those financial difficulties (where appropriately evidenced) could still be considered within the CMA's competitive assessment.

As the SLC test requires that the merger be the cause of competitive harm, the CMA has previously found that mergers should, on the basis of sufficiently evidenced ‘failing firm’ arguments, be unconditionally cleared after rigorous assessment. The conditions for the failing firm scenario (as described further below) are stringent, however, and the CMA’s experience to date (consistent with the experience of other competition authorities, such as the European Commission) has been that relatively few cases have met the criteria to be cleared on the basis of the failing firm counterfactual.

The CMA’s approach to ‘failing firm’ claims is set out in detail in its Merger Assessment Guidelines and decisional practice in this area.⁹ The Merger Assessment Guidelines set out a three-limb framework for assessing the exiting firm scenario, requiring the CMA to consider:

- Limb 1: Whether the firm would have exited (through failure or otherwise) absent the transaction;
- Limb 2: Whether there would have been an alternative purchaser for the firm or its assets; and
- Limb 3: What the impact of exit would be on competition compared to the competitive outcome that would arise from the acquisition.

The CMA’s assessment of the relevant counterfactual, and its application of the three limbs of the exiting firm test described above are, however, determined by the specific facts of each case. There may be specific features of some cases that mean that the wording set out in the Merger Assessment Guidelines is not always directly applicable. In such circumstances, the CMA will seek to apply the broader principles that underpin those tests.

Limb 1: Would the firm would have exited absent the transaction?

The first question the CMA will consider is whether one of the firms would have exited the market absent the Merger.

Where a firm may be exiting because of financial failure, consideration is given both to whether the firm is unable to meet its financial obligations in the near future and to whether it is unable to restructure itself successfully. In practice, the CMA will carefully examine the firm’s profitability over time, cash flows and its balance sheet in order to determine the profile of assets and liabilities. It will also consider the action the management has taken to address the firm’s position and will review contemporaneous internal documents such as board minutes, management accounts and strategic plans. The CMA will also typically request and consider contemporaneous analysis provided by external legal, financial and insolvency advisers, as well as external auditors, in relation to the position of the company.¹⁰ The CMA may also request evidence from the company’s debt or equity providers, such as the banks that provide its financial facilities or existing shareholders.

If the firm is part of a larger corporate group, the CMA will also consider the parent company’s ability to provide continued financial support. In previous cases, the CMA has found that limb 1 has not been met where a parent company would be able to provide continued financial support to a business experiencing financial difficulties.¹¹ An exiting firm scenario may, however, still exist in such circumstances if the CMA were satisfied that the business would have ultimately exited for strategic reasons unrelated to the transaction in question.

Limb 2: Would there have been an alternative purchaser for the firm or its assets?

The second question the CMA will consider is whether there was any substantially less anti-competitive purchaser for the business or its assets.

Even if the CMA believes that the firm would have exited, there may be other buyers whose acquisition of the firm as a going concern, or of its assets, would produce a better outcome for competition than the merger under consideration. These buyers may be interested in acquiring the firm or its assets as a means of entering the

market.

When considering the prospects for an alternative purchaser, the CMA will look at available evidence supporting any claims that there was genuinely only one possible purchaser and will consider the prospects of alternative offers for the business above liquidation value. In particular, the CMA is likely to conduct a stringent assessment of the marketing process through which a business has been sold, and to consider whether other realistic prospective purchasers would have had sufficient opportunity to advance a purchase. The fact that no other bids were ultimately received for a business may not, by itself, support the position that there were no alternative purchasers for a firm or its assets.

Similarly, the possible unwillingness of alternative purchasers to pay the seller's asking price (or to pay as much as the purchaser ultimately chosen) would not rule out a counterfactual in which there is a merger with an alternative purchaser, so long as any alternative offer would have been above liquidation value.¹²

The CMA notes that the management of struggling businesses may wish to maximise shareholder value by selling for the highest price possible (and that, for obvious reasons, a close competitor active in the same market may value the business being sold more highly than other bidders). The CMA notes, in this regard, that businesses wishing to exit the market should carefully consider the implications of choosing to try to sell to a close competitor and, in particular, that execution risks (including those relating to merger control proceedings) should be carefully considered in conjunction with other commercial considerations (including not only what price might be achieved but also how quickly the seller might be able to complete the sales process).

As a voluntary merger control regime, merging parties are not required to notify the CMA of any merger, and the CMA would not call a merger in for investigation unless there was a reasonable chance that the test for a reference to an in-depth phase 2 investigation will be met.¹³ Sellers seeking to minimise execution risk may therefore prefer to pursue a sale 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 this regard, sellers should note that (as explained elsewhere in this document) establishing that a 'failing firm' scenario exists will require a significant amount of information to be provided to the CMA to establish financial failure and the absence of any realistic and substantially less anti-competitive alternative purchaser.

Limb 3: What would the impact of exit be on competition compared to the competitive outcome that would arise from the acquisition?

The third question the CMA will consider is what the impact of exit be on competition compared to the competitive outcome that would arise from the acquisition.

The wording in the Merger Assessment Guidelines for this limb focusses on the sales of the exiting firm. If its sales were likely to have been dispersed across several firms, the merger, by transferring most or all sales to the acquirer, may have a significant impact on competition. If, on the other hand, the majority of sales were expected to have switched to the acquiring firm in the absence of the merger, the merger may be expected to have little effect on competition.

In practice, the CMA has applied this test less mechanistically than is suggested in the wording of the Merger Assessment Guidelines (given the undue emphasis that this wording places on the redistribution of sales for the purposes of competitive assessment). Depending on the nature of the markets at issue, the CMA will not only consider what might happen to the sales of the merging party but will also consider the impact that the merger is likely to have on competition more broadly. More specifically, the CMA is likely to consider the impact that the exit

of the failing firm would have on competition within the markets at issue (looking at the overall market structure and taking all relevant parameters of competition into account) compared to the competitive outcome that would arise from the acquisition.

Application in completed transactions

In keeping with its established practice, the CMA will not, for the purposes of substantive assessment, treat completed acquisitions any differently to anticipated transactions. Accordingly, the fact that a merger is a 'done deal' will not be taken into account by the CMA when considering whether to call in a transaction that has not been notified for investigation or in its substantive assessment (including in considering whether a failing firm scenario applies). Previous cases show that completed mergers can be referred for a Phase 2 investigation and have remedies imposed by the CMA in appropriate circumstances.¹⁴

Moreover, as noted above, only events that are not a result of the merger under review can be incorporated into the counterfactual. Accordingly, a 'failing firm' scenario is unlikely to exist where the merger under review is a contributing factor to the target firm's exit. Similarly, the fact that a merger may have served to reduce the interest of alternative purchasers in a business or its assets (for example, because of the access that the acquirer might have had to proprietary business information during the intervening period) is also unlikely to be taken into account by the CMA, which will typically look at whether there were alternative purchasers for the business around the time that the merger agreement was entered into.

Finally, as the Guidance on the CMA's jurisdiction and procedure makes clear, merging parties that choose to complete a merger without prior CMA approval necessarily accept certain costs and risks.¹⁵ In particular, the CMA will typically impose interim measures in completed mergers, which will require the acquiring business to preserve the viability and competitive capability of the acquired business during the CMA's investigation.¹⁶ This is likely to include making sufficient resources available to the target business to ensure that it is able to continue to operate on the basis of its pre-merger business plan.¹⁷ The CMA may also use its powers to unwind integration that took place prior to interim measures coming into force. It is therefore the case that the investigation of a completed transaction is likely to result in the acquirer incurring significant additional transaction-related costs, even if the acquisition is ultimately cleared.

In addition, completing a merger without first obtaining clearance from the CMA carries the risk that the completed transaction may be terminated by disposal of the acquired business (or otherwise remedied by disposal of other businesses or assets) following an investigation. Where this is the case, the CMA will not normally consider the cost of divestiture to the merger parties in selecting appropriate remedies.¹⁸

Evidential standards

The Coronavirus (COVID-19) pandemic has not brought about any relaxation of the standards by which mergers are assessed or the CMA's investigational standards. It remains critical to preserve competition in markets through rigorous merger investigations in order to protect the interests of consumers in the longer term.

The CMA needs to ensure its decisions are based on evidence and not speculation, and will carefully consider the available evidence in relation to the possible impacts of Coronavirus (COVID-19) on competition in each case.

At Phase 1, the CMA will select the most competitive counterfactual, provided that situation is a realistic prospect. At Phase 2, the CMA will ultimately select the counterfactual it considers would be the most likely scenario to have arisen absent the merger.¹⁹ Merging parties, giving proper consideration to execution risks (as noted above), should therefore note that there is a higher evidential bar to establish that a 'failing firm' scenario exists in Phase 1

proceedings (where, as the Merger Assessment Guidelines make clear, the CMA requires ‘compelling evidence’ to satisfy that the test is met). Given the implications of a ‘failing firm’ scenario (the clearance of a transaction that could otherwise raise significant competition concerns), ‘failing firm’ claims are only likely to be accepted, whether at Phase 1 or Phase 2, where supported by a material body of probative evidence, which the merging parties can expect the CMA to test thoroughly with both the merging parties and their advisers, as well as third parties. Unsupported assertions in relation to the financial health of a business or the absence of alternative purchasers are highly unlikely to be sufficient to establish a failing firm scenario.

Engagement with the CMA

Where the CMA has opened (or will open) a merger investigation, the CMA recommends early engagement with the case team to discuss what information is likely to be required to inform the CMA’s assessment of a firm’s financial position and the existence of alternative purchasers for a business or its assets. In particular, merging parties are advised to make clear that they consider that a ‘failing firm’ scenario exists when submitting a case team allocation form.

The CMA notes that its Guidance on the CMA’s jurisdiction and procedure states that the CMA may be willing to give informal advice in relation to whether one of the merging businesses can be regarded as a ‘failing firm’.²⁰ The CMA notes that informal advice is only available for good faith confidential transactions,²¹ and where there is a ‘genuine issue’.²² The CMA’s guidance makes clear that informal advice is not available as a substitute for external legal advice or as a tool to seek endorsement of external legal advice.

A considerable amount of information to inform merging parties’ own analysis of the exiting firm test is available in the Merger Assessment Guidelines, in this guidance and in the CMA’s decisional practice. Moreover, the CMA would not, within the context of informal advice, be able to carry out a fact-intensive investigation (likely, as noted above, to require the use of formal evidence-gathering powers and evidence from third parties) to assess whether the first two limbs of the test are met in a given case. Accordingly, while the CMA is aware of the pressures which the current crisis is causing for a number of businesses and the economy as a whole, and is keen to provide guidance to merging businesses where appropriate, it notes that informal advice is, in practice, only likely to be available where a genuinely ‘novel’ query arises.

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1. Merger Assessment Guidelines (OFT1254/CC2) (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/284449/OFT1254.pdf), September 2010, paragraph 4.3.1. The Merger Assessment Guidelines have been adopted by the CMA. ↩
 2. Merger Assessment Guidelines (<https://www.gov.uk/government/publications/merger-assessment-guidelines>), paragraphs 4.3.1 and 4.3.6. ↩
 3. Merger Assessment Guidelines (<https://www.gov.uk/government/publications/merger-assessment-guidelines>), paragraph 4.3.1. ↩
 4. ‘Failing firm’ arguments may alternatively apply to the acquiring business (see, for example, A report on the completed acquisition by Sonoco Products Company of Weidenhammer Packaging Group GmbH (https://assets.publishing.service.gov.uk/media/559662c7ed915d1595000015/Final_report.pdf), 3 July 2015, in which ‘failing firm’ claims were made by both the acquirer and the target). 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). ↩
 5. An exiting firm scenario can also apply where a firm will exit the market for reasons other than financial failure, for example as a result of a (pre-merger) change in corporate strategy by the selling firm. The focus of this statement is on failing firm scenarios (although many of the principles set out would be applicable in the extent of exit as a result of changes in corporate strategy). ↩

6. Merger Assessment Guidelines
(https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/284449/OFT1254.pdf), paragraphs 4.3.2 and 4.3.6. ↩
7. See, in this regard, *British Sky Broadcasting plc v Competition Commission*
(https://www.catribunal.org.uk/sites/default/files/1.Judg_revised_BSkyB_1095_Virgin_Inc_1096_290908.pdf) e.a. [2008] CAT 25, paragraph 91. ↩
8. Merger Assessment Guidelines (<https://www.gov.uk/government/publications/merger-assessment-guidelines>), paragraph 4.3.2. ↩
9. Merger Assessment Guidelines
(https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/284449/OFT1254.pdf), paragraphs 4.3.8 to 4.3.18. Since the formation of the CMA in April 2014, the CMA has applied the ‘failing firm’ defence under the Enterprise Act 2002 in: (i) ME/6642-16 Completed acquisition by East Coast Buses Limited of the east coast operations of First Scotland East Limited
(<https://assets.publishing.service.gov.uk/media/58a18713e5274a040d000008/first-scotland-east-coast-buses-ftd.pdf>) (East Coast buses) (23 Jan 2017) (‘failing firm’ defence met at Phase 1 in respect of certain bus operations); and (ii) completed acquisition by Alliance Medical Group Limited of the assets of IBA Molecular UK Limited used to manufacture 18F-Fluorodeoxyglucose (Alliance/IBA) (see Final Report
(https://assets.publishing.service.gov.uk/media/53ee079140f0b62d98000001/Final_report.pdf), 15 August 2014) (‘failing firm’ defence met after an in-depth Phase 2 investigation in respect of the target IBA business). In the anticipated acquisition by Poundland Group plc of 99p Stores Limited, the CMA rejected the ‘failing firm’ defence after an in-depth Phase 2 investigation and following a detailed assessment of the financial and operational performance of the target 99p (while going on to ultimately clear the transaction) (see Final Report
(https://assets.publishing.service.gov.uk/media/55fc0337ed915d14f100001c/Poundland_-_99p_Final_report.pdf), 18 September 2015, Section 5). In the completed acquisition by Sonoco Products Company of Weidenhammer Packaging Group GmbH, the CMA rejected the ‘failing firm’ claims made by both merging parties after an in-depth Phase 2 investigation (while going on to ultimately clear the transaction) – see Final Report
(https://assets.publishing.service.gov.uk/media/559662c7ed915d1595000015/Final_report.pdf), 3 July 2015, Section 5. ↩
10. In relation to the materials produced by these advisers, the CMA notes that, under section 117(2) of the Enterprise Act 2002, it is an offence to provide information that is false or misleading in a material respect to another person knowing that information is to be used for the purposes of supplying information to the CMA. ↩
11. ME/6523/15 Anticipated acquisition by Chemring Group plc of the air countermeasures and pyrotechnics business and certain assets of Wallop Defence Systems Limited
(<https://assets.publishing.service.gov.uk/media/57289ea140f0b6158700001c/chemring-wallop-full-text-decision.pdf>) (2016), paragraph 51. ↩
12. Merger Assessment Guidelines
(https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/284449/OFT1254.pdf), paragraphs 4.3.13-4.3.17. ↩
13. Guidance on the CMA’s mergers intelligence function
(https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/872435/Guidance_on_mergers_intelligence_function.pdf) (CMA56), September 2015, paragraph 2. ↩
14. Completed acquisition by Euro Car Parts of the assets of the Andrew Page business (see Final Report
(<https://assets.publishing.service.gov.uk/media/59f87b5fe5274a5654e4e381/eurocarparts-andrewpage-final-report.pdf>), 31 Oct 2017). ‘Failing firm’ claims have been made at Phase 1 in a number of completed acquisitions that were then referred by the CMA for an in-depth Phase 2 investigation, but ultimately cleared: for example (i) Alliance/IBA (see Final Report
(https://assets.publishing.service.gov.uk/media/53ee079140f0b62d98000001/Final_report.pdf), 15 Aug 2014); and (ii)

Completed acquisition by VTech Holdings Limited of LeapFrog Enterprises, Inc (see Final Report (<https://assets.publishing.service.gov.uk/media/5877958040f0b60e4a000121/vtech-leapfrog-final-report.pdf>), 12 Jan 2017). ↩

15. Mergers: Guidance on the CMA's jurisdiction and procedure

(https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/384055/CMA2__Mergers__Guidance.pdf) (CMA2) (Guidance on the CMA's jurisdiction and procedure), January 2014, paragraphs 6.20-6.21. ↩

16. Interim measures in merger investigations

(https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/813144/Interim_Measures_in_Merger_Investigations_June_2019.pdf) (CMA108) (Interim Measures Guidance), 28 June 2019, paragraph 1.7. ↩

17. See Template Initial Enforcement Order (Completed Merger)

(https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/812924/initial-enforcement-order-template.pdf), clause 5(b) which requires the acquiring business to ensure, inter alia, that the acquired business (as well as the acquiring business) is maintained as a going concern and sufficient resources are made available for the development of the business on the basis of its pre-merger business plans. The CMA's guidance notes that, in circumstances where the acquired business is in severe financial difficulty, the CMA may permit the acquiring business to exercise direct control over the commercial policy of the acquired business or to appoint an independent manager to run that business, subject to appropriate safeguards (Interim Measures Guidance, paragraph 3.67). This will, however, depend on the specific circumstances of a given case (including, in particular, the reasons for the acquired business's severe financial difficulties). Where, for example, the available evidence indicates that the target business was well-run and its financial difficulties are primarily attributable to changes in market conditions brought about by Covid-19, a derogation to replace the target's existing management team would be unlikely to be granted. ↩

18. Merger remedies

(https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/764372/Merger_remedies_guidance.pdf) (CMA87), December 2018, paragraph 4.80. ↩

19. Merger Assessment Guidelines

(https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/284449/OFT1254.pdf), paragraph 4.3.6. ↩

20. Guidance on the CMA's jurisdiction and procedure

(https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/384055/CMA2__Mergers__Guidance.pdf), paragraph 6.25 and footnote 103. ↩

21. Guidance on the CMA's jurisdiction and procedure

(https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/384055/CMA2__Mergers__Guidance.pdf), paragraph 6.27. ↩

22. Guidance on the CMA's jurisdiction and procedure

(https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/384055/CMA2__Mergers__Guidance.pdf), paragraph 6.28. ↩