The global health emergency caused by the COVID-19 pandemic has exacted a heavy toll on life and economic activity around the world. While some aspects of the outbreak’s fallout are already clear, others will take time to come into focus. Among the many unknowns are for how long impacted firms can weather the crisis, how many businesses will eventually fold, and whether there are ways to keep failing companies (or their assets) in the market.

The potential increase in distressed companies looking for lifelines and stable firms searching for growth opportunities may soon lead to an increase in certain types of M&A activity. Businesses contemplating these kinds of deals should expect antitrust regulators to assess proposed transactions pursuant to ordinary antitrust principles. But when a potentially problematic transaction involves a “failing” firm—generally a business facing bankruptcy, with little hope of reorganization, and without reasonable alternative buyers—then antitrust authorities may allow the transaction to proceed despite apparent underlying competitive concerns. The objective in these situations is to prevent the failing firm’s assets from exiting the market altogether.

In light of the ongoing COVID-19 crisis and the potential increase in M&A activity around distressed firms, this alert discusses the failing firm defense in key jurisdictions, with a particular focus on how the defense operates in times of economic turmoil. Key takeaways include:

- The failing firm defense and its related doctrines—the “flailing firm” and failing division defenses—are viable, if in normal times rare and exacting, mechanisms to secure merger clearance.
- During past economic crises, regulators generally refused to expand the failing firm doctrine’s reach or loosen its requirements, even though they acknowledged that general economic conditions are relevant to merger reviews and, at least in some jurisdictions, certain practical accommodations may be necessary.
- The unprecedented economic conditions presented by COVID-19 may mean the failing firm defense has a greater potential to succeed, not because the standards are lowered, but because the economic reality...
means more firms are actually failing and have fewer options to keep their assets in the market.

The Failing Firm Defense

**The United States.** The Department of Justice/Federal Trade Commission Horizontal Merger Guidelines, which guide agency review during merger investigations, require merging companies invoking the failing firm defense to prove: (1) the allegedly failing firm is unable to meet its financial obligations in the near future; (2) it would not be able to reorganize successfully under Chapter 11 of the Bankruptcy Act; and (3) it has made unsuccessful good-faith efforts to elicit reasonable alternative offers—anything above liquidation value—that would keep it in the relevant market and pose a less severe danger to competition. In litigation, a company invoking the defense must make largely the same showing: (1) one of the firms is in imminent danger of failure, which can mean it is about to enter bankruptcy or receivership; (2) the failing company has no realistic chance of a successful reorganization; and (3) there is no viable alternative purchaser that would pose less risk to competition. Congress has enacted a handful of statutes that apply a less stringent standard for industries deemed particularly important, including banking and newspapers. For those industries, a smaller risk of failure can help justify the transaction.

The same general considerations govern “failing division” defenses, which allow a healthy company to sell one of its divisions despite potential competitive concerns. The US antitrust agencies do not normally credit claims that a division will exit the relevant market unless (1) there is reliable proof of persistently negative cash flow that is not for the firm’s benefit, and (2) the owner of the failing division has made unsuccessful good-faith efforts to find an alternative, less anticompetitive buyer.

The “flailing firm” defense, by contrast, applies when one of the merging parties, while not on the verge of bankruptcy, is a “weakened competitor.” That weakened state suggests that it cannot compete effectively in the future, thereby rebutting the implication of high market shares and the presumption that a merger will have anticompetitive effects. The exact evidence necessary to satisfy the flailing firm defense varies based on the circumstances but has included a firm’s lack of resources required to compete long term, financial difficulties that constrain the firm from improving its competitive position, and poor brand image and sales performance over several years.

The US antitrust agencies suggest that the failing and flailing firm defenses are rarely invoked before courts or the agencies and, even when invoked, that they rarely succeed. While it is difficult to assess how often the defenses are raised (or credited) in confidential agency proceedings, litigants have asserted the defenses roughly 50 times since 1930 and have succeeded, at least in part, on 18 occasions, a success rate of nearly 40 percent.
The European Union. While the EU Merger Regulation (EUMR) makes no explicit reference to a “failing firm” doctrine, the European Commission (EC) assesses the competitive impact of a concentration by taking into account the degree to which the allegedly failing firm would continue to be an effective competitive force in the market. From this perspective, the acquisition of a failing firm might be presented as a “rescue merger” and the only viable way to keep the assets of the firm in the market.

The European Court of Justice approved this approach and its application in the Kali + Salz case in 1998. The case concerned a proposed joint venture between Kali + Salz AG and Mitteldeutsche Kali AG (MdK), an East-German state-owned company incurring large losses. Pursuant to their agreement, the parties proposed to convert MdK into a private company with Kali + Salz receiving 51 percent of the shares and voting rights in the company. The transaction created a near-monopoly for the supply of potash in Germany and resulted in a company with 60 percent of the European market. The Court nevertheless cleared the transaction because MdK likely would have exited the market absent the transaction, leading to the same outcome as the joint venture.

Following the Kali + Salz judgment, the EC Horizontal Merger Guidelines set out the principles of the “failing firm” doctrine: (1) the allegedly failing firm will in the near future exit the market because of its financial difficulties; (2) there is no less anticompetitive alternative to the notified merger; and (3) absent the merger, the assets of the failing firm will inevitably exit the market. The EC has been very strict in applying these criteria, and it has cleared very few “failing firm” cases under the EUMR. Indeed, the EC has rejected the defense in the vast majority of cases and has indicated that it will not expand its application, even in the wake of economic recessions.

In addition to the more traditional “failing-firm” defense, companies have also approached the EC with claims of (1) a “failing division,” where a part of the selling firm’s assets would exit the market absent the transaction, and (2) a “fading firm,” where a firm’s financial difficulties suggest that the firm cannot compete effectively in the future. The EC has acknowledged that these arguments can succeed under the right circumstances. In the Nynas/Shell/Harburg Refinery case, for example, the purchaser Nynas successfully argued that the oil-refinery assets owned by Shell would close if the proposed transaction did not proceed.

Asia. The failing firm defense has also been recognized throughout Asia. In China, the State Administration for Market Regulation (SAMR), China’s antitrust regulator, requires merging parties to disclose whether the relevant transaction involves a “bankrupt firm” or “a firm on the verge of bankruptcy,” and it recently introduced draft regulations clarifying that SAMR will consider a firm’s financial situation when reviewing mergers. There are, however, no published guidance documents, agency decisions, or court cases describing how the defense is
applied in practice. As a result, it is difficult to assess how often parties raise the defense or how receptive Chinese regulators are, although SAMR considers the financial condition of target companies both in its assessment of competitive effects and when evaluating the timing of its review.

In Japan, the JFTC's M&A guidelines indicate that a company's poor financial results are relevant to the assessment of a transaction's competitive effects. Key factors include: (1) whether the company recorded continuous and significant losses, has excess debt, or is unable to obtain financing for working capital; (2) whether, absent the merger, the company would very likely go bankrupt and exit the market in the near future; and (3) whether there is a viable alternative combination that would have less impact on competition. Again, while it is impossible to estimate with precision how often parties raise the failing firm defense in Japan, there are instances where Japan's antitrust regulator has accepted the argument.

In Korea, merging parties can invoke the “failing firm” defense if: (1) the transaction involves a company (or a business unit) that is insolvent or expected to become insolvent in the near future; (2) absent the transaction, it will be hard to keep the relevant facilities in the market; and (3) it is difficult to identify a less anticompetitive transaction. Because the Korean Fair Trade Commission (KFTC) only publishes decisions blocking mergers or decisions imposing remedies, it is unclear how many times the defense has been raised. From the available decisions, however, merging parties have invoked the “failing firm” defense on more than 20 occasions since 2000, although they have experienced mixed results.

**Regulatory Reactions to the Failing Firm Defenses during Economic Crises**

**The United States.** The US antitrust agencies have consistently rejected calls during times of economic turmoil to ease merger requirements or the standards governing failing firm defenses. Speaking generally about merger review, the FTC recently explained that its "scrutiny of anticompetitive transactions and practices will not be relaxed," “investigations will not be closed if doubts remain, and early termination will not be granted for any transaction for which enforcement action may be necessary.” The Director of the FTC's Bureau of Competition similarly noted that the “antitrust laws are flexible enough to account for changing market conditions, even during uncertain times,” which means “emergency exceptions to the antitrust laws are not needed.”

During the 2008–2009 financial crisis, the Assistant Attorney General for Antitrust at the DOJ similarly explained that the government does not alter its fundamental analysis regarding failing firms, even if they see more companies asserting the defenses during a down economy. The point was echoed by the DOJ's Assistant Attorney General for Economics during the same period, although he also noted “financial distress at the industry or company level is certainly relevant to antitrust analysis,” since enforcers “take account of real-world economic conditions.”
Indeed, regulators have historically taken some measures to accommodate the practical, systemic challenges raised during crises. During the wave of bank failures in the 1980s and early 1990s, the DOJ took steps to coordinate its regulatory reviews with financial industry regulators, including the FDIC. In the wake of the Dot-Com bubble, the FTC expressed a willingness to conduct expedited reviews for firms undergoing bankruptcy. One former Director of the FTC’s Bureau of Competition acknowledged that the FTC sometimes approves a transaction involving a financially weak competitor even though the strict requirements of the failing firm defense are not met. And at least some FTC economists have advocated for a more permissive antitrust policy for failing industries.

**The European Union.** Similar to its US counterpart, the EC has rejected suggestions that it should leniently apply the failing firm defense during economic downturns. In the wake of the 2008–2009 financial crisis, the Deputy Director General for the EC’s DG Competition indicated that the Commission would not depart from its existing policies regarding failing firms. In April 2020, when asked if the EC would be more flexible with failing/flailing firm arguments in light of the COVID-19 pandemic, Jose-Maria Carpi Badia, the Head of DG Competition’s Unit A/2 in charge of merger case support and policy, had the same message: the EC already has a “very good framework” for analyzing mergers using the doctrine, which it has applied in other difficult contexts. Overall, the EC has shown little flexibility in the application of the failing firm defense, even in the face of recessions.

The EC’s prohibition of the merger between Olympic and Aegean Airlines in 2010 (in the aftermath of the 2008 financial crisis) illustrates the agency’s reluctance. The EC concluded that Olympic did not meet the strict criteria of a failing firm because it was unlikely that, absent the merger, Olympic would be forced out of the market in the near future. However, the EC drew a different conclusion when the airlines presented the merger again in 2013, approving the transaction after concluding that, absent the merger, Olympic would exit the market in the near future due to financial difficulties.

In addition to the EC, certain countries in Europe take the potential financial difficulties of merging parties into account when assessing the competitive impact of a transaction. Most recently, on April 17, 2020, the United Kingdom’s competition authority provisionally cleared Amazon’s investment in Deliveroo, a food delivery company, “in light of a deterioration in Deliveroo’s financial position as a result of coronavirus.” When the regulator took the deal to Phase II of its merger investigation, it explained that it was concerned that Amazon was attempting to re-enter the UK food delivery market after its own business, Amazon Restaurants, left the sector in 2016. Given the COVID-19 crisis, however, Deliveroo was likely to exit the UK market absent Amazon’s investment, resulting in an expedited provisional clearance.
Asia. There is little data available about the failing firm defense in China, Japan, or Korea, and even less so around recessions. But in China SAMR recently issued a number of antitrust-related measures meant to address the economic consequences of the COVID-19 pandemic, including expedited merger review in certain sectors. While SAMR may take into consideration the state of the Chinese economy generally, there is no suggestion that it will relax merger controls for struggling firms. That said, there is no reason to doubt that SAMR will allow a failing firm defense in an appropriate case.

In Japan, we expect the antitrust authorities to take a cautious approach toward the failing firm defense. As just one recent example, in 2018, merging regional banks argued that they would not survive absent a merger given Japan’s shrinking rural population. The Japanese antitrust agency nevertheless imposed remedies on the parties.

In Korea, the failing firm defense was added to the country’s antitrust statute after an economic crisis in the late 1990s. Its addition was meant to facilitate corporate restructuring and ensure the efficiency and transparency of merger review, even during crises. In the same vein, the KFTC recently announced that it would expedite reviews of proposed transactions in markets affected by the COVID-19 pandemic. Notably, the KFTC recently cleared two acquisitions in the airline industry, which is facing serious financial difficulties partly as a result of the COVID-19 outbreak. In HDC Hyundai Development/Asiana Airlines and Jeju Air/Eastar Jet, the KFTC reviewed and approved the transactions faster than usual on account of the severe financial difficulties caused by COVID-19. In Jeju Air/Eastar Jet, the KFTC cleared the transaction under the failing firm defense despite competition concerns for the following reasons: Eastar Jet had operated with impaired capital since 2013; its condition was deteriorating further and it was unlikely that the business would recover in the short term in light of the exceptional circumstances caused by the COVID-19 pandemic; and, finally, the KFTC found that there was no less anticompetitive alternative to the proposed transaction.

Considerations for the COVID-19 Crisis

As the COVID-19 crisis continues to evolve, the global economy is likely to confront new and escalating uncertainties. Companies will face significant strain on their balance sheets and many may be forced into the difficult choice of selling their assets or going out of business. Companies that decide to sell must still satisfy traditional antitrust requirements, but the failing firm defense offers a potential rebuttal to anticompetitive concerns.

Indeed, it is possible that the defense may gain greater traction in front of agencies and in court, not because the standards have changed, but because the economic reality means more firms are actually failing and have fewer options to keep their assets in the market. With the crisis impacting nearly every company in nearly every industry, the number of firms with resources to make major acquisitions is likely diminished. Coupled with the antitrust agencies’ increased focus, at least in the context of divestitures, on ensuring that purchasers have experience in the relevant industry—and thereby ensuring the
post-sale firm is a viable competitor going forward—the number of qualified buyers shrinks even further, potentially giving failing firm defenses a better shot at success. In all events, such arguments require careful planning, robust support, and skilled presentation.

At O’Melveny, our antitrust experts have significant experience in appraising and managing mergers, including those involving failing and flailing firms. Our in-depth understanding of how antitrust agencies in the US, Europe, and Asia work, and our established relationships with those regulators, enable us to help our clients navigate the challenges posed by the COVID-19 crisis. If your company is contemplating a transaction, O’Melveny’s global antitrust team can help.