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Private Equity – A Review of Issues in a Downturn Economy

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In a year of severe economic downturn, activity in the private equity sector has clearly slowed down and as such, focusing this chapter on some of the more classic issues of competition law that arise in private equity deals proved difficult. However, the economic downturn has created opportunities for private equity firms interested in purchasing bankrupt or close to insolvent companies. In this context, two particular topics are of interest – the first one, the failing firm defence. The second one is the possibility of seeking permission to close a deal before final clearance is issued. Both topics have a very real practical impact while also raising policy issues for the authorities. The pressure on competition authorities to adopt or relax their policies to reflect the 'new economy' has been increasing. The end result is however that at least in Europe, authorities are not prepared, generally speaking, to relax their rules when there are substantive issues but may be open to consider emergency derogation requests in cases where no anti-competition effects are expected.

Failing firm defence

In assessing whether a transaction gives rise to a competition concerns, for example, a substantial lessening of competition (SLC) in the UK or a significant impediment to effective competition (SIEC) at the community level, the authorities will employ a hypothetical comparison of the future likely state of competition if the transaction proceeds (ie, the factual) against the likely state of competition if it does not (ie, the counterfactual). In a failing firm case, the argument of the parties will be that the factual and the counterfactual will be the same, and there will be no SLC or SIEC. Failing firm claims are based on the premise that a business will exit the market in the absence of the merger and, as a result, any SLC or SIEC identified should not be attributable to the merger. The current chairman of the UK Competition Commission, Peter Freeman, recently observed that 'competition is not a luxury policy relevant only to times of expansion and growth'.[1] Firms seeking to push through transactions on the basis of current market conditions and any rescue argument, in the UK or the EU, or for that matter in most other jurisdictions, need to remember that, fundamentally, a failing firm defence remains a difficult one to make.[2]

UK's restated position

In December 2008, the Office of Fair Trading (OFT) restated its guidelines on failing firms, seemingly in anticipation of a flurry of reliance on the defence during the economic downturn.[3] In summary, the OFT must be provided with 'sufficient compelling evidence' that: the firm is in such a 'parlous financial situation' that the firm and its assets would inevitably exit the market in the near future; there is no serious prospect of reorganising the business (taking into account that businesses in receivership often survive and recover); and there are no other realistic purchasers whose acquisition of the firm would produce a less anti-competitive outcome. While the OFT explained that it will take into account prevailing economic and market conditions when assessing the evidence, for example, with respect to cash flow difficulties and the realistic availability of alternative purchasers as a result of difficulties in raising investment finance, this does not mean that the OFT has given a green light to easy reliance on the failing firm defence.

The OFT has indeed emphasised that it will not relax its requirement for the production of 'sufficient compelling evidence' that all the relevant criteria of the failing firm defence are met, regardless of market conditions. The OFT's chairman, Philip Collins, stated that competition authorities should resist any calls for a more relaxed view of competition enforcement and the adoption of a more liberal interpretation of the relevant exemption criteria.[4] In a rare event – in fact, only the fifth time in its history that the OFT has cleared a transaction on this basis and the first such case since the OFT issued its restatement of December 2008 – the OFT cleared on 28 April 2009 the proposed acquisition of 15 former Zavvi entertainment stores by HMV plc, having investigated the merger on its own initiative.[5] The OFT decided that a reference to the Competition Commission was not necessary (an obligation incumbent on the OFT where any potential SLC is identified) since the criteria for the failing firm defence were met. The OFT had received compelling evidence that, without the merger, the stores would inevitably have exited the entertainment retail market, and that there was no less anti-competitive alternative transaction, since there was no other realistic entertainment retail purchaser for the stores.

In January 2009, the Competition Commission approved the completed acquisition of the Millway Stilton and speciality cheese business of Dairy Crest Group (Millway) by the Stilton producer Long Clawson Dairy (Long Clawson) on the basis of the failing firm defence.[6] Upon investigation with third parties, the Competition Commission concluded Millway was indeed failing – as claimed by Long Clawson –, it had been operating at a loss for many years and was dependent on the support of its parent company. It had also lost significant customers due to problems with the quality and consistency of its product. The Competition Commission considered that Dairy Crest had invested significantly in an attempt to resolve Millway's production problems but had been unable to make the business profitable, and that Millway was not viable. Compared with the sale of the business to Long Clawson, the Competition Commission would not find a less anti-competitive alternative for Millway or its assets. Furthermore, if Long Clawson had not purchased Millway, Dairy Crest would have closed the business following production of stilton for Christmas 2008 and its assets would have exited the market. Although the Competition Commission found, against this counterfactual, that there would be some loss of competition in the acquisition of Millway's customers, such customers could switch away from Long Clawson if they so wished. The loss of competition was not substantial compared with the situation absent the merger.

The Competition Commission is currently reviewing the completed acquisition by Stagecoach Group plc (Stagecoach) of Preston Bus Ltd (Preston Bus), upon reference by the OFT in May 2009. On 7 July 2009, the Competition Commission published an issues statement setting out the main issues with the acquisition, including the appropriate counterfactual and theories of harm.[7] The Competition

Commission explained that it will consider whether, in the absence of the merger, Preston Bus would have remained an independent and viable business, whether it would have been acquired by a different purchaser, and whether it would have exited the market and, if so, what would have happened to its assets. Preston Bus was in financial difficulties prior to its sale; however, while it was possible that it may have entered administration save for the acquisition, the relevant criteria for a valid failing firm defence were found by the OFT to be lacking. The OFT considered that, while it was possible that the Preston Bus may have failed and gone into administration had it not been sold, there could have been a more competitive alternative to the merger. Given interest expressed by other bidders, it could not be ruled out that Preston Bus' assets could have been used by a new entrant to the market to compete with Stagecoach. The Competition Commission is due to report on its provisional findings in August.

European Commission's position

Under Community law, the failing firm defence is not contained in the EC Merger Regulation and was instead first developed in the mid-1990s in two cases: *Kali+Salz/MdK/Treuhand*[8] and *BASF/ Eurodiol/ Pantochim*.[9] In *Kali + Salz*, the European Commission accepted that the 'failing company defence' could be taken into account pursuant to article 2(2) of the EC Merger Regulation, as far as the causality of the concentration for the creation or strengthening of a dominant position is concerned. Accordingly, a merger is not the cause of the deterioration of the competitive structure where: the acquired undertaking would in the near future be forced out of the market; the acquiring undertaking would take over the market share of the acquired undertaking if the latter were forced out of the market; and there is no less anti-competitive alternative purchaser in the market.[10]

The European Commission explained that the lack of causality means that it is the disappearance of the failing company, which would be unavoidable even in the event of a prohibition of the concentration, and not the concentration itself, which creates or strengthens the dominant position. In those circumstances, a concentration should not be prohibited. The European Commission noted that such a situation only occurred 'in exceptional cases' and the burden of proof is always with the merging parties.[11] The European Court of Justice (ECJ) accepted the doctrine but clarified a general principle that where, in the absence of the merger, the competitive structure of the market would deteriorate in a similar fashion, there would be no basis for its prohibition, since the chain of causation between the implementation of the concentration and the impediment to effective competition is broken.[12] The European Commission followed the ECJ in *Blokker/Toys'R'Us*, stating that that 'it is the disappearance of the failing company, which is unavoidable whether or not the concentration takes place, and not the concentration itself, which creates or strengthens the dominant position', as was the relevant test at the time.[13]

In *BASF/Eurodiol/Pantochim*, the European Commission tweaked the criteria on the basis of the exceptional conditions of the market (butanodiol-related products used in solvents in the pharmaceutical and chemical industries). With growing demand and tight capacity constraints, the bankruptcy of the two companies would be likely to cause supply shortages and price increases which would have disadvantaged consumers more than if the merger were allowed. The European Commission's revised criteria were that: the acquired undertaking would in the near future be forced out of the market if not taken over by another undertaking; there is no less anti-competitive alternative purchaser; and the assets to be acquired would inevitably exit the market if not taken over by another undertaking. The concept of a rescue merger was applicable to the case and the European Commission approved the acquisition. These criteria were later embodied in the European Commission's Guidelines on the assessment of horizontal mergers (Guidelines)[14] and are broadly similar to the OFT criteria as restated. The European Commission observed, with respect to the third criteria as revised in *BASF/Eurodiol/Pantochim*, that the inevitability of the assets of the failing firm leaving the market in question may, in particular in a case of merger to monopoly, underlie a finding that the market share of the failing firm would in any event accrue to the other merging party.[15]

The OECD recently published a substantial report, 'Competition and Financial Markets 2009', regarding competition issues raised by the current financial crisis (the OECD Report).[16] The OECD noted, not surprisingly, that the economic crisis will result in an increase in merger activity and the number of failing firm defences advanced. In its contribution to the OECD Report, the European Commission noted that as yet, there has been no case brought before it where the failing firm defence has been raised as a result of the financial crisis, largely because governments have so far intervened under state aid rules to rescue banks and subsidise industries. The European Commission commented that the EC Merger Regulation allows for account to be had of rapidly evolving market conditions and the failing firm defence. In addition, the European Commission went on to explain that, even where the three failing firm criteria are not met, an analysis of what would be the development of the market absent the merger could still lead to the conclusion that a lessening of competition in the market is not a causal effect of the merger. The European Commission therefore considered that 'there has been no case for setting aside existing policy'.

Derogation requests

In the context of private equity firms having to rescue companies in a short period of time, the review of a transaction by the European Commission and the delays this may cause can often prove fatal to the survival of a company. The question therefore arises as to whether a transaction can be closed before formal clearance is issued and whether the European Commission is prepared to entertain a derogation requestion under article 7(3) of the EC Merger Regulation. On an application for a derogation, the European Commission must take into account the urgency of the situation – this being by far an exceptional procedure –, the effects of a suspension on the undertakings concerned (for example, major financial risks) and the threat to competition posed by the concentration.

The European Commission will seek clear evidence that the target undertaking is in severe financial difficulties requiring a 'quick fix' prior to the expiration of the Phase I procedural time frame. Such evidence could, for example, involve financial statements, timelines for default and letters from lenders under the relevant credit agreements. It is advisable that any parties to such a transaction still prepare a notification filing (using the simplified procedure) and submit a draft during the pre-notification phase, at which point the question of whether a derogation request would be permissible could be raised. In doing so, the European Commission will be more receptive to the suggestion as it will have been presented with the information required to comprehend the competitive impact of the proposed transaction, most particularly, the parties' market analysis. Importantly, having the documents prepared in such a manner will speed up the process as the European Commission will have all the facts needed to assess whether the proposed transaction is a suitable candidate for a derogation request.

Derogation requests have not often been granted by the Commission, in total only seven transactions have been approved in such a manner.[17] These statistics reflect a healthy level of caution by the European Commission. However, in the current global recession, the European Commission has shown willingness to use this procedure and, as a result, it should not be overlooked by notifying parties where relevant.

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The OECD stated in the OECD Report that competition authorities need to create greater predictability through reliance on a similar set of standards for failing firm defences, and warns that divestiture remedies may become more difficult because there are fewer potential purchasers of assets to be divested. This may mean that behavioural remedies must play a greater role than has traditionally been the preference of competition authorities. In the OECD Report, the European Commission indicated that, while existing merger policy remains unaltered, it may accommodate rapidly evolving market conditions by granting a derogation from the stand-still obligation pending the merger review. This will allow for full or partial completion of a transaction prior to obtaining clearance and appropriately reflects the need for urgency in rescue deals.

Given the recent financial support stimulus package offered by the UK government and the repeated emphasis by both UK's competition authorities and the European Commission on maintaining and strengthening existing competition policy, it is unlikely that failing firm defence will become the norm in Europe. Philip Lowe, the current director general for DG Competition at the European Commission explained in May this year that, in his view 'the best way out of the current crisis is a robust and rigorous competition policy'.[18] The competition authorities will, however, need to take a more flexible approach when applying their procedural requirements; although clearly, without loosening evidential burdens. This is a fact recognised by Neelie Kroes recently, when she declared, in a speech concerning Commission enforcement policy in the current economic crisis, that 'if I take a step back now and look at our enforcement and our crisis response – there is a strong pattern that emerges: our desire to be flexible on procedures, but firm on principles'.[19]

No doubt the next year will be challenging for those advising the private equity sector.

Notes

1 Law Society Competition Section Annual Conference 21 May 2009, keynote address, 'The world turn'd upside down'.
2 Other competition authorities around the world have also revisited their failing firm defence position. For example, the New Zealand Commerce Commission published on 9 July 2009 draft supplementary guidelines on failing firms: www.comcom.govt.nz//Publications/ContentFiles/Documents/Draft – Mergers and Acquisitions – Supplementary Guidelines on Failing Firms.pdf.
3 www.oft.gov.uk/shared_oft/business_leaflets/general/oft1047.pdf.
4 'Preserving and Restoring Trust and Confidence in Markets': keynote address to the British Institute of International and Comparative Law at the Ninth Annual Trans-Atlantic Antitrust Dialogue, 30 April 2009.
5 www.oft.gov.uk/shared_oft/mergers_ea02/2009/HMV.pdf.
6 www.competition-commission.org.uk/press_rel/2009/jan/pdf/01-09.pdf.
7 www.competition-commission.org.uk/press_rel/2009/july/pdf/30-09.pdf.
8 Case IV/M.308, [1994] OJ L186/30.
9 Case COMP/M.2314, [2002] OJ L132/45.
10 See also Commission Decision 97/610/EC in Case IV/M.774 *Saint-Gobain/Wacker-Chemie/NOM*, OJ L247, paragraph 247.
11 See footnote 8 at paragraph 72.
12 Joined Cases C-68/94 and C-30/95 *French Republic/Commission* and *SCPA/Commission*, [1998] ECR I-1375.
13 Case No IV/M.890 – *Blokker/Toys'R'Us*, Commission Decision of 26 June 1997, paragraph 111. Note that this merger was however prohibited.
14 OJ C31, 5 February 2004, p5: see paras 89-91.
15 See footnote 111 of the Guidelines.
16 www.oecd.org/dataoecd/45/16/43046091.pdf.
17 See, for example, Case IV/M.1025 *Mannesmann/Olivetti/Infostrada* and Case IV/M.2008 *AOM/Air Liberté/Air Littoval*.
18 'Keeping Markets working effectively: Europe's challenge in recessionary times', European Competition Day, Brno, Czech Republic, 14 May 2009.
19 'Commission Enforcement Policy and the Need for a Competitive Solution to the Crisis', Address to the Irish Centre for European Law, SPEECH/09/348, Dublin, 17 July 2009.

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Recent transactions include representing Bain Capital in its acquisition of the Bath and Kitchen Business of American Standard and its acquisition of Brake Brothers; representing Daikin Industries with respect to the acquisition of OYL Industries Behard (two of the largest air conditioning manufacturers in the world); representing Syniverse Technologies Inc in relation to its acquisition of the data-clearing business of the BSG Group (a '3 to 2' merger cleared in phase II without conditions); representing CCMP Capital in its acquisition of the pump business of the Linde Group; representing Société de Mecanique in its sale to SKF (cleared in Phase II without conditions); representing KEMET Corporation in relation to its acquisition of the tantalum capacitors business of EPCOS AG and its acquisition of Arcotronics; representing Solutia Inc in its acquisition of the joint venture interest in Flexsys; representing Bain Capital in the club deal for the acquisition of the semiconductor business of Philips (now known as NXP); representing Madison Dearborn Partners in relation to its acquisition of VWR; interventions on behalf of third parties in a number of cases including *Nokia/NAVTEQ* and *Tom Tom/Tele Atlas;* and representing various third parties in current patent ambush and FRAND-related investigations before the European Commission.

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