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Shutdown Mergers in the Context of the COVID-19 Crisis

Competition advocacy during and in the aftermath of COVID-19

Federal Competition Authority

Austria

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The COVID-19 pandemic and the corresponding restrictions have triggered a global economic crisis. Fiscal policy measures are the instruments of first choice to mitigate the impacts of this crisis. At the same time, it is to be ensured that state aid does not distort competition, create barriers to entry or result in overcapacities. The measures taken by the authorities to contain the COVID-19 pandemic could also lead to increased merger activity ("shutdown mergers") in the future.

By providing a checklist for the assessment of shutdown mergers, the present handout by the **Austrian Federal Competition Authority** explains how acquisitions of financially distressed companies should be assessed and under which circumstances state aid is better suited than mergers to ensure the survival of these companies.

1 Checklist for the assessment of shutdown mergers

The following table sets out a checklist for the assessment of shutdown mergers. The individual criteria are described in detail in sections 2.1 and 3.1.

Assessment of shutdown mergers in merger control	
Market dominance test	• It must be reviewed objectively whether a dominant position will be created or strengthened • The significance of merger effects has to be assessed in the individual case
Urgency	• Are there objective grounds that make it necessary for the merger to be examined particularly rapidly? • Since when has the mergers and acquisitions process been ongoing?
Criteria for acceptance of *failing firm defence*	• Imminence of failure • No less anticompetitive alternative • No causal link between the merger and a deterioration in the competitive situation
Remedies in merger control	• Prevention of market dominance • Do not infringe fundamental freedoms
State aid as a possible alternative to a merger?	
Macroeconomic relevance	• Macroeconomic significance of the company • Magnitude of frictions and adjustment costs • Avoidance of unequal treatment
Distortions of competition should be avoided	• Rescue already necessary before COVID-19? • Danger of overcapacities • Possibility of other market participants being forced out of the market
Cost/benefit analysis	• Costs of subsidies per job
Remedies in state aid cases	• Greater legal scope • Danger of distortions of competition

2 Shutdown mergers in merger control

2.1 Market dominance test and appreciability of anticompetitive effects

The substantive test for Austrian merger control is currently still the "creation or strengthening of a dominant position" ("**market dominance test**"). The approval of a merger in Phase 1 is only permissible if it is possible to objectively assess that the merger will not lead to the creation or strengthening of a dominant position, or if the creation of a dominant position can be prevented by commitments to respect restrictions and obligations.[1]

Consideration of the appreciability of a merger

The Austrian market dominance test does not require *any particular intensity of deterioration* ***in*** *the market structure*.[2] As a matter of principle, mergers are therefore to be halted even if the market power of the companies involved has minimal impacts. In contrast to this, European merger control presumes that mergers are only to be halted if they would *significantly impede effective competition, in the common market or in a substantial part of it* (hereinafter called "**SIEC test**").[3]

When it comes to very small companies, a takeover frequently generates efficiency gains that may even be to the advantage of consumers. Mergers between very small companies, in particular, would therefore be welcome. If the parties' turnover on the market in question is worth just a few hundred thousand euros, the effect of such a merger on consumers and the whole economy will usually be less than if several million euros are at stake.

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[1] See Section 17 para. 2 Federal Cartel Act. Cf., for instance, Kodek (2011).

[2] Urlesberger, "§ 12 KartG", para. 24, in Petsche, Urlesberger and Vartian, *KartG*, emphasis changed.

[3] Cf. Article 3(2) EC Merger Regulation (Regulation (EC) No 139/2004), emphasis added. SIEC stands for "significant impediment of effective competition". The SIEC test will soon be applied in Austrian merger assessment. If the current legislative process goes according to plan, the Austrian Cartel and Competition Law Amendment Act 2021 (Kartell- und Wettbewerbs-Änderungsgesetz 2021), under which the application of the SIEC test will be implemented in Austrian law, is expected to enter into force in the second half of 2021. The legislative materials underline that the dominant market position is to remain the central anchor for Austrian merger control. This aspect thereby continues to differ somewhat from European merger control.

On the other hand, takeovers of larger companies with high levels of turnover on the affected markets could cause irreversible damage to the market structure. Especially on markets that are defined nationally or locally, that are dominated by two or three major companies, and on which there are barriers to market entry, mergers may result in sizeable, permanent price rises.

By contrast, the takeover of financially ailing companies causes less serious problems on markets that continue to be defined nationally, and on which significant competitors within the EU continue to exist.[4]

2.2 The urgency of the merger has to be assessed objectively

From the point of view of the companies involved, the circumstances of a shutdown merger may make it necessary to very rapidly obtain the **merger clearance** of the respective competition authority.

The grounds for the urgency of implementing a shutdown merger are to be assessed objectively. In this connection, it is relevant, firstly, whether the target company is in **acute financial distress**. Secondly, it is relevant whether the **mergers and acquisitions process was already being prepared** prior to the COVID-19 crisis, or whether consideration was first given to the implementation of the merger after the shutdown had begun. In this connection, it is also to be corroborated when the initial discussions concerning the planned merger were conducted, and when decisions concerning the merger were taken in the companies involved.

2.3 An objective examination of the criteria for the *failing firm defence* is necessary

If a merger would lead to the creation or strengthening of a dominant position and

- the company does not need to be rescued or
- there is a less anticompetitive alternative or
- the merger would bring about a causally linked deterioration in the competitive situation,

[4] The COVID-19 crisis could bring about a regionalisation of global value chains. Upholding competition within the European Economic Area (EEA) is therefore of great importance for Austria.

the merger would increase markups on the markets in question and therefore ultimately decrease gross domestic product ("**GDP**"), labour demand and the wage share. A relaxation of the criteria for rescue mergers is therefore not called for from a macroeconomic point of view.

The satisfaction of the criteria for the *failing firm defence* is to be reviewed in accordance with objective criteria on a case-by-case basis. The following information may be particularly helpful for the assessment of a *failing firm defence*:

Imminence of failure

If it were not for the merger, the acquired company would leave the market because it is in need of rescue and is not capable of surviving on its own. Adequate documentation is required in order to prove imminence of failure: a mere claim to that effect by the parties is not sufficient.[5]

In connection with the COVID-19 crisis, it is also of relevance whether negative cash flows had already been reported prior to the crisis or not. Furthermore, it should be disclosed whether state aid made available to help businesses cope with the COVID-19 crisis (e.g. grants, loans, guarantees, state aid for short-time working, and the deferral of taxes and social insurance contributions) has been applied for, and whether this state aid has been approved and disbursed.

No less anticompetitive alternative

There is no less anticompetitive alternative to the merger project. In particular, there is no alternative purchaser that would not raise comparable competition issues. This requires proof that the seller has made sufficient good faith efforts to find an alternative buyer. In this context, it can also be relevant why negotiations have failed.[6]

- A potential buyer will not be ruled out merely because they have offered the seller a lower purchase price.[7] However, offers below the company's liquidation value may be ruled out.[8]

[5] Cf. German Federal Cartel Office, Guidance on Substantive Merger Control, para. 184.
[6] Cf. Guidance on Substantive Merger Control, para. 184.
[7] Cf. Guidance on Substantive Merger Control, para. 184.
[8] Cf. US Department of Justice (DoJ) and Federal Trade Commission (FTC), Horizontal Merger Guidelines, 2010, Section 11.

- A potential buyer will not represent a viable alternative, in particular, if they do not have a sustainable, long-term concept for the continued operation and financing of the acquired company.[9]

No deterioration in the competitive situation

In *Kali+Salz/MdK/Treuhand*, the European Commission ("**EC**") focussed its assessment of a *failing firm defence* on the causal link between the merger and the creation or strengthening of market dominance. According to the *Kali+Salz* criteria posited by the EC, a *failing firm defence* is accepted if it is found 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 anticompetitive alternative purchase and
- the acquiring undertaking would gain the market share of the acquired undertaking if it were forced out of the market ("**absorption criterion**").[10]

The European Court of Justice ("**ECJ**") has adopted the criteria set out by the EC in its *Kali+Salz decision*. At the same time, it was held that the absorption criterion ultimately described a duopoly situation. The criterion was therefore found to be a sufficient, rather than a necessary, precondition for a failing firm defence.[11] In *BASF/Eurodiol/Pantochim*, the EC addressed this qualification and, supplemented the absorption criterion with an "**assets criterion**", according to which *the assets to be acquired would inevitably exit the market if not taken over by another undertaking*. At the same time, it was ruled in emulation of the US Supreme Court's *General Dynamics decision*[12] that the application of the concept of the *failing firm defence* presupposed, *that the deterioration of the competitive structure through the merger is at least no worse than in the absence of the merger* ("**deterioration criterion**").[13] The **BASF criteria** were included in the Guidelines on the Applicability of Article 101 of the Treaty on the Functioning of the European Union to Horizontal Cooperation Agreements ("**Horizontal Guidelines**"), [14] where the

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[9] Cf. Guidance on Substantive Merger Control, para. 184.

[10] EC, 14 December 1993, IV/M.308, *Kali+Salz/MdK/Treuhand*, paras. 71–72.

[11] European Court of Justice, 31 March 1998, C-68/94 and C-30/95, France, SCPA and EMC/Commission, paras. 91–92.

[12] US Supreme Court, 1974, 415 U. S. 486, 507, *United States/General Dynamics*.

[13] EC, 11 July 2011, IV/M.2314, *BASF/Eurodiol/Pantochim*, paras. 142–143.

[14] Communication from the EC – Guidelines on the application of Article 81(3) of the Treaty (Official Journal C 101, 27/04/2004 P. 0097 – 0118).

absorption criterion is treated as a subcategory of the assets criterion that is essentially to be assessed in the light of the **deterioration criterion**.[15]

According to this approach, in addition to the absorption criterion posited in the *Kali+Salz decision*, the assets criterion and the deterioration criterion of the *BASF decision* should also be applied in the spirit of the Horizontal Guidelines and the Guidance on Substantive Merger Control, and in favour of the merger parties:

- **Absorption criterion**. If it were not for the merger, *the acquiring company would also largely gain the failing firm's market position. This can in particular be expected if the merging parties are the only significant competitors in the market and therefore customers cannot switch to an adequate alternative supplier. If several other competitors remain in the market, it is generally expected that the acquiring company will not gain the failing company's market shares in total. Instead, it is likely that the remaining companies will also be able to gain a significant part of the market shares. However, in some cases this may not be the case, i.e. if it is likely that absent the merger the acquiring company will largely (but not entirely) gain the failing firm's market position and in particular if also shrinkage effects in favour of the competitors are likely after the merger.*[16]
- **Assets criterion**. An insolvency may *be more beneficial than a merger with regard to the impact on competition, if the other suppliers would compete for the market shares and assets of the insolvent company. Insolvency is not a preferable alternative, however, if it is likely to result in the exit of the target company's assets – and consequently of its competitive potential – from the market*.[17]
- **Deterioration criterion**. It is possible for a rescue merger to be cleared if it *will usually not lead to market conditions that are less favourable from a competition perspective than those that would result from the failing firm's exit from the market*.[18]

Higher standards for the *failing division defence*: no "cooking the books" to minimise divisions' profits

The assessment is to be based exclusively on operating costs. The proportional inclusion of overheads in the calculations does not appear appropriate because the company would incur these costs in any case. As far as the operating costs are concerned, attention would have to

[15] Horizontal Guidelines, paras. 89–91.
[16] Cf. Guidance on Substantive Merger Control, para. 184, emphasis changed.
[17] Cf. Guidance on Substantive Merger Control, para. 184, emphasis changed.
[18] Cf. Guidance on Substantive Merger Control, para. 184, emphasis changed.

be paid, in particular, to ensure that the division's costs are not inflated by excessive internal transfer prices or licensing fees.

Higher standards for the *failing division defence*: no strategic grounds for continued operation

As argued convincingly by *Körber* (2014), it is to be established credibly that there are no strategic grounds for the continued operation of the unprofitable division. The evidence that this is the case should be relatively easy to supply by presenting internal documents, such as a decision taken by the executive management to wind down the division's operations.

2.4 Remedies imposed in merger control must correspond to legal requirements

Obligations and restrictions serve to prevent the creation or strengthening of a dominant position, or to achieve one of the justificatory objectives provided for in Section 12 para.2 Austrian Federal Cartel Act.[19]

In the past, obligations were sometimes imposed that were aimed at keeping Austrian sites in operation.[20] In this respect, it is to be ensured that the European principles of freedom of establishment and free movement of capital are respected when crossborder mergers are examined.[21]

[19] Explanatory Remarks to the Government Bill Introducing the Federal Cartel Act (ErläutRV KartG), November 1993, 20.

[20] The *Lenzing/Tencel* merger was ultimately approved subject to remedies. Apart from an obligation intended to open the market, under which licences for the Lyocell production technology were to be made available to potential interested parties on fair conditions, the merger parties were ordered to continue to operate the production site at Heiligenkreuz in Burgenland and conduct research on Lyocell fibre technology at the Lenzing site for six years (Austrian Cartel Court, 5 April 2005, 29 Kt 133/05-12, *Lenzing/Tencel II*). However, it is to be noted that at the time when the obligations were being discussed the continued operation of the production site at Heiligenkreuz and the research site at Lenzing had already been decided on in any case. Moreover, funding had been granted for the continuation of Lyocell research by the Austrian Federal Ministry of Transport, Innovation and Technology (BMVIT) with a subsidy of about €5.7m, which had been applied for on 1 April 2005 (cf. Geyer and Tiefenthaler, "Programmevaluierung 'Headquarter Strategie', Endbericht an das BMVIT", 2011, 45).

[21] According to the established case law of the EU, national measures that constrain fundamental freedoms for purely economic reasons are impermissible, and it must be possible for them to be contested before the national courts; cf. EC, Protection of intra-EU investment, COM/2018/547, and Jones and Davis (2014).

The companies involved may also forward **commitments** to the official parties to respect restrictions and obligations, *in order to achieve that a request for examination be waived or withdrawn*.[22]

3 State aid as a possible alternative?

In connection with the financial crisis, it has been argued that **state aid is better suited** than mergers to ensure the survival of financially distressed companies. While state aid delivers immediate help, it can take some time before profits are earned again following a merger. Past mergers have shown that merging two financially ailing institutions does not create a financially secure, efficient company.[23]

Against the background of the COVID-19 crisis, a **temporary framework** for the assessment of state aid has also been put in place that is intended to make it easier to assist affected companies expeditiously.[24]

3.1 Macroeconomic relevance

Especially when there is a big, temporary, exogenous shock such as the COVID-19 pandemic, it may be economically worthwhile to use state aid under a strict legal regime to ensure **a sufficient number of independent competitors is retained.**

It seems particularly important to ensure the survival of companies that are active on nationally or locally defined markets that hold a large share of consumers' consumption expenditure or are important suppliers or customers for other (national) companies. In this respect, it is also to be ascertained whether there are **frictions** or adjustment costs that prevent companies from being able to adjust to the new circumstances on the market by their own efforts.

Empirical investigations suggest that politically networked companies enjoy preferential treatment when state aid is granted.[25] The unequal treatment of companies runs counter the

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[22] Second sentence of Section 17 para. 2 Austrian Federal Cartel Act.

[23] OECD, Policy Roundtable, Competition and Financial Markets, Submission by the EC, DAF/COMP(2009)11, 2009, 237.

[24] Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak, *OJ C* 1863, 19 March 2020. Since its adoption, the Temporary Framework has been amended five times.

[25] Cf. Faccio et al (2006), Duchin and Sosyura (2012), Amore and Bennedsen (2013), and Behn et al (2015) on state aid, and Dinc and Erel (2013) on political influence over merger control.

general idea of **competitive neutrality** as well as and the **prohibition of discrimination** anchored in the Austrian constitution and European law, and needs to be avoided.

3.2 Distortions of competition should be avoided

Where companies **regularly reported negative operating cash flows** prior to the COVID-19 crisis, there would appear to be a structural weakness, and leaving the market by means of a merger ("**exit by merger**") may be more expedient than a bailout with state aid. In this case, however, it should also be possible for the merged company to implement internal restructuring measures and optimise its cost structure.

As a result of the COVID-19 crisis, there could be permanent falls in demand in some sectors. In this case, the maintenance of existing structures could result in oversupply that is not matched by demand. The consequences could be price wars and a structural crisis that drags on for many years. Where there is a danger of **overcapacities**, exit by merger might by preferable. The merged companies should be free to reduce capacities, optimise costs and adapt their corporate structures to the new market conditions.

At the same time, it is to be borne in mind that the systematic promotion of inefficient companies leads to **more efficient companies being crowded out of the market**, consequently reducing the productivity level and, ultimately, gross domestic product. As long as there is no immediate danger of insolvency, it therefore appears more pragmatic to promote the economy and, in particular, the retention of jobs as broadly as possible instead of subsidising individual companies.

3.3 Consideration of costs

The costs of state aid (grants, loans, guarantees, etc.) eventually have to be met by the **taxpayer**. The currently very low interest rates for many states bonds limit the scale of these costs. The distribution of the tax burden may also be influenced subsequently in a targeted fashion through policy channels (for instance by making the tax system more progressive). By contrast, the costs of market power are passed on to individual **groups of consumers** in the form of higher prices. It is not possible for this burden to be redistributed. In the end, what matters is to capture the societal costs of various policy options in an objective, transparent way.

In order to deploy public funds as effectively as possible, it may be worthwhile to ascertain the **costs of state aid per job** and/or the **costs relative to the value added per job** in subsidised companies. The assessment of these costs has to be conducted in accordance with up-to-date academic findings and methods and, apart from the direct impacts on the company in question, should also take account of the indirect impacts on suppliers, customers and competitors that do not receive any state aid.

3.4 Remedies relating to state aid should not cause distortions of competition

Commitments made by companies to respect restrictions and obligations in exchange for the granting of state aid do not constitute infringements of fundamental freedoms, and therefore offer **greater scope for action**, for instance when it comes to commitments to keep sites open and retain jobs.

In this connection, however, it is to be emphasised once again that the systematic promotion of inefficient companies contradicts the idea of competitive neutrality and causes **distortions of competition**, which ultimately impair economic growth.