



THE FAILING FIRM DEFENCE DURING COVID-19 - AND THE TENSION WITH THE CMA'S APPROACH TO POTENTIAL COMPETITION IN DYNAMIC MARKETS

May 2020

On 17 April 2020 the Competition and Markets Authority (CMA) provisionally cleared the anticipated acquisition by Amazon of a minority shareholding in Deliveroo, relying on the so-called “failing firm defence”.

This case illustrates how the CMA can be expected to apply the failing firm defence in light of the COVID-19 pandemic.

It also highlights what appears to be a clear tension in the CMA's evidentiary approach to failing firm; as compared with its approach to “dynamic counterfactuals” (in particular potential competition) in dynamic markets.

Failing firm as the relevant “counterfactual”

Assessing whether a merger is anti-competitive requires a comparison of the prospects for competition following the merger with the competitive situation absent the merger (the latter being the “counterfactual”).

The failing firm (or “exiting firm”) defence applies where in the counterfactual, one of the firms would have exited the market.

The rationale for the defence is that allowing a transaction, even if it has some adverse impact on competition, may be better for competition than blocking it and thereby causing the firm to go out of business.

The CMA's guidance sets out the following conditions which must hold for the defence to apply:¹

- The firm would have exited (through failure or otherwise) absent the transaction (Limb 1);
- There would not have been an alternative purchaser for the firm or its assets whose acquisition would have had a better outcome for competition than the transaction under consideration (Limb 2); and
- Exit would have resulted in a more adverse outcome for competition than the transaction under consideration (Limb 3).

Relying on failing firm in Phase 1 vs Phase 2

At Phase 1, the CMA selects the most competitive realistic counterfactual. This means that a party seeking to rely on the failing firm defence needs to show “compelling evidence” on Limbs 1 to 3 and that exit is inevitable (for which, historically, the fact of administration alone has not been sufficient). As a result few cases have been cleared at Phase 1 on the basis of failing firm.²

¹ <https://www.gov.uk/government/publications/merger-assessments-during-the-coronavirus-covid-19-pandemic/annex-a-summary-of-cmas-position-on-mergers-involving-failing-firms>

² Since 2008, there have been only eight cases cleared at Phase 1 on the basis of failing firm (and 49 cases in which the defence was rejected)



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At Phase 2, the CMA selects the counterfactual it considers would be the most likely absent the transaction, which clearly improves the prospects for clearance on the basis of failing firm.³

The failing firm defence during COVID-19 (and its application to Deliveroo)

COVID-19 gives rise to the prospect of a far higher number of claims that relevant firms are failing financially and would exit absent merger (Limb 1). It also likely substantially reduces the prospects of alternative purchasers for a failing firm (Limb 2).

The key challenge for the CMA (and other authorities) as they deal with upcoming mergers during the COVID-19 crisis will be to avoid consumer harm either by:

- Approving anti-competitive mergers on weak failing firm grounds; or
- Rejecting genuine failing firm defences, with the result that firms that could have been saved leave the market completely.

The CMA has made it clear that COVID-19 will not change its application of the failing firm defence - and that in particular it will need to ensure its decisions are based on evidence and not speculation. Specifically it has stated that:

“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.”

This approach was followed in Amazon/Deliveroo where the CMA required robust evidence on Limbs 1 and 2.

Specifically, the CMA provisionally found no significant lessening of competition on the basis that:

- The impact of COVID-19 on Deliveroo’s business made exit inevitable without access to significant additional funding (Limb 1);
- Only Amazon would be willing and able to provide this funding at this time; there were no alternative funding options available to Deliveroo to address its liquidity issues given the current state of the economy and financial markets (Limb 2); and
- Deliveroo’s exit from the market would be worse for competition than allowing the Amazon investment to proceed (Limb 3).

In relation to Limb 1, Deliveroo was required to provide detailed evidence as to the financial impact of COVID-19 on its business and the measures it had taken to address its resulting liquidity issues. It

³ Since 2008 there have been five cases cleared at Phase 2 on the basis of the failing firm defence (and 14 cases in which the defence was rejected).



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also provided evidence that, without a reasonable expectation of being able to retain Amazon's investment, its directors would have been obliged to initiate insolvency proceedings.

In relation to Limb 2, the CMA required detailed evidence from Deliveroo's existing investors and financial advisers that Deliveroo could not expect funding from alternative sources (existing shareholders, potential new shareholders, or debt).

The CMA's approach to "dynamic counterfactuals" (and in particular potential competition) in dynamic markets

There has been some unease among regulators that a number of mergers in dynamic (especially digital) markets may have been wrongly cleared as a result of the failure to anticipate market developments. Two cases often cited in this context are *Facebook/Instagram* and *Google/DoubleClick*.

In response, the CMA has developed the concept of "dynamic counterfactuals". In assessing potential competition in digital markets this involves the CMA:⁴

- Taking a longer term view. The CMA notes the findings of the Lear Report that "*the time-frame of 2 years typically used by [the CMA] to assess the counterfactual may be somewhat limiting and should be extended, as even in the fast-moving digital world, becoming successful is likely to take somewhat longer*".⁵
- Allowing for more uncertainty. Again the CMA refers to the view expressed by Lear that competition authorities should be willing to accept more uncertainty in their assessment of the counterfactual.

According to Andrea Coscelli (CMA CEO) it follows that the CMA "*should therefore be cautious in concluding that the absence of the same kind of compelling evidence we might have about near-term market developments should necessarily provide grounds for clearance*".⁶

In the context of *Amazon/Deliveroo* this resulted in the CMA considering whether Amazon was a likely entrant into online restaurant food delivery in the UK (Deliveroo's market) in circumstances where:

- Amazon had previously exited the market (having been unsuccessful);

⁴ <https://www.gov.uk/government/speeches/competition-in-the-digital-age-reflecting-on-digital-merger-investigations>.

⁵ See: <https://www.gov.uk/government/speeches/competition-in-the-digital-age-reflecting-on-digital-merger-investigations> and "Ex-post Assessment of Merger Control Decisions in Digital Markets" (the Lear Report): https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/803576/CMA_past_digital_mergers_GOV.UK_version.pdf.

⁶ <https://www.gov.uk/government/speeches/competition-in-the-digital-age-reflecting-on-digital-merger-investigations>.



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- Amazon had no plans to enter;
- There was no compelling commercial imperative for Amazon to re-enter;
- There are high barriers to entry; and
- Overseas providers had indicated they had no intention to enter as the market was seen as intensely competitive.

Tension between the CMA's approach to failing firm and "dynamic counterfactuals"

In its Provisional Findings, the CMA did not need to reach a conclusion on Amazon's (re)entry into UK online restaurant food delivery (since it relied on the failing firm defence to provisionally clear the deal).

But the above illustrates the clear tension as between the CMA's approach to the evidential standard in assessing the counterfactual in different contexts:

- For the failing firm defence, the CMA requires robust compelling evidence that the relevant firm would exit in the near term. In this context the CMA takes the view that "*it will not in general be necessary to make finely balanced judgements about what is and what is not included in the counterfactual*"⁷.
- But when looking at potential competition in dynamic markets it seems the CMA is prepared to accept considerable uncertainty in making judgments as to future market developments that may result in more competition between the merging parties.

That reflects a clear policy decision to frame the analysis so as to reduce the risk of false negatives (allowing a merger that should have been blocked) in dynamic markets.

Slaughter and May are advising Deliveroo.

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https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/880565/Summary_of_CMA_s_position_on_mergers_involving_failing_firms_.pdf.



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