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A legal update from Dechert's Antitrust/Competition Group

The Responses of European Competition Policy to the Global Financial Crisis

Key Points

- State Aid and merger control are the two core sectors through which the Commission has responded to the global financial crisis.
- An unprecedented level of authorization for State Aid has been granted.
- The Commission wants Member States to help illiquid but sound firms, and to restructure inefficient ones.
- There has been a drop in merger activity at the EU level.
- The Commission is more receptive to defenses that have only been applied exceptionally in the past.
- The window of opportunity to take advantage of these solutions will close once the economy partially recovers.

The European Commission ("Commission") has been sensitive to the difficulties arising from the global financial crisis and has adapted the focus of its competition policy enforcement agenda accordingly. State Aid and merger control are two areas in which the Commission has been willing to adapt its enforcement approach to the current troubled economic circumstances.

State Aid in the EU

The global financial crisis has made unprecedented demands on the European State Aid rules. Many companies have found themselves strapped for cash and have sought help from Member States to survive their illiquidity. Member States, in designing measures to help companies, have had to comply with European State Aid rules. The purpose of these State Aid rules is to ensure that companies operate on a level-playing field within Europe and that competition is not distorted by Member States' subsidies to selected undertakings. State Aid measures are only allowed subject to strict scrutiny and approval by the Commission.

In recent years, under the leadership of Competition Commissioner, Neelie Kroes, the Commission has prioritized the modernization of State Aid rules. Key reforms have been introduced for the most common forms of aid, and efforts have been made to simplify the procedures to notify and authorize aid. This strategy has paid off, as the Commission is now well equipped to deal with the recent surge in State Aid applications.

State Aid on the Rise

The Commission recognizes that State Aid plays a key role in the current crisis by allowing Member States to throw a life-line to struggling firms.

Between September 2008 and January 2009, the Commission approved nearly 60 national State Aid measures (ranging from sector-wide schemes

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to individual rescue packages). A whopping 60% of the aid was directed to financial institutions. This was a dramatic increase as compared to the same period in the previous year, when only 13 aid measures were approved, only one of which was related to a financial institution (Northern Rock).

The Commission has responded swiftly to this unprecedented rise in State Aid measures. It has, in particular, allocated significant human resources to the task of assessing the urgent aid measures proposed by Member States, with priority given to State Aid measures to the financial sector. With the increased resources, State Aid measures are being approved at a pace never seen before. For instance, the Commission recently approved the UK support scheme for financial institutions in less than two working days, while such decisions normally take about six months.

Temporary Help for Fit Firms: Restructuring for Inefficient Firms

In addition to allocating more staff to its State Aid division, the Commission has also published three new Communications (between October 2008 and January 2009) to provide hands-on guidance to Member States on how to grant legitimate State Aid. In these Communications, the Commission has sent a very clear message to Member States: while short-term support for ailing firms or sectors might be acceptable, aid measures must not distort competition. Member States can only grant aid that is non-discriminatory, limited in time, and carefully designed to target the problem for which it was sought. The importance of well-targeted aid was recently re-emphasised by Competition Commissioner Kroes, who stated that "we have to get bang for our buck." In other words, if State Aid does not boost the economy, it is wasted money.

The Commission views the current rise in State Aid as an exceptional event which must be closely monitored. Also, in applying the policy, the Commission makes a clear distinction between two types of beneficiaries: those that, although suffering from illiquidity, are fundamentally sound ("fit firms"), and those that are distressed and less-performing because they were run inefficiently or adopted excessively risky strategies ("inefficient firms").

The Commission is willing to allow Member States to temporarily support "fit firms" because the soundness of the European financial and economic system would otherwise be affected. However, the message is clear that any such form of State Aid is only temporary and must be periodically reviewed: in other words, fit firms should only be given the strictest aid necessary to survive the crisis.

The Commission will not approve aid for "inefficient firms" on the principle that firms that were run inefficiently should not be rescued. However, there is an exception for banks, because they are central to ensure the stability of the financial sector. Aid to inefficient banks can be authorized, but it comes at a high price. Every bail-out plan for inefficient banks must include a restructuring plan or controlled winding-up plan. The idea is that badly managed banks will not be rewarded and are destined either to scale down their business or to be sold.

State Aid Opportunities

Businesses should therefore be alerted to the State Aid opportunities offered in the current crisis:

- There is currently a greater availability of State Aid.
- Firms should monitor closely what the various Member States are offering in terms of State Aid—there are significant opportunities for financial assistance.
- Firms can benefit from informal advice from the authorities and a speedy approval process.

Merger Control: Less Activity, More Flexibility

The Commission's enforcement policy in the financial crisis has not only focused on State Aid funding, but has also been adapted in the sphere of merger control.

The second half of 2008 saw a notable reduction in the number of mergers notified to the Commission—169 cases, compared to the 204 notified in the same period in 2007 (a drop of approximately 20%). The Commission has stated that, when assessing mergers, it can and will take into account the evolving market conditions and, where applicable, it will therefore accept the so-called "failing firm" defense. Likewise, the UK Office of Fair Trading (OFT) has expressed its willingness to consider the prevailing economic and market conditions when reviewing notified mergers.

"Failing Firm" Defense and Public Interest Consideration: Time to Dust Them Off?

In the current financial crisis, the competition authorities are open to arguments relating to the overall depressed economic environment. The "failing firm" defense and the public interest consideration are two mechanisms that have been traditionally applied very exceptionally, but which have made a recent resurgence, perhaps as a sign of troubled times.

"Failing Firm" Defense

The "failing firm" defense states that transactions that would otherwise be considered anti-competitive can be cleared due to the poor financial position of one of the parties. This defense has been recognized by many competition authorities. However, it has only been applied in few cases and under exceptional circumstances. Both the Commission and the UK authorities have recognized this defense, and have provided guidance on its assessment. They have required the parties to prove the following elements when asserting a "failing firm" defense:

- Absent the transaction, the target would be **forced out of the market** because of its financial situation;
- There are **no alternative buyers** that will cause less anti-competitive concerns. For these purposes, the burden rests on the parties to demonstrate that there are no other purchasers whose participation would cause less concern. An example is the *Newscorp/Telepiù*[1] case, in which the Commission declined to accept the "failing firm" defense because the parties failed to show that they actively tried to find a less anti-competitive solution. The case concerned the pay-TV market and dealt with the acquisition of sole control by Newscorp of Telepiù and Stream (a "failing firm" jointly controlled by Newscorp and Telecom Italia). Although the "failing firm" defense was not approved for the reasons mentioned above, the case was cleared subject to compliance with the commitments entered by Newscorp.
- Without the merger, the **assets of the failing firm would be essentially taken over by the acquirer.** In the *BASF/Eurodiol/Pantochim*[2] case, for instance, the Commission stated that it should be sufficient to show that a substantial part of the market share of the target would pass to the acquiring entity, absent the merger. This case dealt with the acquisition by BASF of two Belgian chemical companies (Eurodiol and Pantochim) facing severe financial difficulties at that time. Although BASF was going to have a 70% market share after the transaction, the Commission decided to clear the merger on the basis that it was going to have less harmful impact on the market than the companies exiting the market.

In these cases, the Commission reasoned that deals should not be challenged where the competitive structure is expected to worsen in a similar fashion even without the merger.

The most recent case successfully applying this defense was a transaction in the UK cheese sector decided in January 2009. The UK cheese producer, Long Clawson, was authorized to acquire Millway, the blue stilton and specialty cheese business of Dairy Crest. Millway's business operated at a loss for many years and depended primarily on its parent company's financial support. The UK authorities approved the transaction, even though it reduced the number of large players in the UK stilton market from three to two. The authorities concluded that it was irrelevant, in terms of market conditions, whether Millway was acquired by Long Clawson or was shut down, since in both cases Millway customers would need to purchase from either of the two remaining suppliers.

Long Clawson/Millway is one of only five cases in which the UK authorities have applied the so-called "failing firm" defense. At the EU level, the defense has been authorized by the Commission only in four

1 Case COMP/M.2876, Commission decision of 2 April 2003 (2004 O.J. L110/73).

2 Case COMP/M.2314, Commission decision of 11 July 2001 (2002 O.J. L132/45).

cases. The last Commission case citing this defense was approved in 2002 (Ernst & Young France/Andersen France).

Public Interest Consideration

A spin-off mechanism from the “failing firm” defense, also recently applied in the UK, is the public interest consideration. This empowers a merger considered necessary to be cleared in order to protect the public interest. In the past, public interest considerations were limited to national security and various public interest considerations related to media. This was a mechanism never used in practice.

However, as of October 2008, a new public interest consideration—the stability of the UK financial system—was recognized and applied, for the first time, in the Lloyds/HBOS case. The UK authorities concluded that, although the merger was capable of giving rise to competition concerns, it was necessary to protect the public interest in **maintaining the financial stability in the UK**. The financial situation of the HBOS was considered, at the point of the merger, seriously deteriorated and highly vulnerable to loan losses stemming from UK residential mortgages. Some of the competition concerns mentioned in this case were: the removal of independence of one company (HBOS) and the strengthening position of the market leader (Lloyds); the merger of the first (Lloyds) and third (HBOS) largest mortgage providers; and the increase in Lloyds’ market share that was expected to reduce incentives to compete for new customers. However, because of the major role played by HBOS in the provision of financial services in the UK, and of the consequences that the failure of a single bank can bring to the economy in terms of costs and consumer confidence, the authorities in charge of this case agreed that the merger was the best way to provide more confidence in the UK banking sector and thereby support the UK’s financial stability.

Although the two cases mentioned above were decided in the UK, the application of these two exceptional mechanisms should be viewed more generally as a sign of the willingness of the competition authorities in Europe to adapt competition rules to the current dire economic circumstances. Mergers that in the past would have raised serious competition concerns could, in the current economic conditions, potentially be cleared.

The EU Competition Formula to Survive the Crisis

Competition authorities have responded quickly and proactively to try to soften the blow of the financial crisis on the European internal market. There have been some notable changes: the increased guidance on, and approval of, State Aid; the increase in the number of case teams to work on the assessment of rescue plans; and a dusting-off of exceptional justifications to allow mergers to be cleared.

However pragmatic and flexible these solutions may seem, they must also be viewed as exceptional. Firms should therefore take full advantage of the opportunities granted by the competition authorities while they last, because once the economy has partly recovered, these temporary benefits could be withdrawn.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/antitrust.

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