Failing firm is not enough: Competition Bureau outlines approach to acquisitions of failing businesses

April 30, 2020

On April 29, 2020, the Competition Bureau (the Bureau) released a statement outlining how it reviews mergers involving apparently failing firms in Canada. Section 93 of the *Competition Act* (the Act) provides that a factor to be considered in assessing the competitive effects of a merger is whether all or part of the business of a party "has failed or is likely to fail", potentially providing a path to clearance for acquisitions that might otherwise be challenged.

As the economic fallout from the COVID-19 pandemic continues, businesses facing financial difficulties may be targeted for takeover, whether directly or through bankruptcy processes.[1] Under the Act, the Bureau can challenge any entity's acquisition of or significant interest in another entity because it would likely substantially lessen or prevent competition. This includes acquisitions that occur through the bankruptcy process.

Parties considering acquisitions of distressed assets/businesses in Canada must consider the Bureau's guidance, as well as the recent statement by the federal government that in the "unique" and "extraordinary circumstances" of the global COVID-19 pandemic and "sudden declines in valuations [that] could lead to opportunistic investment behaviour", it will be using the *Investment Canada Act* to "subject certain foreign investments into Canada to enhanced scrutiny."

What you need to know

- **Failing firm is not a defence to an anticompetitive merger.** In Canada, asserting that a party to a merger is a failing firm is not a defence to an anticompetitive merger. Even if a merger involves a failing firm, that is only one factor considered by the Bureau in deciding whether to challenge it.
- **Detailed backup is required.** Parties seeking to avoid a challenge of a merger that could be considered anticompetitive should be prepared to provide extensive information to the Bureau both to show that a firm is truly failing, and that there are not alterative resolutions to the proposed merger that would be less harmful to competition. Information must be provided regarding:

- The failing firm's insolvency or imminent bankruptcy;
- The lack of competitively-preferable purchasers for the failing firm;
- That restructuring and retrenchment of the failing firm would not be competitively preferable; and
- That liquidation of the failing firm would not be competitively preferable.

The Bureau's guidance is provided in its statement about its clearance of a merger completed well before the effects of COVID-19 began: American Iron & Metal Company Inc.'s (AIM) acquisition of Total Metal Recovery (TMR). Prior to the merger, which closed on December 20, 2019, AIM and TMR were the two largest scrap metal processors in Québec, with overlapping operations in the purchase and sale of unprocessed and processed scrap metal. The Bureau investigated the merger before it closed (unless it has otherwise cleared a transaction, the Bureau can challenge any merger up to one year following closing), but in its statement announced that it will not challenge the merger.

Failing firm in practice – not a defence

It is important to recognize that claiming a firm has or is likely to fail is not actually a defence to an otherwise anticompetitive merger under the Act. As the Bureau's statement makes clear, it is merely a factor that the Bureau considers in its analysis of a merger, and one that the Competition Tribunal would also weigh if the Bureau chose to launch a challenge.

The statement reiterates the guidance already provided by the Bureau in its *Merger Enforcement Guidelines* – that its failing firm analysis focuses on whether the assets of the apparently failing firm are likely to exit the relevant market if the proposed transaction is not allowed (*i.e.* because no alternatives that would allow the business to continue to operate exist). This results in two primary factors that the Bureau examines:

1. Whether the firm is really "failing"; and
2. Whether there are truly no alternatives to the proposed merger that would allow the failing firm to remain competitive?

If the Bureau answers "Yes" to both questions, it will not consider the loss of the failing firm's competitive influence to have anticompetitive effects. In most cases, this will result in the Bureau not challenging a transaction, since it will generally be difficult to find that a deal is likely to substantially prevent or lessen competition – the standard for a deal to be blocked – if the loss of competitive influence is not at issue.

Is the firm really "failing"?

The Bureau requires that parties provide detailed financial information on the apparently failing firm to substantiate that it is or is likely to become insolvent; has or is likely to initiate voluntary bankruptcy proceedings; or has or is likely to be petitioned into bankruptcy or receivership. It suggests that parties provide as much information as possible in this regard, such as audited financial statements, liquidity reports and forecasts, business plans, correspondence to and from creditors, as well as documents related to plans to initiate bankruptcy proceedings or seek creditor protection.

In the context of the AIM-TMR transaction, the Bureau states that it retained a financial expert who reviewed TMR's financial situation and the material submitted in support of its claim to be failing. It also considered submissions from a financial expert retained by AIM, ultimately leading it to conclude that TMR was truly failing. Although the statement does not indicate that financial expert reports are required in support of a party's position that it is failing, it is likely that a rigorous arms-length expert report confirming the party's position would generally be well-received and advisable.

Are there alternatives to the merger?

If the Bureau concludes that the firm is truly failing, it then analyzes whether alternatives to the proposed merger exist that would allow the failing firm to continue to compete effectively in the relevant market. The statement indicates that the three primary alternatives it will consider are:

1. Whether there is an alternative potential purchaser of the failing firm who would be competitively preferable to the proposed buyer;
2. Whether the failing firm's restructuring or retrenchment could result in its continuing to compete and facilitating a more competitive market than would exist if the merger was complete; or
3. Whether the liquidation of the failing firm's assets would be competitively preferable?

If the Bureau finds any of these alternatives to be competitively preferable, it will not discount the loss of the failing firm's competitive influence, and thereby may challenge the deal. Therefore, parties must be prepared to provide information that shows that none of these alternatives would likely result in a more competitive market than if the merger was allowed.

Competitively preferable purchaser

The Bureau states that its first step in this analysis is to assess whether a thorough search for other potential purchasers for the failing firm has been carried out. It considers information such as a complete list of potential purchasers that were approached, contact information so this can be verified, information related to the distribution of a Confidential Information Memorandum or similar document describing the operations of the target company to other firms, as well as responses to requests for expressions of interest. If the Bureau finds that a thorough search for alternatives has not been carried out, it may require that an independent third party be engaged to carry out a search for alternative purchasers.

If the Bureau ultimately finds that alternative purchasers did express interest in buying the failing firm, the Bureau considers additional information, such as:

- the steps taken by the failing firm and the interested purchaser in relation to negotiations and attempts to finalize a deal;
- whether such a deal would have been competitively preferable; and
- whether it could have been completed in a timely manner given the financial circumstances of the failing firm.

This includes all correspondence and draft agreements between the relevant parties, due diligence reports, internal correspondence related to the potential deal, as well as recommendations and decisions by senior management or shareholders of both parties. It will also seek information from the interested purchaser in order to determine, with the assistance of business plans, how effective or competitive that alternative purchaser would be if they were successful in purchasing the failing firm.

In the AIM-TMR transaction, the Bureau requested information voluntarily from the parties about TMR's search for alternative purchasers, and used its power under the Act to compel at least one other potential purchaser that had expressed interest in acquiring TMR to produce records relevant to its approach. This information allowed the Bureau to gauge its seriousness and whether such an acquisition would have been competitively preferable. Ultimately, the Bureau determined that neither this nor any other potential alternative purchasers would have been competitively preferable to AIM.

Restructuring and retrenchment

The Bureau also considers whether restructuring and retrenchment is likely to be a viable alternative to a proposed deal that could be anticompetitive, based on information showing attempts to restructure the firm by narrowing the scope of its operations, employing cost-cutting measures, or searching for strategic partners to solidify operations instead of selling the whole business. Parties should be prepared to provide information to the Bureau showing that restructuring and retrenchment of the failing firm would not lead to a more competitive outcome.

Liquidation

Finally, the Bureau states that under limited circumstances it may find that liquidation of the failing firm's assets would be a competitively preferable competitive alternative to a merger. For example, when a failing firm has certain valuable assets that are otherwise difficult to obtain, the Bureau may determine that liquidation of those assets and purchase by another party that could enter the market would be competitively preferable. Therefore, parties must be ready to provide information on potential alternate uses for the failing firm's assets, as well as the ease with which they could otherwise be obtained by other firms seeking to compete, in order to show that liquidation would not be competitively preferable.

Conclusion

In the context of the AIM-TMR deal, the Bureau concluded that TMR was failing, and that its assets were likely to exit the market in the absence of the merger, with no viable competitive alternatives present. As such, it did not consider the loss of TMR's competitive influence on AIM in the Québec scrap metal processing market to be an anticompetitive effect, and therefore did not challenge the merger.

However, the Bureau's statement makes clear that parties seeking to avoid challenge of acquisitions of failing firms, will be required to provide extensive information to show that the firm is truly failing, and that there is no less anticompetitive alternative to the proposed acquisition.

[1] Concern in the United States about large companies capitalizing on the struggle of smaller businesses during the ongoing crisis by acquiring them has led U.S. Senator Elizabeth Warren and U.S. Representative Alexandria Ocasio-Cortez to propose an outright ban on certain mergers and acquisitions for as long as the financial distress from the pandemic continues.

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