3. THE FAILING FIRM DEFENSE IN BRAZILIAN COMPETITION MERGER REVIEW: PROVING THE MERGER IS THE BEST ALTERNATIVE TO MARKET EXIT

3. A DEFESA DA FAILING FIRM NO CONTROLE CONCORRENCIAL DE ESTRUTURAS NO BRASIL: PROVANDO QUE O ATO DE CONCENTRAÇÃO É A MELHOR ALTERNATIVA À SAÍDA DO MERCADO

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Abstract: This article introduces the failing firm defense in the context of competition merger control and discusses some of the advantages of its application. After providing context of how the failing firm defense originated and developed in foreign jurisdictions, it narrates the development of the failing firm defense in Brazil and provides a review of CADE's case law on the subject in order to identify what evidence CADE requires to prove a merger is the best alternative to market exit.

Keywords: Failing Firm Defense. Merger control. Competition. Brazilian Administrative Council for Economic Defense.

Resumo: Este artigo apresenta a defesa da empresa insolvente no contexto do controle concorrencial de estruturas e discute algumas das vantagens de sua aplicação. Depois de fornecer um contexto de como a defesa se originou e se desenvolveu em jurisdições estrangeiras, o artigo narra o desenvolvimento da defesa da empresa insolvente no Brasil e fornece uma revisão da jurisprudência do CADE sobre esse tema para identificar quais elementos são essenciais para demonstrar ao CADE que o ato de concentração proposto é a melhor alternativa à saída da empresa do mercado.

Palavras-chave: Defesa da empresa insolvente. Defesa da *failing firm*. Controle de estruturas. Concorrência. CADE.

1. Introdução

In times of economic crises, one may expect to see a rise in the number of firms in distress. After the 2008 subprime-mortgage crisis, the

number of filings for bankruptcy in the United States doubled in one year.[1] Following the recession faced by Brazil in 2016, the number of firms who were subject to insolvency procedures more than doubled in two years. In 2014, there were 828 insolvency requests, but that number rose to 1,287 in 2015, and 1,863 in 2016. The number of firms that were declared bankrupt also doubled. In 2014, 671 firms were declared bankrupt, while in 2016 that number was 1,516 (OLIVEIRA JR., ESTEVES, 2020). When it comes to the current Covid-19 related crisis, one can expect that the trend will remain. Although there is still no data for the current crisis, given its global scope, its effects can be expected to be even more widespread and far-reaching.

During periods of distress, firms' financial value tends to be severely reduced. This can be caused either by the direct or indirect costs they incur as a result of the distress (which affects their ability to generate returns[2]) or by the very factors that drove them to their state of financial distress in the first place (KANYUGI, 2015). In this context, one often sees an increase in the number of mergers following periods of economic downturn (KRISHNAMURTHY, 2009). In fact, in the midst of the Covid-19 pandemic, an EY study found that 56% of global executives would actively pursue mergers and acquisitions in the year to come (HINKS, 2020).

From the perspective of the firm in distress, a merger is one means of preservation from collapse. Acquiring firms can preserve the target's business by reorganizing its finances and ensuring the injection of much needed capital. From the position of the acquirer, distressed firms may represent an attractive investment. Studies have shown that firms that buy distressed and bankrupt companies or some of these companies' assets earn excess returns that are at least 1.6 percent higher than that earned from regular acquisitions (MEIER; SERVAES, 2014). Furthermore, these acquisitions might not only boost their market share, but also allow them to easily absorb talent and acquire valuable assets.

From an economic welfare perspective, a merger is also a desirable solution to avoid the loss that results when the failing firms exit the

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[1] In January 2008, 43,828 bankruptcy requests were filed. In little over a year, this number had doubled. In March 2009 there were almost 100 thousand bankruptcy requests filed.

[2] A number of empirical studies have found that financial distress contributes to the negative performance of firms (KANYUGI, 2015).

market. When failing firms are acquired, not only is their going concern preserved, but there is also a greater chance that jobs are retained.

In this context of crisis, one can expect an increase in the use of the failing firm defense in mergers that are subject to the review by competition authorities. [3] It is thus not unsurprising that soon after the Covid-19 crisis took hold many authorities issued statements addressing how they planned to consider the failing firm defense in their merger analysis during this crisis. The United Kingdom's Competition and Markets Authority ("CMA"), for example, published guidance on its approach to the analysis of the "failing firm" claim, and stated that "the Coronavirus pandemic has not brought about any relaxation of the standards by which mergers are assessed or the CMA's investigational standards" (UNITED KINGDOM, 2020).

Brazil is among the jurisdictions expecting to see a rise in the use of the failing firm defense. In a webinar addressing the antitrust challenges of COVID-19, the General-Superintendent of the Brazilian Administrative Council for Economic Defense ("CADE") stated that despite the expected increase in the use of the failing-firm defense by companies seeking approval for their deals, the agency was not going to make changes to its approach to merger review, especially when it comes to the application of the failing firm defense (CANDIL, 2020).

Given the expected increase in the use of the failing firm defense in the current economic climate, and on future crises which will inevitably come, understanding what the failing firm defense is and how authorities approach it in their merger review work is critical. This is the aim of the present article. To this end, this article will briefly introduce the concept of the failing firm defense. It will then discuss how the defense originated in foreign jurisdictions. Once this broader context is provided, the article will narrate the development of the failing firm defense in Brazil and provide an overview of CADE's case law on the subject. More specifically, this article will focus on how CADE has been considering a key element of the failing firm defense: whether the merger under review is, from a competition perspective, the least harmful alternative to the firm's exit

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[3] In a guidance published by the CMA in the context of the Covid-19 crisis, the authority stated that it was "aware that the current market environment may lead to additional submissions that firms involved in mergers are failing financially and would have exited the market absent the merger in question" (COMPETITION AND MARKETS AUTHORITY, 2020).

from the market. That is, I will seek to identify what factors weighed in CADE's analysis of whether or not the merging parties sufficiently demonstrated that the proposed merger was the best available alternative to exit from the market, and why that was the case.

Ultimately, the goal of this article is to shed light on when the failing firm defense might be successfully applied, and what actions the merging parties need to take in order to ensure that they have properly attempted to identify available alternatives to the merger under review.

2. The Failing Firm Defense

The failing firm defense is recognized by many antitrust authorities worldwide. The defense applies when one party to a transaction is considered to be "failing". Although the definition of "failing" and the criteria to meet that status might differ between jurisdictions, in general terms it refers to a firm that is likely to exit the market in the near future.

The defense derives from the understanding that when one firm acquires another that is "failing", any reduction in the number of competitors in that market should not be attributed to the transaction itself. Rather, authorities should assess the transaction as if the acquired entity did not exist, did not have any market share, and no longer participated in the market in any way. In practice, this assessment usually takes place in the competition authority's analysis of the counterfactual. The counterfactual is the analytical tool authorities use to evaluate the impact of the transaction on competition. They do so by comparing how the market will look like after completion of the merger with how the market would look like if the merger did not take place. The latter hypothetical scenario is called the counterfactual.

There are numerous hypothetical scenarios that can be used as a counterfactual, and authorities usually assess different scenarios before deciding which is the most appropriate for the purposes of reviewing a given transaction. Probably the most common counterfactual adopted by authorities is the scenario in which market conditions prior to the merger are maintained – that is, the prevailing conditions of competition remain the same, as if the merger had not taken place. Alternatively, authorities can consider that, even absent the merger, there would be a change in competitive conditions.

One scenario authorities may adopt as a counterfactual that is different from the prevailing conditions of competition is when one of the merging parties is a failing firm. When the failing firm scenario is considered in the counterfactual, competition authorities assume that the current conditions of competition will change regardless of the merger because one of the merging parties is likely to leave the market absent the merger. This is what is called the failing firm scenario. In this case, the change in the prevailing conditions of competition is not attributed to the merger, but rather to the fact that the target company was going out of business and about to leave the market.

Although the failing firm defense is an attractive argument for merging parties, it is one that is usually made when parties understand that the merger will have anticompetitive effects. Besides the unappealing prospect of conceding that the conditions of competition following the merger will be worse than the prevailing conditions of competition before the merger takes place, parties often raise the failing firm defense to demonstrate to authorities that the deterioration in conditions of competition should not be attributed to the merger itself but to the fact that one entity was leaving the market regardless of the merger as a result of its economic or financial distress.

3. Advantages of allowing the failing firm defense

Because the failing firm defense is mostly used to allow mergers that may have anticompetitive effects, this argument has been dubbed a "get out of jail free card" (OXERA, 2014). If articulated successfully, it provides a way to clear mergers that would likely be otherwise blocked.

However, from a competition policy perspective, there are significant advantages to allowing a merger on the basis of the failing firm defense. If the failing firm's assets leave the market, there is substantial risk that this results in greater concentrations than if these were to remain. The classic trade-off antitrust enforcers usually face between market power and efficiency, which is present in the context of the prospective union of two robust and lucrative firms, does not arise when one of the firms is about to fail (MCCHESNEY, 1986).

There are also wider economic justifications for why allowing a merger involving a failing firm is a desirable alternative to letting the firm go out of business and rendering its assets comparatively less valuable.

When a firm ceases operation, its tangible and intangible assets will exit the relevant market, which will be left with a smaller offer of its goods or services. Assets of a firm that has gone out of business are likely to be either sold and repurposed for employment in another activity or can be rendered entirely idle and unused. Even when the asset is put to another use, it is unlikely that the economic value derived from this secondary use will be as great as the one derived from its original purpose. This problem is greater the more specific the asset is to its current activity: the more specific the asset, the less valuable it is when employed for any other purpose.

The firm that goes out of business will also generate unemployment, representing a significant welfare loss. Keeping the firm in business generating income and employment is therefore the most efficient course of action.

However, for the above-mentioned advantages to be realized, the right conditions must be present. In order to identify when this is the case, many competition authorities worldwide have developed tests to identify the conditions under which the failing firm defense should be allowed. In essence, the test proposed by most competition authorities can be boiled down to two main elements, which can be summarized as follows:

1. Absent the proposed merger, the failing firm and its assets would exit the market. I will call this the **"Exit Element"**.
2. From a competition perspective, the proposed merger is the best existing alternative to market exit. I will call this the **"Best Alternative Element"**.

Competition authorities worldwide adopt different tests in order to identify when parties have sufficiently proven the two elements described above. These elements tend to be extremely difficult to prove in practice, and different jurisdictions establish different evidentiary standards that must be met in each case.

Within the Exit Element, competition authorities usually consider the financial situation of the firm, whether it would be able to honor its financial obligations, whether a financial restructuring would be able to save it, and whether the assets would exit the market. in case of bankruptcy. As will be seen in the next section, competition authorities usually break down the Exit Element into smaller tests that need to be met by the merging parties.

The Best Alternative Element of the failing firm defense could, arguably, be the most difficult one for parties prove. It requires parties to

make a negative claim, that is: that there are no better alternatives to market exit than the proposed merger. In practice, this is extremely challenging because there is an inherent difficulty in proving a negative fact. It requires parties to identify all existing alternatives to the merger in question and demonstrate that none of them apply or are better than the proposed merger at preserving competition conditions. The greater the number of existing alternatives, the harder this burden becomes.

In order to address this challenge, many competition authorities have limited the scope of the Best Alternative Element to something that is more realistic to achieve. They have converted the burden of proving a negative fact ("that there are no better mergers than the merger at hand") to a burden of proving a positive fact. That is, the burden to prove that parties have undertaken reasonable efforts to achieve a better alternative solution to market exit. To exemplify, and as will be seen in the next section, this is what was done by the United States' Federal Trade Commission ("FTC"), which requires only that the parties demonstrate that they have "made unsuccessful good-faith efforts to elicit reasonable alternative offers of acquisition of the assets of the failing firm" to a competitively preferable purchaser.

In order to apply the failing firm test, some competition authorities require parties to prove that the net loss caused by the failing firm's exit from the market would be greater than the net loss to competition caused by the proposed merger. In Canada, for example, parties need to demonstrate that the merger is the best alternative to liquidation of the failing firm.

However, most authorities do not require parties to demonstrate that the net effects of the merger are positive, as they find that, from an economic perspective it can be presumed that the exit from the market would represent greater net loss than any alternative that allows the assets to remain in production: there is a clear net gain in efficiency in the concentration when compared to its alternative, the exit of the company from the market. (SALOMÃO FILHO, 2007). In general, a firm's exit from the market results in the loss of productive capacity and the strengthening of current competitors, including the dominant firms. This naturally result in an adverse effect on competition. When compared with the exit alternative, which leads to a reduction of the market's overall productive capacity, the concentration tends to be the preferable solution.

In the next section we will look at how different jurisdictions apply the failing firm test and how they reflect the Exit and Best Alternative elements.

4. Origin and Development

In order to better understand the failing firm defense as applied by CADE in the context of merger review, we will first look at the origin of this defense, the first cases in which it was applied by foreign courts or authorities, and how these jurisdictions apply the test today. More specifically, we will look at how this defense is applied in the United States, the European Union, the United Kingdom, and Canada. These jurisdictions were selected because they all have a long tradition with the failing firm doctrine and have thus significantly inspired the approach taken by competition enforcers in Brazil.

In most of these jurisdictions, the relevant competition law statutes do not expressly refer to the scenario of the failing firm or clarify how competition authorities or courts should factor this into their merger control analysis. In most cases, the test adopted in each jurisdiction has been created through case law and was further refined over time. In some jurisdictions, the case law has been summarized and explained in official guidelines or other official statements providing more clarity regarding its application.

4.1. United States

In the United States, competition law is applied by both federal and state governments. In the federal sphere, the two main laws aimed at promoting and protecting competition are the 1890 Sherman Act and the 1914 Clayton Act. The first prohibits agreements that aim to restrict trade and acts attempting (or succeeding in achieving) monopolization but does not address anticompetitive mergers. The latter lists some additional conducts considered anti-competitive that are not covered by the Sherman Act, and prohibits mergers that substantially lessen competition. It also provides for the dual enforcement of competition law, which falls on the FTC and the Department of Justice ("DOJ"), both of which have authority to challenge mergers that are deemed anticompetitive.

The first case on record where the failing firm defense was articulated by the parties with the goal of achieving clearance of an otherwise anticompetitive merger took place in the United States in 1930, when the Supreme Court decided the *International Shoe Co. v FTC* case. On that occasion, the Supreme Court was analyzing the acquisition of McElwain Co, a shoe manufacturing company that had become insolvent after a drop in shoe prices and could no longer maintain production despite possessing excess capacity. The purchaser was International Shoe, a competitor who was economically and financially robust, but was lacking capacity to fulfill all its orders. The Supreme Court held that a merger could not be deemed illegal when (1) the acquired firm was insolvent and (2) the acquirer was the only available buyer. The Supreme Court did not require evidence that the failing firm could not avert liquidation, or that the target had actively engaged in the pursuit for alternative buyers. For years after this decision, the failing firm defense test developed in the International Shoe case was widely applied in the United States.

The second landmark failing firm case in the United States was *Citizen Publishing v. United States*, decided by the Supreme Court in 1969. The transaction at issue involved two town newspapers, one of which was lucrative, and one of which was in debt. The companies had decided to enter into a joint operating agreement whereby they would act jointly financially but would keep their news and editorial staffs separate.

In this case, the Supreme Court rejected the failing firm defense articulated by the merging parties and established a narrower failing firm test than the one which had been in use since the *International Shoe* case. The Court's decision ultimately reinterpreted the test articulated in that case, stating that the failing firm defense's requirements should be tightened, as follows: (1) regarding the first prong of the *International Shoe* test: insolvency would only suffice if it would drive the firm to liquidate and go out of business, which would require evidence that the prospects for reorganization were "dim and inexistent"; and (2) regarding the second prong: the lack of an alternative purchaser required proof that, despite reasonable efforts, parties failed to find any alternative purchaser. Importantly, the Court also made clear that burden of proof of these elements rested with the merging firms.

An important reason the Supreme Court refined the failing firm defense test set out in *International Shoe* and increased the thresholds to its application, is the recognition that the original test contained an undesirable loophole. In *International Shoe*, the Court concluded that the

corporate participants in McElwain Company (shareholders, company directors) were in the best position to decide whether or not they should sell their business to International Shoe rather than secure new loans or reorganize in bankruptcy.

The FTC's approach to the failing firm defense was first summarized in its 1968 Merger Guidelines. Throughout the years, the merger guidelines as well as the failing firm test were updated and refined to reflect the current standard of the time. In the 1992 FTC Merger Guidelines, the Commission updated the failing firm test to include four separate criteria. This version of the test came to be highly influential in foreign jurisdictions, such as Brazil. According to the 1992 Guidelines, a merger involving a failing firm is not likely to be considered anticompetitive if four conditions are met: (1) the allegedly failing firm would be unable to meet its financial obligations in the near future; (2) it would not be able to reorganize successfully under the Bankruptcy Act; (3) it has made unsuccessful good-faith efforts to elicit reasonable alternative offers of acquisition of the assets of the failing firm that would both keep its tangible and intangible assets in the relevant market and pose a less severe danger to competition than does the proposed merger; and (4) absent the acquisition, the assets of the failing firm would exit the relevant market[4] (UNITED STATES, 1992). Conditions one, two and four relate to the Exit Element, and condition three relates to the Best Alternative Element.

In 2010, the FTC and the DOJ produced a joint Merger Guidelines which slightly altered the test applicable to the failing firm defense. Pursuant to these revised guidelines, which are currently applicable, the failing firm defense requires evidence that the failing firm at issue (1) would be unable to meet its financial obligations in the near future; (2) could not reorganize in bankruptcy; and (3) made unsuccessful good faith efforts to obtain reasonable alternative offers from buyers that buyers that would keep assets in the market and pose a less sever danger to competition[5] (UNITED STATES, 2020). In these guidelines, the Exit

[4] As will be seen in section 5 on this article, these four criteria were widely applied by CADE in its own merger review involving failing firms.

[5] The FTC Guidelines further explains that "any offer to purchase the assets of the failing firm for a price above the liquidation value of those assets will be regarded as a reasonable alternative offer. Liquidation value is the highest value the assets could command for use outside the relevant market".

Element is reflected in conditions one and two, and the Best Alternative Element is implemented through condition three.

An important feature of the guidelines is that it clarifies what constitutes a good faith effort to secure reasonable alternative buyers. The merging parties must prove that the target did not receive and refuse an offer from a competitively preferable buyer where the purchase price of that offer, despite being lower than the price offered by a less competitively preferable buyer (ie, the purchaser of the transaction under review), was higher than the liquidation value of the assets outside of the market (although estimating this can prove difficult in concrete cases).

4.2. European Union

The European Union's approach to the failing firm defense is broadly similar (and effectively was inspired by) the US approach. The first landmark European ruling on the issue was *Kali & Salz* case, handed down by the European Court of Justice in 1998. It was the first time that the parties to a merger submitted to the Commission for review successfully argued a failing firm defense. That case involved a merger to monopoly in the potash sector: K&S sought to acquire its rival Mdk, which was facing significant financial difficulties.

The European Commission, upon reviewing the merger, established the following as the failing firm defense test that it would apply: a concentration is not the cause of the competitive structure resulting from a given transaction if three cumulative elements are met. First, the merging parties must prove that the target would have been forced out of the market in the near future absent the merger. Second, they must prove that there is no less anticompetitive alternative purchaser. Third, they must provide evidence that the acquiring undertaking would indeed gain the market share of the target if the latter were forced out of the market (absent a merger). The European Court of Justice agreed with the test articulated by the European Commission, holding that it was compatible with relevant legal provisions (i.e. Article 2(2) of the EUMR), and highlighting that the second element of the Commission's test was particularly relevant as it ensures that the anticompetitive effects resulting from the transaction would be fully observed in the absence of the merger. This second prong of the test refers to the Best Alternative Element.

The third element of the Commission's test as articulated in the *Kali & Salz* case requires parties seeking to put forth a failing firm defense to show that a dominant position would have been created or strengthened even without the merger. This element is a significant departure from the failing firm defense test established in the US, and commentators have pointed out that this added condition may limit otherwise valid failing firm defenses in the context of mergers to monopoly; further, in scenarios where the assets of the failing firm are expected to leave the market, it may just be the case that increasing the acquirer's market share could be less anticompetitive as it would avoid a stark drop in output in the market at issue.

The *Kali & Salz* test was later reinterpreted in the context of the *Basf/Eurodial/Pantochim* case, decided by the European Commission in 2001. This was the second case in which parties to a transaction submitted for review in the European Union successfully pulled together a failing firm defense.

In its decision, the Commission dialed down on the third element described above, concluding that the *Kali & Salz* precedent merely required proof from the merging parties that the same anticompetitive market structure would result. The Commission explained further that this required evidence that (1) the acquired firm would otherwise exit the market; (2) there was no less anticompetitive alternative purchase; and (3) without a merger, the acquired firm's assets would inevitably exit the market. Requirements one and three refer to the Exit Element, and requirement two refers to the Best Alternative Element.

With the *Basf* case, therefore, the failing firm defense in the European Union became largely the same as the test applied in the US. The cumulative criteria articulated in the *Basf* case were three years later reflected in the European Commission's 2004 Horizontal Merger Guidelines (EUROPEAN UNION, 2004).

4.3. United Kingdom

The most recent guidelines in the United Kingdom to summarize the failing firm defense is the 2010 *Merger Assessment Guidelines,* published jointly by the Competition Commission and the Office of Fair Trading ("OFT"). It determines that the following three elements should be taken into account: (1) whether the firm would have exited (through

failure or otherwise); and, if so (b) whether there would have been an alternative purchaser for the firm or its assets to the acquirer under consideration; and (c) what would have happened to the sales of the firm in the event of its exit (UNITED KINGDOM, 2010). Steps one and three refer to the Exit Element, while step two refers to the Best Alternative Element.

The Guidelines provide that, after applying these three elements, the authority will then consider what would be the impact of exit on competition compared to the impact on competition caused by the proposed merger. The merger will not be found to be anticompetitive if the authorities conclude that there is no real prospect of a substantially less anti-competitive alternative to the merger, including the exit of the firm from the market.

When addressing whether there would have been an alternative purchaser for the firm or its assets, the guide states that authorities will consider the prospects of alternative offers for the business below asking price. The fact that the alternative purchasers would not be willing to pay the asking price would not rule it out as a best alternative scenario to be taken into account in the authority's counterfactual analysis.

Amid the 2020 Covid-19 pandemic, the CMA published a refresher on the application of the failing firm test (UNITED KINGDOM, 2020). According to this refresher, the CMA's approach can be summarized in a three-prong test. The CMA must consider: (1) whether the firm would have exited (through failure or likewise) absent the transaction, (2) whether there would have been an alternative purchaser for the firm or its assets, (3) what the impact of exit would be on competition compared to the competitive outcome that would arise from the acquisition. The first prong of this test refers to the Exit Element, while the second two refer to the Best Alternative Element. Differently from the position adopted by the FCA and the DOJ in its *Merger Guidelines,* the CMA's failing firm test does consider the net effect of the transaction because it looks at whether the merger is less competitive than market exit.

4.4. Canada

Section 93(b) of Canada's Competition Act provides that, among the factors that are relevant in assessing a merger and its effects on competition is "whether the business, or a part of the business, of a party

to the merger or proposed merger has failed or is likely to fail" (CANADA, 1985). This factor is further explained in Part 13 of Canada's Competition's Bureau *Merger Enforcement Guideline,* which provides for the failing firm defense and its application (CANADA, 2011).

In order for this defense to be accepted, the Bureau will look at two main elements: (1) whether the firm is failing[6]; and (2) whether alternatives to the merger are available and are likely to result in a materially greater level of competition than if the proposed merger proceeds. The first refers to the Exit Element, and the second to the Best Alternative Element. The available alternatives that are considered by the Bureau are: (a) acquisition by a competitively preferable purchaser, (b) restructuring the company that allows its competitive survival in the market, and (c) liquidation, when it determines that this is likely to result in a materially higher level of competition in the market than if the merger in question proceeds.

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[6] Although the first element of the Canada's Competition Bureau failing firm test does not mention the firm's exit, if read together with Section 93(b) of the Competition Act, one can interpret this as a test which seeks to identify whether the firm is failing to the point that its exit from the market would be likely. According to Canada's Merger Enforcement Guidelines, a firm is considered to be failing if: (1) it is insolvent or is likely to become insolvent; (2) it has initiated or is likely to initiate voluntary bankruptcy proceedings; or (3) it has been, or is likely to be, petitioned into bankruptcy or receivership. In assessing the extent to which a firm is likely to fail, the Bureau typically seeks the following information: (1) the most recent, audited, financial statements, including notes and qualifications in the auditor's report; (2) projected cash flows; whether any of the firm's loans have been called, or further loans/line of credit advances at viable rates have been denied and are unobtainable elsewhere; (3) whether suppliers have curtailed or eliminated trade credit; (4) whether there have been persistent operating losses or a serious decline in net worth or in the firm's assets; (5) whether such losses have been accompanied by an erosion of the firm's relative position in the market; (6) the extent to which the firm engages in "off-balance-sheet" financing (such as leasing); (7) whether the value of publicly-traded debt of the firm has significantly dropped; and (8) whether the firm is unlikely to be able to successfully reorganize pursuant to Canadian or foreign bankruptcy legislation, the Companies' Creditors Arrangement Act, or through a voluntary arrangement with its creditors (Canada, 2011).

5. The development of the failing firm defense in Brazil

In Brazil, Law No. 12.529 of 2011 ("Brazilian Competition Law") (BRAZIL, 2011) structures the Brazilian System for Protection of Competition and sets forth preventive measures and sanctions for antitrust violations. Like most of the jurisdictions described above, the Brazilian Competition Law does not address whether the failing firm scenario should factor into CADE's merger analysis. However, CADE's case law has developed significantly over the years to address this issue.

Since 1995, CADE has analyzed failing firm defenses brought forth by merging parties in at least 15 cases.[7] In the beginning, CADE replicated the tests and standards adopted by foreign antitrust authorities, with an emphasis on the ones developed in the United States. Indeed, in the vast majority of cases decided by CADE up until 2016, the authority applied the four prongs of the failing firm test provided in the FTC's 1992 Merger Guidelines (OLIVEIRA JR., 2014).

In time, CADE developed its own test to delineate its application of the failing firm defense going forward. CADE's test was laid out in its Horizontal Merger Guidelines published in 2016 ("H Guidelines") (CADE, 2016). These guidelines were highly influenced by the experience of foreign competition authorities mentioned above, as well as CADE's own case law, which will be examined in this section.

According to the H Guidelines, for the failing firm defense to be successfully applied in Brazil, it is necessary for the merging parties to demonstrate the following three elements:

(1) if the transaction is blocked, the failing firm would exit the market or would be unable to fulfill its financial obligations due to its economic and financial difficulties;

(2) if the transaction is blocked, the firm's assets would not remain in the market, which could mean that there would be a reduction in supply within that market, a higher level of market concentration and a decrease in economic welfare; and

(3) the firm has made efforts to pursue alternatives that are less damaging to competition (for example, through alternative buyers or through a judicial reorganization process) and that

[7] This statement was made by CADE's Superintendent in the webinar "*Antitrust challenges of COVID-19 — Views from Europe and Brazil," Dutcham Brasil. May 18, 2020.*"

there is no other solution for maintaining its economic activities besides the proposed transaction.

Steps one and two of the test proposed in the H Guidelines both refer to the Exit Element described above. Step three refers to the Best Alternative Element. According to the guidelines, the burden of proving the existence of these elements falls on the merging parties.

The H Guidelines adds that CADE must also find that the net effect of the transaction is positive, and that the harm caused by the firms exiting the market if the transaction were to be blocked is greater than the harm to competition that would result if it were cleared. In practice, in all the precedents were CADE analyzed the failing firm defense, the authority never addressed whether the net effects of the merger would be greater than the net effects of the exit. CADE's focus seems to be on whether there is sufficient evidence that the firm was failing and would exit the market, and whether the parties demonstrated that there were no other alternatives buyers to the asset. The reason for this may well be that CADE never reached this stage of the failing firm analysis (i.e., an examination of net effects) because of the factual circumstances of the cases where the defense was articulated.[8]

In this section, we will look at some precedents in which CADE considered the failing firm argument in order to identify how CADE has addressed this defense throughout the years, from the time it began relying on the FTC 1992 Merger Guidelines up until today, where it uses its own guidelines mentioned above.

Although not a exhaustive list of all existing cases, the precedents summarized below were selected to shed light at what elements CADE looks to when analyzing a failing firm defense – and, most specifically, the last prong of CADE's the test. The precedents described below focus on mergers where CADE addressed the question of whether or not the proposed merger was the least harmful alternative to competition. An examination of these cases allows one to trace some of the characteristics of a successful defense as well as identify the elements that tend to make the claim unsuccessful.

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[8] As will be seen in this section, CADE only applied the failing firm defense in one merger where the failing firm principle was not the only ground on which the merger was cleared, given that there were also efficiencies that, in itself might have been sufficient to clear the merger.

5.1. Gerdau Case[9]

CADE first addressed the failing firm defense in the context of the acquisition of a group of companies by a steel producing company, Siderúrgica Laisa S/A from the Gerdau Group, also active in the steel industry (CADE, 1995). Among the companies that belonged to the purchased group was Cia Siderúrgica Pains, another steel producer. Throughout its review of the case, CADE found that the merger would result in significant concentration levels in the national market for steel rods. Given the competition concerns arising from the transaction, CADE allowed the merger only partially, and ordered the parties to divest Cia Siderúrgica Pains. The parties then submitted a request for CADE to reconsider its divestment decision arguing that the merger should be allowed without remedies due to the fact that Cia Siderúrgica Pains was insolvent.

While handing down its decision regarding the parties' reconsideration request, CADE did not accept the argument brought forth by the parties. One of the commissioners of CADE's Tribunal that voted for the refusal did so on two main grounds. First, he believed that parties had not proved that the firm was insolvent but, instead, that it was still productive. Second, he said that, even if it was insolvent, it did not follow that this merger was the only viable alternative for the firm's survival.

Although the failing firm defense was discussed only briefly in this case, this decision suggests two standards had to be met in order for CADE to accept the failing firm defense. First, the parties had to prove that the target was insolvent. Second, the merger had to be the only viable alternative for the failing firm's survival. In this case, the authority did not go into further detail regarding these issues.

5.2. Mendes Júnior Case[10]

The failing firm defense was once again brought to CADE's attention in 1997 when another steel producer acquired assets from a competing firm. While analyzing the application of the defense in this case, CADE made express reference to the four criteria for application of the failing firm defense as set out in the FTC's 1992 Merger Guidelines.

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[9] CADE. AC n. 0016/1994.

[10] CADE. AC n. 0044/1995.

CADE recognized that the proposed merger might meet the first two criteria given that there was vast evidence that the firm was insolvent.

The Secretariat for Economic Monitoring ("SEAE"), which was then responsible for providing opinions on these mergers, was favorable to the application of the failing firm defense in this case. SEAE's opinion stated that the failing firm argument could apply to this transaction because all other purchase offers which had been made for the relevant assets had failed and that, if the merger was allowed, the purchasing party would be able to keep the assets within the market.

Despite SEAE's assurance that other purchase offers failed, CADE's final decision was still to deny the application of the failing firm defense. In Reporting Commissioner Renault Castro's opinion (with which the majority of the tribunal agreed), the parties had not sufficiently proven that the failing firm had undertaken all efforts to find a viable alternative to this acquisition. Although the parties had brought to the case files elements in support of their statement that the failing firm at issue had reached out to some potential buyers, the Reporting Commissioner concluded that there was evidence that these attempts were half-hearted and insufficient, given that not all possible acquirers had been contacted and some of them had been consulted only briefly.

Despite the rejection of the failing firm defense, the transaction was cleared because CADE found that there were enough efficiencies to justify the resulting concentration, and because it was unlikely that the merged entity would abuse its dominant position due to the fact that the price of the relevant goods was highly influenced by the international market. Although the failing firm was not the reason behind the merger clearance, this decision clarified just how far CADE expected (and required) the parties to go in order for them to prove that the merger is the best available alternative, from a competition perspective, to the firm exiting the market. In this case, it became clear that the burden of proof is on the parties to demonstrate that they have proactively and insistently gone to the market to find alternative solutions.

5.3. INCEPA/Celite Case[11]

In 1998, CADE undertook the review of a merger between two firms in the sanitary ware business when Indústria Cerâmica Paraná S.A

[11] CADE. AC n. 0092/1996.

("INCEPA") purchased the control of Celite S.A. Indústria e Comércio ("Celite"). The merging parties claimed that the merger did not amount to an economic concentration because Celite was undergoing pre-bankruptcy procedure and was about to suspend its business activities. The parties argued that, since the pre-bankruptcy procedure started in 1996, the firm had been for sale since that time but no interested buyers had been found. Only when bankruptcy was about to be officially declared had the merger finally been agreed by the parties.

Although the transaction was cleared on other grounds, CADE did not accept the failing firm defense in this case. In Reporting Commissioner Renault Castro's opinion, he applied the criteria set forth in the FTC's 1992 Merger Guidelines and concluded that "none of the requirements, especially the last two, were met". The Commissioner stated that important formalities in the selection of possible purchasers were not followed and that the parties had not demonstrated that the merger with INCEPA was the only reasonable alternative to keep the target firm in business. However, he did concede that "the circumstances in which the transaction took place do advocate for a more tolerant treatment regarding its anticompetitive effect"[12].

Although the Commissioner did not go into greater detail regarding what the "important formalities" for sale should have been, his opinion does suggest the standard required by CADE to meet the third criteria is high, and that the length of time the company was available for sale is not relevant. On the other hand, it did become clear that even when all four failing firm requirements from FTC's 1992 Guidelines were not met, when the company is in distress CADE might look at the acquisition more favorably than it would otherwise. As was done in this case, the authority may clear the transaction when other factors mitigate the harm to competition, such as when there are acceptable efficiencies associated with the transaction or low barriers to entry.

5.4. Pepsico/Brahma Case[13]

CADE once again refused to accept the failing firm defense articulated by the parties in the context of its review of the partnership between Brahma and PepsiCo, both active in the soda market. The

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[12] CADE. AC n. 0092/1996. Reporting Commissioner's Opinion.

[13] CADE. AC n. 08012.007374/1997-34.

transaction involved a franchise agreement and the acquisition of Buenos Aires Embotelladora S/A ("Baesa") by Companhia Cervejaria Brahma ("Brahma"). Baesa belonged to PepsiCo, and had been going through financial difficulties, high amount of debt, and idle production capacity, amounted by a falling market share.

After applying the four requirements in the FTC's 1992 Merger Guidelines, Reporting Commissioner Arthur Barrionuevo Filho found that although conditions one, two and four (regarding the Exit Element) had been met, the parties had failed to prove the third condition – that there were no alternative buyers for Baesa (Best Alternative Element). CADE did not go into detail as to why this element had not been successfully proven by the parties.

Regardless of CADE's conclusion in respect to the failing firm defense, the merger was cleared because CADE found that there was high rivalry in those market due, in the most part, to the competition with Coca-Cola.

5.5. Metal Leve Case[14]

In 1998, CADE analyzed the failing firm defense in the context of the acquisition of control of Metal Leve S.A. Indústria e Comércio by COFAP - Companhia Fabricadora de Peças and MAHLE GmbH. The reporting Commissioner Lúcia Helena Salgado e Silva made reference to the criteria set forth in the FTC's 1992 Merger Guidelines. In order to verify if the third criteria (Best Alternative Element) was met, she inquired from the companies whether, before the merger under review, they had "offered the business to the market". In response, the parties explained that the previous owners had tried to sell their shares in an auction in New York. Although potential buyers worldwide had been contacted, no firm offer was received during the auction.

Even though the Commissioner did not expressly recognize that the Best Alternative Element had been met, in the end she found that the failing firm did not apply because parties had not sufficiently proven financial distress (Exit Element). Although this was not expressly confirmed, this suggests that the Commissioner found that the parties had,

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[14] CADE. AC n. 0084/1996.

in fact, demonstrated that the Best Alternative Element had been met through the attempt to sell the shares in the New York auction.

5.6. Votorantim Case[15]

The only case in which the failing firm defense was used as a significant basis for allowing a merger to be cleared by CADE was in the review involving the acquisition, by Votorantim Metais Zinco S/A ("Votorantim") of a company's assets out of bankruptcy. The company in question, Mineração Areiense S.A., had been declared bankrupt over five years previously and its mining rights had been sold in bankruptcy court to Votorantim.

Although the transaction would result in a horizontal concentration in the zinc market, as well as a vertical integration, SEAE's Technical Opinion in this case was in favor of clearing the transaction without further investigation due to the fact that "the mining rights (subject of this merger) belonged to an inoperative entity". CADE's Attorney-General was also in favor of clearing the transaction based on the failing firm exception, conceding that "when a company is bankrupt or admittedly insolvent, another company is allowed to acquire its assets even if this results in a significant concentration".

The Attorney-General found that this case fell within all four criteria for the application of the failing firm defense in the FTC's 1992 Merger Guidelines. The Exit Element had been proven because the purchased assets had already exited the market as they had been inoperative for the past years. Regarding the third criteria (proof of the Best Alternative Element), he observed that no other less anti-competitive solutions could be found since the acquisition had been made through a public auction which was open to all interested parties, but which only Votorantim chose to participate in.[16] Because no other interested buyers came forward, the Opinion concluded that there was no better alternative than the merger at hand.

When the issue was at last brought to CADE's Tribunal for a decision, the transaction was cleared not only on the grounds of the failing

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[15] CADE. AC n. 08012.014340/2007-75.

[16] It is worth noting that SEAE's Technical Opinion in this case was in favor of clearing the transaction without further investigation due to the fact that "the mining right (subject of this merger) belonged to an inoperative entity".

firm defense, but also because of the finding that it was unlikely that the merging parties would be able to exercise market power due to existing market conditions, rivalry between market participants, and low entry barriers. However, it is clear that the failing firm argument had significant weight in CADE's final decision in this case.

This can be considered a landmark by CADE involving the failing firm defense not only because it was the first case where a merger was cleared predominately on these grounds, but also because it was the first time CADE comprehensively discussed and addressed its implication to Brazilian competition law. CADE's Attorney-General mentioned that, "though there are no provisions for a failing company defense in Brazilian law, it is in line with the Brazilian competition defense legal system". Because welfare maximization is the goal of competition law, the Opinion said, it is inevitable that the social losses derived from an economic concentration would be weighed with the social benefits brought by avoiding losses and waste that would result from the firm's assets going to waste after its bankruptcy.

5.7. Casil Case[17]

Although the failing firm defense was not expressly brought by the merging parties in this case, both the Secretariat of Economic Law ("SDE") and the SEAE both mentioned it in their analysis, due to the fact that parties had argued that the financial recovery of the target company could count as one of the efficiencies of the deal. In this case, CADE found that the conditions for applying the defense were not met because the parties did not demonstrate any other offers besides the one that led to the proposed merger. Regardless, in the end, the transaction was cleared on other grounds.

5.8. Mataboi/JBJ Case[18]

In 2017, CADE blocked the purchase of Mataboi by JBJ. As part of the merger review process, CADE's Department of Economic Studies (DEE) – which issues non-binding advisory opinions at the request of CADE's General Superintendence or CADE's Tribunal – considered the application of the failing firm doctrine to this acquisition and concluded

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[17] CADE. AC n. 08012.005205/1999-68.

[18] CADE. AC n. 08700.007553/2016-83.

that it should not apply for two reasons. First, the DEE found that, although Mataboi was in financial difficulty and was undergoing judicial restructuring procedure, there was no evidence that the recovery plan underway would not be successful and that, absent the merger, Mataboi would have to exit the market.

The DEE found that the parties had failed to demonstrate the merger was the best available alternative to exit. The parties had only stated that they were "unaware of any other interested buyers" at the time. This, DEE found, was insufficient because the burden of proof on this issue was on the merging parties, who had to demonstrate that there were no other alternatives to this merger that were less harmful to competition.

In order to successfully prove this point, DEE stated that the seller had to prove that there were no other parties interested in purchasing Mataboi. In order to do so, Mataboi should have presented letters with credible sale offer to a reasonable number of potential buyers, with proof that these had been rejected. DEE also recommended that this point would have been more successfully made if Mataboi had advertised the sale of assets in a far-reaching media vehicle and submitted information on all parties that had shown interest in the purchase. As evidence, the merging parties should have listed all interested parties, and justified the rejection of all viable offers which had been received and refused but which had the potential of causing less harm to competition. Given that this had not been done, DEE concluded that the parties had not met the requirement of showing that there were no better alternatives to the proposed merger.

During the merger review process, CADE's General Superintendence reached out to some potential buyers to verify if any of them would be interested in purchasing Mataboi. It was found that at least three of them declared that they would not, while one of them stated that it would need to conduct further inquiries before indicating its position. However, DEE's opinion was that, even if there were no available purchasers at the current price point, the price of the assets could be reduced in order to spark the interest of other firms in the market that had not thought the original purchase price attractive.

In the end, CADE's Tribunal agreed with the DEE and refused to apply the failing firm argument because "there was no evidence that the firm would have left the market if the transaction had not been carried out". Regarding the best alternative element, the Tribunal said that "at the time of the transaction, there were firms who were interested in the asset and, currently, there is no evidence that there would be no such agents,

with interest and financial and technical capacity to make the necessary contributions for Mataboi to remain in the market".

One interesting aspect of this case that is worth noting is that, after the transaction was implemented by the parties[19], three of the target firms' production facilities were shut down. CADE considered this to be an additional argument against the application of the failing firm defense since one of the main objectives of this doctrine is to keep the assets in the market. By shutting down a number of production facilities, the parties demonstrated that the merger would not successfully keep the assets from leaving the market.

5.9. Petrobras/Petrotemex Case[20]

The failing firm argument was once again addressed by CADE in 2018, in relation to the purchase of two subsidiaries of the state-owned enterprise Petrobras, Petroquímica de Pernambuco (PSUAPE) and Companhia Integrada Têxtil de Pernambuco (CITEPE), by the Petrotemex Group, which had been challenged by CADE's General Superintendence ("SG"). The SG had recommended the acquisition be cleared if the parties agreed to undertakings which addressed the risk of foreclosure that was raised by this merger.

In its reasoning, the SG assessed the parties' failing firm defense and found that Petrobras did actively search for alternative buyers. According to Petrobras, before committing to the merger under review, it had undertaken a sale process that involved the following steps: (1) contact with potential buyers, (2) presentation of an information memo to companies that showed interest in purchasing the relevant assets, (3) accreditation of the firms that presented non-binding proposals for the due diligence stage, and (4) presentation of binding proposals after the due diligence stage. In the end, at the stage of binding proposals, according to the merging parties, only themselves and one other firm submitted proposals. The other firm was also a competing firm, which means that the acquisition by that firm was unlikely to be a better alternative from a competition perspective.

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[19] Although Brazilian Competition Law requires that parties do not implement the transactions prior to CADE's approval, this merger had been implemented prior to notification, and parties received a fine for gun jumping.

[20] CADE. AC n. 08700.004163/2017-32.

However, although there was evidence to suggest that the firm was in financial distress, the parties did not manage to prove that the assets would exit the market if the merger was not cleared. Therefore, the SG found that undertakings would need to be taken to address this competition risk. The Tribunal agreed with SG's assessment that undertakings were necessary even though, in its decision, it did not mention the failing firm defense.

However, that Commissioner João Paulo de Resende issued a dissenting opinion where he voted to block the merger on the grounds that it significantly harmed competition. As part of his reasoning, the Commissioner engaged in a thorough analysis of the failing firm argument and, more specifically, of the issue of alternative purchasers. Although this opinion was not adopted by the Tribunal, it does shed some light into how this issue is controversial within CADE's Tribunal itself. The dissenting Commissioner disagreed that parties had sufficiently proven that there were no other parties interested in the assets. In his opinion, the way the sale process was designed restricted the number of firms that would express interest in purchasing the asset, because it imposed criteria that had to be met by those that were to participate in the auction. Furthermore, because direct competitors value the assets more, their purchase offers tend to be greater. This, he claimed in his dissenting vote, discourages other possible purchasers from participating in the sales process even if they would be willing to purchase the asset at a lower price. In short, he observed that the Best Alternative Element should not consider only alternatives buyers that would be willing to pay the highest price but should consider also possibly interested buyers that value the asset less than the competitors.

This position, however, was not adopted by CADE's Tribunal, which found that the Best Alternative Element had been met due to the fact the sale had been conducted through a public auction open to all interested parties, were no other better alternatives were available. It would not be surprising, however, if CADE's opinion regarding the application of the failing firm defense changed if the peculiarities of the case were different. Had a competitively preferable firm demonstrated interest in purchasing the asset, participated in the public auction, but made a losing bid, it is possible that the Tribunal might have considered that the Best Alternative Element had not been met in this case.

6. Analysis of the case law: how to prove that the merger is the best available alternative?

In Brazil, as stated in CADE's H Guidelines, the requirement to prove the Best Alternative Element in the failing firm is twofold: one positive and one negative. The Guidelines state that in order to apply the defense, the parties to a given transaction must demonstrate that: (1) the firm has made efforts in the search for alternatives that are less damaging to competition (for example, through alternative buyers or through a judicial reorganization process) and (2) that there is no other solution for maintaining its economic activities besides the proposed transaction. In practice, however, CADE often looks at the efforts undertaken by the parties and the conditions under which the purchase was made.

CADE has, on two occasions, found that the Best Alternative Element of the failing firm test had been fulfilled. The first occasion was the Votorantim case, involving the purchase of mining rights in bankruptcy court. The reason this case was found to fulfill the Best Alternative Element was because the acquisition had been made through a public auction which was open to all interested parties. Furthermore, no other parties had chosen to participate in the sales process, which suggests that there were no other potential competitively preferable purchasers interested in this asset.

The second case in which CADE found that the Best Alternative Element was fulfilled was the Petrobras/Petrotemex case. Here, CADE's General Superintendence found that Petrobras had undertaken sufficient effort to find an alternative buyer because it had sold the subsidiaries in accordance with a robust sale process that involved the following stages: (1) contact with potential buyers, (2) presentation of an information memo to companies that showed interest in purchasing the relevant assets, (3) accreditation of the firms that presented non-binding proposals for the due diligence stage, and (4) presentation of binding proposals after the due diligence stage. In the end, at the stage of binding proposals, according to the Claimants, only themselves and one other competitor had submitted proposals.

In all other precedents, CADE found that the Best Alternative Element was not met. From an analysis of CADE's case law described above, it is also possible to identify when CADE considers the parties efforts to find a better alternative insufficient. We know that merely stating

that the parties "had no knowledge" of any other interested buyers is not enough to fulfill the Best Alternative Element. In the Mataboi/JBJ case, CADE said that the burden is on the parties to show there are no better alternatives. This could be done by presenting CADE with evidence that (1) parties reached out to a reasonable number of potential buyers with letters of credible sales offer, together with proof that these had been rejected by the potential buyers, or, alternatively, (2) parties advertised the sale of the assets in a far-reaching news media vehicle. In the second case, parties should submit to CADE the information of all parties that had shown interest in the purchase and, if any potential buyer showed interest in the assets, the merging parties should justify the rejection of all viable offers which had been received and refused.

However, merely sending a private letter to potentially interested parties may be insufficient. In the analysis of the acquisition of assets of Mendes Júnior Siderurgia S.A., CADE found that parties had not proven the Best Alternative Element even if they did send private letters to some potential buyers because it found that these attempts were halfhearted. That suggest that CADE wants parties to be more proactive and insistent in their attempt to find alternatives, which places a huge burden on merging parties.

Furthermore, that even when assets have been on sale for a long time, CADE may find that the parties did not do enough to find a better alternative buyer. In the INCEPA/Celite case, the assets had been on sale for a long time, since pre-bankruptcy procedure had begun two years previously, and no other interested parties had been found. Still, CADE concluded that this was not enough to consider the Best Alternative Element met, because important formalities in the selection of possible purchasers had not been followed.

7. Concluding remarks

Times of vertiginous economic downturn, as experienced during the Covid-19 pandemic, bring greater uncertainty about the market and, most importantly, about the value of these assets in the future. A competitor with market power may be the only player interested in acquiring a firm that is insolvent or going bankrupt because it understands the markets' characteristics and peculiarities (OLIVEIRA JR; ALBERTO ESTEVES, 2020). This market knowledge reduces the risks inherent to any new market entry and makes the purchase by a current market participant more likely. In this context, it is important for competition

authorities, including CADE, to recognize that the acquisition by a competing player might be the only available alternative to the failing firm's exit from the market in times of crisis.

Although none of CADE's precedents analyzed above address the issue of timing, this aspect is of the utmost importance in any corporate restructuring decision. If the failing firm is to be saved before its assets leave the market and are rendered obsolete, CADE's analysis of potential alternatives should consider only those that are immediately available and reasonably certain. Claims that there could possibly be unknown potential buyers should not be enough to block a proposed merger if parties have demonstrated that they have undertaken reasonable efforts to find a superior alternative.

Even though the burden is on the parties to prove that they have undertaken reasonable effort to find a better alternative, it is difficult for them to prove a negative fact – that no other alternatives are available. Therefore, once the parties have proven their genuine effort, the burden to prove that there are better alternatives should be on CADE. This way, no party would have the burden to prove a negative fact. Absent proof of competitively preferable buyers, it should be deemed sufficient for the merging parties to prove they have undertaken reasonable effort to find a better alternative.

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