

Goodmans^{LLP} Update

“Failing Firm” Claims in Merger Review – New Canadian Developments

“Failing firm” claims may become more common in merger reviews in the age of COVID-19, when companies must enter into transactions quickly to continue as a going concern due to recent financial challenges. The Canadian Competition Bureau (“**Bureau**”) provided important new guidance for how it assesses failing firm claims in merger reviews under the *Competition Act* (“**Act**”) following its review of two recent mergers. Key takeaways:

- The Bureau expressly indicated that its examination of a firm’s solvency is dynamic and the analysis may be updated as the effects of COVID-19 develop.
- The Bureau demonstrated the ability to analyze failing firm claims quickly.
- The Bureau described the financial and statistical methodologies it will apply in assessing a firm’s solvency and whether bankruptcy is likely (i.e., whether a firm is in fact failing).
- The Bureau indicated that its assessment of whether a competitively preferable purchaser exists includes an examination of whether such a purchaser can close a transaction in a timely manner.

Background

Whether a business or part thereof has failed or is likely to fail is one of the factors the Commissioner of Competition (“**Commissioner**”) or Competition Tribunal considers in determining whether a merger or proposed merger is anti-competitive. The Bureau’s *Merger Enforcement Guidelines* (“**MEGs**”) describes the two-part inquiry for conducting a failing firm analysis.

- First, there is an inquiry as to whether the firm is failing. Failure can be demonstrated in multiple ways, including by demonstrating the firm is insolvent, or the firm has initiated or been petitioned into bankruptcy or receivership proceedings. The Bureau will seek extensive information about the firm’s financial position when reviewing claims of failure (e.g., financial statements, projected cash flows, information about borrowing).
- Second, there is an inquiry into whether there are any competitively preferable alternatives to the merger. Potential alternatives include a restructuring, a liquidation or sale to an alternative purchaser. In assessing whether an alternative purchaser exists, the Bureau warns that a “thorough search for a competitively preferable purchaser” is required and it may “require the involvement of an independent third party (such as an investment dealer...) to conduct a search before the failing firm rationale is accepted.”

Recent Developments

On April 29, 2020, the Bureau [announced](#) it closed an investigation into the merger of the two largest scrap metal processors in Quebec. The Bureau determined the merger was not anti-competitive because the target company was a “failing firm”.

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American Iron & Metal Company Inc.'s ("AIM") proposed acquisition of Total Metal Recovery Inc. ("TMR") was not subject to notification and the waiting periods under the Act. The Bureau commenced an inquiry into the merger before closing, but the merging parties decided to complete their transaction while that inquiry was ongoing. To remove the risk that the Commissioner would seek an interim injunction against the closing of the transaction, AIM entered into a Consent and Preservation Agreement with the Commissioner, promising to preserve and maintain the assets of TMR for 60 days after the transaction closed. This is consistent with the Commissioner's recent decisions to take enforcement actions that minimize the use of litigation to prevent transactions from closing while it conducts its assessment (see this [Goodmans Update](#)). The parties closed their transaction three days after the Consent and Preservation Agreement was signed.

The Consent and Preservation Agreement appears to have offered advantages to all parties concerned. The Commissioner obtained a 60-day period to conduct his inquiry and decide whether to challenge the transaction. AIM obtained the right to simply maintain and preserve the purchased assets (which is far less burdensome than a "hold separate" arrangement). TMR was permitted to receive whatever consideration was promised to it and avoid future transaction risk.

The Bureau conducted an in-depth review in the 60-day period, including with the assistance of a financial expert. The Bureau's review provides new insight about its framework for analysis than the MEGs:

- **Tests for Solvency.** In explaining its assessment of whether TMR was solvent, the Bureau describes for the first time how it will examine a firm's (i) balance sheet solvency and (ii) ability to pay debts as the debts become due. Balance sheet solvency requires an examination of variables that relate to the transaction price, discounted cash flows or earning multiples of similar firms. The ability to pay solvency test requires an examination of liquidity forecasts, calls on debt and the availability of alternative sources of financing.
- **Test for Bankruptcy.** In describing its assessment of whether TMR was likely to enter or be petitioned into bankruptcy, the Bureau describes how it will apply a firm's financial information to statistical bankruptcy prediction models that are used in the accounting industry to determine whether a firm is likely to enter bankruptcy in the near term.
- **Process for Identifying a Competitively Preferable Purchaser.** In describing its assessment of whether a competitively preferable purchaser exists, the Bureau noted that a third party need not be retained to market the target business if it can be demonstrated that other buyers have been approached. The Bureau also emphasized that an alternative purchaser must be able to "finalize an agreement with the failing firm in a timely way, especially given the financial circumstances of the failing firm". (Emphasis added.)

On March 27, 2020, the Bureau [published](#) a report to the Minister of Transport about Air Canada's proposed acquisition of Air Transat. While the majority of the report focuses on how competition would be impacted by the merger, it also explains that the Bureau assessed whether Air Transat would remain solvent. An expert retained by the Bureau noted Air Transat was solvent, but that these views "were based upon data and information collected ... prior to the onset of the current environment of disruption due to the COVID-19 virus pandemic." The report cautions that the "ultimate impact of these events" on Air Transat "may be relevant to the Commissioner's views."

Discussion

Businesses planning M&A that involves a failing firm claim should consider the following :

- **Understanding COVID-19.** The Bureau acknowledged COVID-19 is having significant economic effects and that its assessment of solvency and other matters may evolve as disruption from the pandemic continues.
- **Efficient Reviews if Parties Provide Information.** The Bureau demonstrated its ability to evaluate failing firm claims in short periods of time (e.g., less than 60 days). However, the Bureau warned that prompt reviews depend on parties providing complete information early in the process.
- **Guidance for Counsel.** By describing tests for solvency and bankruptcy, the Bureau provided clear guidance for counsel about the specific types of information and evidence it will expect in support of a failing firm claim.

Goodmans^{LLP} Update

- **Guidance for Corporate Strategy Teams.** By describing the search for a competitively preferable purchaser, the Bureau provided clear guidance to corporate strategy teams about the processes that will support a claim that no alternative purchaser exists. The Bureau will not require a full “auction” of the target business and a failing firm claim will not be unsuccessful due to the mere existence of an alternative purchaser (an alternative purchaser must be competitively preferable and able to close a transaction in a timely way).

In addition to the takeaways arising from the Bureau’s two recent reviews, businesses may also consider the significance of the recent clearance by the UK Competition & Markets Authority (“**CMA**”) of Amazon’s proposed investment in Deliveroo. The CMA concluded Deliveroo’s exit from the market would be “inevitable” but for Amazon’s investment and for that reason approved the transaction.

Businesses contemplating strategic M&A that may involve a failing firm claim should consult counsel early to marshal the evidence the Bureau will require for its review. Any member of our [Competition, Antitrust and Foreign Investment Group](#) would be pleased to answer any questions about or discuss failing firm claims.

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