

OPPORTUNITIES IN CHALLENGING TIMES: THE FAILING FIRM PROVISION OF CANADA'S COMPETITION ACT

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While it is impossible to know the full economic impact of the current COVID-19 pandemic, and the consequential shutdown of much of Canada's, and the world's, economy, it is clearly severe. Regrettably, some businesses will be challenged, and some will fail. However, other businesses, which may be better capitalized or more fortunately situated will likely look for appropriate acquisition opportunities in the near future. Some of those opportunities will involve the acquisition of a competitor, or other businesses where there may be competitive implications. In those circumstances it is important to understand the relevant provisions of Canada's competition laws.

The merger provisions of *Canada's Competition Act*^[1] allow the Commissioner of Competition to challenge mergers and proposed mergers which do or which are likely to give rise to a substantial prevention or lessening of competition. There is no general exemption in times of recession or economic crisis. Mergers in certain industries, such as between financial institutions and mergers involving transportation undertakings may effectively be exempted from *Competition Act* challenge by the Federal Cabinet. However, for most enterprises the general rules apply, even in financially challenged times, and parties proposing a merger must, as a practical matter, be prepared to demonstrate that their merger is not likely to have a problematic impact on competition.

While there is no "recession" exemption from the merger provisions of the *Competition Act*, the Act does, like similar provisions of merger review laws in many other jurisdictions, contain what is generally referred to as the 'Failing Firm Defence'. In fact, it is not a defence at all, but rather a factor which the Competition Tribunal is to take into account in deciding whether a merger is problematic. Section 93(b) of the *Competition Act* provides as follows:

93 *In determining, for the purpose of section 92, whether or not a merger or proposed merger prevents or lessens, or is likely to prevent or lessen, competition substantially, the Tribunal may have regard to the following factors:*

...

(b) *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...*

It is clear from section 93(b) that the Competition Tribunal, and as well the Commissioner of Competition, is not to simply allow a merger if the target is failing, but rather is instructed to consider whether, because of the failure, the merger does not materially injure competition. Typically, the contention would be that there is no injury to competition because the failing firm would exit the market anyway. However, sometimes a firm restructuring out of insolvency, or a firm's assets becoming available after bankruptcy, will be competitively preferable to its acquisition by a direct competitor.

Whether the failing firm defence will be accepted in any particular case will turn on the type of assets in issue and the market structure, amongst other considerations. The Competition Bureau's *Merger Enforcement Guidelines* (the "**MEGs**") include in-depth guidance relating to failing firm issues,^[2] which outline the Bureau's approach to the provision. Some of the highlights are:

- Proving that a firm is failing requires proof that the firm:
 - (i) is insolvent or likely to become insolvent;
 - (ii) has initiated or is likely to initiate voluntary bankruptcy proceedings; or
 - (iii) has been or is likely to be petitioned into bankruptcy;
- The evidence that must be submitted to the Bureau to prove that a firm is failing includes:
 - the firm's most recent, audited, financial statements;
 - the firm's projected cash flows;
 - information and documents showing whether any loans of the firm have been called, or further loans/line of credit advances to the firm have been denied and are unobtainable elsewhere;
 - information and documents showing whether suppliers have curtailed or eliminated trade credit with the firm;
 - information and documents showing whether the firm has been experiencing persistent operating losses or a serious decline in the net worth of its assets;
 - information and documents showing whether any such losses by the firm have been accompanied by an erosion of its market position;
 - information and documents showing the extent to which the firm engages in "off-balance-sheet" financing (such as leasing);
 - information and documents showing whether the value of any publicly-traded debt of the firm has significantly dropped; and
 - information and documents showing whether the firm is unlikely to be able to successfully

reorganize through bankruptcy and insolvency legislation or through a voluntary arrangement with its creditors.

- Before concluding that a proposed transaction involving the acquisition of a failing firm (or failing division) is not likely to lead to a substantial lessening or prevention of competition, merging parties must convince the Bureau that no competitively preferable alternatives exists.
 - Parties will generally have to show evidence of what other parties were solicited to consider purchasing the failing firm:
 - The Bureau wants to assess whether any third party exists who would be willing to purchase the failing firm, and whose purchase of the failing firm would yield lesser anti-competitive effects than the proposed transaction.
 - In practice, this means that the Bureau will review all other significant competitors, customers and suppliers in the relevant market where the failing firm competes.
 - If the Bureau is not satisfied that a thorough search for a competitively preferable purchaser occurred, the Bureau will instruct an independent third party (e.g., an investment dealer, trustee or broker who has no material interest in either of the merging parties or the proposal in question) to conduct such a search.
- Parties must convince the Bureau that retrenchment or restructuring will not be able to save the failing firm. If either retrenchment or restructuring of the failing firm were viable, the Bureau may treat such restructuring as a competitively preferable alternative to the proposed transaction.
- Parties must convince the Bureau that the liquidation of the failing firm is not a competitively preferable alternative. The Bureau will analyze whether the liquidation of the failing firm could facilitate market entry by actual or potential competitors to compete for the assets or the customers of the failing firm. If so, liquidation may be seen as a competitively preferable alternative to the proposed transaction.

As is apparent from the MEGs, historically the Competition Bureau has been quite strict in its consideration of the failing firm provision, generally requiring quite a bit of rigour around demonstrating that the firm is failing (which can sometimes pose timing challenges in a fast moving insolvency environment), and has also been tough on the question of whether there is a competitively preferable purchaser for the firm — again requiring searches for such alternate buyers when time is often of the essence.^[3]

While the Bureau has been quite rigorous in its application of the failing firm provision, our view is that in a time of a crisis such as the COVID-19 inspired economic downturn the Bureau will move with alacrity to consider failing firm arguments, and is likely to accept that, at least in some obvious cases, an exhaustive search for alternate buyers, or chapter and verse on the obviously insolvent state of a target business, may not be practical. In the Commissioner of Competition's [recent letter to the Canadian Bar Association](#) on the

COVID-19 situation, the Commissioner noted:

As you can imagine, the Bureau may also need to prioritize urgent marketplace issues that require immediate action to protect Canadians. Such instances may have implications on our ability to address other ongoing matters.

Rest assured that the Bureau remains dedicated to doing its utmost to serve the public interest and to advance matters in a professional and responsible fashion.

In addition to the failing firm provision, Canada's merger law also contains a unique efficiencies defence. Some transactions involving failing firms also give rise to meaningful efficiencies, which are relevant to merger approval. This brief does not address the efficiencies defence issue in detail, but an in-depth discussion of the use of efficiencies in Canadian merger reviews can be found in our [2015 bulletin on the Supreme Court of Canada's decision in the Tervita merger](#).

Given the requirements of the failing firm provision, and the inevitable time that any merger review in a concentrated market will take, advance planning is important. McMillan's Competition and Antitrust group has considerable experience with the failing firm and efficiencies provisions of the *Competition Act*. Should you be considering a transaction arising out of the current economic circumstances, we would be pleased to discuss with you preliminary deal concepts, to form an initial view as to the viability of transactions, and to determine a course of action with the maximum chances of success.

by James Musgrove and Joshua Chad

[1] RSC 1985, c C-34.[ps2id id='1' target='']

[2] Competition Bureau, "[Merger Enforcement Guidelines](#)" (2011-10-06) at Part 13. [ps2id id='2' target='']

[3] We note that, if timing challenges are the biggest concern, and the purchaser is confident that it can convince the Bureau that the failing firm defence applies, recent cases suggest that the Bureau may be open to entering into interim asset preservation or hold separate consent agreements with proposed purchasers. If the Bureau signals to a party that this is an option, such an agreement could permit closing on the condition that the purchased assets are preserved by and/or held separate from the purchaser's business while the Bureau completes its substantive review.[ps2id id='3' target='']

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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