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12th New Frontiers of Antitrust

#3 Competition Policy in the Post-Covid-19 Economy: What to Do of Zombification Risks?

Webinar - 10 June 2021*

> "A zombie firm is neither productive nor entering formal insolvency proceedings because it is not pressed by its creditors to do so."
>
> Jorge Padilla

Nicolas Petit

Nicolas Petit introduced the discussion, mentioning that even though many in the antitrust community focus on digital threats and monopolies, there is another worry voiced by a large group outside this community. Central bankers and financial economists warn about the growing population of zombie firms in the economy. They are talking about a group of "living dead" firms that spread across industries and crowd out healthy firms and business opportunities, innovation, and entrepreneurship. What to do about this phenomenon, and whether it should be dealt with using antitrust policymaking shall be the point of the discussion.

Jorge Padilla

Jorge Padilla proposed a definition of zombie firms. They are firms that are unable to cover their debt servicing costs from their current profits over an extended period. They manage to stay in business via a symbiotic relationship with banks – the latter extending their loans rather than acknowledging that these are

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nonperforming. A zombie firm is neither productive nor entering formal insolvency proceedings because it is not pressed by its creditors to do so. They do not engage in capital growth or investment. In terms of metrics, interest coverage ratio, and Tobin's q (is a measure of market capitalisation over assets) can help to identify them. They constitute a threat to the economy, as they impose deflationary measures upon it. Their lack of productivity and inability to invest and develop good products drives the market towards excess capacity and deflated prices. This creates a clear negative contribution in the form of reduction of growth and profits for efficient firms. The 2008 experience has demonstrated that zombie firms push out of the market non-zombie firms. The latter find it more difficult to access funding from banks and investors, and to grow their employment. Via the same effects, zombie firms also act as a barrier to entry for young and innovative players. A greater share of zombie firms means depressed total factor productivity, an indicator that is key to sustain growth over time and ensure that people's incomes are sustained.

Mr Padilla disagreed that zombie is an empty label. It is a well-established notion in the economic literature which central banks use and that rely on solid metrics such as debt coverage ratios, investment, and profitability. Central banks all over Europe have identified them as an issue because of the considerable amount of resource that they drain. It is necessary that they exit the market, and merger control may be a way out. Facilitating bankruptcy may be another one, as is restructuring loans. In terms of merger control, however, the failing-firm defence does not properly apply here. The counterfactual here is not exit by the zombie company but rather its permanence on the market, with eternal failure to invest, low productivity and low investment. Higher prices in the short term -following the zombie's exit- may be necessary to ensure greater growth and lower prices in the future.

Karl Soukup

Karl Soukup reminded the audience that it falls onto Member States to decide whether to support a certain company or not. The European Commission is only setting the framework conditions for this support and set boundaries for it. This framework does include a distinction between healthy and companies in difficulty (a term that the Commission prefers over "zombie firms"). Such companies can be identified by the fact that a large share of their capital -around half of it- has been lost, that they are subject to insolvency proceedings or if their interest coverage ratio is below 1 and at the same time the book debt-to-equity ratio is higher than 7.5. There are exceptions in the startups' ecosystem, as it is running on different business cycles and figures that make it hard to compare with other ones.

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Karl Soukup

Mr Soukup also explained that there are two main legal bases for the Commission to use in assessing Covid-19 State aid support. The first one is Article 107(2)(b) TFEU – it provides regulation in cases of mere compensation for damages which are resulting directly from restrictive measures taken by governments in this crisis. The second legal basis is Article 107(3)(b) TFEU that allows broader support for companies that need liquidity or equity due to the economic consequences of the crisis. However, companies that were in difficulty before the crisis are not entitled to State aid awarded based on the latter framework. This interdiction was lightened during the crisis for micro and small firms to balance the administrative burden for the Member States. This is the policy inscribed in the so-called Temporary Framework which will last until the end of 2021. One should not forget, however, that there is a different set of rules for the support of the restructuring of ailing companies, which requires that companies put forward a serious restructuring plan capable of restoring long-term viability before they access State resources.

One should remain careful not to overload the competition boat with policy objectives. Fiscal and monetary authorities are also looking into solving the zombification problem, as there seems to exist a consensus that too many of them still operate. Perhaps the regulatory environment is not yet up to the task of taking them out, but then reform there (and not necessarily in the competition field) should be considered. Maybe the banking regulatory framework still allows for too many nonperforming credits, or maybe insolvency rules do not deliver as they should if they let zombies survive.

Isabelle de Silva

Isabelle de Silva pointed that she does not believe that the French Autorité de la concurrence deals with many zombie firms and that she prefers referring to companies facing economic or financial difficulty. Many mergers and acquisitions are the consequence of such difficulty. It is also common for parties to a merger to argue that the transaction should be allowed based on the failing firm defence. Covid-19 did have an important effect on the number of mergers under review: it fell by 40 per cent compared to the year before. This points to the question of the way to handle Covid-induced difficulties in merger control. The application of the failing firm defence remains submitted to strict conditions set by the Court of Justice and national courts. It is necessary to prove that the target is not able to attract other investors and that the failure of the transaction would result in the target exiting the market. The *Cofigeo* case of 2018 provided an interesting illustration: the merging parties put forward the failing firm defence to counterbalance the fact that the transaction would result in a 60 per cent market share. The merger was cleared subject to two divestments. The decision was overturned by ministerial intervention on grounds of employment. The Autorité believes that the failing firm defence criteria should not be changed in the context of Covid. It remains committed to focusing on market health rather than on the merging parties' financial situation. Its mandate is to protect competition, even though this cannot be made by focusing on price only. The financial system is supposed to ensure that inefficient players with no perspectives of betterment exit the market.

On procedure, companies that face insolvency often ask for a derogation to the standstill obligation of merger control. Derogation requests have tripled because of the crisis – some of them have been granted temporarily to allow the companies to move forward in the corporate processes. However, obtaining such derogation does not suppose a lighter review on substance by the Autorité. Finally, on merger thresholds, the Autorité, like the European Commission, uses turnover as a proxy. Because of the financial turmoil induced by Covid, it is virtually possible that a big company ends up with little or no turnover and therefore falls below merger control thresholds, even though such a case did not come up. If it did, this could be an occasion to apply the new interpretation of Article 22 EUMR and refer the case to the Commission.

> "The application of the failing firm defence remains submitted to strict conditions set by the Court of Justice and national courts."
>
> Isabelle de Silva

Frédéric de Bure

Frédéric de Bure stressed that merger control largely overlooks zombification risks – and this leads to a paradox as mergers can also, to some extent at least, remedy such risks. Mergers involving zombie firms can be divided into three cases. The first case is one where a zombie firm plans on acquiring an efficient company, potentially pushing it towards inefficiency in what can be compared with a killer acquisition. But merger control does not look deep into financials that could reveal zombification, neither does it assess public support as an element of market power. The Commission, in *STX/Aker Yards*, made an exception and entered a discussion on public subsidies granted to the South Korean acquirer and their impact on competition, but ultimately concluded that public subsidies were unlikely to confer market power. There may be an enforcement gap here, which may partly be addressed by the new proposal of the Commission on foreign subsidies. The second case would be one where two zombie firms plan on merging – at first sight, this does not create substantial additional risk to competition since both companies are already inefficient, and an increase in scale could even lead to more efficiency. However, a bigger zombie player could also attract more subsidies, raise higher barriers to exit and become somewhat too big to fail. The third situation is one where an efficient firm plans on acquiring a zombie firm – this could prove efficient as this could be a way to eliminate the zombie while maintaining the assets and know-how on the market, and therefore could be authorised based on the failing firm defence.

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However, experience suggests that the failing-firm defence is very rarely used. It was mentioned by the CMA in Amazon/Deliveroo, but the merger was finally approved on other grounds. This is due to the very strict nature of the criteria, among which are the following: (1) was it not acquired, the target would inevitably exit the market; and (2) there are no less anticompetitive alternatives. On the first criteria, however, it fails to realise that the target may remain active in the absence of the merger, but only at the price of major public subsidies. The reality is that in most cases zombie firms do not exit the market and are artificially kept alive. On the second criteria, does being acquired by another inefficient company count as a more competitive alternative? These questions may lead one to believe that zombification risks are overlooked in merger control. Merger control should ensure that "good" market power based on efficiencies is not treated the same way as "bad" market power derived from everlasting subsidies.

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Gönenç Gürkaynak reflected on the definition of a zombie firm. For instance, a cash-positive company whose debt interests exceed its profits because of past losses should be called a zombie firm. What to do then about such firms? It would be possible to consider efficiencies and failing-firm defences with more candour. Competition agencies so far have not been paying sincere attention to efficiency defences. Efficiencies should be considered more carefully, as they provide the benefit of a dynamic, forward-looking perspective.

Zombie firm may indeed transform and become efficient. We should not however neglect the risks of higher barriers to entry raised by long-lasting and powerful zombie firms. This all will be estimated on a case-by-case basis. Zombie firms come in different forms and shapes, but all companies that face conjectural financial challenges should not be called zombies. Policy decisions will not be easy, and no perfect label is going to solve the issue. Perhaps the question of zombies is more a fiscal and monetary matter than it is a competition one. Wide access to credit initiated by central banks and/or governments does carry the risk of zombification.

In merger control, the mere fact that a company is a zombie does not dispense the agency and the lawyers to enter a discussion on substantial issues. But faster, easier merger control and derogations could be a step towards un-zombification. There will be a Covid-induced recession in some markets, but a cleansing recession is a controlled environment and competition authorities, and merger control can serve this interest. Competition policy will have a role to play in the orderly dissolution of zombie players. ■