FAILING FIRM DEFENSE

-- Note by the United States --

1. In the United States, the acquisition of a firm that qualifies as "failing" is not subject to liability under Section 7 of the Clayton Act.[1] The United States Department of Justice and Federal Trade Commission (hereinafter, collectively referred to as the "Agencies") articulate the rationale for this defense and the framework they use to analyze whether a company qualifies for this defense in the *Horizontal Merger Guidelines* ("Merger Guidelines"), which were issued in 1992 and revised in 1997. This defense is also well established in our case law.[2]

2. The failing firm defense is narrow in scope and is rarely invoked in court or before the Agencies. When invoked, the defense is rarely successful. It has been upheld in only a few court decisions since 1930.[3] Moreover, in light of the strict legal standard, there have been few mergers in which this defense has been proffered and in which the Agencies have accepted it after investigation.

3. Part I of this submission provides a general overview of the framework the Agencies and U.S. courts employ when analyzing the failing firm defense. Part II discusses in detail each of the four requirements for satisfying the defense, as set forth in the *Merger Guidelines*. Part III of the paper addresses a related defense called the failing division defense, and Part IV covers a related consideration involving claims that the merging firm is "flailing" or is a weakened competitor. Finally, Part V of this submission discusses why the demanding standards required to qualify for the failing firm defense should not be relaxed in periods of economic distress.

1. Overview of the Analytical Framework for the Failing Firm Defense

4. The failing firm defense was first introduced into U.S. jurisprudence by the Supreme Court in 1930.[4]

receivership.[6] Second, the acquired company must have had no other reasonable alternatives to the proposed merger that are less detrimental to competition.[7]

5. Regarding the financial condition of the firm, it is important to “distinguish between a firm ‘merely’ facing financ.9(119.6rely)13.3uan. Twrly had . Twrainanfin 11.1()11.erelyto c .6(o)2.55merelyete efec

3. it has made unsuccessful good-faith efforts to elicit reasonable alternative offers of acquisition of the assets of the failing firm[14] 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.[15]

7. If a firm meets these conditions, it satisfies the failing firm defense and the reviewing Agency will not challenge the proposed transaction. However, these conditions are quite demanding and the defense is construed narrowly. The merging parties must convince the reviewing Agency that the entity to be acquired qualifies as a failing firm. When defending against an alleged Section 7 violation in federal court, this is an affirmative defense that must be alleged in the defendant's answer to the complaint,[16] and the defendant bears the burden of proof.[17]

2. Analysis of *Merger Guidelines* Requirements

8. The four requirements set forth in the *Merger Guidelines* are discussed separately and in greater detain8i 2.8 10osfi0.060920.0021 Tc 195.0413 (ti)85 Tw [(the d)1t021 Tc 1otilin506.7592s0i428(r)-2(2.)fhw8(

important to consider whether the company's pre-merger, ordinary course of business documents reveal an imminent financial failure, or if the claims of failure appear to be invented to help defend the merger.[22]

2.2 Inability to Reorganize in Bankruptcy

10. Second, under the *Merger Guidelines*, to qualify for the failing firm defense, the firm must be unable to reorganize in bankruptcy.[23] To determine whether a company can reorganize in bankruptcy, the Agencies consider whether the elimination of the company's debt through the bankruptcy proceeding could correct the company's financial problems. If, for example, the company is unable to meet its current and expected operating expenses from its expected revenues, or capital has been exhausted, reorganization may not be possible. The Agencies may consider the company's projections for improving its condition and whether the company has a viable plan going forward. In addition, the Agencies may talk to the company's creditors to determine whether they can or will work out a plan to restructure the company's debts. It is insufficient to demonstrate that outstanding bank loans may be called in. Creditors may be willing to restructure loans, or loan additional funds, to keep a company in business if its future business prospects are encouraging.[24] Therefore, the Agencies investigate whether the firm has had discussions with its creditors and what the creditors plan to do in the absence of the merger.

2.3 No Reasonable Alternative Less Detrimental to Competition

11. Next, to demonstrate that there were no other reasonable alternatives less detrimental to competition, the *Merger Guidelines* and courts have required a firm to have made a good faith effort to seek "reasonable alternative" offers from other potential purchasers.[25] Any offer to purchase the assets of the failing firm for a price above the liquidation value of those assets—the highest valued use outside the relevant market or equivalent offer to purchase the stock of the failing firm—w fa72 Tw blorf

necessarily benign."[27] This is why the Agencies require the assets to be shopped before determining that a company is entitled to the defense.[28]

12. Determining whether a company sufficiently pursued alternative purchasers can be difficult. The solicitation of alternative offers ought to be such as to avoid discouraging any offers above the assets' liquidation value. For example, an offering solicitation ought not to suggest or imply that bids below a certain level will not be entertained, as this might discourage some bids above liquidation value.

13. The merging firms, of course, would prefer that their proposed transaction be permitted to go through. The required scope of the shop will depend on the nature and size of the relevant industry.[29] The Agencies require the following: that a number and variety of companies be contacted, including investment groups or companies from related industries; that sufficient information be provided to companies expressing interest; and that legitimate expressions of interest be pursued seriously.[30] Where an investment bank is retained to conduct the search, the investment banker must be given proper incentives to do an adequate job, and not, for example, be compensated with a share of the merger's transaction price if no alternative buyer is located.[31]

14. The burden is on the merging parties to demonstrate that there are no reasonable alternative purchasers less detrimental to competition. It is not the Agencies' obligation to find another willing purchaser. However, the fact that the Agency, through its investigation, cannot itself find another interested purchaser may be persuasive evidence that the merging firm's unsuccessful shop was adequate. General expressions of interest from alternative purchasers, without the extension of an actual offer, generally do not constitute reasonable alternative offers.[32] The Agencies also may agree to a supervised shop of the assets conducted by a broker over a period of time. If such a shop does not produce an alternative purchaser, and the other elements of the defense are met, the merger may be allowed to proceed.

2.4 Exiting Assets

15. Finally, the *Merger Guidelines* require that, absent the acquisition, the assets of the firm would exit the market. Simply because no alternative purchaser can be found does not imply that the allegedly failing firm would itself liquidate rather than continue to operate the assets in the market of competitive concern. It can be difficult to determine whether the assets would exit the market, in no small part because the evidence often rests largely in the hands of the allegedly failing firm.[33] The company should be able to provide the Agency with objective evidence sufficient to show that it is not more profitable for it to continue to operate the assets in the market than to have them employed elsewhere – such as through liquidation.

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27 Merger Review, p. 5.

28 Id.

29 For example, in one case the Department found that it was sufficient to contact only a few purchasers when the relevant market was small and unattractive to potential purchasers, the allegedly failing firm was not well established, and the firm had never earned a profit.

30 Arquit Remarks, p. 16.

31 Arquit Remarks, p. 16.

32 See Sutter Health, 130 F. Supp.2d at 1137; United States v. Culbro Corp., 504 F. Supp. 661, 669 (S.D.N.Y. 1981).

33

20. This argument is of course considered since merger analysis is properly forward looking. However, “[f]inancial weakness, while perhaps relevant in some cases, is probably the weakest ground of all for justifying a merger, and certainly cannot be the primary justification for permitting one.”[41] Moreover, as one antitrust official noted, “[a]nyone who seeks to limit competition and pleads financial distress as a justification must make a convincing case that consumers will not be harmed by the proposed limitation on competition.”[42]

21. U.S. courts have provided guidance for analyzing this issue. The Supreme Court first acknowledged in 1974 that a weakened, though not failing, status might affect the competitive impact of a transaction.[43] The Court made clear in that case that the merging firm – a coal production company – did not qualify as failing, but that the firm’s lack of coal reserves rendered it a less effective competitor in the future for long-term contracts.[44] In addition, one court recently noted that, “[a] weak financial condition, or limited reserves, may mean that a company will be a less significant competitor than current market share, or production statistics, appear to indicate.”[45] Courts typically consider the financial weakness of a firm “as one relevant factor among many” to be considered when determining whether the merger will substantially lessen competition.[46]

22. The company’s financial difficulties are “only relevant if the defendant demonstrates that this weakness undermines the predictive value of the government’s market share statistics.”[47] In other words, the financial weakness must affect its prospects as a future competitor. For example, in the FTC’s 1997 investigation of Boeing Co.’s acquisition of McDonnell Douglas, the FTC determined that McDonnell Douglas' significance as an independent supplier of commercial aircraft had deteriorated to the point that it was no longer a competitive constraint on the pricing of Boeing and Airbus for large commercial aircraft, even though McDonnell Douglas was not a failing firm. McDonnell Douglas' decline in competitive significance stemmed from the fact that it had not made the continuing investments in new aircraft technology necessary to compete successfully against Boeing and Airbus, and many purchasers of aircraft indicated that McDonnell Douglas' prospects for future aircraft sales were close to zero. Staff's investigation failed to turn up any evidence that this situation was likely to be reversed, and the FTC closed the investigation without taking any action.[48]

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41 FTC v. Arch Coal, Inc., 329 F. Supp. 2d 109, 154 (D.D.C. 2004), quoting Kaiser Alum. & Chem. Corp. v. FTC, 652 F.2d 1324, 1339, 1341 (7th Cir. 1981) (internal quotations omitted).

42 Shapiro Remarks, p. 19 (emphasis in original).

43 United States v. Gen. Dynamics Corp., 415 U.S. 450, 509 (1974).

44 See Gen. Dynamics, at 508.

45 Arch Coal, 329 F. Supp. 2d at 153.

46 Id. at 157.

47 Id. at 154. Insofar as a firm’s weakened financial condition generally is associated with poor sales, its weakened condition likely already is accounted for in the firm’s market share. See Phillip E. Areeda & Donald F. Turner, Antitrust Law ¶ 935c at 141 (1980).

48 See Statement of Chairman Robert Pitofsky and Commissioners Janet D. Steiger, Roscoe B. Starek III and Christine A. Varney in the Matter of the Boeing Company/McDonnell Douglas Corporation, File No. 971-0051, July 1, 1997. Commissioner Mary L. Azcuenaga issued a separate statement, disagreeing, in part, with the majority's conclusions. See Statement of Mary L. Azcuenaga, File No. 971-0051, July 1, 1997.

5. Failing Firm Defense in a Distressed Economy

23. There recently has been much discussion as to whether it would be appropriate to relax the requirements of the failing firm defense in a distressed economic situation.[49] "While there is no theoretical or empirical basis for departing from the basic principles of competition policy during general economic downturns, financial distress at the industry or company level is centrally relevant to antitrust analysis. . . . [A]ntitrust enforcement should take account of real-world economic conditions."[50] But, because antitrust analysis looks at competition at the industry and company level, the issues considered are in no way unique to a recession.[51] As the head of the Department of Justice's Antitrust Division recently stated:

> We are likely to see firms consider consolidation to alleviate perceived financial weakness in a distressed economy. A down economy does not change the fundamental analysis, however, which looks to the effects of the merger on competition. We will need to stick to the basics with a clear application of our guidelines to each transaction. For instance, although we may see "failing firm" defenses asserted more often, the analysis should be the same as it was before—will the acquisition benefit consumers? Is the acquisition the only way to keep the firm's assets in the market? When to credit a failing firm defense is just one of the issues we will face in the coming months.[52]

5252