# The Failing Firm Defense

By Lauren N. Norris

Section 7 of the Clayton Act prohibits mergers and acquisitions where the effect of such acquisition "may be substantially to lessen competition, or to tend to create a monopoly." 15 U.S.C. § 18 ("Section 7"). Generally, the United States antitrust enforcement agencies will seek to remedy any anticompetitive effects arising from a given transaction, but failing the institution of an appropriate remedy, they will seek to block the transaction. An acquisition that may otherwise substantially lessen competition or tend to create a monopoly may still be permitted if the target firm qualifies as "failing." This defense is articulated in the Federal Trade Commission and U.S. Department of Justice's *Horizontal Merger Guidelines* (*"Merger Guidelines"*), which the agencies generally try to follow when evaluating proposed transactions. The defense is also well established in United States case law, although it is an admittedly small body of case law, since most merger work is done at the agency level, with only a small percentage reaching the courts. The rationale behind the defense is that "a merger is not likely to create or enhance market power or to facilitate its exercise, if imminent failure … of one of the merging firms would cause the assets of that firm to exit the relevant market." *Merger Guidelines*, § 5. Rather, it is better to keep capacity in the market, even in the hands of a monopolist, than to have the capacity leave the market. The defense has a narrow scope, however, and is rarely a successful persuasive tactic. When and how the failing firm defense can be used in merger practice is discussed in more detail below.

**Elements of the Failing Firm Defense**
While the *Merger Guidelines* articulate the failing firm defense slightly differently than the case law, the analysis of whether a firm qualifies as "failing" is substantially the same under both. Under the *Merger Guidelines*, a successful failing firm defense must meet four criteria:

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 Chapter 11 of 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."

*Merger Guidelines*, § 5.1. *See also*, *Citizen Pub. Co. v. U.S.*, 394 U.S. 131, 137 (1969); *Int'l Shoe v. FTC*, 280 U.S. 291, 302 (1930). In determining whether a company faces the 'grave possibility of business failure,' the enforcement agencies and the courts have considered a variety of factors to verify "whether the firm is insolvent or on the brink of insolvency either in the bankruptcy sense, that the firm has no net worth, or in the equity sense, that the firm is unable to meet its debts as they come due." *California v. Sutter Health System*, 130 F. Supp. 2d 1109, 1133 (N.D. Cal. 2001); *Black & Decker Mfg. Co.*, 430 F. Supp. 729, 778-81 (D.Md. 1976). In order to prove that no alternative purchaser exists, the acquired company is required "to conduct a good faith effort to seek offers from other potential purchasers." *Sutter Health System*, 130 F. Supp. 2d at 1136. General expressions of interest from alternative purchasers do not constitute reasonable alternative offers if there is no extension of an actual offer. *Id.* However, any offer above liquidation value is considered a viable alternative. *Merger Guidelines*, § 5.1 n.39. The enforcement agencies and the courts are not concerned about the seller receiving the highest offer. It is therefore important for companies to elicit the assistance of antitrust counsel early in merger discussions when they plan to use the failing firm defense to ensure that the proper steps are taken in their good faith efforts to seek alternative purchasers and to properly structure the transaction to depict their efforts and 'failing' status.

Given the defense's rigorous requirements, the enforcement agencies rarely conclude that a target firm qualifies as 'failing,' and therefore the defense is not often successful in persuading the enforcement agencies to permit an otherwise anticompetitive acquisition. The defense has likewise proven successful in only a small number of court cases. *See e.g.*, *Union Leader Corp. v. Newspapers of New England*, 284 F.2d 582, 589-90 (1st Cir. 1960); *California v. Sutter Health System*, 130 F. Supp. 2d 1109, 1133 (N.D. Cal. 2001); *Reilly v. Hearst Corp.*, 107 F. Supp. 2d 1192 (N.D. Cal. 2000); *FTC v. Great Lakes Chem. Corp.*, 528 F. Supp. 94, 96-98 (N.D. Ill. 1981). As an affirmative defense, a defendant must plead the failing firm defense in its answer, and the defendant also bears the burden of proof.

**"Failing" Firm vs. "Flailing" Firm**

A firm's financial position may still be relevant in the determination of whether a merger is anticompetitive, even if a firm cannot qualify as a "failing" firm, such as when a firm is considered "flailing" because it may not be as competitive in the future as it has been in the past. However, a firm's financial weakness is perhaps the weakest ground for justifying a merger and should not be relied on as a primary argument. *See FTC v. Arch Coal, Inc.*, 329 F. Supp. 2d 109, 154 (D.D.C. 2004).

**Conclusion**

Given the depressed economy over the last few years, there was speculation that the failing firm defense would be invoked more often and the authorities would relax the defense's stringent requirements. This has not been the case, however, and the failing firm defense continues to be a narrowly construed affirmative defense to a Section 7 challenge that is rarely successful at persuading the authorities to permit an otherwise anticompetitive acquisition and is seldom invoked in court proceedings since the defense's scrupulous requirements continue to make the probability of success unlikely. Nonetheless, the defense has proven successful at both the agency and court levels for a small handful of transactions.